VINOD KOTHARI CONSULTANTS PVT. LTD.

SECURITISATION GUIDELINES, 2012

(with Commentary by Vinod Kothari)

Vinod Kothari Consultants Private Limited

Kolkata Office
1012, Krishna Building
224 A.J.C. Bose Road
Kolkata – 700017
Ph.no. -22817715/1276/3472

Mumbai Office
222, Ashoka Shopping Centre
2nd Floor, LT Road, near GT Hospital
Mumbai – 400 001
Ph.no. - 22675600

SECTION A

GUIDELINES ON SECURITISATION OF STANDARD ASSETS

1. REQUIREMENTS TO BE MET BY THE ORIGINATING BANKS

1.1 Assets Eligible for Securitisation

In a single securitisation transaction, the underlying assets should represent the debt obligations of a homogeneous pool of obligors[1]. Subject to this condition, all on-balance sheet standard assets[2], except the following, will be eligible for securitisation by the originators:

(i) Revolving credit facilities (e.g. Cash Credit accounts, Credit Card receivables etc.)

(ii) Assets purchased from other entities

(iii)Securitisation exposures (e.g. Mortgage-backed/asset-backed securities)

(iv)Loans with bullet repayment of both principal and interest[3].

Comments

Transfer of non-performing assets:

The Guidelines contemplate on securitisation of performing assets only; transfers of non-performing assets are covered by separate guidelines. The Guidelines were originally propounded in July 2005 and are subsequently subsumed in master circulars issued in the first week of July every year.

Certain restructured loans are treated as sub-standard. Hence, such loans also will not be eligible for securitisation under these Guidelines.

In the past, several transactions of securitisation or portfolio sales have taken place where the pool consists of a mix of performing and non-performing loans. Question arises – is such a sale permissible under the Guidelines? As we discuss later, the Guidelines cannot be taken as setting a regulatory rule of what can or cannot be done. The Guidelines explicitly make a reference to capital relief – if the parties do not desire any capital relief, there is no reason why such a sale is not permissible.

---

[1] The single asset securitisations do not involve any credit tranching and redistribution of risk, and therefore, are not consistent with the economic objectives of securitisation.

[2] In these guidelines the term loans/assets have been used to refer to loans, advances and bonds which are in the nature of advances as defined in para 2.1 (vii) of Master Circular – Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by banks dated July 1, 2011

[3] Loans with tenor up to 24 months extended to individuals for agricultural activities (as defined by Rural Planning and Credit Department of the Reserve Bank of India, in the Master Circular - Lending to Priority Sector) where both interest and principal are due only on maturity and trade receivables with tenor up to 12 months discounted/purchased by banks from their borrowers will be eligible for securitisation. However, only those loans/receivables will be eligible for securitisation where a borrower (in case of agricultural loans) /a drawee of the bill (in case of trade receivables) has fully repaid the entire amount of last two loans/receivables (one loan, in case of agricultural loans with maturity extending beyond one year) within 90 days of the due date.

Implication of the term "homogenous"

See above for comments on the meaning of "homogenous". The use of the expression "homogenous pool of obligors" is perhaps a casual language – it is not obligors who are homogenous. It is assets which are.

However, repeated stress has been laid on the term "homogenous", but it is difficult to stretch the reference beyond a certain point. Every homogenous pool is intrinsically heterogeneous, constituted by diversified assets. The extent of diversification in the pool is the measure of heterogeneity. For example, a pool of residential mortgage loans is a homogenous pool, but that does not mean all borrowers are alike.

Homogenous pool contains same type of collateral, e.g. car loans, home loans, corporate loans, etc. and indicate the loans sharing similar risk characteristics from viewpoint of internal classification by the bank.

The excluded assets

Single Loans

Single loans cannot be securitized-the underlying assets should represent the debt obligations of a homogenous pool of obligors. In other words, a single loan is not securitisable – though a single loan may be subject matter of a direct assignment covered by Section B.

The essential idea of securitisation is to use structured finance principles. The question of slicing the risk of a single loan into layers does not arise at all – hence, it is understandable that the Guidelines do not permit securitisation of a single loan.

Revolving credit facilities

Revolving credit facilities are the most common form of credit facilities, e.g. cash credit or credit cards. These symbolize a line of credit where the customer is allowed to draw upto a limit and has the liberty to repay the credit any time. Once the credit is paid back, the credit limit gets restored. Securitisation of revolving credit facilities is complex, and regulatory capital standards world-over realize that the securitisation of these assets throw a liquidity risk on the originator. Under Basel II language, these assets are called "controlled" or "committed" facilities.

An important point to be noted here is that the Guidelines do not impose any restriction on ***revolving structure***[4] *of securitisation.* Revolving structures may be a good answer to the problems created by the Guidelines by way of minimum holding period (MHP).

Purchased Assets

The Guidelines have prohibited securitisation of purchased assets. Coupled with restriction on securitisation of MBS/ABS, purchased whole loans, or fractional interests, the Guidelines contain a total restriction on resecuritisation.

As far as the exclusion of assets purchased from other entities are concerned, the straight bar seems to be unreasonable. There may be cases where the bank had bought the entire portfolio long time

[4] To know about the revolving structure of securitisation, refer page 91 of the book *Securitization: The Financial Instrument of the Future* by Vinod Kothari

back, and might have even added its own funding; or a bank might have bought different loans from different sellers, and may now want to resell the pool. Therefore, proper recourse would have been to impose MHP requirements for these assets instead of a straight-away restriction on securitisation of the purchased assets. To add to the rigour of the restraint, the prohibition becomes retroactive; since the assets bought prior to the new Guidelines cannot be securitised post the Guidelines.

It may be also be quite often difficult to identify what exactly are purchased assets. The originator may have lent his own money to an asset acquired a long time back.

However, there is no bar on securitisation of participation rights, or syndicated loans and loans acquired on purchase of entire portfolio of a bank exiting business..

Securitisation exposures: ABS/MBS

Securitisation of Asset-backed securities and Mortgage-backed securities is barred.

During the boom-time of CDO pre 2007 crisis, there was a huge activity in the market called *structured finance CDOs* - these were repackaging of ABS/MBS exposures, basically mezzanine or lower tranches.

The Guidelines do not leave any scope for pooling together of mezzanine tranches. However, the restraint is not absolute – it is only applicable to banks/financial institutions or other entities covered by the Guidelines. This does not stop entities other than the entities in financial system to acquire, pool and securitize mezzanine tranches.

Loans will bullet payments

Loans with bullet payments have been defined under the Guidelines to mean loans where both interest and principal are payable on maturity. However, in general terms, a bullet loan is one where only principal is payable on maturity while interest may be serviced regularly. The idea of excluding the bullet loan from the allowed category of assets is understandable- in the absence of any principal/interest payments during the MHP, there is no demonstration of the quality of the loan; hence seller has not taken any risk at all.

It may also be noted that the prohibition has been fraught with too many exceptions and sub-exceptions. For example, agricultural loans of upto 24 months maturity where the borrower has paid, within 90 days of due date, past two loans of maturity upto 1 years or past one loan with maturity of more than 1 year: such loans are outside the purview of exemptions. Further, trade receivables of tenure upto 12 months, discounted or purchased by banks are also non-exempted provided the obligor/drawee has paid last 2 receivables within 90 days of due date.

The Transferee

The Guidelines do not specify any transferee; however an implicit understanding is that the transferee is a Special Purpose Vehicle.

1.2 Minimum Holding Period (MHP)

1.2.1 Originating banks can securitise loans only after these have been held by them for a minimum period in their books. The criteria governing determination of MHP

for assets listed below reflect the need to ensure that:

- the project implementation risk is not passed on to the investors, and
- a minimum recovery performance is demonstrated prior to securitisation to ensure better underwriting standards.

