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ASSET BACKED SECURITISATION IN PROJECT FINANCE

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ABSTRACT

Asset backed securitisation (ABS) is a method of securitisation, a way of raising funds for a project, whereby revenue-generating assets are issued and the project is backed by future cash flows of the asset. This form of securitisation is often used in Asian countries for the promotion of domestic markets, homeownership and domestic infrastructure growth. For the successful growth of the ABS, there is a need for a regulated and conducive market. In India, there are various issues faced by the ABS both economically and legally. These problems include problems in structuring, interest rates, capital allocation issues, regulatory issues, etc. Further, there is no comprehensive literature that deals with various aspects of ABS. Thus, this article seeks to study the various features of ABS, its advantages and disadvantages in ABS structure, identify the existing regulations, examine the problems faced by it and propose possible solutions to have a smooth market for the ABS.

INTRODUCTION

"Credit" is an essential feature of the economy which moves funds from the savers to the investors and borrowers. Examples of credit include bank loans, stocks, trade credits, credit from financial institutions, etc. Traditionally the financial institutions and banks were lending funds and keeping their receivables idle in their balance sheet until they were repaid. So, to solve this problem of keeping the assets idle, the securitisation concept was introduced.

Securitisation is the act of monetizing financial assets wherein the risk is tied to the repayment instead of the performance of the project. It is generally referred to as a creation of security for or in any kind of financial transaction. It is a device used in structured financing whereby marketable securities are created based on the assets and receivables. Structured finance includes project finance, cross border finance, derivatives and other similar kinds of secured financing[1].

Securitisation is a kind of structured financing primarily used in project finance. It is the process of packaging or bundling various financial promises and using their cash flow to be freely traded amongst the investors[2]. Sometimes, the advances, loans and receivables just remain in the balance sheet of a company being illiquid. Therefore, at times of financial needs, the company need to raise additional funds from the market, while the existing assets remain idle. To solve this issue, the illiquid assets can be pooled and converted into an instrument. This process is called securitisation[3]. This is an innovative technique whereby, illiquid assets are made tradable and the risks are effectively channelled in the financial market. Another important point here is, the repayment is dependent only on the assets

[1] 74 Stephen Lumpkin, Trends and Developments in Securitisation, Financial Market Trends (1999).

[2] Marc Breidenbach, Real Estate Securitisation, European Business School (2005).

[3] Id.

and cash flows backed as collateral to the issue, and the sponsor company has only a limited recourse or non-recourse.

Asset backed securitisation (ABS) is the method of securitisation, a way of raising funds for a project, whereby revenue generating assets are issued and the project is backed by future cash flows of the asset[4]. This form of securitisation is often used in Asian countries for the promotion of domestic markets, homeownership and domestic infrastructure growth[5]. The market for ABS includes home equity loans, credit cards, automobile loans and equipment leases, etc. For example, a bank being a sponsor company, can pool many of its consumer loans and issue bonds over the income generated by these pooled loans. These bond/pooled loans will be transferred to the project company.

ABS is an umbrella term for mortgage-backed securitisation, collateralized debt obligation, commercial mortgage-backed securitisation and residential mortgage-backed securitisation. But in general parlance, few experts don't consider mortgage-backed securitisation as a part of asset backed securitisation and consider that as a separate kind of securitisation[6]. ABS is the process of bundling various receivables and debt instruments and converting the bundle into security, enhancing its credit status. By this bundling process, illiquid assets are converted into liquid and marketable securities. Thus a secondary market is created for such assets. Each pool of such assets is backed by specific collaterals.

In ABS is the securities are backed by cash flows from a variety or various kinds of assets. Hence, these securities are called asset-backed securities. It is not necessary for ABS, only illiquid assets need to be bundled, even tangible assets with regular cash flows can be bundled with and converted[7]. Thus in project finance, the objective of ABS is to create bankruptcy-remote Special purpose vehicles (SPV). They act as security even in case of future cash does not go well or the sponsor company became bankrupt. In cases of normal securitisation, the security is assets themselves. This is possible as the probability of default is very low and the degree of risk is very low. But, in cases of financing projects or SPV's the cash flow will be generated in future, therefore the risk is high. Since there is a high risk the project demands an additional amount of collateral. The pools of assets are transferred to the SPV and serve as a security for the SPV. In this project let us study the history, various kinds of ABS, its mechanisms, advantages and issues pertaining to it.

