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PASS THROUGH INVESTMENT ENTITIES: A CRITICAL EVALUATION OF GOVERNANCE AND TAXATION OF SECURITISATION IN INDIA

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ABSTRACT

"Pass-Through Entities" (PTEs) *are legal entities where the income "passes through" i.e., it passes through the hands of the entity to the ultimate owner (viz. investors). In other words, the income of the entity is passed on and treated as the income of the investors or owners.*

Keywords: *PTEs, Ultimate Owner, Income, Flow-through Entities, Financiers .*

Introduction

What are 'Pass Through Investment Entities'?

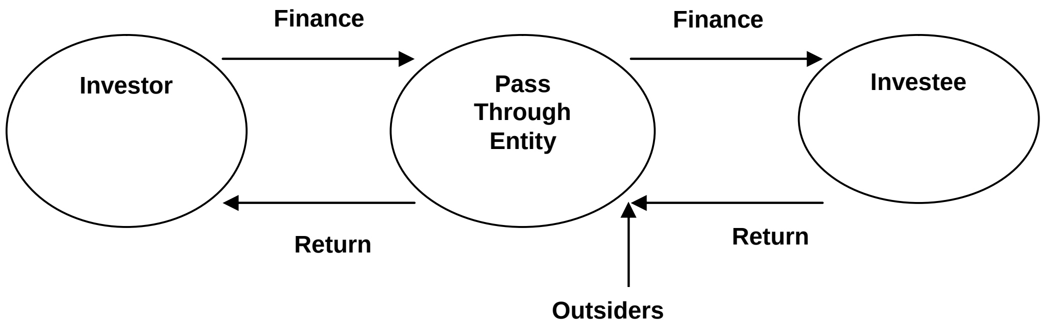
"**Pass-Through Investment Entities" (PTIEs)** are those business, which:

- augment finance for re-financing and
- distribute income earned from re-finance to their own financiers :

thus, passing-through money and its return.

They are also known as **Flow-Through Entities** / **Fiscally-Transparent Entities.**

Since their activity is of pass-through, they are characterized as pass-through for tax purposes also i.e., tax is levied either in hands of the pass-through entity or in the hands of the investor.



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Examples: The various types of pass-through investment entities are: (a) mutual funds, (b) securitisation trusts, (c) venture capital funds, (d) real-estate and infrastructure investment trusts, and various other alternative investment funds.

In this article we shall be making a critical evaluation of governance system and taxation system of Securitisation function in India.

What is 'Securitisation' and what are 'Securitisation Trusts'?

Securitisation is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into a security. The process of securitisation involves:

- creation of "pool of assets" from marketable financial assets (receivables or loans) ;
- repackaging or rebundling of such illiquid assets into marketable securities.

The financial assets, which can be securitised, can be automobile loans, mortgages, credit card receivables, or any other form of receivables.

This activity is carried out by special purpose vehicles termed as **Securitisation trusts.**

The entity which sells financial assets to such Special Purpose Vehicles is called **"Originator"**

Regulatory Framework

Finance Act, 2013, passed in July 2013, provides the legal framework governing securitisation trusts and their transactions. The provisions of this Act are legally binding for all securitisation transactions in India. The other applicable provisions are provided in SEBI Guidelines, Securities Contracts (Regulation) Act, 1956, SEBI Act, 1992 and SARFAESI Act, 2002, etc.