1.2.2 Banks can securitise loans only after a MHP counted from the date of full disbursement of loans for an activity/purpose; acquisition of asset (i.e., car, residential house etc.) by the borrower or the date of completion of a project, as the case may be. MHP would be defined with reference to the number of instalments to be paid prior to securitisation. MHP applicable to various loans depending upon the tenor and repayment frequency is given in the following table[5].

	Minimum number of instalments to be paid before securitisation			
	Repayment frequency – Weekly	**Repayment frequency – Fortnightly**	**Repayment frequency – Monthly**	**Repayment frequency – Quarterly**
Loans with original maturity up to 2 years	Twelve	Six	Three	Two
Loans with original maturity of more than 2 years and up to 5 years	Eighteen	Nine	Six	Three
Loans with original maturity of more than 5 years	-	-	Twelve	Four

1.2.3 The MHP will be applicable to individual loans in the pool of securitised loans. MHP will not be applicable to loans referred to in foot note 3 of para 1.1.

[5] Where the repayment is at more than quarterly intervals, loans can be securitised after repayment of at-least two instalments.

Comments

As per the guidelines, Minimum Holding Period (MHP) runs from the date of full disbursement or purchase of the asset (in case of asset-backed loans) to the date of transfer. MHP requirements have been laid down with reference to the number of instalments to be paid prior to securitisation- therefore, the instalments payable before full disbursement or purchase of the asset are to be ignored.

Applicability of MHP to the loan and not to the borrower

Minimum holding Period, under the guidelines, has been made applicable to loan and not to borrower. For example, if the borrower repays the existing loan and takes a new loan, the new loan cannot be sold. There may be, at times, difficult questions involved. As for instance, the borrower takes a loan, and before maturity, an add-on loan is given. The question may arise as to whether the whole loan can be securitised. The answer should be in positive.

What will determine whether the loan is a new loan, or an extension or an add-on to a new loan? Certainly, the same cannot be determined with reference t the documentation –whether there is a new loan agreement or the existing loan agreement has been used. It should essentially be a question of substance – if the new loan forms a bulk of the total outstanding amount, it should substantively be taken as a new loan, even if it is shown as an add-on to an existing facility.

Questions will also arise in case of restructured loans. A restructured loan is not a new loan – the benefit of track record which is the objective of the Guidelines would have been served.

Track record – whether based on payments due or payments paid:

Questions may arise as to whether the number of instalments mentioned in the MHP requirements are instalments due or instalments actually paid. Note the language of para 1.2.2 – "number of instalments to be paid prior to securitisation". The idea of the Guidelines is to give the benefit of track record – not whether the record is good or bad.

Applicability of MHP to individual assets

Minimum Holding Period has been made applicable to individual loans in the pool of securitized loans. In other words, all the assets in the pool must comply with the MHP requiemenets. Therefore, assets not complying with MHP are to be filtered out.

Inapplicability of MHP

Minimum Holding Period is not applicable to bullet loans that are eligible for securitisation, viz. agricultural loans extended to individuals having a tenor upto 24 months where both interest and principal are due only on maturity; and trade receivables with tenor up to 12 months discounted/purchased by banks from their borrowers. In these cases, track record of performance is seen with reference to previous payments. However, it is obviously important that the borrower must have had past track record with the originator.

1.3 Minimum Retention Requirement (MRR)

1.3.1 The MRR is primarily designed to ensure that the originating banks have a continuing stake in the performance of securitised assets so as to ensure that they carry out proper due diligence of loans to be securitised. In the case of long term loans, the MRR may also include a vertical tranche of securitised paper in addition to the equity/subordinate tranche, to ensure that the originating banks have stake in the performance of securitised assets for the entire life of the securitisation process. The originating banks should adhere to the MRR detailed in the Table below while securitising loans:

Minimum Retention Requirements at the Time of Securitisation

Type of Loan	**MRR**	**Description of MRR**	
Loans with original maturity of 24 months or less	**5%** of the book value of the loans being securitised	(i) Where securitisation involves **neither credit tranching nor any first loss credit enhancement** by originators	Investment in the securities issued by the Special Purpose Vehicle (SPV) equal to 5% of the book value of the loans being securitised.
		(ii)Where securitisation involves no credit tranching, but involves **originators providing first loss credit enhancements** e.g. Off-balance sheet supports, cash collaterals, overcollateralisation etc.	The originator would be providing the required credit enhancement. If the first loss credit enhancement required is less than 5%, then the balance should be in the securitiesissued by the SPV.
		(iii) Where securitisation involves **credit tranching but no first loss credit enhancement** from originator	5% in equity tranche. If equity tranche is less than 5% then balance pari-passu in remaining tranches.
		(iv) Where securitisation involves **credit tranching and first loss credit enhancements by originator** (off-balance sheet supports, cash collaterals, overcollateralisation etc.)	If the first loss credit enhancement is less than 5%, then balance in equity tranche. If first loss credit enhancement plus equity tranche is less than 5%, then remaining pari-passu in other tranches.

Loans with original maturity of more than 24 months	**10%** of the book value of the loans being securitised	(i) Where securitisation involves **neither credit tranching nor any first loss credit enhancement**	Investment in the securities issued by the SPV equal to 10% of the book value of the loans being securitised.
		(ii) Where securitisation involves no credit tranching, but involves first loss credit enhancements from originators, e.g. off-balance sheet supports, cash collaterals, overcollateralisation etc.	The originator would be providing required credit enhancement. If this is less than 10%, then balance in the securities issued by the SPV.
		(iii) Where securitisation involves **credit tranching but no first loss credit enhancement from originator**	5% in equity tranche or less if the equity tranche is less than 5%. The balance (10% - investment in equity tranche) pari-passu in other tranches issued by the SPV.
		(iv) Where securitisation involves **credit tranching as well as the first loss credit enhancements by originators** (off-balance sheet supports, cash collaterals, overcollateralisation etc.)	i) If the first loss credit enhancement is more than 5% but less than 10%, then balance pari-passu in securities including equity tranche issued by the SPV. ii) If the first loss credit enhancement is less than 5%, then in equity tranche so that first loss plus equity tranche is equal to 5%. Balance pari-passu in other tranches (excluding equity tranche) issued by the SPV so that the total retention is 10%.
Bullet repayment loans/receiv a bles referred to in foot note 3 of para 1.1	10% of the book value of the loans being securitised	(i) Where securitisation involves **neither credit tranching nor any first loss credit enhancement** by originators	Investment in the securities issued by the SPV equal to 10**%** of the book value of the loans being securitised.
		(ii) Where securitisation involves no credit tranching, but	The originator would be providing the required credit enhancement. If the first loss credit

		involves **originators providing first loss credit enhancements** e.g. off-balance sheet supports, cash collaterals, overcollateralisation etc.	enhancement required is less than 10%, then the balance should be in the securities issued by the SPV.
		(iii) Where securitisation involves **credit tranching but no first loss credit enhancement** from originator	10% in equity tranche. If equity tranche is less than 10%, then balance pari-passu in remaining tranches.
		(iv) Where securitisation involves **credit tranching and first loss credit enhancements by originator** (off-balance sheet supports, cash collaterals, overcollateralisation etc.)	If the first loss credit enhancement is less than 10%, then balance in equity tranche. If balance is greater than equity tranche, then remaining pari-passu in other tranches.

