CHAPTER 5

CONCEPT AND WORKING OF SECURITISATION

5.1 Meaning and Concept of Securitisation

Securitisation has emerged as an important means of financing in recent time. It is the process which converts the financial assets into a security, which may or may not be traded. The security issued against the financial assets may be redeemed after a period of time. Thus, securitization is also known as the ‘process of asset securitization’, whereby the secured creditor transfers his right to the future cash flows to the subscriber. Asset securitization involves the transfer of assets or risks to a third party normally a special purpose where such transfer is funded by issuing highly rated debt securities to investors. Payments to investors in respect of such debt securities are principally derived directly or indirectly from the cash flows of the asset. The credit rating of such debt securities are derived from the quality of the underlying assets and not the credit rating of the original owner of such assets (generally known as originator) as in the case in debt securities by the corporation itself.

Securitisation process involves the creation of securities as it is a process by which securities, viz, tradable capital market instruments are created. Originally the concept of securitization was to create securities based on financial assets, say receivables on mortgage loans, auto loans, credit cards etc. however with passage of time the innovation has extended application of securitization to cover non-financial assets as aircraft, buildings, and on the other hand, the same device has also been applied to securitize risk, such as insurance risk, whether risk, etc.

Asset Securitisation

Once the assets for Securitisation are selected, they are transferred to a special purpose vehicle. The SPV can either be an entity created for a specific securitisation transaction, or an existing entity used for multiple securitization transactions by different originators. In the latter case it is called the multiseller
conduit. When the SPV is created for a specific transaction, it permits more flexibility in constructing the SPV, the transfer of receivables, and the terms and conditions of securities. However, it also costs more and has a greater uncertainty if the SPV is treated as a bankruptcy remote entity. At the same time, multiseller conduits are better separated from the originator and cheaper; however they are less flexible. As a matter of principle the SPV can be registered as a corporation, a partnership, a limited liability company, or a trust.36 Academic works, however, almost unanimously assert that a trust is the best choice because "a trust other than a "business trust" is ineligible to be a debtor under the [Bankruptcy law]".187

The transfer of receivables to an SPV is one of the most sensitive points in a securitization transaction. There are two possibilities: sale of receivables and creation of security interest in the receivables. Both of these options can be used. One important feature of the most often used assets is that they represent a right to receive payment, which is secured by certain collateral. Mortgage loans are secured by the real estate for which they are taken. Credit card payments are secured by money in other accounts of the credit card owner. The collateral for automobile loan is the automobile itself. Collateral that secures the payment of receivables is very valuable to the creditors, and thus increases the value of receivables because even if for one reason or another the debtor fails to make the payment, the creditor may resort to the collateral and have his claims satisfied. 41 If upon transfer of receivables, the rights to collateral did not pass to the new creditor, the value of receivables would deteriorate. Therefore, to successfully conduct asset securitization, it is important that the rights to collateral are transferred to the SPV together with receivables.

After receivables are transferred to an SPV, the SPV "issues securities to capital market investors and uses the proceeds to pay for the financial assets. "Securities are tied to the receivables of the SPV. Once securities are issued, there may be a number of institutions involved in raising or evaluating their credit rating including insurance companies, rating agencies, and credit enhancers. The cumulative effect of these institutions is that investors have

more safeguards against problems on returns from their investment and are therefore willing to buy securities at a lower price. Thus, securities can either be privately placed to institutional investors or publicly traded in selected capital markets.

5.2 Background of Securitisation

Securitisation as a technique gained popularity in the United States in the 1970s. United Kingdom is the second largest market for securitization after the United States. Securitization started in United States in 1970 with the issue of residential mortgages by public housing finance corporations. These institutions have found that they had to pay higher interest to attract short term deposit, while rates earned on long term mortgage loans were less. This created mismatches between assets and liabilities. The solution was found in securitization.

The modern asset securitisation transactions were devised in early 1970s by the governmental agencies of the United States. Pioneered by Governmental agencies, this technique was later adopted by private companies. As volumes of asset securitization expanded and the calculations showed substantial benefits for companies involved, the businesses and legislators in other jurisdictions started searching for ways to implement asset securitization at home. Among them were the two most developed civil law countries: France and Germany.

In 1988 France was among the first European countries to provide the legal framework for asset securitization. This resulted in an immediate boost of securitizations, but later the development turned out to be less explosive than anticipated. Germany began conducting securitization in early 1990s. During this decade Germany boasted a significant part of European asset backed securities issuance.

Securitisation as a technique gained popularity in the United States in the 1970s. favourable tax treatment, legislative enactments, establishment of Government

backed institutions that extend guarantees and pragmatic regulatory environment are essential for this system to work. The Government wanted to promote secondary markets in mortgages to allow liquidity for mortgage finance companies. GNMA was the first one to buy mortgages from mortgage companies and to convert them in to pass through securities. Other US Government agencies like FNMA and Freddie Mac joined in later. The first securitization of receivables outside the mortgages happened in 1975 when Sperry Corporation securitized its computer lease receivables. The European Model :Pfanbriefe and mortgage bonds: another mortgage funding device, slightly different from the US tyre pass through, has expired in Europe for almost two centuries in the past. In Denmark, for example, mortgage bonds are more than 200 years old. Germany also has a long history of pfanbriefes and it is stated that there have been no defaults on these instruments for all these years.

The success of securitisation has been due to the United States Federal Government. For encouraging the home ownership, Congress created government-owned and government-sponsored entities for creation of residential mortgages.

Mae and was a privately-owned government-sponsored entity. The second entity is the Government National Mortgage Association, better known as Ginnie Mae, and is a government-owned entity. Both Fannie Mae and Ginnie Mae were created to purchase and sell federally-insured mortgages.

Finally, in 1971, Congress created the Federal Home Loan Mortgage Corporation or Freddie Mac in order to improve the secondary market for conventional home mortgages. Secondly, the government broadened the authority of the Federal National Mortgage Administration ("Fannie Mae") to increase Fannie Mae's activities in the secondary mortgage market. Finally, the Government National Mortgage Association ("Gennie Mae") began to guarantee the payment of certain mortgage-backed securities.

In the 1980s there was emergence of more complex payment structures creating a wider investment market for mortgage backed securities. Beginning in 1983,

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Freddie Mac issued Collateralized Mortgage Obligations known as CMOs. These CMOs altered the traditional pay-through structure of mortgage-backed securities by creating tranches with different payment structures in order to meet the needs of different investors. The Tax Reform Act of 1986 allowed for pass-through tax treatment for entities issuing multiple classes or tranches of securities by creating Real Estate Mortgage Investment Conduits, or REMICs.

The private sector entered the secondary mortgage market when California Federal Savings and Loan issued the first publicly rated mortgage backed security in 1975. In 1977, Bank of America issued the first publicly rated security backed by conventional mortgages. Eventually, mortgage bankers, home builders, investment banks, and insurance companies began issuing mortgage backed securities of their own. Gaining from the experiences of the secondary mortgage market, other types of financial assets were soon being securitized. In 1975, Sperry Corporation began securitizing operating leases for computer equipment. This transaction received a higher credit rating than Sperry's own rating. The securitization of other types of leases soon ensued, including the securitization of automobile, equipment, and aircraft leases.

Also, in 1985, automobile loans were first securitized by Marine Midland Bank and Valley National Bank. Soon after, larger issuers began securitizing automobile loans, including General Motors Acceptance Corporation, Chrysler Financial Corporation, and Nissan Motors Acceptance Corp. By 1987, Bank of America and Republic Bank of Delaware offered securities backed by credit card receivables. As early as 1994, securitizations of credit card receivables were increasing while mortgage securitization began to significantly decline.

The Federal Government also remained active in the securitization of financial assets other than residential mortgages. The Federal Government has participated in the securitization of student loans through the Student Loan Marketing Association, also known as Sallie Mae, and agricultural loans through the Federal Agricultural Mortgage Corporation or Farmer Mac.

The federal Housing Administration was established with the enactment of the Housing Act 1934. The act provide for the insurance of home mortgage loans made by private lenders and for the chartering of national mortgage association.
The Act led to the establishment of National Mortgage Association of
Washington in 1938, whose name was later changed to Federal National
Mortgage Association.192

According to the amendments made to the Act in 1968, the Federal National
Mortgage Association was divided into two separate entities, the Government
National Mortgage Association (Ginnie Mae) and the Federal National
Mortgage Association (Fannie Mae). Ginnie Mae remained as a wholly owned
government entity, while Fannie Mae became privately owned by retiring the
government-held stock.

Securitization started in the early 1970s through the sale of mortgage loans by
Ginnie Mae. The mission of Ginnie Mae is to support expanded affordable
housing in the US by providing an efficient government-guaranteed secondary
market vehicle, linking the capital markets with Federal housing markets.

Ginnie Mae does not loan money for mortgages but acts as a guarantor or a
surety. Ginnie Mae does not issue, sell, buy mortgage-backed securities or
purchase mortgage loans. Ginnie Mae manages a mortgage-backed securities
program, where it guarantees securities backed by pools of mortgages. These
securities are called Mortgage-Backed Securities (MBS). These MBS are issued
by certain private institutions that are approved by Ginnie Mae. The mortgages
insurances are undertaken by the Rural Housing Service (RHS) or are
guaranteed by the Department of Veterans Affairs (VA).

In the 1980s, there was growth in the market with the introduction of
transactions by the quasigovernmental agencies. Freddie Mac and Fannie Mae
buy mortgages from commercial banks, thrift institutions, mortgage banks and
other primary lenders. Then, Freddie Mac and Fannie Mae either hold these
mortgages in their own portfolios or package them into mortgage-backed
securities for re-sale to investors.193

192 Kevin Fox GothamRacialization and the State: The Housing Act of 1934 and the Creation of
the Federal Housing Administration Sociological Perspectives Vol. 43, No. 2 (Summer, 2000),
pp. 291-317
193 Comparative Law of Security Interests and Title Finance, Philip R. Wood, Vol- 2, Second
5.3 Basic Features of Securitisation

5.3.1. Creation of security

In order to further have a better understanding of the concept of “securitisation”, it is necessary to have a basic idea of the term “securities”. In connection with securitization, the word "security" does not mean what it traditionally might have meant under corporate laws or commerce: a secured instrument. The word "security" here means a financial claim which is generally manifested in form of a document, its essential feature being marketability. To ensure marketability, the instrument must have general acceptability as a store of value. Hence, it is generally either rated by credit rating agencies, or it is secured by charge over substantial assets. Further, to ensure liquidity, the instrument is generally made in homogenous lots.

5.3.2. Special purpose Vehicle

In case the securitization involves any asset or claim which needs to be integrated and differentiated, that is, unless it is a direct and unsecured claim on the issuer, the issuer will need an intermediary agency to act as a repository of the asset or claim which is being securitized. For example, a secured debenture, in essence, is a secured loan from several investors. Here, security charge over the issuer's several assets needs to be integrated, and thereafter broken into marketable lots. For this purpose, the issuer will bring in an intermediary agency whose basic function is to hold the security charge on behalf of the investors, and then issue certificates to the investors of beneficial interest in the charge held by the intermediary. So, whereas the charge continues to be held by the intermediary, beneficial interest therein becomes a marketable security.

The same process is involved in securitization of receivables, where the special purpose intermediary holds the receivables with it, and issues beneficial interest certificates to the investors.

The Securitization Company (SPV) acts as a conduit between the Originator and the investor in regard to the financial receivables. The investor is interested in the return on his investment and he is not bothered about any privity of contract between the Originator and the Obligor or between the Originator and the SPV. One of the essential features of securitization is that the
receivables/financial assets are transferred to the SPV so that the beneficial interest of the SPV is created. In any case, the essential function of the SPV is that it acts as a trust which is created solely for the purpose of holding the receivables on behalf of the investor. It, thus, protects the interests of the investor as well and insulates them from the originator of financial assets.

The Securitization Company (SPV) should treat the Originator as a third party and should be managed by professionals only. The staff should be employed on regular basis and should have a thorough knowledge of the subject and the prevailing laws in force and these may be given special training in the subject.

**5.3.3 Re-distribution of risks**

If there is a transfer of assets from the originator to the SPV (and from there, beneficially or indirectly to the investors), it should follow that there is a transfer of risks as well. For more financial assets, there is an element of credit risk, interest rate risk, or similar risks so, the question is, how are these risks redistributed upon securitisation.

In most securitisation transactions, the risks are transferred in a structured fashion: in terms of a sequence as to who will take the first hit and who will come thereafter, and who will be the last one to be concerned or affected. Based on these priorities, the risks are referred to as the first loss risks, second or subsequent loss risks, and so on. The one takes the first loss risks a junior holder, and one who takes subsequent risk is a senior one. There might, of course, be one or more mezzanine security holders. If there are more than three classes, for want of a better terminology in English, these different classes may be referred to as A class, B Class, C Class and so on, the first one referring to the senior-most.