Figure 1: How Securitisation Works

Source : CRISIL

Figure 2: Process of Securitisation

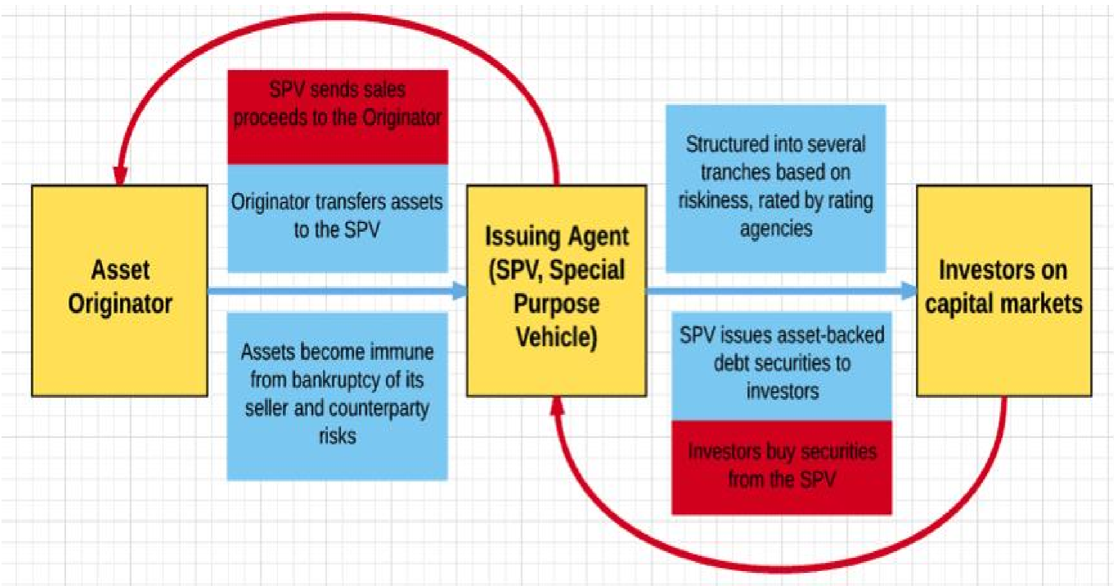
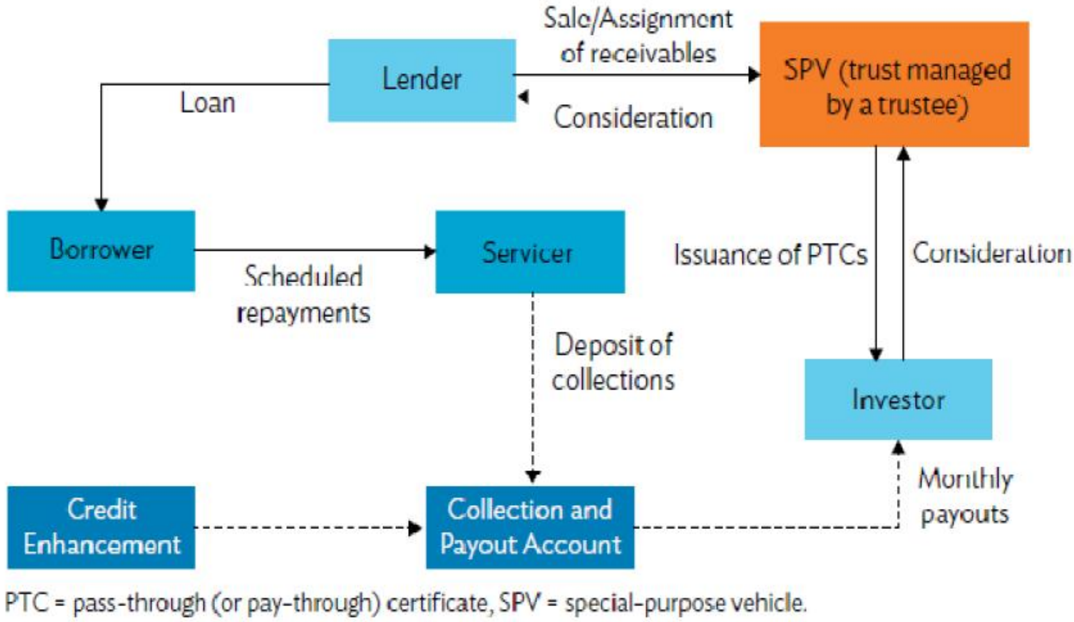
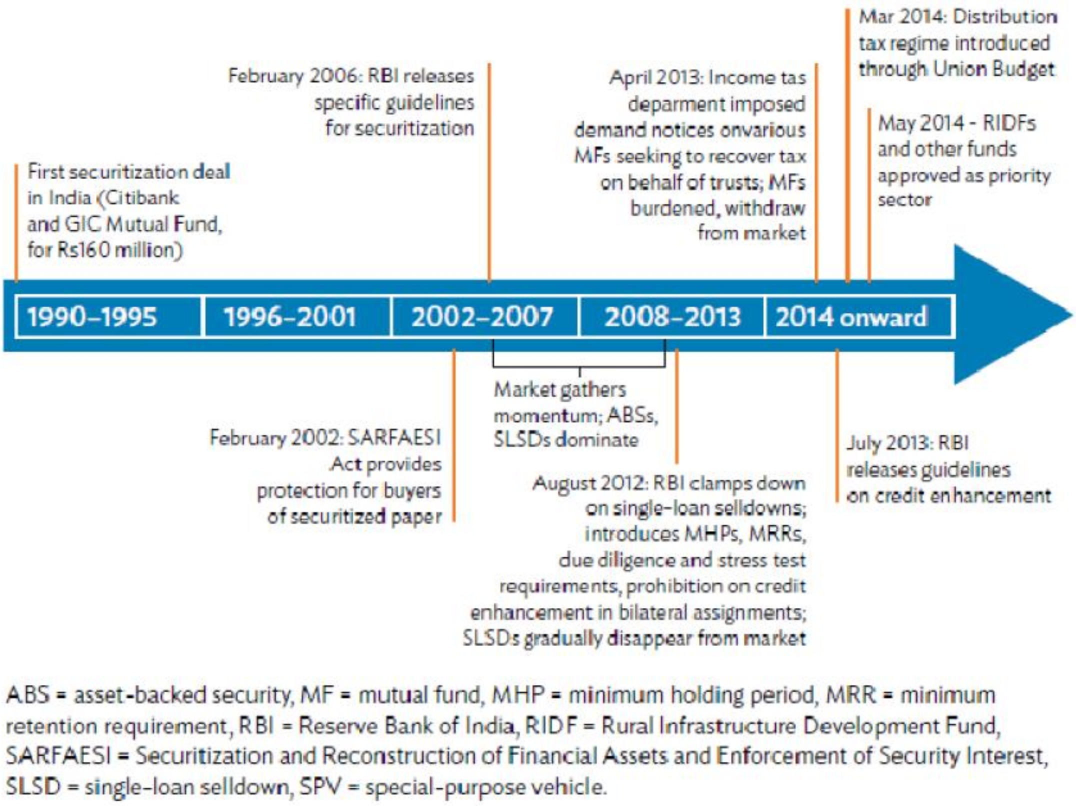


