

RBI's Guidelines on Securitisation: Comments by Vinod Kothari

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February 1, 2006

All Commercial Banks (excluding RRBs)
All India Term Lending and Refinancing Institutions (FIs)
All Non Banking Financial Companies (including RNBCs)

Dear Sir,

Guidelines on Securitisation of Standard Assets

As you are aware, Reserve Bank had issued draft guidelines on securitisation of standard assets vide letter DBOD.No.BP.1502/21.04.048/ 2004-05 dated April 4, 2005. On the basis of the feedback received from all stakeholders, the draft guidelines have been suitably modified. The guidelines on securitisation of standard assets as **applicable to banks, financial institutions and non-banking financial companies** are furnished in the Annex.

Comment: Our understanding is that these will be applicable to housing finance companies also, which are also NBFCs as per law.

2. These guidelines come into force with immediate effect. **The Reserve Bank would take a view on the treatment for the securitization transactions undertaken in the prior period on a case-by-case basis with the objective of ensuring adherence to basic principles of prudence.**

Comment: The biggest concern in the market is the retroactive applicability of the guidelines. Something like Rs 600 bil of securitisation deals have been done in the past, mostly by banks and NBFCs, and the first loss portion in most of the past deals ranged anywhere between 10% to 20%. The present guidelines require 100% capital while existing practice of banks is to hold only 9% capital. While the RBI intends to examine these cases on "principles of prudence", it would be surprising if the RBI would let banks go with 9% capital on past deals, as prudence is not something which is drastically different for past deals. The only saver would be the extent to which these deals have been paid off, increasing the level of credit enhancement.

Yours faithfully,

(Prashant Saran)

Chief General Manager-in-Charge

Encls : As above.

Annex

Guidelines on Securitisation of Standard Assets

SCOPE

1. The regulatory framework provided in the guidelines covers securitisation of standard assets by banks, All India Term Lending and Refinancing Institutions, and Non Banking Financial Companies (including RNBCs). **The reference to 'bank' in the guidelines would include all the above institutions.**
2. **Securitisation is a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment.** The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitisation thus follows a two-stage process. In the first stage there is sale of single asset or pooling and sale of pool of assets to a 'bankruptcy remote' special purpose vehicle (SPV) in return for an immediate cash payment and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities.
3. Banks' exposures to a securitisation transaction are referred to as "securitisation exposures". Securitisation exposures include, but are not restricted to the following: exposures to securities issued by the SPV, credit enhancement facility, liquidity facility, underwriting facility, interest rate or currency swaps and cash collateral accounts.

Comment: As that is the definition, it transpires that the guidelines do not apply to whole loans transfers, or transfers of loans to a conduit, with the latter selling them to an SPV for securitisation. Two-tier structures, commonly prevalent in several countries, do not seem to have been envisaged by the guidelines. Ideally, the guideline prevailing for sale/securitisation should be the same.

Also clearly, the guidelines do not apply to synthetic transactions.

STRUCTURE

4. The guidelines have been grouped under the following headings:
 - i) Definitions
 - ii) True sale
 - iii) Criteria to be met by SPV

- iv) Special features
- v) Policy on provision of credit enhancement facilities
- vi) Policy on provision of liquidity facilities
- vii) Policy on provision of underwriting facilities
- viii) Policy on provision of services
- ix) Prudential norms for investment in securities issued by SPV
- x) Accounting treatment of the securitisation transactions
- xi) Disclosures

DEFINITIONS

5. The broad definitions of various terms used in these guidelines are furnished below. These terms have been supplemented as appropriate at various relevant portions of these guidelines.

- (i) "Bankruptcy remote" means the unlikelihood of an entity being subjected to voluntary or involuntary bankruptcy proceedings, including by the originator or its creditors;
- (ii) "credit enhancement" is provided to an SPV to cover the losses associated with the pool of assets. The rating given to the securities issued by the SPV (PTCs) by a rating agency will reflect the level of enhancement;
- (iii) A "first loss facility" represents the first level of financial support to a SPV as part of the process in bringing the securities issued by the SPV to investment grade. The provider of the facility bears the **bulk (or all) of the risks associated with the assets held by the SPV**;
- (iv) A "second loss facility" represents a credit enhancement providing a **second (or subsequent)** tier of protection to an SPV against potential losses;

Comment: Obvious enough, the reference is to credit risk – not all risks. For example, a non-credit-enhancing but prepayment protecting class will not be taken as a first loss class.

The very basis of distinction between first loss and second loss, without reference to rating levels, makes little sense. For example, if in a transaction, 4% credit enhancement is sufficient to attain a BBB rating, and 10% enhancement is required to attain AAA rating, then 4% is the first loss piece and 6% is the second loss piece. But if only the AAA class is sold, there are only two classes – a rated class with AAA rating, and an unrated class of 10% - in which case the entire unrated piece may seem like first loss piece, but then this is illusory.