**5.3.4 Rating**

Credit rating agencies assigns rating to asset-backed securities issues just as they do for corporate bonds. Credit rating is based on three criteria: the probability of the issuer defaulting on the obligation, the nature and provisions of the obligation and the relative position of the obligation in the event of bankruptcy.
5.4 Securitisation as a tool of Risk Management

“Securitisation” is one way in which a company might go about financing its assets. There are generally seven reasons why companies consider securitization:

- to improve their return on capital, since securitization normally requires less capital to support it than traditional on-balance sheet funding;
- to raise finance when other forms of finance are unavailable (in a recession banks are often unwilling to lend - and during a boom, banks often cannot keep up with the demand for funds);
- to improve return on assets - securitization can be a cheap source of funds, but the attractiveness of securitization for this reason depends primarily on the costs associated with alternative funding sources;
- to diversify the sources of funding which can be accessed, so that dependence upon banking or retail sources of funds is reduced;
- to reduce credit exposure to particular assets (for instance, if a particular class of lending becomes large in relation to the balance sheet as a whole, then securitization can remove some of the assets from the balance sheet);
- to match-fund certain classes of asset - mortgage assets are technically 25 year assets, a proportion of which should be funded with long term finance; securitization normally offers the ability to raise finance with a longer maturity than is available in other funding markets;
- to achieve a regulatory advantage, since securitization normally removes certain risks which can cause regulators some concern, there can be a beneficial result in terms of the availability of certain forms of finance (for example, in the UK building societies consider securitization as a means of managing the restriction on their wholesale funding abilities).

5.4.1 Securitisation and credit derivatives

Credit derivatives were developed along the lines of other OTC derivatives, but have found an excellent companion in securitisation. A credit derivative is a non-fund based contract when one person agreed to undertake, for a fee, the risk inherent in a credit without acting taking over the credit. The risk could be
either the risk of specified credit events such as bankruptcy, failure to pay, etc.
or could be the risk of any deviation in the total return from a credit asset.

The party which provides protection against such risk is called the protection
seller and the party which buys such protection, normally but not necessarily the
originator of the credit asset is called the protection buyer.

In a sense, credit derivatives seem to contradict securitisation. Securitisation
results into transfer of assets of the originator, while the risk is largely retained
by one or more credit enhancements of the originator. Credit derivatives, on the
other hand, do not result into transfer of assets but transfer risk. Therefore, the
two operate apparently in opposite directions.

5.4.2 Salient Features of Securitised Instrument

A securitised instrument generally has the following features

(a) Marketability: the basic purpose of securitisation is for ensuring
marketability to financial claims. Securitisation is of no use unless securitized
product is marketable. The purpose of securitisation shall not be served if the
instrument is loaded on to a few professional investors without any possibility
of having a liquid market therein. Liquidity to a securitized instrument is
afforded either by introducing it into an organized market (such as securities
exchanges) or by one or more agencies acting as market makers in it, that is,
agreeing to buy and sell the instrument at either pre-determined or market-
determined prices.

(b) Merchantable quality: a securitized product must have a merchantable
quality for being market acceptable to merchants in normal trade. With
reference financial products it means that the financial commitment embodied
in the instruments are secured to the investors’ satisfaction. The rule is that the
broader the base of the investors, the less is the investors' ability to absorb the
risk, and hence, the more the need to securitize. For widely distributed
securitized instruments there is an evaluation of the quality and certification by
an independent expert for ratting. The rating serves for the benefit of the lay
investor, who is otherwise not expected to be in a position to appraise the
degree of risk involved. With reference to the securitization of receivables, the
The concept of quality undergoes drastic change making rating a universal requirement for securitizations.

**c) Wider distribution:** the main purpose of securitization is the distribution of product. The extent of distribution which the originator would like to achieve is based on a comparative analysis of the cost and benefit achieved thereby. Wider distribution leads to a cost benefit in the sense that the issuer is able to market the product with lower return, and hence, lower financial cost to him. But wide investor base involves cost of distribution and serving. Most of the securitizations have been privately placed with professional investors.

**d) Homogeneity:** To be as a marketable instrument, the instrument should be packaged as into homogenous lots. Homogeneity, like the above features, is a function of retail marketing. Most securitized instruments are broken into lots affordable to the marginal investor, and hence, the minimum denomination becomes relative to the needs of the smallest investor. The need to break the whole lot to be securitised into several homogenous lots makes securitization an exercise of integration and differentiation: integration of those several assets into one lump, and then the latter's differentiation into uniform marketable lots. This often invites the next feature: an intermediary to achieve this process.

**e) Special Purpose Vehicle:** This is not a machine or vehicle. Actually, a trust is created which works for an investor, takes charge of all receivables, collects the money from loanees or from electricity consumers and gives to investors. The SPV (Trust) issues an instrument call "Pass through certificate" (PTC) which provides the right to proceed on behalf of the investors to take charge of property (Assets viz. housing loan/vehicle loan, sell it and bring the proceeds to trust).

**e) The securitisation Company** acts as a conduit between the originator and the investor in regard to the financial receivables. The investor is interested in the return on his investment and he is not concerned about any privity of contract between the originator and the obligor or between the originator and the SPV. One of the basic features of securitization is that the receivables/financial assets are transferred to the SPV so that the beneficial interest of the SPV is created. The essential function of the SPV is that it acts as a trust which is created solely for the purpose of holding receivables on behalf
of the investor. It protects the investors as well and insulates them from the originator of financial assets.

The Securitisation Company (SPV) should treat the originator as a third party and should be managed with the help of professionals. The staff should be employed for regular basis and must have a thorough knowledge of the subject and the relevant Legislative framework in force and they may be provided with the training in this regard.

5.5 Understanding the process of Securitisation

5.5.1 Parties involved in the Process of Securitisation:

In a securitisation process there is involvement of variety of counterparties and advisers.

The Originator: - owner and “generator” of the assets to be securitized. Originators may be banks and other financial institutions, corporates, government authorities It is the entity on the books of which the reconstruction to be done. Examples of the originators are banks and other financial institutions, corporate, governments and municipalities. In case of sale, the originator transferred both legal and the beneficial interest in the asset to the Special Launch Vehicle owner and generator of the assets to be securitized. Originators may be banks and other financial institutions, corporate, Government authorities.

A Special purpose vehicle: A trust is created which works for an investor, takes charge of all receivables, collects the money from loanees and gives to investors. The SPV(Trust) issues and instrument call “Pas through Certificate” (PTC) which provided the right to proceed on behalf of the investors to take charge of property.

The Investor: The investors purchase the interest in the pools of receivables.

The Obligor(s): An obligor is a customer of the originator who is obliged to pay on a contractual basis for goods or services provided by the originator.

Seller: Seller of the assets to securitised. In many cases, the seller and the originator in a transaction are identical. This is however not necessarily the
case. For instance, an entity may purchase assets from its affiliates and then act as a central seller in a securitisation.

**Purchaser:** A special purpose vehicle (SPV) acquiring the assets to be securitised. The purchaser funds the purchaser price by issuing asset-backed securities in the capital markets. This SPV can either be a trust, corporation or forum of partnership set up specifically to purchase the originators' assets and act as a conduit for the payments flows. The issuer is also known as SPV or trust and project the trust and project the interest.

**Servicer:** Servicer the assets to be securitised. Where receivables are securitised, the Servicer will collect, administer and if necessary, enforce the receivables. There are two types of loan servicers, master servicers and special servicers. The master servicer is responsible for the commercial real estate loans that substantially comply with the terms of the loan agreements following the jobs required to be done by him. The master servicer collects payments in satisfaction of the instalment payment obligation of the borrower and remits those funds to the SPV for the benefit of the CMBS investors. Servicer will also be reporting to the investors, the underwriters and the credit rating agencies the status of the loans, the cash flow of the properties, and the market value of the property.

**Back up servicer:** It will service the assets in the event the servicer is unable to service them, or in the event the Purchaser exercises its right to remove the servicer (for instance, as a result of the insolvency of the Servicers).

**Liquidity Facility Provider:** Provides a liquidity facility in relation to certain tranches of the asset-backed securities. Typically, a liquidity facility is provided in conduit transactions where the Purchaser issues revolving short-term commercial paper to fund the purchase of the assets. The Purchaser may draw upon the liquidity facility if it is unable to refinance maturing commercial paper because of a market disruption.

**Investors:** In every securitisation transaction there has to be some investor or purchaser of the asset-backed securities. Examples of investors in the securitisation market are: pension’s funds, banks, mutual funds, hedge funds, insurance companies, central banks, international financial and corporate. The
security receipts issued by QIB which is evident the fact that they have undivided interest in the property. In India we concept of securitisation is on the early stages that is the reason the securities are only issued by the QIBs.

**Lead Manager:** Arranger and structure of the transaction. The Lead Manager is often the primary distributor of the asset-backed securities in a particular transaction. Individual distributors are also referred to as Managers.

**Credit Rating Agency:** In the process the credit rating agency rate the asset backed securities. Credit rating agencies assign rating to asset backed securities as like they provide for corporate bonds. Following criteria are applied for the credit rating: the probability of the issuer defaulting on the obligation, the nature and provisions of the obligation and the relative position of the obligation in the event of bankruptcy.

**A merchant or investment banker:** a vital role is played by the merchant or investment banker in the process of securitisation. They generally act as a Special Purpose Vehicle. There are various issues involved in securitization namely the timing of the issue of pass through certificates, pricing of these certificates for marketing and above all underwriting of these issues. While in private placement they act as agents for the issuer connecting the sellers and buyers. They can also involve in structuring the issue to see that the issue meet all legal, regulatory, accounting, tax and other requirements. In the above mentioned perspective the merchant banker plays a vital role. The securitization process has further widened the scope of the activities of the merchant bankers.

**A servicing agent:** Receiving and paying agent (RPA). Service providers are usually the originators or affiliates of the originators of the assets, are responsible for collecting principal and interest payments on the assets when due and for pursuing the collection of delinquent accounts. They also provide the trustee and the certificate holders with monthly and annual reports about the portfolio of assets sold or used as collateral.

**(vi) The prospective investors i.e. the buyer of securities:** - purchasers of the asset-backed securities. Examples of investors in the securitization market are: pension funds, banks, mutual funds, hedge funds, insurance companies, central banks, international financial institutions and corporates.
(vii) Trustees- A Trustee in asset-backed security is the intermediary between the servicer and the investors and between the credit enhancer and the investors. A trustee is used whether the issue is a sale of assets by the issuer or a collateralized debt obligation of the issuer. The responsibilities of the trustee include buying the assets from the issuer on behalf of the trust and issuing certificates to the investors. As the obligors make principal and interest payments on the assets, the servicer deposits the proceeds in a trust account, and the trustees passes them on the investors. The trustee should be willing to take over the servicer’s role if the servicer withdraws or is unable to perform.

The process of securitization primarily involves three parties namely, the originator, the special purpose vehicle (SPV) and the investor. The originator is the one who owns the financial asset and who wants to offload the same in the market. The originator could be a banking, industrial or finance company. The SPV or in other words the issuer is the one who issues mortgage-backed securities to investor in the market. Generally merchant bankers function as SPV’s. The investor is the one who buys securities from the SPV.

The three stages in the process of securitization are represented in the form of a diagram given below:

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The process involved in the process of securitization consists of the following stages:

- The process initiates when the lender (or originator) segregates loans/lease/receivables into pools which are relatively homogenous in regard to types of credit, maturity and interest rate risk.
- The pools of assets are then transferred to a Special Purpose Vehicle (SPV) usually constituted as a trust. The originator may float the SPV as a subsidiary in the form of a limited company. Another option could be for the SPV to be floated jointly by the originator/individuals/banks/institutions who are interested in the securitization deal.
- Based on these, the SPV issues asset backed securities in the form of debt, certificates of beneficial ownership and other instruments. The securities issued may be with or without recourse.
- Interest and principal payments on the loans, leases and receivables in the underlying pool of assets are collected by the servicer (who could also be the originator) and transmitted to the investors.
- Credit enhancement can add features to boost investor confidence. This could be in the form of a provision of recourse, a guarantee requiring the originator to cover losses, a letter of credit from a bank, or over collateralization.

5.5.2 Structures of Securitisation

It is the duty of the structure to suggest a proper mode of securitization depending upon various factors like assets, availability of time, legal framework etc. However, interestingly the Indian Act does not give this scope to the structurer since it creates an altogether new structure of securitization from the known modes of securitisisation. Before dealing with that aspect, it is necessary to understand the two major methods of securitization structure.
**Pass Through Structure:**

In this structure, the entity acquiring the assets enabling the investors. The SPV may act as either a trustee or there may be a special trustee appointed for this very purpose.

In pass through certificates, a direct participation in the cash flow is sold. Receipt of asset cash flow is deposited in a designated account. The funds are then passed on to Certificate Holders. Receivables are directly assigned to investors through SPV. Thus, the cash is collected by the original lender which is then passed on to SPV (securitisation company).

**Pay through Structure**

This structure gives investors only a charge against the securitized assets, while the assets themselves are owned by the SPV. In other words, investors do not have any beneficial interest in the assets and the SPV gets more freedom to deal with the securities. All that the investors will be entitled to is the interest and the principal from the SPV. A securitisation structure where the payments to the investors are routed through the SPV who does not strictly pay the investors only when the receivables are collected by it, but keeps paying on the stipulated dates irrespective of the collection dates. In order to allow for smoothed payment to investors by removing the fluctuations in its collections, the SPV
uses a guaranteed investment contract or credit enhancements or both. Pay through certificates have a multiple maturity structure depending upon the maturity pattern of underlying assets, Thus, two or three types of securities with different maturity patterns like short term, medium term and long term may be issued. This type is more attractive from the investor's point of view because the yield is often inbuilt in the price of the securities themselves i.e., they are offered at a discount to face the value as in the case of deep-discount bonds.

