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Mortgage Securitisation : Some Legal, Accounting and Tax-Related Issues

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1.0 INTRODUCTION

1.1 'Securitization' is an off-balance sheet financing technique which has been developed in the US in the mid 1970s. This concept has been introduced into the financial system in India only recently. The primary objective of securitization is to mobilize resources at a comparatively lower cost through a wider investor base, by removing loan assets from the balance sheet of a lending institution.

1.2 Securitization involves the packaging of designated pools of loans and receivables and sale of these packages to various investors in the form of securities which are collaterised by the underlying assets and their associated income stream. It is the process through which illiquid assets are transformed into more liquid form and distributed to a wide range of investors through the medium of capital market.

1.3 Basically, all assets which generate cash flows can be securitized. These include mortgage loans, housing loans, car loans, credit card receivables, trade receivables etc. But this paper deals mainly with mortgage securitization.

2.0 MORTGAGE SECURITIZATION - TYPICAL STRUCTURE

2.1 Mortgage securitization involves converting mortgages into tradable securities which are sold on the capital markets and acquired by investors. It refers to a carefully structured transaction whereby a mortgage lender (originator) with a substantial pool of mortgage receivables transfers or sells the portfolio of mortgages to a Special Purpose Vehicle or to a specially established Trust (SPV) for a price/consideration.

The SPV issues mortgage-backed securities in the form of pass through certificates (PTCs) to various investors in the market and raises funds through such issue for payment of the price to the originator. The PTCs so issued represent an undivided interest in the pool of mortgages and the payment stream from those mortgages.

2.2 The SPV acts as trustee for the investors (PTC holders) and holds the various types of security interests on their behalf. The cash flow from the underlying mortgages is "passed through" to the holders of the PTCs in the form of periodical payments of interest, principal etc. In the event of default in the payment of moneys due in respect of the PTCs, the SPV as the trustee would pursue legal remedies for realization of dues.

2.3 Normally, third party credit enhancement is added to the structure to provide protection against (a) liquidity risk i.e. the risk of delay between the receipt of moneys from mortgage borrowers and the date for payment of interest etc. on the PTCs and (b) credit risk i.e. the risk of loss resulting from default by mortgage borrowers. Such credit enhancement is provided through guarantee/letter of credit from a bank or indemnity of an insurance company.

2.4 The originator will usually be appointed to administer the mortgage portfolio on behalf of the issuer and continue to maintain the relationship with the borrower in return for a fee.

2.5 In order to attract a wide range of investors, the securities/PTCs are independently rated by a credit rating agency. To provide liquidity, these securities are also listed on stock exchanges.

3.0 GLOBAL SCENARIO

3.1 Securitization as a financing technique has been developed in the U.S. about 23 years ago and the markets in that country have grown at a rapid pace over the years. It has now reached a high degree of sophistication and securitised debt is at present available to the US investors in a variety of forms allowing them to select instruments which meet specific risk and maturity preferences. As at September 1991, more than 40 per cent ($1.2 tr.) of all US mortgages had been securitised.

3.2 In other countries, the technology being relatively new, has not yet been fully developed. Only in UK, mortgages worth over 12 bn Pounds have been securitised as at September 1992. Other European countries are now beginning to play a role in this new area. Governments in France, Belgium and Spain are giving support through the introduction of new legislations to assist development of the markets. In Japan, necessary changes in domestic laws are being made to allow the Japanese institutions to join the fray.

4.0 NATIONAL SCENARIO

4.1 In India, securitization technique is totally new. Only recently this technique has been introduced into the financial system of this country.

If this concept develops, the secondary market in India will have a new instrument viz. mortgage-backed security in which the investors can park funds. This instrument can be traded from investor to investor till maturity, thus bringing fresh liquidity into the financial system.

4.2 Mortgage securitization exercise, in its typical form, has so far not been attempted by any one in India. During the last 3 years, Citibank has structured only certain non-mortgage securitization transactions viz. the auto loans portfolio of that bank, bills portfolio of ICICI, hire purchase receivables of TELCO and receivables of DLF Universal Ltd. from sale of residential properties on deferred payment basis. In another transaction, Citibank has purchased at a discounted price housing loans of certain value granted by Alacrity Housing Ltd. to various persons. But this cannot be construed as mortgage securitization. Vishwa Priya Financial Services & Securities Ltd. (Madras) has introduced the concept of retail asset securitization under which a large corpus of assets like bills of exchange is broken into many small units to be subscribed by individual investors. In 1992, Housing Development Finance Corporation Ltd. (HDFC) and Infrastructure Leasing and Financial Services Ltd. (ILFS) signed a Memorandum of Understanding under which ILFS was to sell the individual loans extended by HDFC to institutional investors, while HDFC was to retain its agency role in the administration of the loans. This deal, however, fell through because of certain legal complexities. Thus, the real mortgage securitization has not yet taken place in this country.