Figure 3: Securitisation Structure in India



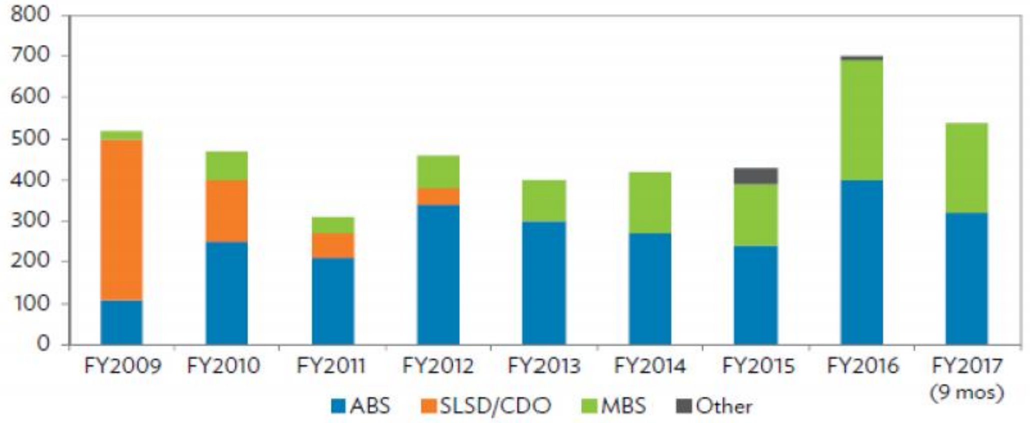
Source : CRISIL

Figure 4: Key Events in the Indian Securitisation Market



Source : CRISIL

Figure 5: Securitisation Issuance in India, by Volume (₹billion)



ABS = asset-backed security, FY = fiscal year, CDO = collateralized debt obligation, MBS = mortgage-backed security, mo = month, SLSD = single-loan sell down.

Source : CRISIL Ratings

Benefits of Securitisation

Benefits of Securitisation to Originator

The Originator i.e., the entity which sells financial assets to Special Purpose Vehicles (Securitisation Trusts) is benefited by the following:

- **Off – Balance Sheet Financing & Improved Liquidity:** In the securitisation process,:
  - loan/receivables are sold, which releases the tied-up capital
  - resulting in off Balance Sheet financing.