5.5.3 Ways of asset transfer

There could be three basic methods of transfer of assets:

a) Novation

Novation is the clearest way of selling a loan and effectively transferring both the rights and obligations. In novation, the existing loan between originator and borrower is cancelled and a new agreement between the investor and borrower is substituted. The buyer accepts the terms and conditions as of original lender or seller who ceases to have any obligations to the borrower. The loan, is therefore, excluded from the balance sheet of the seller.

b) Assignment

Assignment transfers from the seller to buyer, all rights to principal and interest. Assignments for the purpose of disposing of assets may fall into two basic legal categories:

The first is statutory assignment, transferring both legal and beneficial title. A statutory assignment will pass and transfer from the seller to the buyer all the legal rights to principal and interest. In most cases, it will also pass on all the legal remedies available against the borrower to ensure discharge of debt. In other words, the buyer acquires the full legal and beneficial interest in the loan.

The second is equitable assignment, transferring only beneficial title. It does not transfer legal rights. Thus, a buyer may not be able to proceed directly against a borrower. The seller must be joined in action. However, the seller is not liable for debt.

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c) **Sub-participation**

Sub-participation does not transfer any of the seller’s rights, remedies or obligations against the borrower to the buyer. But, it is an entirely separate, back-to-back, non-recourse funding arrangement, under which the buyer places funds with the seller. In return, the seller passes on to the buyer, payments under the underlying loan, which the borrower makes to him. But, the loan itself is not transferred.

**5.5.4 Stages involved in the Securitisation Process**

The securitisation process can be understood with the help of following stages involved in it:

a) Identification stage/process

b) Transfer stage/process

c) Issues stage/process

d) Redemption stage/process

e) Credit rating stage/process

**5.5.4.1 Identification process**

The originator has got assets comprises of variety of receivables like commercial mortgages, lease receivables, hire purchase receivable etc. The originator has to pick up a pool of assets of homogeneous nature considering the maturities, interest rates involve, frequency of repayments and marketability. The process of selecting pools of loans and receivables from the asset portfolios for securitization is called identification process.

**5.5.4.2 Transfer Process**

When the transfer process is over the selected pool of assets are then passed through to the special purpose vehicle (SPV) or trust which is ready to help the originator for converting those pools of assets into securities. The pass through transaction between the originator and the SPV is either by way of outright sale i.e., full transfer of assets in question: for valuable consideration or by passing them for a collateralized loan. Generally, it is done on an outright sale basis.
This process is called ‘transfer process’ and once this transfer process is over, the assets are removed from the balance sheet of the originator.

5.5.4.3 Issue Process

Once the transfer process is over, the SPV takes up the task of converting these assets of various types of different maturities. On this basis the SPV issues securities to the investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV is called by different, names like 'Pay through Certificates', 'Pass through Certificates', ‘Interest only Certificates’, ‘Principal only Certificates’ etc. The securities are structured in such a way that the maturity of these securities may synchronize with the maturities of the securitized loans or receivables.

5.5.4.4 Redemption Process

The redemption and payments of interest on the securities is facilitated by the collections received by the SPV from the securitized assets. The task of collection of dues is generally provided to the originator or special servicing agent is appointed for this purpose. This agency is provided with a certain percentage of commission for the collection services rendered. The serving agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. The originator is appointed as the servicer. Under securitization the role of the originator get reduced to that of a collection agent in behalf of the SPV, in case he is appointed as a collection agent. The main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment of interest and principal to the investors.

5.5.4.5 Credit rating process

As the pass through certificates has to be publicly issued, they require credit rating by a good credit rating agency so that they are made attractive and easily acceptable. These certificates are rated by at least one credit rating agency during the process of securitization. The issue can also be guaranteed by external guarantor institutions like merchant bankers which can enhance the credit worthiness of the certificates and would be readily acceptable to the
investors. The rating guarantee provides a sense of confidence to the investor with regard to the timely payment of principal and interests by the SPV pass through certificates like debentures directly reflect the ownership rights in the assets securitized their repayment schedule, interest rate etc. These certificates, before maturity, are tradable in a secondary market to ensure liquidity for the investors. They are negotiable securities and hence they can be easily tradable in the market. 197

5.5.5 Modus – Operandi of Securitisation

Visualize an entity having a receivable as one of major assets, say a housing finance company are a leasing company. Suppose the company has already created these receivables (that is, it has a contractual right to collect these receivables). This means the company’s working capital is tied in the receivables.

Securitisation will unlock this working capital, and make it free for further assets-creation. In this sense, securitisation is a mode of financing, or rather refinancing.

The company will select the receivables to be securitised, following a certain criteria. See below for the criteria to be adopted for such selection. While selecting, a set of discriminants can be used but generally it is not advisable that the company cherry-picks assets, that is selects assets of the best quality leaving behind poor quality assets with the company. For understandable reasons, cherry-picking is frowned upon by the equity shareholder and banks having traditional loan facilities with the company.

Such selected receivable will be transferred to a special purpose conduit, which could be trust or a special purpose corporation, viz, the special purpose vehicle (SPV).

So, once the receivables will be transferred by the originating company to the SPV, it is the SPV which now becomes the owner of the receivables.

The SPV now finances itself by issuing securities. These securities can be either beneficial interest certificates, or debt securities similar to bonds/debentures.

While the SPV holds the receivables, investors acquire either a beneficial right therein by either buying the beneficial interest certificates, or by buying the debt securities of the SPV. In either case, as the SPV is merely a shell consisting of the assets of the originator, rights of investors are collateralized by the assets transferred by the originator.

The difference between the weighted average cost of the securities issued by the SPV, and the yield transferred by the originator (depending on the discounting rate employed for selling the receivables), is called excess spread is normally captured as the residual profit of the originator.

The originator would usually continue to act as the servicer, that is, it will continue to collect the receivables, and remit the proceeds to the investors.

The transfer of the receivables to the SPV, and the creation of beneficial rights therein by the SPV, involve complicated legal issues in most countries. Hence, there might be lengthy legal documentation, and stamping involved to complete the transfer. 198

As the servicing is mostly done by the originating company, the debtors may often not even come to know of the fact of securitisation, unless they are notified. The servicer continues to collect the receivables, mostly in a separate escrow account, from where the collections are drawn by the SPV. The SPV used this collection, either to pay off to the investors proportionately (as in case of pass through securitisation), or reinvests the money to pay to the investors on stated intervals (as in case of pay through or bond-structure securitisation). In case of pass-thoughts, since the SPV would be making a proportionate payment to investors every period, the transaction automatically comes to an end when substantially all receivables are paid off. In case of pay through securitizations, generally the originator would have provided some of his own cash, including his retained spread or an over-collateralisation support, or simply an equity contribution to the SVP; therefore, the residuary cash with SPV at the end of the transaction is the originator’s residuary cash inflow.

198 Vinod Kothari’s securitisation: The Financial Instrument of the New Millennium.
If at all any enforcement is required against the debtors, the SPV as the legal owner of the receivables will bring action may be taken by the originator as an agent of the SPV.

The basic process of securitization is illustrated in the table below:

<table>
<thead>
<tr>
<th>The basic process of receivables Securitisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The originator either has or creates the underlying assets, that is, the transaction receivables out of which are to be securitised.</td>
</tr>
<tr>
<td>The originator selects the receivables to be assigned.</td>
</tr>
<tr>
<td>A special purpose entity is formed.</td>
</tr>
<tr>
<td>The special purpose company acquires the receivables, at their discounted value.</td>
</tr>
<tr>
<td>The special purpose vehicle issued securities to investors—either debt type securities or beneficial interest certificates. These are publicly offered or privately placed, as found conductive.</td>
</tr>
<tr>
<td>The servicer for the transaction is appointed, normally the originator.</td>
</tr>
<tr>
<td>The debtors of the originator or obligors are/are not notified depending on the legal requirements of the country concerned. Most likely, the originator will try to avoid notification.</td>
</tr>
<tr>
<td>The servicer collects the receivables, usually in an escrow mechanism, and pays off the collection to the SPV.</td>
</tr>
<tr>
<td>The SPV either passes the collections to the investors, or reinvests the same to pay off to investors at stated intervals.</td>
</tr>
<tr>
<td>In case of any default, the servicer takes action against the debtors as the SPV’s agent.</td>
</tr>
<tr>
<td>When only a small amount of outstanding receivables are left to be collected, the originator usually cleans up the transaction by buying back the outstanding receivables.</td>
</tr>
<tr>
<td>At the end of the transaction, originator’s profit, if retained and subject to any losses to the extent agreed by the originator, in the transaction is paid off.</td>
</tr>
</tbody>
</table>
5.5.5.1 Documentation required for Securitization Process

The following legal documents are required to be executed by parties to the securitization transactions.

(a) Memorandum of Agreement (sale/Purchase Agreement or terms of Agreement) – The agreement between originator and investor/trustee covering the underlying securities, rights, titles and interests. The document also specifies the consideration to be paid and set out detailed operational terms and roles and responsibilities of various parties to the transactions.

(b) Deed of Assignment: this deed transfers to the SPV/investors the beneficial and legal interest in the receivables. Investors as absolute owners and assignee are entitled to receive the cash flow there from.

(c) Collection and Paying Agent Agreement: it covers the appointment of the C&P agent for servicing the cash flows, details their duties and obligations and arrangements for holding, as trustees. In case of default and, if so required, institute legal proceedings.

(d) Trust Deed/Declaration of Trust: The Company would create a Trust (a Special Purpose Vehicle) over the beneficial and legal interest in the security to the loans. A trust deed would be executed to describe in details the powers, duties and responsibilities of the Trustee(s) and the operational details of the Trust. 199

5.6 Merits and demerits of Securitisation

Securitization process provides various benefits to all the parties such as the originator, investors, and the regulatory authorities. Let’s have an insight into the merits of the securitization.

(a) Source of Fund: by the process of securitization the originator (i.e. the lending institution) is benefited as securitization provides an additional source of funds by converting an otherwise illiquid asset into ready liquidity. As a result of this there is instant improvement in the cash flow of the originator.

(b) Greater Profitability: Securitization helps financial institutions to get liquid cash from medium term and long term assets immediately rather than over a longer period. It leads to greater recycling of funds which, in turn; leads to higher business turnover and profitability. Again, the cash flow could be recycled for investment in higher yielding assets. This means greater profitability.

(c) Enhancement of Capital Adequacy Ratio: Securitisation process enables the financial institutions to enhance their capital adequacy ratio by reducing their asset volumes. During the process of securitization, once the, assets are transferred they are removed from the balance sheet of the originator. It results into the reduction of asset volume which later increases the capital adequacy ratio. Capital adequacy ratio can also be improved by replacing the loan assets with the lesser risk weighted assets.

(d) Spreading of credit risk: Securitisation process facilitates the spreading of credit risk to different parties involved in the process of securitization. In the absence of securitization, the entire credit risk associated with a particular financial transaction has to be borne by the originator himself. Due to securitization the originator is able to diversify the risk factors among the various parties involved in securitization.

(e) Lower cost of funding: As a result of cash flows and diversification of risk factors, securitisation enables the originator to have an easy access to the securities market at debt ratings higher than its overall corporate rating. It implies that the companies with low credit can issue asset backed securities at lower interest cost due to high credit rating on such securities. It provides help for securing funds at lower cost. In the present situation of scarcity of funds and higher interest rates, securitization process provides a good scope for cheap funding.

(f) Higher rate of Return: As compared to traditional debt securities like bonds and debentures, the securitised securities offer better rate of return along with better liquidity. Such instruments are rated by good rating agencies as results are more attractive. Being structured assets backed securities; they offer more protection and yield a good return. The bankruptcy/winding up of the
originator does not affect the investors since the payment is guaranteed by the SPV.

**g) Prevention of capital:** when the securitisation process is not there capital would remain in the form of illiquid assets like mortgages, term loans etc., with many of the lending institutions. The securitisation process helps recycling of funds by converting these assets into liquidity, liquidity into assets, assets into liquidity and so on by means of issuing tradable and transferable securities against these assets. Thus, it provides impetus for capital formation.

**h) Compared than the traditional instruments:** There are the certificates are issued to investors against the backing of assets securitised. The underlying assets are used not only as collateral to the certificates but also to generate the income to pay the principal and interest to the investors. It does not involve any servicing needs and as a result does not require much cost. It is better than It is better than even mutual fund units because it is issued against the backing of collateral securities whereas there is no such backing for mutual fund certificates. Thus, these instruments, being structured asset backed securities, afford a greater protection to investors. Again, there is much transparency from the investors’ point of view. They can very well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element.

**Other benefits**

Securitisation when carried out in true sprit can lead to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. In the long run the process of securitisation is beneficial to the borrowers also. Securitisation is a low cost and innovating funding source ensuring economy in the use of capital.

**5.7 Risks in Securitisation**

**Credit Risk**

This risk of non-payment by the underlying obligors, which is dependent on underlying obligor’s ability and willingness to pay. The underlying obligor’s ability to pay is primarily driven by adequacy and stability of income. Loan to value (LTV) ratio and income generating capability of the underlying asset will
indicate the obligor’s willingness to pay. CARE analyzes the originator’s sourcing and credit appraisal system, historical portfolio performance and actual pool to assess the credit and liquidity risk.\textsuperscript{200}

\textbf{Market Risk}

- Macro-economic Risk - The macro-economic scenario affects underlying asset valuation, income generating capacity of the asset (if case of certain asset class), borrower’s income, market interest rates, etc. The expected economic scenario has an impact on future behavior of the pool. The regulatory scenario is also a critical aspect to consider for different asset classes, for e.g. change in regulations for repossession process.