HISTORY OF ABS

The securitisation started first in the United States, in the 1930s[8]. The emergence of the secondary market and the establishment of the Federal National Mortgage Association are the roots of the ABS. Though the origin traces back to 1930, the first security was issued in the 1950's and ABS started in the 1980's only[9]. The US faced a savings and

[4] Securitization in India Managing Capital Constraints and creating liquidity, to fund infrastructure, Asian Development Bank, ISBN- 978-92-9257-984-5 (2017).
[5] Supra Note 2.
[6] Supra Note 4.
[7] Supra Note 4.
[8] Supra Note 2.
[9] Sumit Agarwal, Jacqueline Barrett, Crystal Cun, & Mariacristina De Nardi , The asset-backed securities

loan crisis in the 1980's. In 1985, securitisation was first made for car loans. The first transaction became successful and securitisation of other assets developed. At that time of savings and loan crisis, Loan securitisation played an important role. Thus from the 1980's the US securitisation market started growing constantly and it was one of the fastest-growing sectors in the world.

This growth came to a standstill position with the 2007 global credit crunch. Due to this financial crisis, house prices started decreasing; there were a lot of mortgage and credit defaults. Soon, there were high defaults in consumer loans, credit card loans and student loans, also[10]. In 2008, due to the failure of the Lehman Brothers, there was a big shock in the financial market and the yields fell deeply[11]. Thus there is no economic interest for the investors to invest in ABS. Therefore, the Board of Governors of the Federal Reserve System introduced Term Asset-Backed Securities Loan Facility (TALF) in 2008. The TALF facilitated the issuance of new ABS and provided safety nets to the investors[12]. Thus the ABS market slowly started evolving again in the US and is still growing in a progressive field.

Securitisation in India began in the 1990's. The CRISIL rated the first securitisation transaction, the loan securitisation transaction of Citibank in 1992. In 1990's the CRISIL started a device for "bilateral acquisition of portfolios of finance companies"[13]. These transactions were not exactly securitisation or there were quasi-securitisations, wherein the assets were transferred from the balance sheet of the originator to another party. In this phase, the originator was provided recourse and new loan sales using the direct transfer method. In 2000's this changed and India started having complete securitisation transactions. In 2000, the CRISIL rated mortgage backed securitisation for National Housing Bank[14]. From 2000's India economy's securitisation exists more in the real estate and infrastructure sectors.

In 2002, the SARFAESI Act was passed. The SARFAESI Act provided a framework for asset reconstruction and from the securitisation market began to be regulated. After the entry of the Non-Banking Financial Companies into a retail business, homogenous receivables like loans, automobile loans and credit card loans started increasing. This led to a large number of players entering the ABS market. India follows the trust structure of ABS. The assets and receivables of the originator are transferred to the trust and the trust will be a special purpose vehicle. The SPV will issue two kinds of securities in India namely, the "Pass through securities" and "Pay through securities". In the cases of Pass through securities, the investors who purchase the securities from the SPV get a beneficial interest in the underlying assets held by the SPV also. In cases of the Pay through Securities, the investors will get beneficial interest only in the cash flow that would be generated by the underlying assets.

In India, the growth of the ABS was constant but it suffered a severe share in 2020 due to

markets, the crisis, and TALF, Federal Reserve Bank of Chicago (2012).

[10] Id.

[11] Id.

[12] Id.

[13] Supra Note 4.

[14] Supra Note 4.

the Covid 19 pandemic[15]. Again it started recovering in 2021. As per Jan 2022 CRISIL report the ABS accounted for two thirds of the Indian Securitisation market, MBS constituting the remaining one third[16]. The same Jan 2022 report that the cumulative value of the ABS in India between April 2021 and Jan 2022 accounted for Rs 80,000 crores, which is 65% higher than 2021[17].

THE KINDS OF ABS

Generally, there are three kinds of ABS. Those are mortgage-backed securities, Collateralised debt securities and asset backed securities in a narrower sense.