  This, in turn, leads to improved liquidity.
- **Focus on Core Business:** By selling the receivables/assets, the originator (say, banks) can transfer "servicing of loan" function to SPVs and use the increased liquidity to focus on the core business of lending. Further, if the transfer is made on non-recourse basis, even the risk of default is transferred.
- **Financial Ratios are Improved:** Due to conversion of financial assets into cash, the Financial Institutions and Banks can manage their Capital–To-Weighted Asset Ratio.
- **Borrowing Costs are Reduced:** The securitised instruments enjoy good rating due to credit enhancement; hence, they can be issued at reduced rate as compared to general debts. Therefore, the originator enjoys a interest-rate spread and gets reduced borrowing cost.

Benefits to investors

The investors of securitised instruments enjoy the following benefits :

- **Diversified Risk:** Securitised securities are based upon different types of financial assets as their underlying. This reduces risk due to diversified portfolio.
- **Meeting statutory requirement:** Banks have to meet various statutory requirements of investing in particular industry (say, micro finances, MSME, etc.). This requirement can be met by buying securities backed by underlying assets pertaining to that particular industry (MSME, etc.).
- **Protection against bad debts:** If securitisation arrangement is on recourse basis, then, any bad debts of loans, etc. are made good by the originator. Further, the investors can also obtain insurance against defaults.

Securitisation Instruments

The securitised instruments are of three types:

- **Pass Through Certificates (PTCs) [Full transfer with Single Maturity]:** In this case, the originator (e.g., bank selling loans) **transfers** all receipts (Interest + Principal repayment). Investors get:

- "direct claim" on all securitized financial assets through the SPV ;
- proportionate beneficial interest in the said financial assets ;
- payments (including prepayments) of principal/interest by borrower is distributed pro rata amongst all the securities holders.

On final payment of assets, all the securitized securities are terminated simultaneously.

- **Pay Through Security (PTS) [Different tranches with different maturities] :** In this, SPVs—
  - issue securities which are backed by financial-assets portfolio and
  - hence, they can issue different tranches of securities with different maturities.

  This structure has the following benefits as compared to PTCs :
  - the "timing of receipt of cash from financial assets" is de-synchronized from "timing of servicing of securities" [prepayments are not immediately returned back] ;
  - therefore, SPVs can reinvest surplus funds for short term yield ; and
  - can freely issue securities in different tranches with different maturities.
- **Stripped Securities [Interest and Principal are separated] :** In Stripped Securities, the cash flows generated from underlying financial assets are divided and two types of securities are issued :
  - **Interest Only (IO) Securities:** They entitle the investor only to interest generated from the underlying assets.
  - **Principal Only (PO) Securities:** They entitle the investor only to principal repayment generated from the underlying assets.

The interest-rate change perceptions have high impact on the valuation of both of these securities and therefore, these are highly volatile in nature and preferred less by investors :

Market interest rate perception	Impact on valuation of Interest Only (IO) Securities	Impact on valuation of Principal Only (PO) Securities
• If market interest rate rises	Value goes up, as interest calculated on borrowings increases	Value falls, as borrowers postpone the payment on cheaper loans
• If market interest rate falls	Value falls, as interest calculated on borrowings decreases	Borrowers repay the costly loans and borrow fresh loans at lesser interest.

Accounting Aspects

The following Indian Accounting Standards (Ind AS) deal with accounting of financial instruments :

- Ind AS 109 – Financial instruments
- Ind AS 32 – Financial instruments: Presentation
- Ind AS 107 – Financial Instruments: Disclosures

The accounting aspects are governed by the aforesaid Ind AS and involve the recognition of financial assets and financial liabilities separately and revaluation thereof as required by aforesaid IndAS. Accounting for Securitisation involves the following entries :

1. *In the books of bank*	Cash or SPV A/c Dr. Finance Charges A/c Dr. To Receivables (Receivables transferred)
2. *In the books of SPV/ Securitisation Trust*	**(a) for receivables bought** Receivables Dr. (at cost) To Cash/Bank **(b) for securities issued** Cash/Bank Dr. To Securities (Name of security)

	(c) On interest received or repayment received from loans Bank Dr. To Finance Income To Receivables **(d) On passing through income or repayment to investors** Finance Charges Dr. Securities A/c Dr. To Cash/Bank
3. *In the books of Investor*	Investment in Securities A/c Dr. To Bank (Being Investment made) Bank A/c Dr. To Finance Income [Income earned on Securities]

Taxation of Securitisation Trusts under Income-Tax

Section 115TCA of the Income-tax Act, 1961 and related rules provide for taxation of securitisation trusts as follows:

- **Definitions**

[A] Securitisation Trust [Clause (d) of *Explanation* below section 115TCA]: "Securitisation trust" means a trust being a:

	Form	Regulation
(i)	A special purpose distinct entity	SEBI (Public Offer and Listing of Securitised Debt Instrument) Regulations, 2008
(ii)	A special purpose vehicle	The guidelines on securitisation of standard assets issued by RBI
(iii)	A trust setup by a securitisation company or a reconstruction company	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) (or) the RBI directions/guidelines.