- Asset Risk - The general risk perception of the asset, introduction of new models/substitutes or new technology will directly impact the performance of pool.

- Prepayment Risk – The prevailing and expected market interest rates and expected income levels will influence the prepayment rates. CARE assesses the historical prepayment rates observed for that asset class for the originator as well as similar issuances. Based on the historical data and expected interest rates and income levels, scenario analysis is carried out.

- Interest rate Risk – The interest rate type mismatch may arise in case where the collections from underlying borrowers are based on fixed interest rate and the payouts to investors are based on floating rate or vice versa. The interest rate benchmark mismatch may arise when the both collections and payouts are based on floating rate but reference benchmarks are different. CARE assesses the interest rate risk assuming different interstate scenarios and its consequent impact on collections from underlying borrowers. This risk is more prominent in MBS transactions.

\textbf{Counterparty Risk}

\textbf{a) Servicer Risk} – The ability of the Servicer to service the pool over the tenure of the transaction is an important risk factor. Typically, the originator acts as a

\textsuperscript{200} Securitisation: history forms and risks Edward P. M. Gardener, Jack Revell University College of North Wales. Institute of European Finance Institute of European Finance, University College of North Wales, 1988
Servicer in Indian securitization transactions. CARE takes into account the Servicer’s experience, length of the pool is a direct reflection of the sourcing, underwriting norms and credit appraisal system of the Originator. As the Originator also acts as Servicer in India, the collection and monitoring methods used by Originator becomes equally important. The Originator analysis involves evaluating the management quality and experience, changes in the management in recent years, business growth, strategies and policies, major policy changes, financial strength, etc. CARE studies Originator’s sourcing channel, underwriting norms, credit appraisal system, monitoring methods, collection mechanism and changes in the any of them over a period of time.

b) Portfolio Analysis (Dynamic)

CARE analyzes the performance of Originator in terms of collection efficiency, portfolio ageing (bucket movement), prepayments, etc. This quantitative analysis supplements the qualitative analysis of Originator, as mentioned above.

Collection Efficiency

The collection efficiencies are calculated to analyze the effectiveness of collection mechanism employed by the Originator. The collection efficiency can be further divided into two components – collection efficiency from current billings and collection efficiency from over dues.

5.8. Salient Features of SARFAESI Act 2002

5.8.1 Background of the SARFAESI Act, 2002

Sick Industrial Companies (Special Provisions) Act, 1985 (SICA): this has already been discussed in detailed in the previous chapter. 201Parliament enacted the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 for providing for the establishment of tribunals and appellate tribunals for speedy disposal of dues due to banks and financial institutions. Various committees were constituted and they recommended on the issues given to them. This also has been already discussed in the previous chapter.

201 The SICA Act, 1985 has been repealed by notification No. S.O. 3453(E), 30/7/2016, with effect from November 15, 2016
The Government desired to give effect to the recommendations of the Eradi Committee by incorporating the changes in the Companies Act vide the Companies (Second Amendment) Act, 2002. As a result of this amendment Act of 2002, several new Chapters have been added to the existing Companies Act. These include a Chapter on creation and functioning of NCLT, a Chapter on Revival and Rehabilitation of Sick Industrial Companies, as also transfer of powers from the High Courts to the NCLT in respect of mergers and amalgamations and winding up of companies. At the same time an Act was passed by the Parliament repealing the SICA.\textsuperscript{202}

Several radical changes including appointment of professional liquidators, time bound liquidation process, etc., have been provided for in the Companies Act by virtue of the said Amendment Act. It was envisaged that with such time bound and professional approach it would be possible to tame the hydra headed monster that was eating away the national assets.\textsuperscript{203}

The Non-Performing Assets or bad debts of banks and financial institutions, which crossed the figure of Rs.1,10,000 crores as on March 31, 2002 are understandably a cause of great concern not only to lenders banks and financial institutions but also to the Government. To deal with this grave problem, the Central Government promulgated the Securitization and Reconstruction of Financial Assets and Enforcement of Securities Ordinance, 2002 on June 21, 2002. The Act in hand has substituted that Ordinance.

The Government established 33 Debt Recovery Tribunals (DRTs) to collect the NPAs. According to the available statistics, 33,049 cases involving Rs.42,989 crores are pending before the DRTs as on March 31, 2002. With a view to recovering NPAs, the Government promulgated the Securitisation and Reconstruction of To help banks and financial institutions to provisions for NPAs Financial Assets and Enforcement of Securities Interest Ordinance, 2002 on June 21, 2002.

\textsuperscript{202} Due to various reasons the constitution of NCLT ha remained on paper for the last ten years. As stated earlier, the Provisions relating to the constitution of NCLT are covered in the newly introduced Part IB comprising of sections 10FB to 10G of the Companies Act, 1956, but they were not notified. But in 2016 I was notified.

\textsuperscript{203} Pradeep K Mittal, “Companies (Second Amendment) Bill, 2002- Sick Companies: Distinction”, [2003] 46 SCL 38 at 41
The Minister had to say that banking sector reforms have proceeded in a phased manner over the past decade, yet the problem on non-performing assets with banks has continued, and, therefore, special attention had to be and was being paid to the recovery of NPAs.

“Presently, banks are allowed to deduct up to 5% of their total income against provisions made by them for bad and doubtful debts. In order to strengthen the financial position of banks, I propose to increase this allowance to 7.5% of the total income. Further in my budget for the year 1999-2000, I had granted an option to banks to deduct up to 5% of their NPAs falling in the category of loss or doubtful assets as on the last day of the accounting year. I propose to enhance this optional deduction upto 10% of loss or doubtful assets to public financial institutions”.

5.8.2 Features of the SARFAESI Act, 2002

The SARFAESI Act, 2002 Act consists of 41 sections in 6 chapters and a schedule. Chapter 1 consists two sections dealing with the applicability of the Securitization Act and definitions of various terms chapter 2 consists of sections providing for regulation of securitization and reconstruction of financial assets of banks and financial institutions, setting up of Securitisation and reconstruction companies and matters related thereto. Chapter three consists nine sections providing for enforcement of security interest and allied incidental matters. Chapter four contains seven sections providing for the establishment of a central Registry, registrations of securitization, reconstruction and security interest transactions and matters related thereto. Chapter five contains four sections providing for offences, penalties and punishments. Chapter six contains ten sections providing for routine legal issues.

Sections thirteen fifteen, seventeen and 34 of this Act, were under challenge. The impugned statute created a mechanism by which secured creditors could recover their dues from non-performing assets. It permitted the secured creditor to take recourse to various measures e.g. securing possession of the secured assets on the borrower’s default. Section 17 permitted the borrower to institute an appeal against the said measures – but before filing the appeal, he would

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204 Para of Part B of the speech of the Minister of Finance in Lok Sabha. While presenting the Union Budget on February 28, 2002, the Finance Minister stated in his speech
have to deposit a sum equivalent to 75% of the amount claimed by the secured creditor with the Debt Recovery Tribunal.\textsuperscript{205}

The SARFAESI Act with effect from 21-06-2002 allows secured lenders to sell or lease assets, which are charged with them by defaulting borrower (classified as NPA) without protracted legal tussle.

The third concept under the preamble is the right of the secured creditor, including the securitisation or the reconstruction company, to enforce the security interest without intervention of the court. On the above conditions being satisfied, the secured creditor can take, for enforcement of the security interest,

**Who is empowered to enforce security interest?**

The Act states that any security interest created in favour of secured creditor may be enforced without the intervention of the court or tribunal, by such creditor in accordance with the provision of the Act. Therefore only secured creditors can enforce the security interest without the intervention of the court or tribunal

**Condition precedent for the enforcement of security interest:**

Upon satisfaction of the entire following precondition a secured creditor would become empowered to enforce the security interest:

i. The borrower should be under an obligation towards creditors

ii. The borrower should have defaulted discharging obligation of repayment.

In case of default by the borrower the creditor can take the following actions:

i. when the secured asset so acquired by the secured creditor is transferred by the secured creditor, the transferee will get all the rights in relation to secured asset transferred the transferor had been made by the owner of such secured asset.

ii. Take over the management of secured assets by the borrower including the right to transferring or take any step for selling or transferring the secured assets

so acquired. Appoint any person, to manage the secured assets the possession of which has been taken over by the secured creditor.

iii. Require any person who has acquired any of the assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

The Act overrides some of the provisions of the Companies act 1956 as well as the transfer of property act. The Act requires 60 days’ notice to be given to the defaulter. The action under SARFAESI Act, 2002 can be initiated only by issuing a Demand Notice to the defaulter borrower. This is the first step towards realization of security under the SRES Act. It forms basis for further actions under the Act. Under the Demand Notice, the Bank/ Secured Creditor requires from the borrower in writing to discharge his liabilities within sixty days from the date of Notice. The purpose of Notice is to obtain a reply from the borrower as to why measures may or may not be taken under the Act in case of non-compliance to the demand. It is not merely a show cause notice but a notice of demand based on the footing that borrower is under a liability and his account has become sub - standard, doubtful or loss. In fact, because it is a notice of demand, which constitutes an action under the Act, it provides for an opportunity to the borrower to make representation. The next step, for which the Bank is entitled, is either to take possession of the secured assets or to take over management. The borrower stands restrained from transferring the secured assets by way of sale, lease or otherwise without prior written consent of the secured creditor.\(^{206}\) It is an enabling provision given to the borrower whereby rights of borrower are jealously guarded.

Following conditions must be there at the time of issuance of the notice:

a) The borrower must be under a liability to the Bank under security Arrangement or there must be a secured debt.

b) There must be default in repayment.

c) The account must be classified as Non-Performing Asset in the books of the Bank.

\(^{206}\) Section 13(4) of the SARFAESI Act 2002
d) The Bank must have taken a conscious decision that either the borrower should discharge his liability in full or for selling the securities.  

**Contents of Notice**

As per the provisions of section 13 (2) of the Act the notice should contain the following details:

a) Of the amount payable by the borrower

b) Of the secured assets intended to be enforced by the Bank, in the event of nonpayment or failure to discharge the liability in full.

c) Of the time limit in which the borrowers expected to make repayment i.e. sixty days

d) Of the information that the borrower may object the notice.

The purpose of the serving Demand notice is that the borrower can explain his reasons as to why measures may or may not be taken under the Act and may submit a reply. Service of the demand notice is the condition precedent to the invocation of the Act. Service of the notice must be through the mode of speed post. Where the borrower willfully avoids service of the notice and where the normal modes of services have failed. The service of the notice shall be published in two newspapers one being in local language.

The notice has to be very specific about defaulted amount. On receiving the notice, no borrower can sell, lease or transfer the secured assets mentioned in the notice, without the lenders consent. Bankers can act, even on those cases that are pending with the BIRF, provided more than 75% of such secured creditors agree on the same. No fresh references shall be made to BIFR after commencement of this Act where financial assets have been acquired under the Act. Now of course SICA i.e BIFR has been repealed w.e.f 01.01.2004 and the SICA (special Provisions ) Repeal Bill become effective after notification in the official gazette. If borrower fails to respond to the notice by offering payment, the security lender at his discretion can take any of the following actions:

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(a) take possession of the assets mortgaged and transfer the same either by selling or by leasing.

(b) takeover the management of the secured assets of the defaulting borrower.

(c ) can appoint manager to take charge of secured assets taken into possession.

The demand notice may be served to any or all persons against whom bank intend to enforce Security Agreement secondly to any person who is under liability to repay loan. The act does not provide any specific word indicating that the issuance of the notice is essential for the guarantor but since the term ‘borrower’ in section 2(1)(f) is an inclusive definition for guarantor also.

If there is more than one secured creditor, the decision to make provisions of this Act will be made applicable only when seventy percent of them are agreeable. In the event of the total dues of the secured creditor are not recovered from the sale of secured assets, they will have right of approaching DRT for recovery of balances amount from the borrower / guarantors. Chief Metropolitan Magistrate or district magistrate will assist the secured creditors on request being made to them. No injunction shall be granted by any civil court or other authority in respect of action undertaken under this Act.

Rights of Borrowers

A borrower can object to the measures taken under this Act within forty five days subject to condition of depositing seventy five of the amount outstanding with DRT, or lower amount if approved by DRT.\(^{211}\)

If at appeal level, it can be established that the possession of secured assets by the secured creditor was wrongful then DRT appellate tribunal will direct the secured creditor to return such secured assets to the concerned borrower. Limitation as prescribed under Limitation Act 1963 will be applicable even to this Act. Borrowers can also apply to the state government in Maharashtra and Gujarat for relief under, Bombay Relief undertaking Act. The stay against securitization proceeding may be granted on a case by case basis on merits.

\(^{211}\) Section 2(1)(f) - 'Borrower' means any person who has been granted financial assistance by any Bank or financial institution or who has given any guarantee or created any mortgage or pledge as security for the financial assistance granted by any Bank or financial institution and includes a person who becomes borrower of a securitization company or reconstruction company consequent upon acquisition by it of any rights or interest of any Bank or financial institution in relation to such financial assistance.
Normally, it will be decided by Industries Minister or chief minister, though very few instances have been witnessed for such relief at present. The relief is normally given for one year.

**Remedies and borrowers for a borrower under the SARFAESI Act, 2002**

Right of redemption is basic right of a mortgagor / borrower

Right of redemption is basic right of a mortgagor/borrower. This right to redeem is recognized by law since long. Securitisation is an additional remedy for a Bank/Secured Creditor, the rights provided under the Transfer of Property Act cannot be said to have been recorded. Right to redeem of property is the foremost right available to a borrower.