1.3.2 MRR will have to be maintained by the entity which securitises the loans. In other words, it cannot be maintained by other entities which are treated as 'originator' in terms of para 5(vi) of the circular dated February 1, 2006 containing Guidelines on Securitisation of Standard Assets.

1.3.3 The MRR should represent the principal cash flows. Therefore, banks' investment in the Interest Only Strip representing the Excess Interest Spread/ Future Margin Income, whether or not subordinated, will not be counted towards the MRR.

1.3.4 The level of commitment by originators i.e., MRR should not be reduced either through hedging of credit risk or selling the retained interest. The MRR as a percentage of unamortised principal should be maintained on an ongoing basis except for reduction of retained exposure due to proportionate repayment or through the absorption of losses. The form of MRR should not change during the life of securitisation.

1.3.5 For complying with the MRR under these guidelines banks should ensure that proper documentation in accordance with law is made.

Comments

Categories of Minimum Retention Requirements

The Guidelines impose Minimum Retention Requirements (MRR) on the basis of original maturity of loans. MRR has been fixed at 5% of the book value of the loans being securitised, for transactions with original maturity of 24 months or less and 10% of the book value of the loans being securitized for transactions with original maturity exceeding 24 months. These are further sub-categorised into four categories-

i. Where there is neither tranching nor first loss credit enhancement.
ii. Where there is no credit tranching but there is first loss credit enhancement from the originator.
iii. Where there is credit tranching but there is no first loss credit enhancement from the originator.
iv. Where there is tranching as well as first loss credit enhancement.

However, the guidelines have not properly appreciated conceptual distinction between first loss credit enhancement and tranching. For example, if there are Senior and Junior securities, the retention of junior securities by the originator is nothing but first loss support.

Precise MRR Requirements

i. In case where there is neither tranching nor first loss credit enhancement, MRR to be calculated at the straight rate prescribed, i.e. 5% or 10% (RMRR %) as the case may be.

ii. Where the originator provides first loss credit enhancement, but no tranching is involved in the securitisation transaction then MRR will be the whole of the first loss support. If first loss support is lower than 5% or 10%, then MRR=(RMRR –First Loss)% of securities.

iii. In case there is tranching, but the originator does not provide any first loss credit enhancement, MRR=RMRR% of the value of securitised pool in the equity tranche. If equity tranche is less than RMRR, MRR=(RMRR-equity tranche)% of securities

iv. Where both tranching and first loss credit enhancement are involved, MRR= Total exposure of the originator in first loss support plus equity tranche. If this is less than 5%, balance is to be provided in senior securities.

It should be noted that the Guidelines does not mandatorily expose the originator to first losses upto RMRR%. The only principle involved is that a first loss support must necessarily come from the originator; likewise, equity tranche at least upto RMRR% must be held by the originator. In cases where the transactions provide for RMRR%, the originator invests in a vertical tranche. Therefore, in essence, what Guidelines lay down is a combination of horizontal + vertical tranche – the so-called L tranche.

What all may count as MRR

MRR should be based on percent of the principal value. Therefore, banks' investment in Interest Only strip is not to be counted.

About the first loss piece

Under the Guidelines, the first loss piece is the junior-most security, other than IO strip. All forms of originator support are treated as first loss support. However, if there are 2 or more levels of support, then the first loss piece is only the junior piece. Guidelines leave lot of flexibility permitting originators to minimise first loss retention, which is unlike EU regulations or even the regulations under Frank Dodd.

Maintenance of MRR

Guidelines clearly prohibit reduction of MRR through hedging of credit risk or selling the retained interest. However, what the Guidelines stipulate is that RMRR has to remain constant as percentage,

not as amount. One of the big confusions in the Feb 2006 Guidelines was that the first loss support had to remain constant through the term of the transaction. The Guidelines make it very clear that amortisation of the RMRR is possible- payback of RMRR, not faster than the payback of the senior classes, is therefore possible. It is to be noted that the form of MRR is not allowed to be changed during the life of securitisation.

1.4 Limit on Total Retained Exposures

1.4.1 At present, total investment by the originator in the securities issued by the SPV through underwriting or otherwise is limited to 20% of the total securitised instruments issued. Credit enhancement, liquidity support and counterparty credit exposures in the case of interest rate swaps/currency swaps with the SPV are outside this limit. However, under the Basel II requirements, there should be transfer of a significant credit risk associated with the securitised exposures to the third parties for recognition of risk transfer. In view of this, the total exposure of banks to the loans securitised in the following forms should not exceed 20% of the total securitised instruments issued:

- Investments in equity/subordinate/senior tranches of securities issued by the SPV including through underwriting commitments

- Credit enhancements including cash and other forms of collaterals including over-collateralisation, but excluding the credit enhancing interest only strip

- Liquidity support.

1.4.2 If a bank exceeds the above limit, the excess amount would be risk weighted at 1111%[6].

1.4.3 Credit exposure on account of interest rate swaps/currency swaps entered into with the SPV will be excluded from this limit as this would not be within the control of the bank.

1.4.4 The 20% limit on exposures will not be deemed to have been breached if it is exceeded due to amortisation of securitisation instruments issued.

[6] As per Basel III, the maximum risk weight for securitisation exposures, consistent with minimum 8% capital requirement, is 1250%. Since in India minimum capital requirement is 9%, the risk weight has been capped at 1111% (100/9) so as to ensure that capital charge does not exceed the exposure value.

Comments

Maximum Risk retention

The maximum exposure of the bank should be 20% of the total securitised instruments issued, including credit enhancements whether funded or non-funded and equity tranche; any investments in senior tranche; and any liquidity support.

The Basel II Connection

Basel II Standard requires substantive transfer of risk associated with the securitized exposures to the third parties for recognition of risk transfer. The Guidelines seek to impose a limit to the extent of originator's retention of ABS/MBS, keeping in view the Basel II requirement. However, there is a basic difference between Basel II and the Guidelines, i.e. Basel II is a capital standard and not a regulation. Moreover, Basel II concept is founded on "substance over form", i.e. if there is no in-substance transfer of risk, then there is no capital relief.

What if the limit is breached?

If the maximum limit is breached, the excess over the limit will be deducted from capital. The Guidelines provide that the excess amount would be risk-weighted at 1111%. The treatment is very much different from that under Basle II. As stated earlier, under Basel II requirements, if there is no substantive risk transfer, the transaction does not qualify for capital relief. Not qualifying for capital relief does not necessarily mean capital deduction.

Credit exposure owing to interest rate swaps/currency swaps entered into with the SPV would be outside the control of bank; as such these have been kept outside the boundary of maximum limits. Moreover, if the limit gets exceeded due to amortisation of securitisation instruments issued and that result into increase of originator interest; the Guidelines will not be deemed to be breached.

1.5 Booking of Profit Upfront

1.5.1 In terms of para 20.1 of our circular DBOD.No.BP.BC.60/21.04.048/2005- 06 dated February 1, 2006, any profit/premium arising on account of securitisation of loans should be amortised over the life of the securities issued or to be issued by the SPV. These instructions were inter alia intended to discourage 'originate-to-distribute' model. Now that these concerns are sought to be addressed to some extent by MRR, MHP and other measures being proposed in these guidelines, it has been decided to allow higher recognition of cash profits during a year based on amortisation of principal and losses incurred as well as specific provision requirements on the securitisation exposures as explained below:

The amount of profit received in cash may be held under an accounting head styled as "Cash Profit on Loan Transfer Transactions Pending Recognition" maintained on individual transaction basis. The amortisation of cash profit arising out of securitisation transaction will be done at the end of every financial year and calculated as under:

Profit to be amortised = Max {L, [(X*(Y/Z))], [(X/n)]}

X = amount of unamortised cash profit lying in the account 'Cash Profit on Loan

Transfer Transactions Pending Recognition' at the beginning of the year
Y = amount of principal amortised during the year
Z = amount of unamortised principal at the beginning of the year
L = Loss[7] (marked to market losses incurred on the portfolio + specific provisions, if any, made against the exposures to the particular securitisation transaction + direct write-off) excluding loss incurred on credit enhancing interest only strip[8]
n = residual maturity of the securitisation transaction

1.5.2 The above method of amortisation of profit can be applied to outstanding securitisation transactions as well. However, the method can be applied only with respect to the outstanding amortisable profit and un-amortised principal outstanding as on the date of issuance of this circular.