Ideally, since ratings are anyway mandatory under the Guidelines, the determination of first loss and second loss should have been on the basis of rating levels.

Comment: The word "subsequent" is, again, illusory. In most ABS issuances, there are multiple classes, and all classes except the senior-most are credit enhancing classes, in a step structure. Treating all such subsequent classes alike is inappropriate.

- (v) "Liquidity facilities" enable SPVs to assure investors of timely payments. These include smoothening of timing differences between payment of interest and principal on pooled assets and payments due to investors;
- (vi) "Originator" refers to a bank that transfers from its balance sheet a single asset or a pool of assets to an SPV as a part of a securitisation transaction and would include other entities of the consolidated group to which the bank belongs.
- (vii) "Securitisation" means a process by which a single performing asset or a pool of performing assets are sold to a bankruptcy remote SPV and transferred from the balance sheet of the originator to the SPV in return for **an immediate cash payment**;
- (viii) "Service provider" means **a bank that carries out on behalf of the SPV** (a) administrative functions relating to the cash flows of the underlying exposure or pool of exposures of a securitization; (b) funds management; and (c) servicing the investors;
- (ix) "SPV" means any company, trust, or other entity constituted or established for a specific purpose - (a) activities of which are limited to those for accomplishing the purpose of the company, trust or other entity as the case may be; and (b) which is structured in a manner intended to isolate the corporation, trust or entity as the case may be, from the credit risk of an originator to make it bankruptcy remote;
- (x) "Underwriting" means the arrangement under which a bank agrees, before issue, to buy a specified quantity of

Comment: The word immediate cash payment is a misnotation that pervades through the whole of the guidelines. There is an element of retained interest which is no different from a consideration for the transfer. Besides, quite often, the SPV issues securities to the originator which is also a form of consideration.

Comment: These words should not be taken to preclude the possibility of independent servicers other than banks. Since the RBI's regulatory ambit is banks, the Guidelines apply when the servicing is handled by banks. Needless to say, specialized servicers have a very significant role in securitisation business and they may not be banks or finance companies.

securities in a new issue on a given date and at a given price if no other purchaser has come forward.

TRUE SALE

6. For enabling the transferred assets to be removed from the balance sheet of the originator in a securitisation structure, the isolation of assets or 'true sale' from the originator to the SPV is an essential prerequisite. In case the assets are transferred to the SPV by the originator in full compliance with all the conditions of true sale given below, the transfer would be treated as a 'true sale' and originator will not be required to maintain any capital against the value of assets so transferred from the date of such transfer. The effective date of such transfer should be expressly indicated in the subsisting agreement. In the event of the transferred assets not meeting the "true-sale" criteria the assets would be deemed to be on the balance sheet of the originator and accordingly the originator would be required to maintain capital for those assets. The criteria of true-sale that have been prescribed below are illustrative but not exhaustive.

Comment: The Guidelines unfortunately miss a very significant point – under revised IAS 39, true sale is not a precondition for off-balance sheet treatment. Regulatory Guidelines are not statement of accounting principles – regulatory accounting, that is, accounting for the purpose of regulators' reporting, and accounting for financial reporting, are understandably different. It is open for the RBI to reject regulatory off-balance sheet unless a true sale takes place, but true sale as a precondition for securitisation is increasingly being questioned in several countries, except the US where the provisions of bankruptcy laws insist on a true sale.

Notably, it is neither necessary nor proper for a regulator to lay down what true sales involve. True sale is a substance-over-form question, and in appropriate circumstances, true sale will have to depend on determination by a court. Regulators' guidelines such as these here are at best, illustrative of what the RBI's understanding of true sale is.

7. The criteria for "True Sale" of assets

- 7.1 The sale should result in immediate legal separation of the originator from the assets which are sold to the new owner viz. the SPV. The assets should stand completely isolated from the originator, after its transfer to the SPV, i.e., put beyond the originator's as well as their creditors' reach, even in the event of bankruptcy of the originator.
- 7.2 The originator 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 to the SPV. An agreement entitling the originator to any surplus income on the securitised assets at the end of the life of the securities issued by the SPV would not be deemed as a violation of the true sale criteria. The SPV should obtain the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining

Comment: This is a very casual statement and goes counter to a number of other stipulations made in the Guidelines. First of all, the fact that the buyer of receivables is accountable to the seller for any surplus is itself one of the factors that goes against a true sale – as held by several rulings both in the US and UK. Second, if we talk about an arms length transaction at fair values, the seller has received all that he was supposed to receive, and there is no question of being entitled to residual surplus. One of the common ways of recapturing residual surplus is by setting a deferred sale consideration, but then these Guidelines provide that the entire consideration for transfer should be received immediately and in cash.

condition.