Mortgage backed securitisation (MBS) - The first kind of ABS is Mortgage Backed Securities (MBS). These MBS are bank based securities. MBS is backed by a pool of residential or commercial properties' mortgage loans. That is these loans are completely secured loans and are real estate receivables. Some organisations consider MBS separate from the ABS. In India, the CRISIL rates and values MBS separate from the other ABS. MBS includes Commercial Mortgage-Backed Securitisation (CMBS) and Residential Mortgage-Backed Securities (RMBS)[18]. CMBS are securities backed by loans of commercial properties like shopping centres, multiplex complexes, industrial parks, etc. RMBS are securities backed by loans of residential and housing properties.

Collateralised debt obligations (CDO)- CDO's are backed by portfolios of bonds, loans, receivables, etc. CDO includes Collateralised Loan Obligations (CLO), and Collateralised Bond Obligations (CBO)[19]. Thus these are also secured categories of securities, but these may or not may not be bank based.

Asset backed securitisation in a narrower sense – The third category of ABS is, miscellaneous loans such as Company loans, automobile loans, leases, consumer loans, credit cards, future receivables and trade receivables, etc. If these loans are supported by collaterals these loans will become a part of CLO.

There is another special kind of ABS that is specifically used in the real estate and infrastructure sector. This is called real estate security.

Real estate securitisation (RES) - This kind of ABS is specifically for real estate and infrastructure. This will have a combination of MBS and CDO. Here the cash flow from any kind of asset or receivable is securitised[20]. In RES, the originator need not be a bank, and if it is a bank also it need not commit any value to it[21]. Now, let us deal with the ABS process.

THE ABS PROCESS

The ABS process involves the identification of the parties of the ABS, step by step procedure involved in ABS, the mechanisms of ABS, and the structuring of ABS. First, let us look into the key participants in an ABS.

PARTICIPANTS IN AN ABS

ABS transaction has many parties as a part of it. Each party has different roles and motives in an ABS transaction. The parties involved in ABS are originator, SPV, sponsor, service agent, trustee, investor, rating agencies.

[15] Securitisation: Volume growth slows to 8% in third quarter, (Feb. 18, 2022, 10.04pm), Securitisation: Volume growth slows to 8% in third quarter (crisil.com).
[16] Id.
[17] Id.
[18] Supra Note 2.
[19] Supra Note 2.
[20] Supra Note 2.
[21] Supra Note 2.

1. Originator/Borrower/Seller
The originator is otherwise called the borrower or seller depending on case to case basis. The originator is generally a bank, sometimes it is a corporate or financing company or even a government[22]. This originator will pool his illiquid assets or a part of his illiquid assets and sell/transfer them to the SPV on a non-recourse basis.

2. **Special Purpose Vehicle (SPV)/ Issuer**
The SPV buys the pooled assets from the originator[23]. The pooled assets can be either receivables or fixed assets or both. The SPV then does refinancing with the pooled assets. It issues securities privately or publicly by offering notes in the capital market[24]. These notes are served by the cash flows arising from the assets. SPV is the critical party in ABS. The important feature of SPV here is that it is bankruptcy remote; therefore it can insulate the trust from the originator.

3. **Arranger/Sponsor**
The arranger or the sponsor administers the entire SPV. The Sponsor sets up the SPV, structures its transactions, works on its legal and administrative requirements, coordinates investors, rating agencies and lawyers[25]. Generally, investment banks are sponsors of an SPV.

4. Service-Agent / Servicer
The service agent or servicer takes care of the accounting process and submission of cash flows. The originator is generally the servicer.

[22] Supra Note 4.
[23] Supra Note 4.
[24] Supra Note 4.
[25] Supra Note 4.

5. Trustee
The trustee is an intermediary between the investor and the servicer. The trustee secures the interests of the investors. He will receive payments from the servicer and pay out the cash flow to the investors on the pre-specified dates[26]. If not, he may invest the money again until the next specified date. In India, the originator performs the role of trustees and servicers.

6. Investor
The investor is the purchaser of the notes or securities from the SPV. The investors could be banks, mutual funds or insurance funds.