[B] Investor means a person who is holder of any securitised debt instrument or securities or security receipt issued by the securitisation trust.

[C] Securities means debt securities issued by a Special Purpose Vehicle as referred to in the guidelines on securitisation of standard assets issued by RBI

- **Exemption to securitisation trust**

The income of securitisation trust from the activity of securitisation is exempt under section 10(23DA).

- **Taxation of income received by investor from securitisation trust**

Treated as if directly earned even if not actually received [Section 115TCA(1) & (2) & (3)]	Income earned by the investor from the securitisation trust, out of investments made in securitisation trust, is taxable: • in the same manner as if the investor had made investment directly in the underlying assets and not through the trust ; and • such income deemed to be of the same nature and in the same proportion in the hands of the investor, as in the hands of the securitisation trust ; and • such income is deemed to be credited to investor on last day of the previous year, even if not actually paid.
Trust will give statement of income to investor as well as department	The securitisation trust shall provide breakup regarding: • nature and proportion of its income and • other relevant details to the following :

<table>
<tr><td rowspan="2">[Section 115TCA(4) & rule 12CC]</td><td>To the investors</td><td>by 30th June of the financial year following the previous year during which such income is distributed</td></tr>
<tr><td>To Principal Commissioner or the Commissioner of Income- tax within whose jurisdiction the principal office of the securitisation trust is situated</td><td>by 30th November of the financial year following the previous year during which such income is distributed</td></tr>
<tr><td>Income taxed in the year of accrual not taxable again in the year of payment [Section 115TCA(5)]</td><td colspan="2">If income has been included in the total income of the investor on accrual basis in a previous year, it shall be not be against included in the year of actual payment.</td></tr>
</table>

- **TDS by securitisation trust on income paid to investor [Section 194LBC]**

  Tax deduction at source under section 194LBC is to be made by the securitisation trust :

	Payee	Rate of TDS
(i)	Resident individuals and HUF	25%
(ii)	Resident payees, other than individuals and HUF	30%
(iii)	Non-corporate non-residents and foreign companies	Rates in force

Timing of TDS

Time is to be made at the time of payment of income, or, credit of income to the account of the investor (including credit to Suspense/Provision A/c), whichever is earlier.

Application for Low or Nil Deduction of Tax at Source

The facility for the investors to obtain low or nil deduction of tax certificate would be available; the investor can make an application to the Assessing Officer, and he can, on an application made by the assessee in this behalf, issue a certificate under section 197 in this behalf for no deduction of income-tax or deduction of income-tax at a lower rate.

- ***Example :*** A Securitisation Trust derived income of ₹ 17 lakhs comprising dividend of ₹ 4 lakhs from shares from a Company and interest of ₹13 lakhs on loan granted to such undertaking. The investor M/s. G receives income of ₹ 2 lakhs from such trusts.

  Solution: The entire ₹ 17 lakh shall be exempt in hands of trust.

For investor M/s. G, The income paid or credited by the securitisation trust shall be deemed to be of the same nature and in the same proportion in the hands of the investor of the securitisation trust, as if it had been received by, or had accrued and arisen to, the securitisation trust during the previous year. Hence, taxability of ₹ 2 lakhs received by M/s. G shall be as under —

Dividend income (exempt from tax) [Income received from trust × dividend income of trust ÷ total income of trust ₹ 2 lakhs × ₹4 lakhs ÷ ₹17 lakhs]]	47,059
Interest income from trust [Income received from trust × Interest income of trust ÷ total income of trust ₹ 2 lakhs × 13 lakhs ÷ ₹17 lakhs]]	1,52,941
Total amount received from trust	2,00,000
Less: Dividend income exempt from tax	47,059
Taxable Income of M/s. G from trust	1,52,941

The trust shall have to make TDS on said Rs. 1,52,941.