- 7.3 The originator shall not have any economic interest in the assets after its sale and the SPV shall have no recourse to the originator for any expenses or losses except those specifically permitted under these guidelines.
- 7.4 There shall be no obligation on the originator to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by SPV or provide additional assets to the SPV at any time except those arising out of breach of warranties or representations made at the time of sale. The originator should be able to demonstrate that a notice to this effect has been given to the SPV and that the SPV has acknowledged the absence of such obligation.
- 7.5 An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ("clean up calls") as allowed vide paragraph 10 can be retained by the originator.
- 7.6 The originator 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 scheme or investors.
- 7.7 The sale shall be only on cash basis and the consideration shall be received not later than at the time of transfer of assets to the SPV. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.
- 7.8 Provision of certain services (such as credit enhancement, liquidity facility, underwriting, asset-servicing, etc.) and assumption of consequent risks/ obligations by the originators as specifically allowed in these guidelines would not detract from the 'true sale' nature of the

Comment: This condition is completely impractical. Notably, accounting rules etc talk about "surrender of control", that is, the buyer's right to resell the assets, but then, SPVs are never allowed the right to resell the assets. The effect of being able to resell the assets is achieved by making the securities of the SPV freely transferable. In fact, as the Guidelines provide later, the SPV should be a non-discretionary body. If it has the right to resell the assets, exercise of such right is nothing but a discretion.

It may not be a far-fetched worry that if assets of the originator are sold to an independent SPV, run by directors majority of whom are independents, there is worry that the assets may get sold off against the wishes of the originator. And that may completely deprive the originator of both his servicing rights as also his residual profit.

In short, this condition is completely impractical and is a product of misconceived idea of what is meant by "surrender of control". This condition is neither implied by Basle II nor by IAS 39 or FAS 140.

Comment: Retention of residual profit is nothing but an economic interest.

Comment: This condition is also impractical. In many cases, originators may look for an opportune time for issuance and keep the securities "on shelf" – that is, do a transfer to the SPV but hold on to the securities for sale to investors at an appropriate point of time. The SPV paying to the originator in form of securities is quite a common practice. Provisions having been made about capital maintenance for first and second losses, there is no reason to limit the originator's right to hold the securities. Basle II does not put any such condition – on the contrary, it contains elaborate provisions for ratings-based risk weights to securities held by the originator.

transaction, provided such service obligations do not entail any residual credit risk on the assets securitized or any additional liability for them beyond the contractual performance obligations in respect of such services.

7.9 An opinion from the originating 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 SPV; (ii) originator is not liable to investors in any way with regard to these assets other than liability for certain permitted contractual obligations for example, credit enhancement/ liquidity facility; and (iii) creditors of the originator do not have any right in any way with regard to these assets even in case of bankruptcy of the originator.

7.10 Any re-schedulement, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the SPV, shall be binding on the SPV and not on the originator and shall be done only with the express consent of the investors, providers of credit enhancement and other service providers. This should be expressly provided in the sale transaction documents.

Comment: This is also a very casual, almost thoughtless condition. Seeking the sanction of investors for reschedulement etc is both impractical as also conflicting with the scheme of securitisation. The SPV buys the assets, not the originator. Restructuring or taking such efforts at resolution of a debt are common servicing powers – they have been listed as servicers functions even in Regulation AB of the US SEC.

These Guidelines provide, later below, that the investors' sanction may be sought at the time of issue of the securities itself – which makes the whole concept of sanction redundant.

7.11 The transfer of assets from originator 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.

7.12 In case the originator also provides servicing of assets after securitisation, under an agreement with the SPV, and the payments/repayments from the borrowers are routed through it, it shall be under no obligation to remit funds to the SPV/investors unless and until these are received from the borrowers.

Comment: An agreement to provide servicer advances should not be frowned upon – that is one way of providing liquidity support to the transaction.

7.13 The originator should not be under any obligation to purchase the securities issued by the SPV and should not subscribe to their primary

issue. The originator may, however, purchase at market price only senior securities issued by the SPV if these are at least 'investment grade', for investment purposes. Such purchase, along with the securities that may devolve on account of underwriting commitments, should not exceed 10% of the original amount of the issue.

Comment: See our comment above that it is unreasonable to limit the originator's investment in a securitisation transaction – once capital requirements have been laid down.

7.14 The originator shall not indulge in market-making or dealing in the securities issued by the SPV.

7.15 The securities issued by the SPV shall not have any put options. The securities may have a call option to address the pre-payment risk on the underlying assets.

Comment: Once again a misnomer. Prepayment is an implicit call option, not a call option as such.