1.5.3 At times, the originating banks retain contractual right to receive some of the interest amount due on the transferred assets. This interest receivable by the originating bank represents a liability of the SPV and its present value is capitalised by the originating bank as an Interest Only Strip (I/O Strip), which is an on-balance sheet asset. Normally, a bank would recognise an unrealised gain in its Profit and Loss account on capitalisation of future interest receivable by way of I/O Strip. However, consistent with the instructions contained in circular dated February 1, 2006 referred to above, banks should not recognise the unrealised gains in Profit and Loss account; instead they should hold the unrealised profit under an accounting head styled as "Unrealised Gain on Loan Transfer Transactions". The balance in this account may be treated as a provision against potential losses incurred on the I/O Strip due to its serving as credit enhancement for the securitisation transaction9. The profit may be recognised in Profit and Loss Account only when Interest Only Strip is redeemed in cash. As banks would not be booking gain on sale represented by I/O Strip upfront, it need not be deducted from Tier I capital. This method of accounting of Interest Only Strip can be applied to outstanding securitisation transactions as well.

---

[7] The losses, including marked-to-market losses, incurred by banks, specific provisions, if any, and direct write- offs to be made on the MRR and any other exposures to the securitisation transaction (other than credit enhancing interest only strip) should be charged to Profit and Loss account. However, the amortisation formula would ensure that these debits to Profit and Loss account are offset to the extent there is balance in *"Cash Profit on Loan Transfer Transactions Pending Recognition Account"*. Banks should also hold capital against securitisation exposures in terms of extant guidelines of RBI without taking into account balance in "*Cash Profit on Loan Transfer Transactions Pending Recognition* Account".

[8] For accounting of losses in respect of credit enhancing interest only strip, please see para 1.5.3.

[9] The I/O Strips may be amortising or non-amortising. In the case of amortising I/O strips, a bank would periodically receive in cash, only the amount which is left after absorbing losses, if any, supported by the I/O strip. On receipt, this amount may be credited to Profit and Loss account and the amount equivalent to the amortisation due may be written-off against the *"Unrealised Gain on Loan Transfer Transactions"* A/c bringing down the book value of the I/O strip in the bank's books. In the case of a non-amortising I/O Strip, as and when the bank receives intimation of charging-off of losses by the SPV against the I/O strip, it may write-off equivalent amount against *"Unrealised Gain on Loan Transfer Transactions"* A/c and bring down the book value of the I/O strip in the bank's books. The amount received in final redemption value of the I/O Strip received in cash may be taken to Profit and Loss account.

Comments

Recognition of gain on sale is an accounting issue

Off- balance sheet treatment and gain on sale recognition are accounting issues. In principle, it is not proper for a regulator to lay accounting rules in this respect particularly when they materially differ from accounting standards.

What do Accounting Standards say?

Accounting standards relate off balance sheet and gain on sale together – latter being the consequence of the former. If there is a sale, there is a gain/loss on sale. Since gain/loss is the logical consequence of a sale treatment; one cannot justify the recognition of gain/loss being deferred if the sale has been recognised already.

The accounting standards relevant to securitisation are IAS 39, adopted as IndAS 39. An AS version of IAS 39 has been adopted in India as AS 30. IAS 39/ AS 30 lay down conditions for profit recognition under the accounting standards. AS 30 is currently in a recommendatory state in India. However, it is difficult to understand how a regulator can write a rule conflicting with the requirements of AS 30 on a matter which is completely an accounting issue, and not a regulatory issue.

Note that pursuant to Dodd Frank Act in the USA, US regulators have come with a requirement called "premium capture cash reserve account". This requirement is not the same as amortisation of profits under the Guidelines. By far, the amortisation approach under the Guidelines does not have an international parallel.

Recognition of Cash Profits

Guidelines allow recognition of cash profits only- cash profits arise when the sale price of the pool exceeds its par value. However, it is difficult to understand the expression "cash profit". Guidelines require the originator to invest RMRR% of the securities of the SPV. Now, there is no cash profit to the extent of originator's contribution to such securities and it would be illogical to limit cash profit to only consideration paid by third parties.
This situation gives rise to two extreme scenarios, both leading to absurd results:

i. If "cash profit" means only third party consideration, then given the RMRR requirements, most securitisation transactions would lead to a cash loss
ii. If cash profit includes consideration paid by the originator too, then every originator will have a free hand in increasing equity tranche and generating a cash profit

What should be the proper recourse?

Eventually, the accounting rule must be allowed to prevail. Under the accounting rules, the fair value of the retained interest of the originator is allowed to be booked upfront and fair value takes into account estimated losses.

Amortisation of Profit

Types of Profit

Guidelines make a distinction between two types of profit- realised profit (so-called cash profit) and unrealised profit. In case of unrealised profit, Guidelines make a reference to IO strip. In the Indian context, most Indian transactions have not had anything called IO strips; though residual profits have flowed back to originators on sweep-all-left basis. Moreover, IO strip is certainly not the only for

unrealised gains but Guidelines have envisaged only IO strip- hence the guidelines provide for profit to be recognised only when actually received.

Spreading the Profits

In case of realised profits, Guidelines require amortisation of the profits by spreading the profits. Spread should be based on higher of:

i. Proportionate splitting, in proportion to principal amortised
ii. Equal splitting, in proportion to number of months

The Formula

The way the formula has been framed seems illogical. The formula given in Guidelines puts a number L (mark to market loss) within the brackets with a "Max" formula. Since "L" represents mark to market loss, it will be a negative number. As such, the "Max" Formula will always ignore the loss.

1.6 Disclosures by the Originating Banks

1.6.1 Disclosures to be made in Servicer/Investor/Trustee Report

The originating banks should disclose to investors the weighted average holding ~~period of the assets securit~~ised and the level of their MRR in the securitisation. The originating banks should ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures. The disclosure by an originator of its fulfillment of the MHP and MRR should be made available publicly and should be appropriately documented; for instance, a reference to the retention commitment in the prospectus for securities issued under that securitisation programme would be considered appropriate. The disclosure should be made at origination of the transaction, and should be confirmed thereafter at a minimum half yearly (end-September and March), and at any point where the requirement is breached. The above periodical disclosures should be made separately for each securitisation transaction, throughout its life, in the servicer report, investor report, trustee report, or any similar document published. The aforesaid disclosures can be made in the format given in **Appendix 1.**

1.6.2 Disclosures to be made by the Originator in Notes to Annual Accounts

The Notes to Annual Accounts of the originating banks should indicate the outstanding amount of securitised assets as per books of the SPVs sponsored by the bank and total amount of exposures retained by the bank as on the date of balance sheet to comply with the MRR. These figures should be based on the information duly certified by the SPV's auditors obtained by the originating bank from the SPV. These disclosures should be made in the format given in **Appendix 2**.

1.7 Loan Origination Standards

The originating banks should apply the same sound and well-defined criteria for credit underwriting to exposures to be securitised as they apply to exposures to be held on their book. To this end, the same processes for approving and, where relevant, amending, renewing and monitoring of credits should be applied by the originators.