4.3 There is good scope for the HFCs in India for securitization of their mortgage portfolios. The term loans advanced by the HFCs to their constituents are normally secured by a first mortgage/charge on the house property financed by them. The HFCs enter into innumerable long term financial transactions with their clients. They have, therefore, idle assets involving huge amounts in their balance sheets. The process of securitization helps the HFCs to transform these idle asset into cash. They need not hold on their loans portfolio till they become due; they can raise money on these loan assets as soon as they are created for recycling the amounts advanced by them. This process could also change the integral ratios of their balance sheets and make them more healthy. Further, through securitization, the HFCs can alter their asset-risk profile by transferring risk assets and retaining others in their asset portfolio. In this way, the HFCs can strategically manage their balance sheets.

Thus the securitization tool could serve a very useful purpose for the HFCs particularly in the context of their ever increasing requirement for funds and the growing incidence of non-performing assets in their balance sheets. For the reasons mentioned above, the HFCs are well positioned to take advantage of the technique of mortgage securitization to enhance their capital ratios to meet capital adequacy norms.

4.4 Mortgage securitization, however, involves a wide range of legal issues, besides accounting and tax-related problems.

These issues will have to be identified and suitable solutions found to facilitate the development and growth of this new technique in India. Some of the issues/problems relevant in this context are discussed later in this paper.

5.0 POSSIBLE METHODS OF SECURITIZATION

5.1 Considering the legal system in India, two methods would be possible for structuring a transaction involving mortgage securitisation. These are explained below:

I. First Method : By transfer of portfolio of loans

Under this method of securitization, the portfolio of loans which have been identified for the purpose will be sold/transferred by the lending institution (originator) alongwith the relative mortgages to the SPV for an agreed price. For carrying out the transaction, a transfer deed will have to be executed by the originator in favor of the SPV transferring the mortgage loans which are being securitised. Such transfer deed is required to be stamped on ad valorem basis under the stamp law of the concerned State and is also required to be registered with the concerned Sub-Registrar of Assurances under the Indian Registration Act, 1908. After such transfer, the SPV will issue PTCs to the investors and act as trustee for the investors.

II. Second Method: By transfer of beneficial interest in the portfolio of loans

A. Through the creation of a trust by the originator and constituting itself as trustee for the investors

Under this method, the lending institution by a declaration of trust creates an express trust in favor of the investors and declares that the beneficial interest/economic interest in the portfolio of loans will be held by it for the benefit of the investors and constitutes itself as the trustee for the purpose. The lending institution/trustee then issues PTCs to various investors through a market maker.

Thus, under the Second Method, the real interest of the originator/settlor of the trust in the assets securitised is bifurcated into legal interest and beneficial/equitable interest; the legal interest therein is retained by the settlor for itself and the beneficial/equitable interest is transferred to the PTC holders. Though the Indian law does not recognize an equitable ownership in the sense known to the English law (because in India we do not, as in England, have two kinds of law or jurisdiction viz. common law and equity), yet it is recognized on an analysis of the legal incidents involved. On this basis, separation of legal interest and beneficial interest in the securitised assets is legally permissible. In this context, reference is invited to the decision of the Gujarat High Court in Suleman Isubji Dadabhai Vs Naranbhai Dayabhai Patel [(1980) 21 GUJ L.R. 232] and the decision of the Punjab High Court in Punjab Province Vs. Daulat Singh (1942 FCR 67 at p.80).

It may also be mentioned here that under sections 5 and 6 of the Indian Trust Act, 1882, if the declarer of the trust is himself the trustee also, there is no need that he must transfer the property to himself as trustee; but the law implies that such a transfer has been made by him, and no overt act except a declaration of trust is necessary (Tulsidas Kilachand Vs Commissioner of Income-tax, Bombay city: AIR 1961 S.C.1023 at 1026).

Under this method of securitization, the originator will be the declarer of the trust as also the trustee for the investors (PTC holders). For the above reasons, it is felt that the securitization procedure contemplated under this method would be legally feasible.

B. Through the execution by the originator of an agreement to transfer the portfolio of loans with a power of attorney in favor of SPV to enable it to perfect a legal transfer

Under this method, SPV will be constituted as a separate entity and the originator will execute in favor of the SPV (i) an agreement agreeing to assign/transfer to the SPV, the assets to be securitised for the price agreed to between them, (ii) a declaration of trust constituting the SPV as trustee for the investors and (iii) an irrevocable power of attorney to enable the SPV to perfect a legal transfer in the event of the originator not co-operating with the SPV in enforcing the underlying mortgages in certain circumstances. Thereupon, the SPV will raise funds from the market through the issuance of PTCs to the investors for payment of the purchase price.

The English law draws a distinction between law and equity and recognizes both legal and equitable estates. Therefore, in England, a contract for sale of mortgage makes the purchaser the owner in equity of the property. The Seller becomes trustee for the purchaser in respect of the property agreed to be sold/transferred from the date of the contract for sale.