7. Rating Agencies
Generally, the originator of an ABS will have additional and secret information about the ABS compared to the other parties[27]. Due to this information advantage of the originator, the investor can make an ineffective investment. The credit rating agencies solve this problem by giving signals on the quality of each transaction[28]. These rating agencies evaluate the complete transaction and determine its legal and economical requirements. Now, let us look into the securitisation procedure of ABS.

ABS SECURITISATION PROCEDURE
The ABS process is a "Taylor-made structure". The sponsor needs to take into account a lot of considerations like; the needs of the originator, the class of assets to be securitised, the range of assets, the national regulatory mechanisms, etc.

[26] Supra Note 4.
[27] Supra Note 2.
[28] Supra Note 2.

1. The first step is to identify the class of assets that need to be pooled.
2. Next, the sponsor needs to set up an SPV on a limited or non-recourse basis.
3. Next, the sponsor needs to assign roles for different parties- the originator, trustees, servicer, credit rating agency, etc.
4. The SPV, which is an independent entity usually a trust purchases the assets from the originator.
5. The SPV will convert the pooled assets into breakable and tradable securities.
6. Then, all the parties together will put the transaction into place.
7. In the transaction process, the SPV will obtain the credit rating for the securities.
8. The SPV issues the ABS notes or ABS papers in the capital market. The SPV will issue the notes with the cooperation of the investment banks or commercial banks as the case may be.
9. The investor purchases the securities from the SPV with risk, but for a high rate of return.
10. The cash flows from the pooled assets would be used to pay back to the investors.

These are the general step by step procedures in ABS. But, the ABS transactions have their technicalities such as the mechanisms in ABS and cash flow, which are very important considerations in a transaction.

THE THREE MECHANISMS OF ABS

The ABS is generally issued in three different mechanisms. The three mechanisms are- "Pass-Through Certificates, Pay-Through Certificates and Stripped Derivative Structures."

"**Pass-Through Certificates**"[29]- In Pass-through certificates, the cash flows generated are transferred to the investor using an SPV. The originator holds the rights of the receivables in this mechanism.

"**Pay-Through Certificates**"[30]- In Pay-through certificates, the cash flows generated are reinvested by the SPV in gilts and other securities. The SPV pays the investors from the proceeds of that reinvestment.

"**Stripped Derivative Structures**"[31]- In Stripped Derivative structure, the SPV breaks the cash flow generated in two streams. The first stream is "principal only" and the second stream is "interest only". The derivates are issued against these two streams. The "Principal only" derivative holders will be paid from the cash flows generated from the principal component of the original cash flow. The "interest only" derivative holders are paid from the cash flow generated from the interest component.

CASH FLOW STRUCTURING OF THE ABS BY THE SPV

Cash flow structuring is an important part of the ABS process. Proper structuring of the cash flow from assets is a mandate for the SPV to provide flexibility for the originator to tailor the instruments and to meet investor specifications. In India, the SPV's follow two kinds of cash flow structures for the assets.

Par structure of cash flow[32]. - In this kind of cash flow structure, the investor has to pay the consideration equal to the par value of the principal. As a return, the investor will be

[29] Nishith M. Desai & Lubna Kably, Asset Securitisation, Nishith Desai Associates (1997).
[30] Id.
[31] Id.
[32] Supra Note 4.

receiving principal repayments from the pooled assets and the contracted yield every month. To illustrate, the pool of assets' principal amount is Rs 2 crores, it has a collective yield of 20%. In par structure, the polled assets will be sold to the investor for the whole principal amount of Rs 2 crores. The investor would be receiving an additional 16% yield. The remaining 4% will be the excess amount for the SPV that will offer protection against any shortfall.

Premium structure of cash flow[33]- In this structure, the investor shall pay considerably greater than the principal amount of the pooled assets. As a premium, the investor will be receiving the entire cash flow from the pooled assets every month. To illustrate, the pool of assets' principal amount is Rs 2 crores, it has a collective yield of 20%. The total cash flow will amount to Rs 2.26 crores. The investor will be paid the entire Rs 2.26 crores, but the consideration price will be higher, maybe Rs 2.5 Crores. Finally, the investor would be getting the whole principal amount plus interest. Now, let us discuss the applicable legal framework for particular issues in ABS.

THE LEGAL FRAMEWORK OF INDIA FOR ABS

The following are the laws that govern specific transactions in ABS.