1.8 Treatment of Securitised Assets not Meeting the Requirements Stipulated above

All instructions contained in this paragraph will be applicable only to the new transactions unless explicitly stated otherwise. If an originating bank fails to meet the requirement laid down in the paragraphs 1.1 to 1.7 above, it will have to maintain capital for the securitised assets as if these were not securitised. This capital would be in addition to the capital which the bank is required to maintain on its other existing exposures to the securitisation transaction.

Comments

The Guidelines have been set in line with Basel II requirements, but it is not a mandatory regulation. The implication is that banks may securitise outside the Guidelines too. The effect would be that there will no capital relief in such cases.

However, Standards for Due Diligence stipulated in Para 2.1.1. negate the effects of Para 1.8. As per Para 2.1.1., investing banks shall not invest in securitised tranches unless originating bank has complied with MHP and MRR requirements. This is well in line with EU Regulations.

However, the non-regulatory stand of the Guidelines is still an appreciable difference from the previous Guidelines.

2. REQUIREMENTS TO BE MET BY BANKS OTHER THAN ORIGINATORS HAVING SECURITISATION EXPOSURES

2.1 Standards for Due Diligence

2.1.1 Banks can invest in or assume exposure to a securitisation position only if the originator (other banks/FIs/NBFCs) has explicitly disclosed to the credit institution that it has adhered to MHP and MRR stipulated in these guidelines and will adhere to MRR guidelines on an ongoing basis. The overseas branches of Indian banks should also not invest or assume exposure to securitisation positions in other jurisdictions which have not laid down any MRR. However, they can invest in such instruments in the jurisdictions where the MRR has been prescribed, though it may be different from that prescribed in this circular.

2.1.2 Before investing, and as appropriate thereafter, banks should be able to demonstrate for each of their individual securitisation positions, that they have a comprehensive and thorough understanding of risk profile of their proposed / existing investments in securitised positions. Banks will also have to demonstrate

that for making such an assessment they have implemented formal policies and procedures appropriate to banking book and trading book for analysing and recording the following:

a) information disclosed by the originators regarding the MRR in the securitisation, on at least half yearly basis;

b) the risk characteristics of the individual securitisation position including all the structural features of the securitisation that can materially impact the performance of the investing bank's securitisation position *(i.e., the seniority of the tranche, thickness of the subordinate tranches, its sensitivity to pre- payment risk and credit enhancement resets, structure of repayment water- falls, waterfall related triggers, the position of the tranche in sequential repayment of tranches(time-tranching), liquidity enhancements, availability of credit enhancements in the case of liquidity facilities, deal-specific definition of default, etc.);*

c) the risk characteristics of the exposures underlying the securitisation *position (i.e., the credit quality, extent of diversification and homogeneity of the pool of loans, sensitivity of the repayment behavior of individual borrowers to factors other than their sources of income, volatility of the market values of the collaterals supporting the loans, cyclicality of the economic activities in which the underlying borrowers are engaged, etc.);*

d) the reputation of the originators in terms of observance of credit appraisal and credit monitoring standards, adherence to MRR and MHP standards in earlier securitisations, and fairness in selecting exposures for securitisation;

e) loss experience in earlier securitisations of the originators in the relevant exposure classes underlying the securitisation position, incidence of any frauds committed by the underlying borrowers, truthfulness of the representations and warranties made by the originator;

f) the statements and disclosures made by the originators, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures; and

g) where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator to ensure the independence of the valuer.

2.1.3 When the securitised instruments are subsequently purchased in the secondary market by a bank, it should, at that point in time, ensure that the originator has explicitly disclosed that it will retain a position that meets the MRR.

2.2 Stress Testing

Banks should regularly perform their own stress tests appropriate to their securitisation positions. For this purpose, various factors which may be considered include, but are not limited to, rise in default rates in the underlying portfolios in a situation of economic downturn, rise in pre-payment rates due to fall in rate of interest or rise in income levels of the borrowers leading to early redemption of exposures, fall in rating of the credit enhancers resulting in fall in market value of securities (Asset Backed Securities/Mortgage Backed Securities) and drying of liquidity of the securities resulting in higher prudent valuation adjustments. The results of stress test should be taken into account in Pillar II exercise under Basel II framework and additional capital be held to support any higher risk, if required.

2.3 Credit Monitoring

Banks need to monitor on an ongoing basis and in a timely manner, performance information on the exposures underlying their securitisation positions and take appropriate action, if any, required. Action may include modification to exposure ceilings to certain type of asset class underlying securitisation transaction, modification to ceilings applicable to originators etc. For this purpose, banks should establish formal procedures appropriate to their banking book and trading book and commensurate with the risk profile of their exposures in securitised positions as stipulated in para 2.1.2. Where relevant, this shall include the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis. Banks may inter alia make use of the disclosures made by the originators in the form given in **Appendix 1** to monitor the securitisation exposures.

2.4 Treatment of Exposures not Meeting the Requirements Stipulated above

The investing banks will assign a risk weight of 1111% to the securitisation exposures where the requirements in the paragraphs 2.1 to 2.3 above are not met. While banks should make serious efforts to comply with the guidelines contained in paragraphs 2.1 to 2.3, the higher risk weight of 1111% will be applicable with effect from October 01, 2012. Banks should put in place necessary systems and procedures to implement the requirements in paragraphs 2.1 to 2.3 before September 30, 2012.

SECTION B

GUIDELINES ON TRANSACTIONS INVOLVING TRANSFER OF ASSETS THROUGH DIRECT ASSIGNMENT OF CASH FLOWS AND THE UNDERLYING SECURITIES

1. REQUIREMENTS TO BE MET BY THE ORIGINATING BANKS

1.1 Assets Eligible for Transfer[10]

1.1.1 Under these guidelines, banks can transfer a single standard asset[11] or a part of such asset or a portfolio of such assets to financial entities through an assignment deed with the exception of the following:
(i) Revolving credit facilities (e.g. Cash Credit accounts, Credit Card receivables etc.)
(ii)Assets purchased from other entities
(iii)Assets with bullet repayment of both principal and interest[12].

Comments

Ineligible assets are the same as in case of securitisation- revolving credits, purchased loans and bullet repayment loans.

1.1.2 However, these guidelines do not apply to:

(i) Transfer of loan accounts of borrowers by a bank to other bank/FIs/NBFCs and vice versa, at the request/instance of borrower;
(ii) Inter-bank participations;
(iii) Trading in bonds;
(iv) Sale of entire portfolio of assets consequent upon a decision to exit the line of business completely. Such a decision should have the approval of Board of Directors of the bank;

---

[10] In these guidelines, transfer would mean transfer of assets through direct sale, assignment and any other form of transfer of assets. The generic term used for transfers would be sale and purchase.

[11] In these guidelines, the term loans/assets have been used to refer to loans, advances or bonds which are in the nature of an advances as defined in para 2.1 (vii) of Master Circular – Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by banks dated July 1, 2011.

[12] Loans with tenor up to 24 months extended to individuals for agricultural activities (as defined by Rural Planning and Credit Department of the Reserve Bank of India, in the Master Circular - Lending to Priority Sector) where both interest and principal are due only on maturity and trade receivables with tenor up to 12 months discounted/purchased by banks from their borrowers will be eligible for direct transfer through assignment. However, only those loans/receivables will be eligible for such transfer where a borrower (in case of agricultural loans) /a drawee of the bill (in case of trade receivables) has fully repaid the entire amount of last two loans/receivables (one loan, in case of agricultural loans with maturity extending beyond one year) within 90 days of the due date.