In India, however, the doctrine of equitable estate has no application. The whole law of mortgages is statutory and is embodied in the Transfer of Property Act, 1802 (TP Act) read with the relevant provisions of the Code of Civil Procedure, 1908. In terms of Section 154 of the TP Act, a contract for sale of property does not of itself create any interest in or charge on the property agreed to be sold.

Though the Contract for Sale does not of itself have the effect of transferring or assigning the mortgage loans to the SPV, it embodies an agreement to transfer or assign the same to the SPV. The contract also contemplates that the necessary transfer/assignment would be effected by means of a regular deed when required. Under the agreement, there would be a clear understanding between the parties that as soon as the originator receives any payments from the underlying mortgages, it would make over such payments to the SPV. Therefore, after the full purchase price is paid by the SPV to the originator, the beneficial interest in the loans would vest only with the SPV and not with the originator. In view of this, the payments received by the originator from the mortgage borrowers would be held by the originator for the benefit of the investors. On this basis, it is felt that this method of securitization also would be feasible.

6.0 **LEGAL ISSUES**

Stamp duty

6.1 As mentioned earlier, under the First Method, securitization involves transfer/assignment of mortgage debt.

Since mortgage debt is regarded as 'immovable property', its transfer can be effected only by means of an instrument in writing (Mulla's Transfer of Property Act, 7th edition P.16). In the State of Maharashtra, such instrument of transfer attracts stamp duty as a 'conveyance' on ad valorem basis (at a rate varying from 3% to 10% depending upon the location of the property) under Article 25 of Schedule I to the Bombay Stamp Act, 1958. Under the corresponding provisions of the stamp laws of other States, the rates of stamp duty on such transfer range from 3% to 17% of the consideration for the transfer. The transfer deed is also required to be registered with the concerned Sub-Registrar of Assurances under Section 17(1)(b) of the Registration Act, 1908. Therefore, execution of a transfer deed for the above purpose involves payment of heavy stamp duty and also registration charges.

6.2 Under the Second Method, since legal transfer of the mortgage debt is not contemplated, the question of payment of ad valorem stamp duty and registration charges on the transfer does not arise. A declaration of trust is executed by the originator for creating a trust and for appointing itself as a trustee for the investors. Such declaration of trust is required to be stamped as per the stamp law of the State in which it is executed. Under the Bombay Stamp Act, if the declaration of trust involves disposition of property, it attracts ad valorem stamp duty as a 'conveyance' under Article 61 read with Article 25 of Schedule I to that Act.

Since the declaration of trust referred to above is likely to be construed by the stamp authorities at Bombay as an instrument involving disposition of property, substantial stamp duty (ranging from 3% to 10%) would be payable on this instrument itself. The stamp duty on declaration of trust is chargeable on ad valorem basis in the States of Uttar Pradesh (6.25% for the first Rs.10,000 and 0.3% for every additional Rs.1,000) and Kerala also (varying from 5% to 7.5%). In the other States, the stamp duty payable on declaration of trust is only nominal. If a contract of sale and a power of attorney are also to be executed under the Second Method, they are chargeable with only a nominal stamp duty.

6.3 One stamp duty saving technique that might be adopted by the HFCs for securitization would be for relevant documentation to be completed in Delhi where at present stamp duty of only Rs.30 is payable on the declaration of trust as per the stamp law applicable to that State. It may be clarified here that the documents relating to mortgage securitization can be executed any where in India. There is no legal restriction in this behalf. The only requirement of law is that a documents must be stamped at or before the time of its execution in accordance with the stamp law of the place where it is executed. In case, however, the securitization documents executed at Delhi are subsequently brought to Maharashtra or other State for institution of foreclosure proceedings, they will have to be stamped as per the stamp law of that State.

6.4 Since securitization under the First Method involves payment of substantial amount by way of stamp duty and registration charges on the transfer/assignment of debt, it will not be practicable for the HFCs to adopt that method unless necessary remission is granted by the concerned State Government(s). Therefore, if the HFCs decide to mobilize resources through the securitization route, they must necessarily structure the transactions only under the Second Method.

6.5 Irrespective of whether the securitization transaction is structured under the First Method or under the Second Method, a PTC may be issued either in the form of a receipt or a promissory note. If it is issued in the form of a receipt, it would attract only nominal stamp duty (i.e. 20 paise) under Article 53 of Schedule I to the Indian Stamp Act, 1899. But in that event, such instrument could not command good marketability since it is not transferable by endorsement and delivery. If, on the other hand, the PTC is structured as a promissory note, it can be easily transferred from investor to investor by mere endorsement and delivery and thus facilitate development of secondary market for the instrument. In such case, however, the instrument attracts stamp duty at the rate of 1% on the face value thereof under Article 49 read with Article 13 of Schedule I to the Indian Stamp Act and further read with Notification No.16 dated 16th March, 1976 issued by Government of India. This is in addition to the stamp duty on the documents referred to in paragraphs 6.1 and 6.2 above.