Phase one- "Establishment of securitisation trusts"

The RBI governs the registration of the securitisation companies and purchase of assets from the originator as per the Securitisation of Standard Assets guidelines, 2006[34]. The SEBI governs the issuance of security notes by its Regulations for Public Offer and Listing of Securitised Debt Instruments, 2008[35]. As per the 2006 RBI regulations SPV needs to be set up for securitisation and it shall be a bankruptcy-remote institution. This SPV is formed as a trust and it can be formed in two ways, either under RBI's Securitization Companies and Reconstruction Companies (Reserve Bank) Guideline and Directions, 2003[36] or as a subsidiary of a securitization company created and registered with the RBI under the SARFAESI Act for the specific purpose of securitization[37].

Phase two- Transfer of Assets by Originators

The transfer of assets by an originator is governed by the RBI's Guidelines on Securitisation, 2012[38]. The following conditions must be satisfied for the transfer-legal isolation of the assets from the originator, the ability of SPV to pledge the assets, surrender of effective control[39].

33 Supra Note 4.
34 RBI Securitisation of Standard Assets Guidelines, 2006 (India).
35 SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 (India).
36 RBI Securitization Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003 (India).
37 RBI Securitisation of Standard Assets Guidelines, 2006 (India).
38 RBI Guidelines on Securitisation Transaction, 2012 (India).
39 Id.

Phase three- Issuance of Securities to Investors

Section 115TC of the Income Tax Act[40], states that securitised instruments need to be defined according to the SEBI Regulations, (Public Offer and Listing of Securitised Debt Instruments), 2008 which, in turn, refer to the definition provided in the Securities Contracts (Regulation) Act, 1956. SCRA defines securities to include- " *shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate; derivative units or any other instrument issued by any collective investment scheme to the investors in such schemes; security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; units or any other such instrument issued to the investors under any mutual fund scheme; Government securities; such other instruments as may be declared by the Central Government to be securities; and rights or interest in securities*"[41].

Phase four- Cases default by the borrower.

In case of default by a borrower, an SPV can proceed under Section 13 of the SARFAESI Act, 2002 to take possession of the secured assets from the borrower[42]. If the borrower is a company, the SPV can also approach the NCLT under Section 272 of the Companies Act, 2013[43].

BENEFITS, CHALLENGES AND ISSUES IN ABS IN INDIA

THE BENEFITS OF ABS TRANSACTIONS

Now let us first discuss the various benefits, advantages and merits of the ABS transactions.

Advantages for the originator-

1. Better Management of Assets in Balance Sheet

This is an advantage for the originator as the high-risk assets are removed from the balance sheet, leading to a better capital return ratio.

2. Liquidity of originator's assets

By selling a portfolio or a pool of assets, the illiquid assets are converted to a liquid form. These assets are traded similar to a negotiable instrument and earned revenue from it.

3. Conversion of assets into marketable securities

Generally, the CDO and other ABS-like credit card loans, lease, and automobile loans are not marketable in their original forms. ABS converts such loans into marketable securities.

4. Cheaper funds

ABS is a cheaper form of fund for all parties, the originator, sponsor, SPV and the investor compared with the traditional direct financing mechanism.

[40] Income Tax Act, 1961 (India).
[41] Securities Contracts (Regulation) Act, 1956, S 2 (h) (India).
[42] SARFAESI Act, 2002, S 13 (India).
[43] Companies Act, 2013, S 272 (India).

5. Less risk

The ABS transactions are usually limited recourse or non-recourse transactions. Therefore, along with the assets the risks associated are also transferred to the SPV.

6. Alternate investor base

ABS brings in new classes of investors into the market. This makes alternate funding sources from institutional investors possible.

7. Better return on equity

If the SPV structures the cash flow properly and chooses appropriate mechanisms the originator will get a better return on equity.

Advantages for the investor-
1. Diversification of debt portfolio
2. Safer investments as the investments are credit enhanced securities.
3. Flexibility in structuring the cash flow.
4. Participation is based on own risk appetite.

Advantages for the economy-
ABS provides a lot of additional and alternate instruments and securities in the capital and financial market, by making the market much more liquid. This diversifies the markets, enhances return on capital, leads to specialisation in the market and provides economies of scale. ABS improves the efficiency in the functioning of the financial market through diversification of risks and increasing liquidity.