Recent Key Developments for Securitisation in India

- **Passage of the Insolvency and Bankruptcy Code, 2016:** In 2016, India's Parliament approved the long-awaited Insolvency and Bankruptcy Code, which repealed several outdated laws and amended 11 other laws to speed up the resolution of financial distress, boost investor confidence, and encourage risk-adjusted investments in the medium term.
- **Granting of Tax Pass-Through Status to Securitised Papers in India :** In the Union Budget for FY2016, securitised papers were granted complete tax pass-through status, thereby addressing the most critical barrier to the growth of the infrastructure securitisation market in India. Before the announcement, securitised papers were subject to distribution tax of 30%, which significantly reduced yields for investors and dampened investor interest in securitised instruments. *This is already discussed in preceding para.*

Problems Faced in Securitisation in India

Stamp Duty	In some states, mortgage debt stamp duty goes upto 12%. This impedes the growth of securitisation in India. However, since Pass Through Certificates (PTCs) are evidence only of receivables and not of any debt, hence, they are exempt from stamp duty. Some states have given relaxation in stamp duty.
Accounting	Securitisation is termed as an off-balance sheet item; however, in books of originator, it leads to removal of receivables from balance sheet itself. Hence, accounting aspect needs special area of concern.
Lack of standardization	There is no standardized format for documentation and administration.
Lack of Debt Market	There is no well-developed debt market in India, which hampers the growth of securitised or asset-backed securities.
Ineffective Foreclosure laws	In event of default by borrower, foreclosure laws are not effective enough to support lending institutions and such institutions face difficulty while making transfer of property.

Key Success Factors for Securitisation

For the Securitisation to function better and achieve its objectives, the following critical success factors must be realized:

- **Asset Selection**

  Assets selected for a transaction must have the necessary identified attributes, namely:

  - operational assets, with a minimum of 1 year of stabilized operations, to provide adequate comfort to institutional investors in India;
  - homogenous assets, in terms of the credit risk, tenure, payment profile, to ensure that payments to investors of securitised paper are made on time; and
  - adequately sized asset pool, to ensure the marketability of a smaller pool and the built-in protection provided by a larger, more diversified pool.

- **Credit Enhancement Mechanism**

Securitisation of infrastructure assets requires adequate support in the form of external credit enhancement to match the ratings and risk expectations of institutional investors in India. Given the early development stage of the securitisation market in the country, commercial market players may be unwilling to provide the guarantee facility in the medium term. This facility could be provided in two ways:

  - directly by the originator; or
  - by a government-promoted entity, functioning as a market maker.

- **Floating-to-Fixed Interest Rate Conversion**

Infrastructure loans in India are based on floating interest rates, linked to banks' base rate. The nature of liabilities of institutional investors in India keeps them from taking on the interest rate risk of floating instruments. In the absence of an interest rate swap market in India, the floating rate risk must be borne by one of three entities. This matter could be explored and negotiated during the transaction stage:

  - **Originator.** Better suited to bear risk, as the interest payments will be linked to its base rate. Originators could provide a fixed coupon rate to investors, for a premium or fee. In the past, the interest rate risk in a few MBS transactions was borne by originators.
  - **Investors.** Investors could bear the floating rate risk through higher coupon rates adjusted to price in interest rate risk.
  - **Third-party entities.** In the absence of an interest rate swap market, a government-promoted entity providing a guarantee facility could, for a fee, also provide a guarantee against the interest rate risk.

The securitisation trust could renegotiate terms from floating rate to fixed rate with the developer, after the sale of assets by the originator, but it is difficult to get consent from the developers of all the projects in the pool. However, the renegotiation of a few assets in the pool could offset interest rate risk.

- **Institutional Mechanisms**

To provide the required comfort to investors, monitoring and oversight mechanisms for the underlying asset pool need to be provided by a third party.

- **Secondary Market for Infrastructure Securitised Paper**

Given the long-term nature of infrastructure securitised paper, a secondary market for securitisation must be promoted in India, to provide investors with viable exit options, if required.

Given the early development stage of the market, PTCs (Pass-Through Certificates) in the initial transactions are expected to be privately placed with institutional buyers.

Conclusion

Securitisation of infrastructure assets could be a viable option to help strengthen the capital position of PSBs in India, while also deepening the access of infrastructure financing to institutional investors. This option is especially important given the challenges plaguing the infrastructure and banking sector in the country.

There have been no prior instances of infrastructure loan securitisation in India—and limited instances globally with adequate support and institutional mechanisms. But infrastructure securitisation will nonetheless unlock significant value for the Indian economy, the effects of which will be felt across all industries and sectors.

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