6.6 By virtue of Article 264(1) of the Constitution of India read with Entry 91 of the Union List in the Seventh Schedule, the Parliament has exclusive power to specify the rates of stamp duty in respect of (i) bills of exchange, (ii) promissory notes, (iii) bills of lading, (iv) letters of credit, (v) policies of insurance, (vi) transfer of shares, (vii) debenture, (viii) proxies and (ix) receipts. The State Legislatures have exclusive power to specify rates of stamp duty in respect of other documents [Article 246(3) of the Constitution read with Entry 63 of the State List].

The Indian Stamp Act enacted by the Parliament (the Central Act) applies to the whole of India except the State of Jammu & Kashmir. Some of the States viz. Maharashtra, Gujarat, Karnataka and Kerala have enacted separate Stamp Acts for their respective States, while the other States have extended, amended and adapted the Central Act to their respective States. The rates prescribed under the Central Act in respect of the aforesaid documents apply through out the country. The rates prescribed under the State enactments in respect of the other documents apply in the respective States.

In this context, it be mentioned that under section 9 of the Central Act, the Central Government and the State Governments are empowered to reduce or remit stamp duty in respect of documents falling within their respective legislative power. The HFCs could consider taking up the matter with the State Governments through the Central Government for reduction or remission of stamp duty on the transfer/assignment deed referred to above.

6.7 In the UK, as a general proposition stamp duty is chargeable on any instrument in writing which implements the sale of an interest in property, with the duty being charged at the rate of 1% of the value of the property transferred. A transfer of mortgages will not normally be chargeable to stamp duty as the duty in relation to "Mortgage, Bond, Debenture ....." in Schedule I to the Stamp Act, 1891 was abolished by Section 64 of the Finance Act, 1971 of the UK ['Securitization' by David C. Bonsall (1990)].

7.0 MORTGAGOR'S CONSENT FOR SECURITIZATION

7.1 The concept of mortgage securitization is based on the principle that a mortgage is a right of property and therefore it is capable of being sold with or without the mortgagor's consent or knowledge. Further, according to the general principles of law, a right arising under an agreement can be freely assigned by the beneficiary of the right unless that agreement specifically states otherwise or unless the right in question is regarded in law as being personal to the contracting parties so that the person entitled to the right cannot assign it, such as rights arising under a contract of employment. In principle, therefore, the law will allow a lender to assign the right to receive repayment of its loan to a third party without the borrower's consent. However, obligations under an agreement cannot be transferred by the party on whom they have been imposed without the consent of the party to whom they are owed. Accordingly, where a lender has obligations to the borrower, for example, to make further advances, the lender cannot by law transfer those obligations without the consent of the borrower.

7.2 Subject to what is stated above, while strictly there is no need to obtain the mortgagor's consent in a mortgage securitization, it is desirable to secure his general consent at the time of execution of loan documents. This can be done through the incorporation of a suitable provision in the loan documents.

7.3 Where mortgagor's specific or general consent is not obtained, the question arises whether at least a notice of transfer of mortgage should be given to the borrower. In U.K. where there is legal assignment of mortgage, written notice of the transfer must be given to the borrower in accordance with Section 136 of the Law of Property Act, 1925. In the case of assignment of mortgage in equity, however, no such notice is required to be given to the borrower. While France, Belgium and Italy have most formal requirement to give notice to the borrower through a court bailiff or in a document executed before a notary, Spain and Germany do not require that such notice should be given to the borrower.

7.4 In India, it is not a requirement under law that notice of transfer of mortgage should be given to the borrower. But the consequence of not obtaining the mortgagor's consent for such transfer or notifying him of such transfer is that the mortgagor can continue to pay his original mortgagee (originator) and by such payment he would get good discharge of the debt. The mortgagor is also entitled to exercise his right of set-off against the original mortgagee in respect of any amounts owed by him to the mortgagor.

This is based on the general principle that a transferee of a debt (including a debt that is secured by a mortgage) takes the debt subject to any equities that arise before notice of the transfer is given to the original debtor. Considering the above, it is advisable for the concerned parties to notify the mortgagors regarding securitization of the mortgages.

8.0 TRANSFERABILITY OF PTCS

8.1 Normally, PTCs are issued to the investors "without recourse" to the issuer which means that the issuer gives no guarantee or indemnity to the holders of PTCs regarding the payments to be made to them in respect thereof. Therefore, the issuer will be under an obligation to pay the PTC holders only if payments are received from the borrowers on the underlying assets. If there is any shortfall, the loss would be borne by the PTC holders pro rata. Wherever required, the issuer/Trustee would, in accordance with the terms of issue, initiate legal proceedings against the mortgage borrower for recovery of dues. Upon realization of the proceeds, the trustee would adjust the costs incurred by it for the purpose and distribute the balance amount amongst the PTC holders on pro rata basis. It is in this context that the need to provide some form of credit enhancement for securitization transaction arises to make the PTCs more secure, safe and attractive.