CHALLENGES AND ISSUES FACED BY ABS IN INDIA
The following are the challenges and issues faced by the ABS in India.

1. Floating Interest rates

The interest rates in India are generally floating and are linked to the bank's base rate. Since ABS is a high risk and high return transaction, the investors will prefer a fixed interest for the security.

2. In the cases of the infrastructure sector, syndication of banks provides loans in India. Therefore, it requires coordination from all banks for the creation of the SPV.
3. Stamp Duty

In India, the stamp duty for any kind of transfer of assets is high. Any kind of sale or novation needs to pay a huge amount of stamp duty, which poses a huge problem for the investors. The exception is only in the case of Pass-Through Certificates (PTC) wherein the certificate just acts as evidence for the transfer of title to the pooled assets[44].

4. Homogeneity of underlying assets

The RBI regulations mandate the homogeneity of assets in an asset pool. But, there is no definition for the term homogeneity[45].

5. Transfer of debt

IBC provides for a "minimum requirement of 25% of debt for a creditor to have the rights of an effective negative vote in case bankruptcy procedures need to be initiated.[46]" Thus this 25% of project debt is transferred to the SPV, so the SPV gets the

[44] Supra Note 4.
[45] Supra Note 4.
[46] Insolvency and Bankruptcy Code, 2016.

required control. But, there are chances for the SPV to lose its status as a pass-through trust, as it has taken the form of an entity with a specific business arrangement.

RBI Draft Framework for securitisation of standard assets, 2020[47]

In 2020, the RBI proposed a draft comprehensive framework to solve the various issues of securitisation and give clarity to various terms and transactions. For the first time, this draft defines terms such as Mortgage-backed securities and securitisation. Mortgage-backed securities are defined as "*securities issued by the special purpose entity against underlying exposures that are all mortgages, which includes commercial as well as residential mortgages*[48]". Securitisation is defined as "*the set of transactions or scheme wherein credit risk associated with eligible exposures is tranched and where payments in the set of transactions or scheme depend upon the performance of the specified underlying exposures as opposed to being derived from an obligation of the originator, and the subordination of tranches determines the distribution of losses during the life of the set of transactions or scheme*[49]".Special-purpose entity is defined as " *a corporation, trust or other entity organised for a specific purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE, and the structure of which is intended to isolate the SPE from the credit risk of an originator*"[50]. This guidelines also provides that except "revolving credit facilities (e.g. Cash Credit accounts, Credit Card receivables etc., Loans with bullet repayments of both principal and interest; and Securitisation exposures" all other receivables are capable of being securitised. The draft Directions also deal with due diligence, liquidity facilities, credit enhancement facilities, and conditions to be satisfied by the special purpose entity, etc.

SUGGESTIONS PROPOSED AND CONCLUDING REMARKS.

The following suggestions are proposed for the betterment of the ABS market and to have a smooth securitisation process leading to efficiency in the economy;

a) Implementation of a comprehensive code that defines the terms associated with ABS, dealing with due diligence, regulation of SPV, credit enhancement, recovery in case of defaults, etc. As a first step towards it, the 2020 RBI draft framework shall be finalised and implemented.
b) There shall be uniform stamp duties for securitisation throughout the country and the same must be reduced keeping into account the economic growth due to ABS.
c) There is a need for better taxation for ABS and SPV. As per the Finance Bill 2016, the income from securitisation trust will be taxable in the same manner, if the investment had been made directly. Similarly, the distribution tax is already present for SPV's. This makes the yield on the investment very less.

Thus this study had examined the various types of ABS, its mechanisms, advantages, regulatory framework, practical issues and

[47] RBI Draft Framework for Securitisation of Standard Assets, 2020 (India).
[48] RBI Draft Framework for securitisation of standard assets, 2020, Direction 5M (India).
[49] RBI Draft Framework for securitisation of standard assets, 2020, Direction 5U (India).
[50] RBI Draft Framework for securitisation of standard assets, 2020, Direction 5X (India).

suggestions. This study strongly recommends a comprehensive legal framework on ABS.

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