(v) Consortium and syndication arrangements and arrangement under Corporate Debt Restructuring mechanism;
(vi) Any other arrangement/transactions, specifically exempted by the Reserve Bank of India.

Comments

Inapplicability of Guidelines

Transfers with the request of the Borrower
Transfers that happen with the request of the borrower have been excluded from the purview of guidelines. This would mean novation transactions will also be excluded.

Inter-bank participations
Along with Inter Bank Participations, arguably the transferable participation rights envisaged by Nair committee have also been excluded.

Trading in bonds:
By excluding bonds, Guidelines will promote issue of bonds as a replacement of loans, particularly in case of corporate lending. However, due to this, bonds become an easy route to escape the entire Guidelines.

Sale of entire portfolio upon exit decision
The stress is on "entire portfolio", which should mean a portfolio sharing risk features. For example, portfolio in a particular region may be seen as a portfolio

Consortium or syndication arrangements in case of CDR:
Interest in assets acquired by banks under consortium arrangements, in case of CDR, also remain out of the Guidelines

Specific exemptions
This is a power reserved with the RBI to come out with specific exemptions.

Ensuring Liquidity

The whole loan sale market is quite a liquid market internationally, particularly the so-called leveraged loans market. Many such loans are written to be sold. CDS is not allowed in case of loans – ruling out synthetic transfers. So the question is- how do banks ensure that their loans are liquid?

One probable answer is by transforming a loan into a transferable instrument. Bonds are transferable instruments, but are excluded assets. One downside is- bonds require MTM valuation; under IFRS 7, even loans require MTM valuation.

MTM does not necessarily mean volatility of reported profits. In case of AFS assets, the gains/losses on MTM are parked in "other comprehensive income"

1.2 Minimum Holding Period (MHP)

Same as in para 1.2 of Section A.

Comments

MHP is the same in case of securitisation

1.3 Minimum Retention Requirement (MRR)

1.3.1 The originating banks should adhere to the MRR detailed in the Table below while transferring assets to other financial entities:

Type of asset	**MRR**
Assets with original maturity of 24 months or less	Retention of right to receive 5% of the cash flows from the assets transferred on pari-passu basis.
i) Assets with original maturity of above 24 months; and ii) Loans referred to in foot note 11 of para 1.1 of Section B.	Retention of right to receive 10% of the cash flows from the assets transferred on pari-passu basis.

1.3.2 In the case of partial sale of assets, if the portion retained by the seller is more than the MRR required as per para 1.3.1 above, then out of the portion retained by the seller, the portion equivalent to 5% of the portion sold or 10% of the portion sold, as the case may be, would be treated as MRR. However, all exposures retained by the selling bank including MRR should rank pari-passu with the sold portion of the asset.

1.3.3 Banks should not offer credit enhancements in any form and liquidity facilities in the case of loan transfers through direct assignment of cash flows, as the investors in such cases are generally the institutional investors who should have the necessary expertise to appraise and assume the exposure after carrying out the required due diligence. Banks should also not retain any exposures through investment in the Interest Only Strip representing the Excess Interest Spread/ Future Margin Income from the loans transferred. However, the originating banks will have to satisfy the MRR requirements stipulated in para 1.3.1 above. Banks' retention of partial interest in the loans transferred to comply with the MRR indicated in para 1.3.1 should be supported by a legally valid documentation.

At a minimum, a legal opinion regarding the following should also be kept on record by the originator:

(a) legal validity of amount of interest retained by the originator;
(b) such arrangement not interfering with assignee's rights and rewards associated with the loans to the extent transferred to it; and

(c) the originator not retaining any risk and rewards associated with the loans to the extent transferred to the assignee.

1.3.4 MRR will have to be maintained by the entity which sells the loans. In other words, it cannot be maintained by other entities which are treated as 'originator' in terms of para 5(vi) of the circular dated February 1, 2006 containing guidelines on securitisation of standard assets.

1.3.5 The level of commitment by originators i.e., MRR should not be reduced either through hedging of credit risk or selling the retained interest. The MRR as a percentage of unamortised principal should be maintained on an ongoing basis except for reduction of retained exposure due to proportionate repayment or through the absorption of losses. The form of MRR should not change during the life of transaction.

1.3.6 For complying with the MRR under these guidelines, banks should ensure that proper documentation in accordance with law is made.

Comments

Though MHP is the same in case of securitisation, MRR becomes curious.

Retention of Cashflows

The Guidelines require retention of 10% cashflows. This would mean a fractional transfer fractional transfers under common law systems lead to joint ownership.

Credit enhancement not to be offered

Banks are not allowed to offer credit enhancements. It would imply the retained risk is a pari passu risk, i.e., the seller sells 90% of the loan, retaining 10% of the loan, on a proportional basis. This indicates that the originator only has 10% of the risk, not risk upto 10%.

IO Strip not to be held back

The Guidelines provide for the interest spread, that it, the excess spread not to be retained by the seller.

Legal validity of the proportional transfer

Fractional transfer may be held valid- just that the seller and buyer become co-owners.
In essence, the direct assignment business is fully "hands off" sale

1.4 Booking of Profit Upfront

1.4.1 The amount of profit in cash on direct sale of loans may be held under an accounting head styled as *"Cash Profit on Loan Transfer Transactions Pending Recognition"* maintained on individual transaction basis and amortised over the life of the transaction. The amortisation of cash profit arising out of loan assignment transaction will be done at the end of every financial year and calculated as under:

Profit to be amortised = Max {L, [(X*(Y/Z)], [(X/n)]}

X = amount of unamortised cash profit lying in the account 'Cash Profit on Loan Transfer Transactions Pending Recognition' at the beginning of the year
Y = amount of principal amortised during the year
Z = amount of unamortised principal at the beginning of the year
L = Loss (specific provisions to be made on retained exposures for credit losses plus direct write-off plus any other losses, if any)13 incurred on the portfolio
n = residual maturity of the securitisation transaction

Comments

The profit recognition rule is the same as in case of securitisations. This is, however, most illogical since the originator is not exposed to any credit risk of the transferred pool in case of direct assignments, the question of the seller not recognising a profit does not arise at all. Further, the seller holds only a pari passu interest- so, if the seller transfers 90% of the pool, there is no reason for the seller not to recognise 90% of the profit, whether realised or unrealised.

See our notes under Section A.

1.4.2 Accounting, Asset Classification and provisioning norms for MRR

The asset classification and provisioning rules in respect of the exposure representing the MRR would be as under:

a) The originating bank may maintain a consolidated account of the amount representing MRR if the loans transferred are retail loans. In such a case, the consolidated amount receivable in amortisation of the MRR and its periodicity should be clearly established and the overdue status of the MRR should be determined with reference to repayment of such amount. Alternatively, the originating bank may continue to maintain borrower-wise accounts for the proportionate amounts retained in respect of those accounts. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.

b) In the case of transfer of a pool of loans other than retail loans, the originator should maintain borrower-wise accounts for the proportionate amounts retained in respect of each loan. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.

c) If the originating bank acts as a servicing agent of the assignee bank for the loans

---

[13] The specific provisions to be made as well as direct write-offs and other losses, if any, on the retained exposures should be charged to Profit and Loss account. In addition banks should hold capital against the exposure retained as part of MRR as required in terms of extant guidelines of RBI without taking into account balance in *"Cash Profit on Loan Transfer Transactions Pending Recognition"* account. Banks will also be required to separately maintain 'standard asset' provisions on MRR as per existing instructions which should not be charged to the *"Cash Profit on Loan Transfer Transactions Pending Recognition" A/c.*

transferred, it would know the overdue status of loans transferred which should form the basis of classification of the entire MRR/individual loans representing MRR as NPA in the books of the originating bank, depending upon the method of accounting followed as explained in para (a) and (b) above.