8.2 If the PTC is issued in the form of a promissory note, the question arises whether such PTC, being a 'without recourse' instrument, would be negotiable.

The definition of 'promissory note' under Section 4 of the Negotiable Instruments Act, 1881 postulates that it should contain an unconditional undertaking signed by the maker to pay a certain sum of money. In the case of the PTC, there is no such undertaking by the maker and payment thereon will be conditional upon receipt of moneys from the borrower on the securitised assets. Therefore, the PTC does not satisfy the definition of 'promissory note' under Section 4 of the Negotiable Instruments Act. But it falls within the wider definition of 'promissory note' under section 2(22) of the Indian Stamp Act which covers conditional promissory note also. On this basis, while the PTCs are not negotiable, they are transferable by endorsement and delivery.

8.3 In this context, another question that arises for consideration is whether the transfer of the PTC by the holder thereof attracts any stamp duty under the Stamp law. The power of levying stamp duty on 'transfer' is vested in State Governments. Under Article 59 of Schedule 1 to the Bombay Stamp Act (and the corresponding provisions in the stamp laws of other States), 'transfer' by endorsement of a 'promissory note' is exempt from payment of stamp duty. But the Bombay Stamp Act does not contain the definition of 'promissory note'. Therefore, the question arises whether the conditional promissory note (PTC) could be regarded as a 'promissory note' even for the purpose of the Bombay Stamp Act. In other words, the wider definition of 'promissory note' under section 2(22) of the Indian Stamp Act can be read into the Bombay Stamp Act.

In this context, Section 76 of the Bombay Stamp Act makes it clear that the provisions of the Indian Stamp Act to the extent they relate inter alia to a promissory note would be applicable in the State of Maharashtra. In view of this, the wider definition of 'promissory note' as contained in Section 2(22) of the Indian Stamp Act could be applied for the purpose of the Bombay Stamp Act also. The legal position in this regard is the same in other States also. On this basis and in view of the exemption contained in Article 59 of Schedule I to the Bombay Stamp Act and the corresponding provisions in the stamp laws of other States, it would be clear that transfer of the PTCs would not attract any stamp duty. Therefore, if PTCs are issued in the form of promissory notes, they could be freely transferred by one investor to another without payment of any stamp duty on such transfer, and this would go a long way in facilitating the development of secondary market for these securities.

9.0 PROVISIONS GOVERNING INVESTMENT IN MORTGAGE-BACKED SECURITIES BY PROVIDENT FUNDS, GRATUITY FUNDS, SUPERANNUATION FUNDS, INSURANCE COMPANIES AND MUTUAL FUNDS

9.1 Provident Funds, Gratuity Funds, Superannuation Funds, Insurance Companies and Mutual Funds constitute an important segment of the secondary market. There are, however, certain restrictions regarding investment of funds by these bodies.

9.2 As regards Provident Funds, Gratuity Funds and Superannuation Funds (the Funds), they are normally constituted as trusts and are governed by the provisions of the relevant statutes. For the Provident Funds which are governed by the Provident Funds Act, 1925, no pattern of investment is prescribed under the said Act. These funds can, therefore, invest their investible funds, inter alia, in mortgage-backed securities if they are so authorised under their respective Rules.

9.3 The pattern of investment for Provident Funds covered by the Employees Provident Funds and Miscellaneous Provisions Act, 1952 has been prescribed under para 52 of the Employees Provident Fund Scheme, 1952. The said pattern of investment, as it stands now, does not provide for investment of monies by the Provident Funds in the mortgage-backed securities issued by the HFCs. The Central Government is, however, empowered to permit such Funds by issue of necessary directions in that regard, to invest a part of their investible funds in such securities also.

9.4 As regards the Provident Funds, Gratuity Funds and Superannuation Funds recognized by the Commissioner of Income-tax under the Income-tax Act, 1961, the Central Government by virtue of - (i) its notification dated January 18, 1993 and (ii) the amendment made to Rule 67 of the Income-tax Rules, 1962 [by the Income-tax (Sixth Amendment) Rules, 1993] permitted such Funds, with effect from April 1, 1993, to invest upto 15% of their investible funds in the bonds/securities issued by a public financial institution or a public sector company or a public sector bank.

The term 'securities' referred to in the said notification and the said rules may cover PTCs issued by an institution/bank/company referred to therein. The said Funds, however, cannot invest funds in the securities (PTCs) which are issued by non-public sector bodies like HDFC, Canfin Homes Limited etc. pursuant to the said notification since such securities are not covered by it. If, however, the above pattern of investment is amended by the Government/CBDT suitably so as to cover the securities issued by non-public sector bodies also, these Funds would be able to invest a part of their investible funds in the PTCs.