Section 60 of Transfer of Property Act, 1882 recognizes the right of mortgagor/borrower for redemption of his property which runs as follows:

“60. Right of mortgagor to redeem. At any time after the principal money has become due, the mortgage-money has become due, the mortgagor has a right, on payment or tender, at a proper time and place, of the mortgage-money, to required the mortgagee (a) to deliver to the mortgagor the mortgagor-deed and all document relating to the mortgaged property which are in the possession or power of the mortgagee, (b) where the mortgagee is in possession of the mortgaged property to deliver possession thereof to the mortgagor, and (c) at the cost of the mortgagor either to re-transfer the mortgaged property to him or to such third person as he may direct, or to execute and (whether the mortgage has been effected by a registered instrument) to have registered an acknowledgment in writing that any right in derogation of his interest transferred to the mortgagee has been extinguished:

Provided that the right conferred by this section has not been extinguished by the Act of the parties or by decree of a Court

The right conferred by this section is called a right to redeem and a suit to enforce it is called a suit for redemption.

Nothing in this section shall be deemed to render invalid any provision to the effect that, if the time fixed for payment of the principal money has been
allowed to pass or no such time has been fixed, the mortgagee shall be entitled
to reasonable notice before payment or to tender of such money.

Redemption of portion of mortgaged property. Nothing in this section shall
entitled a person interested in a share only of the mortgaged property to redeem
his own share only, on payment of a proportionate part of the amount remaining
due on the mortgage, except only mortgagees has or have acquired, in whole or
in part, in the share of a mortgagor”.

Section 91 of the Transfer of Property Act also points the same conclusion.

“91. Person who may sue for redemption.- Beside the mortgagor, any of the
following persons may redeem, or institute a suit for redemption of, the
mortgaged property, namely :-

(a) any person (other than the mortgagee of the interest sought to be redeemed)
who has any interest in, or charge upon, the property mortgaged or in or upon
the right to redeem the same:

(b) any surety for the payment of the mortgage-debt or any part thereof ; or

(c) any creditor or the mortgage who has in a suit for the administration of his
estate obtained a decree for sale of the mortgaged property.”

Thus as per Section 91 of the Transfer of Property Act, certain others persons
though not borrower but having interest in secured assets are also entitled for
redemption. Even the property of guarantor under mortgage will be liable to be
released if the borrower pays the entire amount before confirmation of sale
under SARFAESI Act, 2005 the above said rights are recognized and reaffirmed
in a different manner when Section 13(8)1 of the SRES Act declares in no
uncertain terms that the action under the SRES Act for disposal of security
cannot be taken up when the dues of Bank are tendered. This is another form of
right of redemption.

This right of redemption is available up to the date before sale or transfer
finally. The words ‘sale or Transfer’ in Section 13(8) of the SARFAESI Act
connotes execution of the conveyance/registered sale deed. Borrower, being
owner of the property, has right to stop the sale: either if he has tendered all his
dues to Bank or D.R.T. thus exercising his right of redemption or if the power
of sale is being exercised in fraudulent manner contrary to the terms of contract or the Act.

Equity of redemption is available to borrower till the purchaser does not perfect his title by some legal instrument. In Mardia Chemicals, it was held that the borrower had the right to redemption of mortgage and that right is preserved by the Act.

**Right to Receive Compensation**

This is another important right of the borrower embodied in section 19 of the SARFAESI Act, 2002 which runs as follows:

The Section recognizes a borrower’s right to receive compensation & cost, if Debt Recovery Tribunal/Debt Recovery Appellate Tribunal finds that possession of secured assets/sell of secured assets/ transfer of secured assets is not in accordance with the provisions of the Act and the Rules made thereunder. The Section does not cover an Appellant under Section 17 who is not a borrower but only a person aggrieved. It appears that such an Appellant/person aggrieved who is not a borrower is left to pursue a claim of his damages in Civil Court. From reading of the Section the right of borrower appears to arise once Debt Recovery Tribunal comes to the conclusion that possession is not in accordance with the provisions of the Act. However it does not appear necessary that in each and every case Debt Recovery Tribunal should pass an order quantifying the compensation. The Section declares only entitlement and therefore once an appeal under Section 17 has been disposed of in favour of borrower, he may apply before DRT under Section 19 for quantifying/determining the compensation for the losses caused due to breaches committed by secured creditor in carrying out the provisions of the Act. Therefore whenever action of Bank/Secured Creditor is held illegal, the losses; if any, may be recovered and even notionally a borrower may get compensation.

**Right to Object Demand Notice**

Demand Notice is the first step by which proceedings under SARFAESI Act, 2002 are initiated. Borrower has been given an unequivocal right to bring on record all his objections in reply to such Demand Notice.
The right to object a Demand Notice under Section 13(2) is valuable right of borrower. The borrower is entitled to raise or to take any objection which may ultimately result in termination of proceedings. The borrower if he desires to challenge the action of Bank this is the opportunity given by the SARFAESI Act, 2002 under Section 13(3-A)\(^2\). Section 13(3A) of the SARFAESI Act is mandatory and omission to consider representation is fatal. If the borrower makes any representation or raised any objection, the secured creditor shall consider such representation or objection and if the secured creditor comes to the conclusion that such representation or objection is not acceptable or tenable, secured creditor shall communicate within one week of receipt of such representation or objection the reasons for non-acceptance of the representation or objection of the borrower.

In objection any intricate question of facts can be raised by the borrower. By submitting the representation an obligation is cast upon the Bank to communicate within one week the non-acceptance of the representation or objection of the borrower. Though the reason communicated does not confer any right upon the borrower to prefer an application/appeal before DRT under Section 17 or 17(A) yet it will compel the Bank to reconsider the steps which are being intended by the Bank.

The proviso to Sub-section (3-A) of the SARFAESI Act, 2002 precludes a borrower from immediately assailing the rejection by the secured creditor of the objection /representation. The wordings of the proviso are such that the challenge to rejection can be carried at a later stage. The right to challenge the rejection made by secured creditor is merely suspended till such time that the secured creditor resorts to any of the measures under Section 13(4) of the SARFAESI Act 2002.

The reason appears that merely rejection of objection in response to Demand Notice is not going to cause any material prejudice to the borrower. Therefore the right to challenge the rejection accrues only upon the material prejudice is caused following Section 13(4) being invoked by secured creditor/Bank.

\(^2\) Section 13(3A) was inserted after the judgment of the Supreme Court in Mardia Chemicals vs. Union of India (2004) 3 SCC 311
It is a valuable right of notice recipient to object before Bank as to why action under the Act should not be taken. This right is very important in the sense it is a face to face dialogue with the lender. The objection of borrower will put a question to the lender as to genuineness, purpose, legality of the exercise under the Act. Further, these objections of borrower will form a foundation for appeal under Section 17 or for compensation. If genuine objections are not considered, it will not lie in the mouth of Bank to oppose the claim for compensation at some later stage of proceedings.

The provision contained in Section 13(3A) of the Act are mandatory in nature and the secured creditor Bank has no right to proceed in violation of the provisions contained in Sub-section (3A).

Merely, rejection of objections of borrower will not give right to the borrower to approach Court, but the remedy for borrower will be to prefer appeal under Section 17 in the event of any measure is taken under Section 13(4).\textsuperscript{213}

Section 13(3-A) puts an obligation on the Bank to convey the reasons for non-acceptance within fifteen days from the date of receipt of such objections/representation. Undoubtedly the liability to be discharged is subject to the decision of Bank taken on pursuance of Section 13(3A) of the SARFAESI Act.

A measure under Section 13(4) cannot be taken against the decision taken in pursuance of Section 13(3A). It is obligatory on the part of the authority first to consider and dispose of the objection by speaking and reasoned order and communicate the order to the borrower.

It is condition precedent for issuance of notice under Section 13(4) of the Act. The authority cannot ignore the statutory provisions treating them merely to be a decoration piece in the statute rather they need a strict adherence. Bank cannot get rid of the obligation of disposal of objections merely on the ground that objections of borrower were submitted through his advocate because the Act does not lay down any limitation or boundaries within which the objections should be framed. The borrower can take any objection viz. legal, factual, moral, humanitarian, procedural etc. and yet in any form the scope of objection

\textsuperscript{213} Mardia Chemicals vs. Union of India (2004) 3 SCC 311
is unlimited and it will always depend on case to case basis but some examples of objection are given in order to point out the area and boundaries for objection.

i. Objection as to date, manner of N.P.A.

ii. Objection pertaining to the very existence of security interest.

iii. Objection as to authority of the various officers of Bank/Board Government etc.

iv. Objection as to accounting like wrong calculation of interest, penal interest, various charges, capitalization etc.

v. Objection as to form and information contained in Demand Notice like incompleteness of the Notice, wrong facts in the Notice etc.

vi. Objection as to availability of security for disposal like another charge, inability of borrower under different laws.

vii. Objection as to parties to Notice like passing away of some parties to loan contract or changing of partners or change of directors etc.

viii. Objection of legal and technical nature by putting different interpretations to the various provisions of the Act.

ix. Seeking time for repayment of loan.

x. Rescheduling of loan as per the needs.

xi. Deferring of payment of installments due to unforeseen events like loss, damage in business.

xii. Objection that the borrower is operating loan account without break.

The objections must necessarily give reference of Demand Notice. A borrower understands well that if nothing serious is contended in the objection, the same will be liable to rejection. The borrower has to show in Court that non-disposal has resulted in some kind of injury to his rights which could be avoided if the objections were considered by the Bank. Therefore where defaulter borrower raised an objection that the loan was taken under Credit Guarantee scheme for small industries and the Bank may move the Central Government for recovery of the amount, and the Bank failed to dispose the objection but Jharkhand High Court refused to provide benefit of M/s Mardia Chemicals to borrower by treating the objection worthless and frivolous. Seeking of extension of time will also be an objection under the Act and Bank has to reply the same on reasonable
basis either by giving the desired time or by giving the time which Bank thinks fit. Where Bank issued a Demand Notice but failed to reply/dispose the objection of borrower and filed its claim before Debt Recovery Tribunal but during pendency of proceedings issued another Demand Notice, it was held that since objections were not disposed of within the stipulated time, the Bank cannot revive the action. However once objection stand disposed of, the Notice under Section 13(2) of SRES Act cannot be interfered between the stage unless measure under Section 13(4) is taken. If the objections are sent through registered post, a presumption under Section 27 of General Clauses Act, 1897 can be raised being validly served. A bald denial is not a valid rebuttal of a presumption in law.

**Right to File Appeal**

Section 179 permits/ allows any person including the borrower/ aggrieved by any of the measures referred to in Sub-section (4) of Section 13 taken by secured creditor to make an application in to the Debt Recovery Tribunal concerned for the reliefs in Sub-section (3) thereof.. The forum constituted under Debt Recovery Tribunal Act has been made available for the adjudication, not of recovery proceedings per se but for determining the validity of the acts/measures of the secured creditor under Section 13 which is without intervention of Court. But right to challenge the rejection by a secured creditor of the representation of the borrower in reply to notice under Section 13(2) is suspended till such time that the secured creditor takes recourse to any of the measures under Section 13(4). The reason being that a mere rejection will not cause any material prejudice to the borrower. Right to challenge accrues only upon the material prejudice being caused following Section 13(4) being invoked by Bank/ Financial Institution.

Though proceedings under Section 17 are given nomenclature as an appeal, but being original proceedings, the procedure applicable will be that of a suit. Section 17(1) of the Act enables a person including a borrower to prefer an appeal/application against any of the measures taken by the Bank.

While Sub-section (2) of Section 17 prescribed the scope for determination of such application/appeal. Section 17(2) provides that DRT shall examine the
facts and circumstances and shall decide whether the measures under Section 13(4) taken by secured creditor are in accordance with the provisions of the Act or Rules. Thus in a challenge under Section 17, the action of the secured creditor under Section 13(4), can be shown to be transgressing the limits and powers available to a secured creditor. Right of appeal is created for judicial security of enforcement of secured creditor’s rights and for creating any wrongs therein against the affected persons. An action under Section 14 constitutes an action taken after the stage of Section 13(4) and therefore the same would fall within the ambit of Section 17(1) of the Act and therefore appealable.\textsuperscript{214}

It is noticeable that actions taken under Section 13(5) to (8) of the Act are measures taken after the issuance of the Possession Notice under Section 13(4) and therefore remedy will be appeal under Section 17 of the Act. Questions of facts are more effectively and comprehensively determinable in appeal as in Mardia Chemical, the Apex court has held, “the position of the appeal under Section 17, of the Act is like that of a suit in the court of the first instance under Civil Procedure Code. This is a safeguard available to borrower within the framework of the Act.

The Act has not prescribed the procedure for disposal of application/appeal Under Section 17 except for saying that such an application shall as far possible be disposed of. Within sixty days from the date of such application. The last limb of Section 17, Sub-section (3) is of widest amplitude and empowers the Tribunal to pass such orders as it may consider appropriate and necessary in relation to any of the measure and there is no limitation apparent from the relevant words as to the authority of Tribunal to effectively deal with the situation. So far as parties to appeal are concerned the Authorized Officers though may be added as a party in the appeal but mere his absence will not render the appeal invalid/defective. Provided an effective order can be passed. As per Section 17(1) of the Act ‘any person aggrieved’ by any of the measure Under Section 13(4) taken by the secured creditor or its Authorized Officer may make an application which shows that appeal can be filed by adding secured creditor primarily as a party. But a stranger, who purchases property subsequent

\textsuperscript{214} Kanhaiyalal Lalchand v. State of Maharashtra (2011) 2 SCC 782

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to mortgage favoring Bank have no locus standi to question legality and validity of Demand Notice and Possession thereof.