1.5 Disclosures by the Originating Banks

Same as in para 1.6 of Section A.

1.6 Loan Origination Standards

Same as in para 1.7 of Section A.

1.7 Treatment of Assets sold not Meeting the Requirements stipulated above

All instructions contained in this paragraph except in para 1.4.2 will be applicable only to the new transactions undertaken on or after the date of this circular. Instructions in para 1.4.2 will be applicable to both existing and new transactions[14]. If an originating bank fails to meet the requirement laid down in paragraphs 1.1 to 1.6 above, it will have to maintain capital for the assets sold as if these were still on the books of the bank (originating bank).

2. REQUIREMENTS TO BE MET BY THE PURCHASING BANKS

2.1 Restrictions on Purchase of loans

Banks can purchase loans from other banks/FIs/NBFCs in India only if the seller has explicitly disclosed to the purchasing banks that it will adhere to the MRR indicated in para 1.3 on an ongoing basis. In addition, for domestic transactions, purchasing banks should also ensure that the originating institution has strictly adhered to the MHP criteria prescribed in the guidelines in respect of loans purchased by them. The overseas branches of Indian banks may purchase loans in accordance with the regulations laid down in those jurisdictions.

2.2 Standards for Due Diligence

2.2.1 Banks should have the necessary expertise and resources in terms of skilled manpower and systems to carry out the due diligence of the loans/portfolios of loans before purchasing them. In this regard the purchasing banks should adhere to the following guidelines:

a) Banks with the approval of their Board of Directors, should formulate policies regarding the process of due diligence which needs to be exercised by the banks' own officers to satisfy about the Know Your Customer requirements and credit quality of the underlying assets. Such policies should inter alia lay down

[14] For existing transactions para 1.4.2 would apply to credit enhancements or any other type of retained exposures.

the methodology to evaluate credit quality of underlying loans, the information requirements etc.

b) The due diligence of the purchased loans cannot be outsourced by the bank and should be carried out by its own officers with the same rigour as would have been applied while sanctioning new loans by the bank.

c) If a bank wishes to outsource certain activities like collection of information and documents etc., then this should be subject to the extant Reserve Bank of India (RBI) guidelines on outsourcing of non-core activities by banks, which would inter alia imply that banks would continue to retain full responsibility in regard to selection of loans for purchase and compliance with Know Your Customer requirements.

2.2.2 Before purchasing individual loans or portfolio of loans, and as appropriate thereafter, banks should be able to demonstrate that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures commensurate with the risk profile of the loans purchased analysing and recording:

a) Information disclosed by the originators regarding the MRR, on an ongoing basis;

b) the risk characteristics of the exposures constituting the portfolio purchased *(i.e., the credit quality, extent of diversification and homogeneity of the pool of loans, sensitivity of the repayment behavior of individual borrowers to factors other than their sources of income, volatility of the market values of the collaterals supporting the loans, cyclicality of the economic activities in which the underlying borrowers are engaged, etc.);*

c) the reputation of the originators in terms of observance of credit appraisal and credit monitoring standards, adherence to MRR and MHP standards in earlier transfer of portfolios and fairness in selecting exposures for transfer;

d) loss experience in earlier transfer of loans/portfolios by the originators in the relevant exposure classes underlying and incidence of any frauds committed by the underlying borrowers, truthfulness of the representations and warranties made by the originator;

e) the statements and disclosures made by the originators, or their agents or advisors, about their due diligence on the assigned exposures and, where applicable, on the quality of the collateral supporting the loans transferred; and

f) where applicable, the methodologies and concepts on which the valuation of loans transferred is based and the policies adopted by the originator to ensure the independence of the valuer.

2.3 Stress Testing

Banks should regularly perform their own stress tests appropriate to the portfolios of loans purchased by them. For this purpose, various factors which may be considered

include, but are not limited to, rise in default rates in the underlying portfolios in a situation of economic downturn and rise in pre-payment rates due to fall in rate of interest or rise in income levels of the borrowers leading to early redemption of exposures. The results of stress test should be taken into account in Pillar II exercise under Basel II framework and additional capital be held to support any higher risk, if required.

2.4 Credit monitoring

2.4.1 The purchasing banks need to monitor on an ongoing basis and in timely manner performance information on the loans purchased and take appropriate action required, if any. Action may include modification to exposure ceilings to certain type of asset classes, modification to ceilings applicable to originators etc. For this purpose, banks should establish formal procedures appropriate and commensurate with the risk profile of the purchased loans. Such procedures should be as rigorous as that followed by the bank for portfolios of similar loans directly originated by it. In particular, such procedures must facilitate timely detection of signs of weaknesses in individual accounts and identification of non-performing borrowers as per RBI guidelines as soon as loans are 90 days past due. The information collected should include the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis. Such information, if not collected directly by the bank and obtained from the servicing agent, should be certified by the authorized officials of the servicing agent. Banks may inter alia make use of the disclosures made by the originators in the form given in **Appendix 1** to monitor the exposures.

2.4.2 Depending upon the size of the portfolio, credit monitoring procedures may include verification of the information submitted by the bank's concurrent and internal auditors. The servicing agreement should provide for such verifications by the auditors of the purchasing bank. All relevant information and audit reports should be available for verification by the Inspecting Officials of RBI during the Annual Financial Inspections of the purchasing banks.

2.5 True Sale Criteria[15]

2.5.1 The **'sale'** (*this term would hereinafter include direct sale, assignment and any other form of transfer of asset, but does not include loan participation through Inter- Bank Participation Certificates, bills rediscounted, outright transfer of loan accounts to other financial entities at the instance of the borrower and sale of bonds other than those in the nature of advance*) should result in immediate legal separation of the **'selling bank'**[16] *(this term hereinafter would include direct selling*

[15] For true sale criteria for securitisation transaction, please refer to Annex 7 of our Master Circular – New Capital Adequacy Framework dated July 01, 2011.

[16] In this para, the term 'selling bank' will include other financial entities selling loans to banks.

*bank, assigning bank and the bank transferring assets through any other mod*e), from the assets[17] which are sold. The assets should stand completely isolated from the selling bank, after its transfer to the buyer, i.e., put beyond the selling bank's as well as its creditors' reach, even in the event of bankruptcy of the selling/assigning/transferring bank.

2.5.2 The selling bank should effectively transfer all risks/ rewards and rights/ obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale except those specifically permitted under these guidelines. The buyer should have the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition. The selling bank shall not have any economic interest in the assets after its sale and the buyer shall have no recourse to the selling bank for any expenses or losses except those specifically permitted under these guidelines.

2.5.3 There shall be no obligation on the selling bank to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by the buyer or provide additional assets to the buyer at any time except those arising out of breach of warranties or representations made at the time of sale. The selling bank should be able to demonstrate that a notice to this effect has been given to the buyer and that the buyer has acknowledged the absence of such obligation.

2.5.4 The selling bank should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the buyer.

2.5.5 The sale shall be only on cash basis and the consideration shall be received not later than at the time of transfer of assets. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.

2.5.6 If the seller of loans acts as the servicing agent for the loans, it would not detract from the 'true sale' nature of the transaction, provided such service obligations do not entail any residual credit risk on the sold assets or any additional liability for them beyond the contractual performance obligations in respect of such services.