9.5 The investment of funds by insurance companies are governed by the provisions of the Insurance Act, 1938. In terms of Section 27A of the Insurance Act, no insurer shall invest or keep invested any part of his/its controlled fund otherwise than in any of the approved investments specified therein. Approved investments under the said Act do not cover investments in the PTCs. The Central Government is, however, empowered to include within the definition of 'approved investment' such other investment as it may by notification in the official gazette declare to be approved investment for the purpose of Section 27A of the Act. If the Government issues the necessary notification declaring investments in the PTCs to be approved investment, the General Insurance Corporation of India and its subsidiary companies (National Insurance Company, New India Assurance Company, Oriental Insurance Company and United Insurance Company) can invest their funds in the PTCs.

9.6 As regards Life Insurance Corporation of India (LIC), though the provisions of the Insurance Act are not applicable to it, the provisions of Section 27A of the Insurance Act are made applicable to it by virtue of Section 43 of the LIC Act. In view of this, LIC also would be in a position to invest in the PTCs, if the requisite notification is issued by the Central Government in that behalf.

9.7 It is felt that HFCs may approach the Central Government/CBDT for bringing about the necessary amendments for the above purpose.

9.8 Mutual Funds are governed by the investment limitations prescribed under the Guidelines issued by SEBI in February 1992. In terms of these Guidelines, Mutual Funds will be allowed to invest only in transferable securities either in the money market or in the capital market, including any privately placed debentures or securitised debt. Thus Mutual Funds can invest their funds in PTCs subject to the limits specified in the Guidelines.

UTI can, under section 19 of the UTI Act, 1963, invest in the mortgage-backed securities.

10.0 FORECLOSURE OF MORTGAGES

10.1 Under the provisions of the Code of Civil Procedure, 1908, the persons having an interest either in the mortgage security or in the right of redemption shall be joined as parties to any suit relating to the mortgage (Order 34 Rule 1). Under the First Method, since there will be a legal transfer of the securitised assets by the originator in favor of the SPV, the SPV can by itself institute a suit against the borrowers for recovery of dues without impleading the originator as one of the parties to the proceedings. Under the Second Method, since the originator continues to be the legal owner, the suit for enforcement of the underlying mortgages must be filed by the originator himself/itself. The trustee also will have to be impleaded as party to the suit either as a co-plaintiff or as a proforma defendant.

10.2 The suit for enforcement of mortgage will have to be instituted in the appropriate court after payment of the necessary court fees. The proceedings in the court takes considerable time both in the matter of passing a decree as well as in the execution thereof. In 1993, a new legislation viz. the Recovery of Debts Due to Banks and Financial Institutions Act (Recovery Act) was passed by the Indian Parliament which provides for the establishment of Special Tribunals (the Tribunals) for expeditious adjudication and recovery of dues due to banks and financial institutions. The Tribunals are being constituted under the said Act.

10.3 Where a bank or a financial institution has to recover any debt exceeding Rs. 10 lacs from any person, it has to make an application to the appropriate Tribunal. For the purposes of the Recovery Act, financial institution means (i) a public financial institution within the meaning of Section 4A of the Companies Act, 1956; (ii) such other institution as the Central Government may, having regard to its business activity and the area of its operation in india, by notification, specify. Thus an HFC can be notified by the Central Government as a financial institution for the purpose of the said Act. If they are so notified, the debts due to them can be recovered through the Tribunals.

10.4 Besides the above facility, powers may also be conferred on the HFCs under the National Housing Bank Act, 1987 (NHB Act) or under a special statute for expeditious recovery of dues from defaulting borrower concerns by taking over possession of the property mortgaged to them, as well as right to transfer by way of lease or sale and realize the property. Such powers are contained in Section 29 of the State Financial Corporations Act, 1951 (SFCs Act) and Section 20 of the Industrial Reconstruction Bank of India Act, 1984 (IRBI Act). Under the NHB Act/special statute, the HFCs may also be empowered to recover the amounts due to them from the defaulting borrowers, as arrears of land revenue on the lines of the provisions contained in Section 32G of the SFCs Act.

10.5 In this context, the question arises whether the HFCs, if notified as financial institutions under the Recovery Act, will be entitled to avail of the facility under the said Act in respect of the mortgage loans securitised. It may not be legally possible for the HFCs to avail of such facility in respect of the loans securitised under the First Method since their legal title to such assets is transferred to the SPV. But they can avail of such facility in relation to the mortgage loans securitised under the Second Method as the legal title in respect of these loans is retained with them.

The same position as indicated above holds good even in the case where special powers are conferred on the HFCs under a statute for expeditious recovery of their dues from the defaulting borrowers on the lines of section 29 and/or section 32G of the SFCs Act.