**Benefits of securitization**

- Liquidity: selling a portfolio results in availability in ready cash.
- Raising of cheaper funds: experience in the US and Europe shows that Securitisation is a cheaper form of raising finance from the originator than the traditional forms of debt financing.
- Conversion of Marketable securities: Assets such as mortgages, credit card receivables, lease/hire receivables, which are not marketable in their original forms, are converted into marketable securities.
- Transfer of Risk: transfer of assets to a special purpose vehicle (SPV) results in transfer to all associated risks such as risk of default, currency risk and inherent risk.

**RBI Guidelines for Securitisation and ARC**

The RBI guidelines cover the following aspects:

a) Guidelines and directions covering the registration and operation of ARC.

b) Guidance notes in relation to the financing and accounting policies thereof

c) Guidelines to the lenders in relation to transfer of financial assets to ARCs.

As per 29/03/2004 guidelines

- Every securitization company or reconstruction company seeking the Bank’s registration under Section 3, or carrying on business on commencement of the Securitization Companies and Reconstruction Companies (Reserve Bank ) (Amendment) Guidelines and Directions 2004, shall have a minimum owned Fund not less than fifteen percent of the total financial assets acquired or to be acquired by the Securitization Company or reconstruction company on an aggregate basis, or Rs 100 crore, whichever is less; irrespective of whether the assets are transferred to a trust set up for the purpose of securitization or not.

- Further the securitization company or Reconstruction Company should continue to hold this owned fund level until the realization of the assets and redemption of security receipts issued against such assets.
• The securitization company or reconstruction company can utilize this amount towards the Security receipts issued by the trust under each scheme. This will ensure the stake of the Securitization Company or Reconstruction Company in the assets acquired.

• No subsidiaries of banks: some of the ARCs are currently being promoted by banks and FIs. The shareholdings of such ARCs are dispersed in such a manner that they do not become subsidiaries of any of the promoting institutions.

• NPA to be taken over at proper price: care has to be taken in constituting the management structure and operations of the ARC such that even if the promoting bank of FIs transfer their NPA portfolio, then it will be treated as transfer to an independent or non-subsidiary ARC. Valuation of the NPA portfolio will have to be negotiated at arm’s length and upsides on recovery can be even shared with ARC.

• NPA acquisition based on properly framed policies Every ARC is required to have a “financial asset acquisition policy” which interalia must lay down policies and guidelines for the valuation of NPA acquired by the ARC (having realizable value and capable of being reasonably estimated and independently valued).

• True sale and not adjustment assets by an ARC must conform to the principles of a “true sale”

• Due Diligence: proper due diligence and NPA portfolio valuation before any transfers should be made by banks or FIs to the ARCs. This means that the pricing of NPA portfolio transfers will take place through a process of discovery, as in the case of a business acquisition.

• The provisions of paragraph 9 of the above guidelines and directions relating to maintaining an ongoing basis, a capital adequacy ratio, which shall not be less than 50% of the total risk weighted assets of the Securitization Company or Reconstruction Company, shall be applicable.215

The distinction between SARFAESI and RDBFI Act as:

215Vinod Kothari, Securitisation, Asset Reconstruction and Enforcement of Security Interests, published by Butterworths Lexis-Nexis Wadhwa
SARFAESI Act enables Banks and FIs to realize long term assets, manage problems of liquidity, asset liability mismatch and to improve the recovery of debts by exercising powers to take possession of securities, sell them and reduce the nonperforming assets by adopting measures for recovery and reconstruction. Enactment of SARFAESI Act is not derogation of the DRT Act. SARFAESI removes the fetters which were in existence on the rights of secured creditors… DRT provides for adjudication of disputes as far as the debt is concerned. It covers secured as well unsecured debts SARFAESI covers only secured debts.

The issue was necessary to issue notice to the borrower or any other person who may be in possession of the secured asset and give him a hearing. The Bank or financial institutions shall before making an application under section 14 has to verify and confirm that notice under section 13(2) had been given and that the secured assets fall within the jurisdiction of the CMM/DM before whom the application has been made. CMM/DM acting under section 14 of the act is not required to give any notice any notice either to the borrower or to any third party. He has to only verify from the bank notice under section 13 (2) is given or not whether the secured assets falls within his jurisdiction. There is no adjudication of any kind at that stage. If the above conditions are not fulfilled that CMMM can refuse to pass an order under section 14 of the Act.

Security Interest (Enforcement) Rules Amendment : The rules were amended in 2007. The said amendments have been made in the enforcement rules in 2007. The said amendments have been made in the enforcement Rules to curb the powers of the enforcing authority in the sale of security and also to bring in transparency in the securitisation sales.

The following amendments made in security interest (Enforcement) Rules:

- Approved value has been defined as a person registered as a value under section 34 AB of the Wealth Tax Act 1957
- Possession notice has to be published in two leading newspapers
- As per Rule 7 of the Enforcement Rules, if any surplus money is available, the same has to be returned to the purchasers.

216 Trade Well vs. Indian Bank , Division Bench Judgement of Bombay High Court.
217 Luxco Electronics & others vs. Corporation Bank 2008 (DRAT’), Allahabad
Following are the main changes brought by the Amendment Act in 2012 which are dealt in the chapter under the following headings:

a) Provisions relating to multi-state co-operative banks: these kinds of cooperative banks are formed under the Multi-State Co-operative Societies Act, 2002 (2002 Act). These kinds of banks fall under the regulatory framework of the Reserve Bank of India in view of the provisions provided under the Banking Regulation Act, 1949. Multi state cooperative banks were not included either in the definition of banks under sec 2 (c) of the SARFAESI Act or under section 2(d) of the Recovery Act. As a result of this the multi state cooperative banks has to resort to recovery action under the provisions contained in chapter IX of the 2002 Act which provides for referring the dispute to arbitration in terms of section 84 of the 2002 Act. Amendment Act has included the multi-State Co-operative Banks with in the definition of ‘bank’ in both SARFAESI and Recovery Act. Hence, after coming into force of this amendment, a multi-State Co-operative Bank can have recourse to SARFAESI and Recovery Act in addition to section 84 of the 2002 Act.

Similar worded proviso have been inserted into section 18 and section 31 of the Recovery Act providing for continuance of the proceedings already initiated by a multi-State Cooperative Banks before the commencement of the Amendment Act and providing that the banks can not resort to the Recovery Act in respect of the pending proceedings.

After amendment of section 19 of the recovery act, an option is provided to a multi-State Cooperative banks either to initiate proceedings to recover debts under the 2002 Act or under the recovery Act. A multi-State Cooperative Bank, who has filed recovery proceedings under the Recovery Act, has the option for withdrawal of application and resort to the provisions of the Section 84 of the SARFAESI Act with the permission of the Debt Recovery Tribunal. For obtaining the permission, a multi-State Co-operative Bank has to make an application to the DRT. DRT has been mandated to dispose of the application within thirty days from the date of the application. DRT has also the power to refuse the permission after recording the reasons for such refusal. An appeal will lie to the Debts Recovery Appellate Tribunal against the order of refusal by DRT under section 20 of the Recovery Act. This withdrawal option is in addition to the option available under the provisos contained in section 19 (1) of
the Recovery Act dealing with the withdrawal of application filed by a bank to initiate action under SARFAESI.

By virtue of new sub-section (20A) of section 19 of the Recovery Act, DRT can record any agreement, compromise or satisfaction of the claim after satisfying itself about the genuineness of the agreement, compromise or the fact of repayment of the claim. DRT need not have concern about the adequacy of settlement amount or reasonableness of the terms of the compromise.

Section 9 (g) of the SARFAESI act allows conversion of a portion of debt into shares of a borrower company. The Amendment Act confers retrospective effect to the conversion option by the insertion of the proviso to clause (g) explicitly stating that the measure shall be deemed always to have been valid as if the provisions of this clause were in force at all material times. Section 81(3)(b) of the Companies Act, 1956 has provisions relating to conversion of debentures or loans raised by a company in to shares in the company. Public Companies (Terms of Issue of Debentures and Raising of Loans with option to convert such Debentures or Loans into Shares) Rules, 1977 were also framed to operationalise conversion of debenture or loan into shares. In order to enable the banks and financial institutions to convert a portion of the loan or debentures into equity, it was required that a stipulation as to this right should have been incorporated in the loan agreement or subscription agreement. The amendment aims to permit conversion of debt into shares as a measure for asset reconstruction by a securitisation company (SC) or asset reconstruction company (ARC) under SARFAESI. If a stipulation was available for conversion in the debenture subscription agreement or loan agreement, the SC/ARC acquiring the financial assets from the banks or financial institutions could have derived such right in terms of section 5(2) of SARFAESI. In view of the specific provision now included in SARFAESI, whether or not such right was available to a bank or financial institution transferring financial asset to SC/ARC, the latter can resort to conversion of any portion of debt into shares of a borrower company. Under the SARFAESI Act the word share has not been defined, it will have the same meaning provided under the Companies Act. As per section 2(26) of the Companies Act 1956.
The share capital of a company limited by shares shall be of two kinds only, namely: -

(a) equity share capital-
(i) with voting rights; or
(ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed;
(b) preference share capital.

Hence after the above discussion an Securitisation company/ asset reconstruction company can try conversion of a part of the debt into shares like equity shares, equity shares with differential rights, cumulative preference shares, non-cumulative preference shares, Optionally convertible cumulative preference shares etc.

For an Securitisation company / asset reconstruction company to exercise the conversion option, the borrower company shall have sufficient unissued share capital. Otherwise the borrower company will have to increase its share capital as per the procedure under the companies act. Regulation 10 (1) (e) of the Securities and Exchange Board of India (Substantial Acquisitions and Takeovers) Regulations, 2011(Takeover Regulations) contains provisions exempting from the purview of the Takeover Regulations the acquisition of shares by SC/ARC pursuant to SARFAESI. However, the SC/ARC may have to comply with the provisions of sub-regulations (5) and (6) of Regulation 10 of the Takeover Regulations.

**Enabling the Secured Creditor to Acquire the Property Brought For Sale**

As per section 13(5A) (5B) (5C) of the SARFAEISI Act secured creditor is permitted to bid for the property brought for sale through its authorized officer in any subsequent sale, if the previous sale has been postponed for want of bid for an amount not less than the reserve price. Bidding for the property by the secured creditor at the reserve price in the first attempt is not permitted; but the secured creditor can bid in the second or subsequent sale of the property. as per sec13( 5B) the secured creditor, being the declared purchaser of the property, has been permitted to adjust the amount of purchase price towards the amount of claim of the secured creditor. Section 13(5C) limits the time up to which property can be held by the secured creditor being the declared purchaser of the property.
Application to chief metropolitan magistrate or district magistrate to assist in taking possession of secured asset:

Section 14 (1) provides for the content of the application to be made to the CMM or DM. CMM or DM may authorize any officer to take possession of the assets and documents and forward them to the secured creditor. The section provides details to be included in the application / affidavit.

As per sec 14 (3) the act of the CMM or DM or any other officer authorized by CMM or DM shall not be called in question in any court or before any authority.

Right to lodge a caveat:

Right to lodge caveat is provided under section 18C. This section provides for both the creditor as well as the borrower to file a caveat where an application or an appeal is expected to be made under section 17(1) or section 17A or section 18(1) or the section 18(B) of the SARFAESI Act.

Registration of subsisting transaction with the central registry:

Under section 23 of SARFAESI the Central Government is empowered to extend the registration of all transactions of securitization, or asset reconstruction or creation of security interest which are subsisting on or before the date of establishment of the Central Registry to register such transactions after coming into force of the Amendment Act and upon issue of another notification by the Central Government in this regard.

The Benefits of the Securitisation

Benefits to the firm

- The right market imperfections are present. This is typically the case when investors lack information about the originators’ operations, or when issuers are constrained by capital or other regulations, or when investors’ choices are constrained, or when the government provides explicit or implicit backing for the issuer's debt.
- Monitoring is not impaired. A financial incentive for the originator to keep defaults to a minimum can be built into the structure of a transaction, and the monitoring role can be assigned to those best able to
undertake it -- not the investors, but the rating agencies, guarantors and trustees.

- The right legal and tax framework exists. Such a framework protects both issuers and investors when certain assets are separated from the originating bank or business.