2.5.7 An opinion from the selling bank's Legal Counsel should be kept on record signifying that: (i) all rights, titles, interests and benefits in the assets have been transferred to the buyer; (ii) selling bank is not liable to the buyer in any way with regard to these assets other than the servicing obligations as indicated in para 2.5.6 above; and (iii) creditors of the selling bank do not have any right in any way with regard to these assets even in case of bankruptcy of the selling bank.

2.5.8 Any re-schedulement, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the buyer, shall be

[17] In case of sale of a part of an asset, true sale criteria will apply to the part of the asset sold.

binding on the buyer and not on the selling bank except to the extent of MRR.

2.5.9 The transfer of assets from selling bank must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents from obligors (including from third parties, where necessary) should have been obtained.

2.5.10 In case the selling bank also provides servicing of assets after the sale under a separate servicing agreement for fee, and the payments/repayments from the borrowers are routed through it, it shall be under no obligation to remit funds to the buyer unless and until these are received from the borrowers.

2.6 Representations and Warranties

An originator that sells assets to other financial entities may make representations and warranties concerning those assets. Where the following conditions are met the seller will not be required to hold capital against such representations and warranties.

(a) Any representation or warranty is provided only by way of a formal written agreement.
(b) The seller undertakes appropriate due diligence before providing or accepting any representation or warranty.
(c) The representation or warranty refers to an existing state of facts that is capable of being verified by the seller at the time the assets are sold.
(d) The representation or warranty is not open-ended and, in particular, does not relate to the future creditworthiness of the loans/underlying borrowers.
(e) The exercise of a representation or warranty, requiring an originator to replace asset (or any parts of them) sold, on grounds covered in the representation or warranty, must be:
    * undertaken within 120 days of the transfer of assets; and
    * conducted on the same terms and conditions as the original sale.
(f) A seller that is required to pay damages for breach of representation or warranty can do so provided the agreement to pay damages meets the following conditions:
    * the onus of proof for breach of representation or warranty remains at all times with the party so alleging;
    * the party alleging the breach serves a written Notice of Claim on the seller, specifying the basis for the claim; and
    * damages are limited to losses directly incurred as a result of the breach.
(g) A seller should notify RBI (Department of Banking Supervision) of all instance where it has agreed to replace assets sold to another financial entity or pay damages arising out of any representation or warranty.

2.7 Re-purchase of Assets

In order to limit the extent of effective control of transferred assets by the seller in the case of direct assignment transactions, banks should not have any re-purchase agreement including through “clean-up calls” on the transferred assets.

2.8 Applicability of Capital Adequacy and other Prudential Norms

2.8.1 The capital adequacy treatment for direct purchase of corporate loans will be as per the rules applicable to corporate loans directly originated by the banks. Similarly, the capital adequacy treatment for direct purchase of retail loans, will be as per the rules applicable to retail portfolios directly originated by banks except in cases where the individual accounts have been classified as NPA, in which case usual capital adequacy norms as applicable to retail NPAs will apply. No benefit in terms of reduced risk weights will be available to purchased retail loans portfolios based on rating because this is not envisaged under the Basel II Standardized approach for credit risk[18]. However, banks may, if they so desire, have the pools of loans rated before purchasing so as to have a third party view of the credit quality of the pool in addition to their own due diligence. However, such rating cannot substitute for the due diligence that the purchasing bank is required to perform in terms of para 2.2 of this Section.

2.8.2 In purchase of pools of both retail and non-retail loans, income recognition, asset classification, provisioning and exposure norms for the purchasing bank will be applicable based on individual obligors and not based on portfolio. Banks should not apply the asset classification, income recognition and provisioning norms at portfolio level, as such treatment is likely to weaken the credit supervision due to its inability to detect and address weaknesses in individual accounts in a timely manner. If the purchasing bank is not maintaining the individual obligor-wise accounts for the portfolio of loans purchased, it should have an alternative mechanism to ensure application of prudential norms on individual obligor basis, especially the classification of the amounts corresponding to the obligors which need to be treated as NPAs as per existing prudential norms. One such mechanism could be to seek monthly statements containing account-wise details from the servicing agent to facilitate classification of the portfolio into different asset classification categories. Such details should be certified by the authorized officials of the servicing agent. Bank's concurrent auditors, internal auditors and statutory auditors should also conduct checks of these portfolios with reference to the basic records maintained by the servicing agent. The servicing agreement should provide for such verifications by the auditors of the purchasing bank. All relevant information and audit reports should be available for verification by the Inspecting Officials of RBI during the Annual Financial Inspections of the purchasing banks.

2.8.3 The purchased loans will be carried at acquisition cost unless it is more than the face value, in which case the premium paid should be amortised based on straight line method or effective interest rate method, as considered appropriate by the individual banks. The outstanding/unamortised premium need not be deducted from capital. The discount/premium on the purchased loans can be accounted for on

---

[18] Investment in tranches of securitised loans, will attract capital adequacy and other prudential norms as applicable to securitisation transactions.

portfolio basis or allocated to individual exposures proportionately.

2.9 Treatment of Exposures not Meeting the Requirements Stipulated Above

The investing banks will assign a risk weight of 1111% to the assignment exposures where the requirements in paragraphs 2.1 to 2.8 above are not met. While banks should make serious efforts to comply with the guidelines contained in paragraphs 2.1 to 2.4, the higher risk weight of 1111% for non-compliance of these paragraphs will be applicable with effect from October 01, 2012. Banks should put in place necessary systems and procedures to implement the requirements in paragraphs 2.1 to 2.4 before September 30, 2012.

SECTION C

SECURITISATION ACTIVITIES/EXPOSURES NOT PERMITTED

1.At present, banks in India including their overseas branches, are not permitted to undertake the securitisation activities or assume securitisation exposures as mentioned below.

1.1 Re-securitisation of Assets

A re-securitisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more re-securitisation exposures is a re-securitisation exposure. This definition of re-securitised exposure will capture collateralised debt obligations (CDOs) of asset backed securities, including, for example, a CDO backed by residential mortgage-backed securities (RMBS).

1.2 Synthetic Securitisations

A synthetic securitisation is a structure with at least two different stratified risk positions or tranches that reflect different degrees of credit risk where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of funded (e.g. credit-linked notes) or unfunded (e.g. credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. Accordingly, the investors' potential risk is dependent upon the performance of the underlying pool.

1.3 Securitisation with Revolving Structures (with or without early amortisation features)

These involve exposures where the borrower is permitted to vary the drawn amount and repayments within an agreed limit under a line of credit (e.g. credit card receivables and cash credit facilities).Typically, revolving structures will have non-amortising assets such as credit card receivables, trade receivables, dealer floor-plan loans and some leases that would support non-amortising structures, unless these are designed to include early amortisation features. Early amortisation means repayment of securities before their normal contractual maturity. At the time of early amortisation there are three potential amortisation mechanics: (i) Controlled amortisation; (ii) Rapid or non-controlled amortisation; and (iii) Controlled followed by a subsequent (after the completion of the controlled period) non-controlled amortisation phase.

2. The appropriateness and suitability of transactions prohibited in the above guidelines would be revisited in due course.

Comments on the Guidelines as a whole

Commentator has criticised the Guidelines as it virtually kills the direct assignment business. The provisions of the Guidelines about direct assignment are inconsistent. But this adverse impact of the guidelines on the direct assignment business should not be lamented upon, because direct assignments are not something that was the first love of the market and the market shifted to direct assignments following the Feb 2006 guidelines only. So, if we are forced to move back to "securitisation" structure, that is a forward move, not backward. However, the Guidelines have been unduly harsh on direct assignments, as simpler bilateral sales don't have to follow the complex structure of "securitisations".