10.6 It is also relevant to mention here that the right of private sale without intervention of the court is conferred on the mortgagee under certain circumstances mentioned in Section 69 of the TP Act. Such a right is available only to a very limited extent. The reasons for the limitations prescribed in Section 69 of the TP Act in 1802 no longer exist now. It is felt that exclusion of English mortgage where the mortgagor or the mortgagee is a Hindu, Mohammedan or Buddhist, from the mortgages where the right of private sale is permissible, should be done away with. In other words, irrespective of the race, sect, tribe or class of the mortgagor or the mortgagee, the right of private sale should be permissible. Further, in cases where the mortgage deed confers upon the mortgagee a right of private sale, the restriction under Section 69 of the TP Act that the mortgage should be a Government or that the mortgaged property should be situate within the towns of Calcutta, Madras and Bombay should also be removed. It is also felt that the benefit of right of private sale under Section 69 of the TP Act should be made available to mortgagees under equitable mortgages as well.

11.0 ACCOUNTING TREATMENT

11.1 The real benefits of securitization would accrue to the lending institution (originator) only if the securitised assets are removed from its balance sheet. In this context, the important question that arises for consideration is whether securitization process contemplated under the aforesaid two Methods would result in the removal of securitised assets from the balance sheet of the lending institution.

11.2 There is no statutory provision or guiding principle which can clearly throw any light on this matter. In England, it is generally accepted that a sale of an asset has taken place for accounting purposes where all significant risks and rewards of ownership of the asset have been transferred by the originator to the buyer. According to the major banks and accounting firms in England, if there has been a substantial and material transfer of risks and rewards of ownership of the assets consequent on securitization, then those assets should stay off the balance sheet.

11.3 In the United States, under US Statement of Financial Accounting Standards No.77, for removal of the assets from balance sheet, the originator must comply with the following requirements viz. (i) the transferor must surrender control of the future economic benefits embodied in the receivables, (ii) the transferee cannot require the transferor to repurchase the receivables sold and (iii) the transferor must be able to estimate reasonably its obligations under the recourse provision.

11.4 In India, the relevant enactments (e.g. the Companies Act, 1956, the Banking Regulation Act, 1949 and the concerned special statutes) lay down that all 'assets' and 'liabilities' of the concerned entity must be shown in its balance sheet. But they do not define what constitutes an asset or a liability. Similarly, these enactments require that accounts should give a 'true and fair' view, but do not provide detailed guidance on what it means, nor how it should be applied.

Therefore, the matter is left to the professional judgement of the auditor. He has to justify that the off-balance sheet treatment for the assets securitised was necessary in order to give a true and fair view in the originator's accounts.

11.5 Under the First Method of securitization, since the portfolio of loans together with the relative mortgages are sold/transferred by the originator to the SPV, all the risks and rewards in respect thereof pass on to the SPV and, therefore, there is no doubt that in that case the securitised asset would go off the balance sheet. Even under the Second Method, the originator transfers all beneficial/economic interest in such loans to the PTC holders and merely retains a formal legal interest therein. Further, on securitization, the relative loan assets on the balance sheet of the originator get substituted by the income received by it representing the proceeds of the PTC issue. It is also relevant to mention here that since the securities are issued "without recourse" to the originator, no fresh liability arises to him on that account. The appropriate disclosure regarding securitization could also be given in a note to the accounts. For these reasons, it is felt that off-balance sheet treatment could be given for the assets securitised even under the Second Method.

12.0 TAX-RELATED ISSUES

12.1 Tax is a complex area and one which is in a constant state of flux. Several tax considerations arise in the context of structuring a securitization transaction. But it is beyond the scope of this paper to deal with all the tax-related issues. The implications of the important provisions of the Income-tax Act, 1961 (I.T. Act) which are relevant to the HFCs are discussed in the following paragraphs.

12.2 Under Section 88 of the I.T. Act, any payment made by the assessee towards repayment of the loan borrowed by him from the approved HFC for purpose of purchase or construction of a residential house property will be allowed as deduction upto Rs.10,000. This is to provide a fiscal incentive for channelizing savings into the housing sector, as indicated in the Budget Speech of the Prime Minister and Minister of Finance for 1987-88.

When a mortgage loan eligible to the above deduction is securitised by the HFC under the Second Method, the position of the borrower is not affected and he continues to be governed by the terms of the Loan Agreement entered into by him with the HFC. There will be no privity of contract between the borrower and the trustee or between the borrower and the investor. The object of the above provision will not be defeated merely by reason of securitization of the mortgage loan advanced by the HFC. In view of this, it is felt that the relief provided under Section 88 of the Act continues to be available to the borrower even after securitization of the loan advanced to him by the HFC.

12.3 For the reasons mentioned above, the relief provided by Section 24 of the I.T. Act under which the amount of interest paid on the loan borrowed by the assessee for acquisition or construction of house property is allowed as deduction (subject in the case of a self-occupied house to the limit mentioned therein), also continues to be available to the borrower even after securitization.