Benefits to the originator:

a) **Assets removed from the balance sheet.** If structured as a sale, securitization can allow the issuer to reduce its assets and its debt, thereby increasing its scope for borrowing. In effect, securitization allows a bank or business to achieve greater leverage.

b) **Retention of servicing revenues.** The seller normally continues as servicer, retaining the servicing fees, the excess of the SPV’s revenue over costs, and surplus collateral once the ABS are redeemed.

c) **Lower financing costs.** Well-regarded pools of assets owned by a company or bank can be used to structure a security of higher credit quality and, therefore, of lower market cost than the corporate entity could issue itself.

d) **Reduction in required capital.** For a bank or finance company that faces regulatory capital requirements, a securitization transaction that qualifies as a sale of assets for bank-regulatory purposes reduces the need for equity financing. The latter may be costly and hard to obtain, and it may dilute control.

e) **Retention of competitive advantage.** Securitization allows for a reduction in assets without the sale of a business franchise and often with the retention of much of the earning power of the assets.

f) **Nondisclosure.** For privately held companies, securitization can offer a means of raising public debt without extensive disclosure of proprietary information. Instead, disclosure is confined to the characteristics of the assets being securitized and, perhaps, the servicing capabilities of the originator.

g) **Recognition of gains (or losses).** Depending on accounting rules, a securitization structured as a sale of assets may allow a seller to recognize an accounting gain (or loss) equal in the aggregate to the present value of any expected future cash flows payable to the seller that will be derived from the assets.
h) **Improved asset/liability management.** Securitization of assets allows the selling institution to arrange debt issues to fund assets whose payments are perfectly matched to the cash flows on the assets. This transfers the funding-mismatch risk to those more willing or able to bear it, such as those who have an opposite mismatch.

**Benefits to the investors:**

a) **Superior return.** The main benefit from the investor's viewpoint is a higher return or spread than is generally available on corporate or sovereign debt of a similar rating.

b) **Liquidity.** The securitization structure offers far greater liquidity than do the individual loans backing the transaction.

c) **Diversification.** Investors gain an opportunity to diversify their portfolios by participating in a different class of assets.

d) **Mitigation of event risk.** Unlike similar, high-rated corporate bonds, asset-backed securities are largely immune from event risk. The latter results from takeovers, restructurings and other events that effectively alter the credit status of senior unsecured corporate obligations.

e) **Coping with Constraints.** Many institutional investors are constrained to purchase only investment grade securities, and some are limited to triple-A paper. Both requirements can be met in the ABS market.

**Effects on the National Economy**

i. Capital market development, as more high-quality securities are added to the fixed-income market.

ii. A source of funds for rapidly growing, capital-constrained, banks, finance companies and industrial companies whose expansion depends on the extension of credit to their customers.

iii. An expanded source of financing for residential home ownership.

iv. The potential for financing of infrastructure projects, such as toll roads, that produce reliable revenue streams capable of being contractually assigned to a separate legal entity.
Demerits of Securitization process in India

Despite of the various benefit embedded in the securitization this is not firmly rooted in India due to following reasons

(a) **New Concept:** securitization itself is a new concept in debt market. There is lack of awareness not only among the investors but also among the various financial intermediaries. Despite of the fact that securitization process brings immediate benefits to the lending institutions, most of them are not aware of the concept and the advantages in it.

(b) **Stamp duty and Registration Fee**

In a securitization process there is requirement of transfer of various illiquid and non-performing assets to a central agency called Special Purpose Vehicles. This transfer involves heavy stamp duty and registration fees. There is involvement of higher costs which makes discouraged from using this unique technique of financing.

(c) **Complicated Transfer Procedures**

The transfer of assets involves very complicated procedure which comes as an impediment in the way of securitization.

(d) **Difficulty in assignment of debts**

The right to assign debts to third parties has been permitted only under certain circumstances under the Transfer of Property Act and in fact, this transfer/sale of debts forms the central theme of securitization. As a need the Transfer of Property Act should be suitably amended so as to facilitate securitization in India.

(e) **Lack of standardized Loan Documentation:**

There is lack of standardized documentation procedure in India. There is lack of uniformity between different financial institutions regarding the loan documentation even for the same type of loans. As a result it becomes very difficult for an agency like the Special Purpose Vehicle to pool the similar assets of the various financial institutions for securitization.
(f) Inadequate Credit Rating Facilities

Credit rating is inseparable part of securitization. But the credit rating in India is at the infancy level. It is necessary to get credit rating for all debt instruments issues by the non-banking companies. The credit rating agencies are not available in India at present to take up the, stupendous task of credit rating instruments for securitization purposes. However, a good progress has been made in this direction in recent times.

(g) Absence of proper Accounting Procedures

There is need of Proper accounting procedure for securitization. Creation of a Trust or Special Purpose Vehicle is a must for securitization and as such there is no accounting procedure for the recognition of this trust. Again, securitization paves way for the removal of the securitized assets from the Balance sheet of the originator. It is a challenge to the accounting professionals in the country to evolve suitable accounting procedures for securitization.

5.9 An overview of the framework for the assets Securitisation in France and Germany

5.9.1 An overview of the framework in France

A special law was passed in 1988 that introduced asset securitization to the French market and regulated all the aspects of the transactions. The main provisions were embodied in the Monetary and Financial Code ("MFC."

SPV

A special purpose vehicle is the central entity for asset securitization. It buys or acquires interest in the receivables and restructures the receivables by issuing securities. Thus, it works as a pipe into which receivables enter and from which transformed marketable securities exit. The structure of this entity must be both flexible and secure. Flexibility permits a restructuring of the receivables into securities acceptable for investors. Security means that investors can look to the

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receivables as the collateral for their investment and do not have to fear that they will be deprived of priority rights.

French law on asset securitization created a new kind of entity to serve as a special purpose vehicle. The nature of the entity is different from any other entities that were known before in either French corporate law or French general commercial law. It is called a securitization fund (\textit{le fonds commun de créances}) (FCC\textsuperscript{*}). According to the law, the FCC's objective is "the acquisition of receivables and the issuing of units which represent those receivables. Thus the entity is designed specifically and solely for asset securitization.\textsuperscript{219}

| FCC Main Features of Fonds Commun De Créances | Sole object: acquisition of receivables and issue of securities Co-ownership, but unitholders liable only within the limits of their share Some rights of public company shareholders to unitholders No Legal Personality |

The law, as it was initially passed, allowed FCC to issue securities only once and the securities had to be of the equity type. This position evolved over time. According to the current state of regulation, the FCC may issue both equity and debt instruments and more than once. Furthermore, the fund may be divided into several compartments, where each compartment holds its own receivables, issues separate securities and uses only the cash flow from its receivables to pay the securities it has issued. Through this mechanism different cash flow structures may be offered to investors without needing to establish a number of different funds, yet still within the framework of the same fund. Finally, the law permits separating cash flows from principal and interest by giving different rights over the two. This contributes to an even wider array of possible securities' structures.

The life and activities of the FCC are organized by two entities. A management company and a legal entity acting as a custodian of the fund's assets jointly set up a securitization fund. The management company organizes the transaction, gets the receivables, structures securities, and markets them. This can be any commercial company, but it has to receive an authorization from the Financial

\textsuperscript{219} CODE MONETAIRE ET FINANCIER [C. MON. ET FIN.] art. L214-43 (Fr.).
Markets Authority. Moreover, the management of securitization funds must be the sole business of this company, it cannot engage in any other activity. Accordingly, it must earn all its income from the management of funds, which encourages the company to reach for maximum efficacy.

The law does not restrict the number of funds that can be managed by one company. Therefore the management company does not have to be a one-time establishment for the lifetime of one FCC. Instead it may gain expertise and specialize in the activity by managing different funds. Such requirements ensure specialization and efficiency in the industry of asset securitization.220

The second entity involved in the life of the FCC is the custodian. The custodian has to open an account for the FCC in which it will keep the FCC's assets.90 The law prescribes that the custodian may be either a credit institution approved in France, a French branch of a credit institution having its registered office in a European Economic Area Member State, or any other institution approved by the Minister for the Economy. Each of these alternatives falls under tight supervision of competent authorities (such as determined by the law). Credit institutions are usually subjected to strict requirements and scrutiny of supervisory authorities. Additionally, if any non-credit institution wishes to get involved in this activity, it will be supervised by the Ministry of the Economy.221

**Transfer of Receivables**

Transfer of receivables is another major issue that arises when structuring asset securitization transactions. The intangible nature of receivables makes their possession and ownership less evident than that of tangible assets. Therefore traditional rules of tangible property cannot be applied, but special regulation must address these issues

The traditional way of transferring receivables in France is cession. The cession in French law has in personam nature, and "the right to a claim is a personal right. In personam nature means that the relationship is as between persons,

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220 C. MON. ET FIN. Art. L214-48(II) (Fr.).
where one has a right to request performance of an obligation and another has a duty to perform it. However this relationship is not connected to any specific thing. Thus in French law, the receivable is not regarded as a piece of property, but rather as a combination of rights and obligations between persons.

When faced with the challenge of creating rules for asset securitization, the French legislature decided that none of the existing methods for the transfer of receivables was good enough. Therefore a new kind of assignment was created, which is performed by delivering a transfer deed (bordereau). The assignment takes effect between the parties and becomes enforceable against third parties on the date affixed on the transfer deed when it is handed over. Additionally, the law underlines that this takes effect regardless of the receivable’s origination date, maturity date or due date, and without any other formality being necessary.’ Such a structure ensures the investors that once a transfer deed is delivered to the SPV it is the only prerequisite required and the transfer is effective between the parties as well as against third persons. This way the receivables are transferred without the burden of formalities attached to the cession transaction.

Since assignment is performed by delivery of a deed, certain requirements are applicable to this document. The deed must be named an 'act of assignment of receivables', it must indicate that it is subject to the provisions of the Monetary and Financial Code dealing with asset securitization, the name of the assignee must be included, and the assigned receivables must be indicated and identified. The peculiarity of the French formulation is that such a deed is not regarded as a contract in the sense that it is not a document prepared by two parties - assignor and assignee - together. In fact, the assignee is not even required to sign it. Instead it is the assignor, who determines the contents of the document and performs the transfer by handing in the document to the assignee. Once the assignee has the deed, it has all rights to the specified receivables.

In summary, the concept of cession in French law is not suitable for asset securitization. Seeing this, the French legislature came up with a new way to transfer receivables, unburdened by formalities and completed by a mere transfer of a document. However, the transfer is restricted to the sale of
receivables to the SPV and the law and its resulting uncertainties limit the kinds of receivables that can be used in French securitization transactions.

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<thead>
<tr>
<th>The mechanism</th>
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<td>The way of transfer</td>
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<tr>
<td>Options</td>
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<td>Receivables</td>
<td>Future receivables</td>
<td>Uncertain</td>
</tr>
<tr>
<td>Global assignment</td>
<td>Not possible</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>A deed must be delivered</td>
<td></td>
</tr>
</tbody>
</table>

The Transfer of Receivables in France, Summary

Transfer of Collateral

The peculiar feature of receivables most often used in asset securitization transactions is that their payment is ensured through certain tangible property. Specifically, certain property usually serves as collateral for creditor interests until the receivables are redeemed.

Once receivables are transferred from the originator to the SPV, the issue arises as to the destiny of the underlying collateral, which in turn directly influences the quality of the receivables. If, upon transfer, the collateral is lost, the new creditor cannot look to it in case the debtor defaults. Such a solution would be hardly acceptable for asset securitization transactions; therefore, it is important to see if the new creditor can acquire the rights to collateral together with the receivables.

Initially, the position of the French law regarding the transfer of collateral over securitized receivables was not clear. Doubts were raised since, according to the law, the sole and exclusive purpose of the French SPV (the FCC) was to acquire receivables. However, because the FCC was not supposed to acquire any other kinds of property, the question arose whether sureties and collateral form an
integral part of receivables, or whether they are a different kind of property and must thus be treated as separate objects.

This issue was clarified by the legislature through later amendments to the law. The current formulation provides that the delivery of the transfer deed automatically gives rise to the transfer of sureties, the collateral, and any ancillaries attached to each receivable including mortgages. Additionally, such transfer of collateral is enforceable against third parties without any other formality being necessary.

These provisions highlight several important issues. First, sureties and collateral form an integral part of a receivable and once the receivable is transferred, they also pass together with the receivable to the new creditor. Second, the transfer of sureties and collateral becomes enforceable against third parties after the new creditor receives the delivery deed. This solution is very favorable to the party acquiring the receivables. It means that once the transfer is effected between the two parties (assignee and assignor), it becomes binding on third parties (providers of sureties and collateral). One may note that this is the same consequence as in the case of the transfer of receivables where a third party - the debtor - becomes the debtor of the assignee. However, the peculiarity, in respect to collateral, is that usually mortgages have to be registered in a registry. If the transfer of mortgages becomes effective after delivery of the deed, without any need to inform the registry, the records of the registry become unreliable.

Thus, the French legal framework ensures that in securitization transactions the collateral passes to the FCC together with the receivables. No additional steps are required. Though some uncertainties remain for the registration system, these should not affect the success of asset securitization.

**Notification of the Debtor**

One more issue that arises after the receivables are transferred to the assignee is whether the debtor must be informed about the assignment. The law may require notification to the debtor as a means of protecting the debtor from being exposed to unknown creditors. However, in the context of asset securitization such a requirement would hamper the transaction.
The rules of French law on cession require that notification be made to the debtor. The legislature took a formal approach considering the debtor to be properly informed only if certain rules are complied with. The actual effect of the notification is not important, as long as the rules are followed. Moreover, the rules are quite complicated and have led to much jurisprudence trying to determine how they must be complied with. Such rules are too cumbersome and uncertain to be used in commercial transactions. For this reason the legislature made a separate set of rules applicable to the assignment of receivables for securitization purposes.

The laws on asset securitization do not require that the debtor be notified once receivables are transferred. The transfer is completed by the agreement between the assignor and the assignee and no involvement of the debtor is required. Such an approach seems very appropriate, since in securitization transactions there are usually tens or hundreds of thousands of receivables transferred. The requirement to contact each of the debtors to inform them about the transfer, or ask for their consent would simply be impractical. The increase in time and costs could erase the profitability of asset securitization.

The pro-securitization approach of the French legislature led to rules which release the creditor from formally notifying the debtor of an assignment of receivables. Instead, the legislature provided a simplified procedure of informing the debtor by ordinary letter when a new creditor wants to cause the debtor to make payments to a different account.

5.9.2 An overview of the framework in Germany

Modern asset securitization transactions only became known by German credit institutions in the 1990s when the first such transaction was carried out.

It took five years until the second transaction. This was because of the negative approach of the German banking supervisory authority, which frowned on asset securitization and claimed that it may have detrimental effects for German credit institutions. Its position changed only in 1997, when it issued a circular letter and enumerated the criteria with which a transaction must comply to be acceptable and permissible. The commercial companies in Germany did start to securitize their receivables a few years earlier.
However, the turnover of those securitization transactions was much more modest than the transactions that were conducted by German banks after the permission was granted to them.

Since the German legislature has not created any specific framework for asset securitization transactions these transactions have to be conducted on the basis of general laws. Germany is a civil law country and the concept of a trust is not endorsed in German law. Thus, arrangers of securitization have to choose from entities designed for other commercial purposes or look to foreign common law jurisdictions and use foreign trusts. It also appears that some originators are more capable than others in making use of alternatives to the nonexistent trust vehicle. This distinction is particularly clear between banks and corporate originators.222

In Germany there is no entity that can fully perform the functions of an SPV. As a result, businesses use foreign SPVs or resort to using a private commercial company as a domestic alternative. However, this solution can only be taken by banks. Other commercial companies have serious difficulties in accessing capital markets.

**Transfer of Receivables**

Transfer of receivables in Germany is conducted on the basis of general commercial laws because Germany lacks special laws on asset securitization. German law provides three mechanisms for the transfer of receivables:

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novation, sub-participation, and cession Novation means "the replacement of each receivable agreement between [a debtor] and the originator by a new agreement made between the [debtor] and the [SPV] on the same terms." Accounting for the fact that securitization usually involves transferring tens or hundreds of thousands of receivables, novation of all of them would be simply infeasible. sub-participation, ":[an SPV] or another third party as a new creditor to [the debtor] joins the contract between the originator and its [debtors]."

However, the new creditor has no direct collection rights against the debtor and the title to underlying receivable remains with the originator. Thus it is not well suited for asset securitization because without the transfer of the title the receivables cannot be safeguarded against the bankruptcy estate of the originator.

The German concept of cession is peculiar in that it has an in rem (dingliche) nature. Therefore, it has the effect erga omnes, even if specific formalities are not respected. 83 In other words, the receivable is treated as a piece of property; thus, even if the requirements as to the form of the contract are not properly followed, the parties still retain their obligations against each other. At the same time, such nature of the contract leaves some space for variations; e.g., a failure to notify the debtor about cession of his debts does not void the transaction.

As defined in the German Civil Code, cession is the transfer of a receivable, accomplished by an agreement between the original creditor and the new creditor, whereby the new creditor steps into the place of the original creditor. The definition reveals that only an agreement between the original and the new creditor is needed for cession. The participation of the debtor is neither required nor envisaged. Also, the new creditor acquires all the same rights to the receivables that the original creditor had. Thus the new creditor becomes the true creditor in respect to the debtor - he is entitled to receive all the money and take required actions without resort to the original, now former, creditor. Because of these features, the cession is the most suitable way to transfer receivables for asset securitization. The way receivable assignment is introduced in the Civil Code, the new creditor takes over all the powers from the original creditor. 190 As the new creditor steps into the place of the original,
the latter steps out of that place. Thus, on their face, these provisions are meant to regulate the sales of receivables.

However, the nature of cession in German law permitted the creation of fiduciary assignment practices. Fiduciary assignment is the assignment of a receivable to the new creditor, but for security purposes only. The transferee cannot execute upon it except in cases of default, and the transferee is also under a duty to return the receivable upon the redemption of obligation. This way, in German asset securitization both the sale of receivables and the creation of security interests over them is known.

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<thead>
<tr>
<th>The mechanism</th>
<th>Nature of cession</th>
<th>In rem</th>
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<tr>
<td>The way of transfer</td>
<td>Cession</td>
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</tr>
<tr>
<td>Options</td>
<td>Both sale and security interest</td>
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</tr>
<tr>
<td>Receivables</td>
<td>Future receivables</td>
<td>Permitted</td>
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<td></td>
<td>Global assignment</td>
<td>Permitted</td>
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<td></td>
<td>Revolving receivables</td>
<td>Individual examination in case of banks</td>
</tr>
<tr>
<td>Other</td>
<td>Confidentiality requirements for banks</td>
<td></td>
</tr>
</tbody>
</table>

The Transfer Of Receivables In Germany

The nature of German cession permits both sale and creation of security interests over receivables. At the same time it allows various kinds of receivables in securitization transactions to be used. Nevertheless, some limitations arise from administrative authorities and court decisions.

**Transfer of Collateral**

The rule in German law is partially similar to the one in French law. The Civil Code states that sureties and mortgage rights pass to the assignee together with the receivables for which they exist. This rule is created in correspondence with another provision, which prohibits transferring receivables, if such a transfer needs modifications to the original contract between the debtor and the originator. This means that the transfer of sureties and mortgage rights per se does not require modifications to the original contract. Therefore they can be transferred and pass to the new creditor together with the receivables over which they are created.
However, the peculiarity of German law is that not all collateral is treated equally. Instead it is divided into accessory (abhangig) and non-accessory (unabhangig) collateral. Accessory collateral is understood to be one that is needed for a new creditor to exercise his rights as the owner of receivables. Into this group falls collateral that is created through mortgage, ship mortgage and pledge. This kind of collateral is automatically transferred to the new assignee.

The collateral defined as non-accessory is one, which according to German law, is not so closely connected and therefore independent from the receivables which it ensures. A majority of authors agree that collateral created through land mortgages (Sicherungsgrundschuld) falls into the category of non-accessory collateral. This kind of collateral does not follow the receivables automatically. Nevertheless, it can also be assigned through a separate agreement between the originator and the SPV. Additionally, an agreement on land mortgage must be registered in an appropriate registry.

Thus, in Germany, passage of collateral together with receivables is not direct in all cases. Only collateral that is neither land nor real estate automatically passes together with receivables to the SPV. Additional steps are required for mortgages on land and real estate. Nevertheless, the industry has come up with certain solutions to evade these additional steps.

**Notification of the Debtor**

German law provisions on cession accept a transfer of receivables without notifying the debtor. However, if the debtor is unaware of the transfer, he will fulfill his obligation to the originator. As was already explained in the previous section of this article, this may be convenient and acceptable as long as the originator is in good financial health. Then the originator can perform the function of the servicer and pass the payments to the assignee.

The law does not entail specific rules to determine how notice of assignment is to be given. Instead, it relies on the concept of effective knowledge. Specifically, the party willing to prove notification, has to show that whatever was the way of communication, the debtor had the knowledge that the debt was ceded. From the moment of notification the debtor cannot relieve his obligation by paying to the old creditor: the payments have to be made to the new creditor.
The nature of the German cession permits it to be done without notification to the debtor. However, if the new creditor decides to inform the debtor, there are no specific provisions on how it has to do so. The only requirement is that the debtor becomes aware of the transfer; thereafter he is bound by the notification.

**Summary of the chapter**

One of the objectives of Securitization is to ensure that the creditors of a company who have sold their assets to the special purpose vehicle will have no claim against the SPV in the event of the company becoming bankrupt. In order to separate the securitized assets from the seller’s potential bankruptcy, in the US, the SPV must be “bankruptcy remote” from the originator and the transfer of assets to the trust or the SPV must be accomplished by “true sale”. Where the SPV is owned or controlled by the originator, it must meet certain requirements to assure that its assets are isolated from the bankruptcy risk of the originator. They are laid down as follows:

The SPV’s business activities must be strictly limited to those necessary to carry out the securitization. The SPV must have its own board with independent directors, and the SPV’s organizational documents must restrict its ability to place itself into bankruptcy without approval by a requisite number of independent directors. The SPV must maintain separate assets, bank accounts and recording keeping. The SPV must pay its own expenses out of its own funds. The originator must disclose to its creditors that the assets of the SPV are separate and not available to satisfy their claims. There should not be inter-company guarantees, and all other dealings between the originator and the SPV should be conducted on an arms’ length basis.

‘Securitization’ is designed to offer a number of advantages to the seller, investor and debt markets. For seller or originator, securitization mainly results in receivables being replaced by cash thereby improving the liquidity position. It removes the assets from the balance sheet of the originator, thus liberating capital for other uses, and enabling restructuring of the balance sheet by reducing large exposures or sectoral concentration. It facilitates better asset liability management by reducing market risks resulting from interest rate mismatches. The process also enables the issuer to recycle assets more
frequently and thereby improve earning. Finally, transparency may be improved since securitization results in identifiable assets in the balance sheet. In the process of securitisation the underlying assets are mainly secured loans like housing loans, auto loans, commercial vehicle loans, construction equipment loans, two-wheeler loans, tractor loans, three-wheeler loans and unsecured loans like personal loans, consumer durable loans.

Features of Securitization:

(a) There is transfer of all the risks and rewards associated with underlying pool to the buyer.

(b) The structure of transaction should be such that the bankruptcy of the seller does not affect the underlying pool;

(c) No recourse to the seller once the underlying pool is sold.

Asset securitization, though very beneficial, is a complicated mechanism. It relates to several branches of law and requires certain leeway’s in order to be conducted. Some specificities of asset securitization create particular challenges for civil law jurisdictions attempting to adopt mechanisms developed in common law jurisdictions, but being unable to do so because of the differences in the legal systems. The challenges discussed in this paper are: (1) the creation of a special purpose vehicle, (2) the flexibility of the mechanism for the transfer of receivables, (3) the transfer of collateral securing the payment for receivables, and (4) the requirement to notify the debtor about transfer of receivables. The major difference between French and German regulation on these issues is that one jurisdiction has passed specific legislation for this purpose whereas the other relies on general laws. This difference determines the availability of required mechanisms as well as their flexibility.

The SARFAESI Act 2002 was brought with an objective to empower the banks and financial institutions by arming them with the right to enforce security interest without the intervention of the court.

As compared to other jurisdiction with regard to the Securitisation the framework is different. French law has provided mechanism by creating a new entity specifically to be used for asset securitization-the FCC. The legislature considered possible issues that may arise and incorporated them into the law on
the FCC. First, the structure of the FCC ensured its bankruptcy remoteness. Absence of a legal personality as well as special accounts with the servicer served this purpose well. Second, allocation of control over the FCC is meant to preserve it from mismanagement. While the management company performs FCC's everyday business, the custodian holds on to its funds and at the same time supervises the actions of the management company. Third, the creation of the special vehicle permitted the legislature to deal with the rights of investors. The legislature could choose which rights are essential for investors and permit them to supervise their investments. Thus, other rights that may be of importance to shareholders in a company but should not be exercised by investors in the FCC could be distinguished. Altogether the FCC was constructed to perfectly suit the needs of asset securitization.

The different approach of the German legislature led to a different result. Absent a domestic entity appropriate for asset securitization, German originators have to look to foreign jurisdictions. The French law demonstrates a pro-securitization approach by stating that the collateral is automatically transferred to the FCC as soon as receivables are sold to it. In Germany this problem is approached differently. The collateral is distinguished into accessory and non-accessory. Of these two, the former passes to the assignee together with receivables, whereas additional steps are required for the latter. These steps tackle the registry problem and oblige parties to make adequate records in the registry books when mortgages are transferred. At the same time, this requirement creates a burden on the transaction. Therefore, the parties look for ways to overcome them.

Securitization, if carried out in true spirit, leads to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. This is a great boon to the regulating authorities as well since their primary objective is to prevent the accumulation of capital where it is not needed. In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrowers. There is no doubt that securitization is a low cost and innovative funding source ensuring economy in the use of capital.
The above graph displays the trend of the Non-Performing Assets in the Indian banking sector. One trend is very clear that there is consistent rise in level of the non-performing assets. This result shows that that despite the enactments of various Legislations and policy framework the situation has been the same. The SARFAESI Act, 2002 was brought with an aim to enforce the security interests for recovery in a stronger manner without the intervention of the court.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lok adalat</th>
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<tr>
<td>2002-03</td>
<td>16</td>
<td>7</td>
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The data analysis mentioned above reveals that the mechanism of debt recovery brought under the SARFAESI Act, 2002 has not been successful in yielding the desired result. In the year 2016-17 it is evident that the lowest NPA recovery has been through the SARFAESI Act 2002.

A modern insolvency law is essential in a market economy. It provides enterprises that are insolvent with an orderly means of exit from the market. Moreover, enterprises in financial difficulty but potentially viable will be given an opportunity to restructure. Most importantly for present purposes, banks and financial institutions may be able to recover their outstanding loans by threatening reorganisation or insolvency proceedings. It is vital that both liquidation and reorganisation are determined by financial considerations, and not guided by political and social considerations. If the reorganisation of a debtor company appears to be financially viable, then it must be pursued in order to restore its profitability and to maintain its work force in employment. If, however, a reorganisation were not viable, the enterprise must be wound up.

But as the popular adage goes, ‘no law is a complete law’, even the SARFAESI Act, 2002 has its own loopholes. SPVs still have an enforcement issue because a secured creditor was defined with reference to banks and financial institutions.