12.4 Under Section 60 of the I.T. Act, income arising to a person by virtue of a transfer will be chargeable to tax as the income of the transferor, if there is no transfer of assets from which the income arises. Obviously, this section applies only when there is a transfer of income without transfer of the assets generating the income. But in a mortgage securitization (even under the Second Method), since the entire beneficial interest in the securitised assets including the income arising therefrom would be transferred to the investors, it is felt that the provisions of Section 60 of the Act would not be attracted and hence the income transferred cannot be taxed in the hands of the HFC.

12.5 Section 160 of the I.T. Act defines 'representative assessee' to mean, inter alia, a trustee appointed under a trust who receives or is entitled to receive income on behalf or for the benefit of any person. Since the HFC may constitute itself as a trustee for the investors in respect of the securitised assets and receive on their behalf payments on the underlying mortgages, it may be regarded as 'representative assessee' within the meaning of Section 160. In view of this, it would be possible that under Section 161 of the Act, the income by way of interest etc. received by the HFC on behalf and for the benefit of the investors might be assessed for tax in its hands. However, by virtue of Section 166 of the Act, the income-tax authorities have the option in such cases to make an assessment under Section 161 either on the representative assessee or a direct assessment on the persons beneficially entitled to the income. For this reason, it would be permissible for Government of India to issue suitable instructions to the income-tax authorities for making direct assessment on the individual investors.

12.6 In terms of Section 194A of the I.T. Act, a person responsible for paying interest is required to deduct tax at source at the rates in force. But the provisions of that Section are not applicable to the income credited or paid to a financial corporation or a notified institution. The benefit of the above exemption should continue to be available even to the income credited or paid to the financial institution/notified institution as the trustee for the investors in respect of the assets securitised. Considering the objective of Section 194A, this would seem to be possible if the lending institution (HFC) gives a declaration to the effect that it will deduct tax at the time of making payment to the investors. On this basis, it is felt that the Government may issue necessary clarification or bring about suitable amendment to the Act, if required, for the above purpose.

12.7 In this context it may be mentioned that under Section 10(23D) of the I.T. Act, the income of Mutual Fund set up by the institutions specified therein is exempt from income-tax. It would facilitate securitization if similar exemption is provided in respect of the income of Trustee for the investors in a securitization transaction.

It is felt that the HFCs may take up the matter with the Central Government for the above purpose.

13.0 CONCLUSION

13.1 It would be seen from the foregoing discussion that several problems - legal, accounting, tax-related and others - are involved in structuring securitization transactions. If these problems are solved, mortgage securitization can take off very well in this country. In the United States, there is Government sponsored system for securitization. The existence of three Government agencies viz. Government National Mortgage Association (GNMA or 'Ginnie Mae'), the Federal Home Loan Mortgage Corporation (FHLMC or 'Freddie Mae') and the Federal National Mortgage Association (FNMA or 'Fannie Mae') which have been empowered to guarantee principal and interest on securities issued by other lenders simplified the whole process of structuring mortgage securitization transactions. The other key factor contributed to the successful development of this concept in the US is the accommodating nature of the accounting and tax rules. In U.K., the Bank of England has played a leading role in publishing guidelines for banking institutions through its "Loan Transfers and Securitization" Notice of February 1989 specifying the circumstances in which off-balance sheet status could be given for securitised assets of banks for capital adequacy purposes. New legislations have been passed in France, Spain, New Zealand and Japan to assist securitization process.

13.2 In India, there is urgent need to evolve a proper legal frame work which would provide for simpler procedure involving payment of nominal stamp duty for transfer/assignment of mortgage loans.

Government sponsored agencies need to be set up in India on the lines of 'Ginnie Mae' and 'Fannie Mae', to provide credit enhancement to securitization transactions to make the PTCs more attractive. Tax considerations play a major part in determining the detailed mechanics of securitization transactions. Therefore, required changes will have to be made in the present tax laws to remove the impediments in the development and growth of the new concept. PTCs fall within the purview of the definition of "securities" under Section 2(1)(i) of the Securities and Exchange Board of India Act, 1992 read with Section 2(j) of the Securities Contracts (Regulations) Act, 1956 and, therefore, SEBI is empowered to regulate the issue of, and trading in, the PTCs. It will facilitate smooth operation of the transactions in these new financial instruments, if SEBI comes out with clear guidelines in that behalf.

13.3 Reserve Bank of India may, in consultation with the Institute of Chartered Accountants of India, lay down appropriate accounting policies and disclosure requirements to be followed by banks and other lending institutions with regard to securitization transactions, so that the economic substance of these transactions are properly reflected in their financial statements.

13.4 Pending completion of the above formalities, it is felt that mortgage securitization under the Second Method can be attempted by the HFCs in consultation with rating agencies and market makers and documentation for the same completed at Delhi after taking the necessary precautions in that regard.

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