CRITERIA TO BE MET BY SPV

8 SPV is a special purpose vehicle set up during the process of securitisation to which the beneficial interest in the securitised assets are sold / transferred on a without recourse basis. The SPV may be a partnership firm, a trust or a company. Any reference to SPV in these guidelines would also refer to the trust settled or declared by the SPV as a part of the process of securitisation. The SPV should meet the following criteria to enable the originator to treat the assets transferred by it to the SPV as a true sale and apply the prudential guidelines on capital adequacy and other aspects with regard to the securitisation exposures assumed by it.

Comment: Partnership firms are not legal entities – hence, cannot be SPVs.

Comment: This phrase is confusing – the trust itself is the SPV. The trust is declared by the trustee – the trustee is not an SPV.

8.1 Any transaction between the originator and the SPV should be strictly on arm's length basis. Further, it should be ensured that any transaction with the SPV should not intentionally provide for absorbing any future losses.

Comment: This benign looking statement may reflect an underlying design to require capital for SPVs. Since SPVs issue asset-backed securities, and not absolute obligations of the SPV, there is no question of any "securitisation exposure" of the SPV. The whole notion is misplaced.

8.2 The SPV and the trustee should not resemble in name or imply any connection or relationship with the originator of the assets in its title or name.

8.3 The SPV should be entirely independent of the originator. The originator should not have any ownership, proprietary or beneficial

interest in the SPV. The originator should not hold any share capital in the SPV.

Comment: While this statement is correct, it counters the point above regarding right of the originator to sweep residual profits of the SPV.

8.4 The originator shall have only one representative, without veto power, on the board of the SPV provided the board has at least four members and independent directors are in majority.

Comment: This is, obviously, only true if the SPV is a company. If the SPV is a trust, an independent board of trustees suffices the requirement.

8.5 The originator shall not exercise control, directly or indirectly, over the SPV and the trustees, and shall not settle the trust deed.

8.6 The SPV should be bankruptcy remote and non-discretionary.

Comment: Notably, the US FAS 140 conditions on “qualifying SPEs” put up several detailed requirements on what the SPV may do or not do. Any right of the SPV to retain and reinvest cash, for example, for a cash reserve creation, also amounts to a discretion and this requirement may need more detailing.

8.7 The trust deed should lay down, in detail, the functions to be performed by the trustee, their rights and obligations as well as the rights and obligations of the investors in relation to the securitised assets. The Trust Deed should not provide for any discretion to the trustee as to the manner of disposal and management or application of the trust property. In order to protect their interests, investors should be empowered in the trust deed to change the trustee at any point of time.

Comment: In reality, this question may be quite complicated. Investors’ consent is of course commonly required for removal of trustees, but the key question is – which class of investors? And what percentage of investors? Logically, the subordinated investors have the first loss risk and are, therefore, in most precarious condition. The proportion of voting rights, therefore, should appropriately not be the same as between senior and subordinated investors.

8.8 The trustee should only perform trusteeship functions in relation to the SPV and should not undertake any other business with the SPV.

8.9 The originator shall not support the losses of the SPV except under the facilities explicitly permitted under these guidelines and shall also not be liable to meet the recurring expenses of the SPV.

8.10 The securities issued by the SPV shall compulsorily be rated by a rating agency registered with SEBI and such rating at any time shall not be more than 6 months old. The credit rating should be publicly available. For the purpose of rating and subsequent updation, the SPV should supply the necessary information to the rating agency in a timely manner. Commonality and conflict of interest, if any, between the SPV and the rating agency should also be disclosed.

Comment: Commonly, some of the securities are rated, not all. There is generally an unrated class. This statement should not be taken to mean all securities require rating.

8.11 The SPV should inform the investors in the securities issued by it that these securities are not insured and that they do not represent

deposit liabilities of the originator, servicer or trustees.

- 8.12 A copy of the trust deed and the accounts and statement of affairs of the SPV should be made available to the RBI, if required to do so.

SPECIAL FEATURES

9. Representations and Warranties

An originator that sells assets to SPV may make representations and warranties concerning those assets. Where the following conditions are met the originator 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 originator 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 originator 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 assets, the performance of the SPV and/or the securities the SPV issues.
- e. The exercise of a representation or warranty, requiring an originator to replace assets (or any parts of them) sold to a SPV, must be:
 - undertaken within 120 days of the transfer of assets to the SPV; and
 - conducted on the same terms and conditions as the original sale.
- f. An originator 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:

Comment: This is another unwarranted and thoughtless stipulation. Many of the warranties relate to representation of facts and there is no reason to limit the time within which such facts come to light.

- 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 originator, specifying the basis for the claim; and
 - damages are limited to losses directly incurred as a result of the breach.
- g. An originator should notify RBI (Department of Banking Supervision) of all instance where it has agreed to replace assets sold to SPV or pay damages arising out of any representation or warranty.

10 Re-purchase of Assets from SPVs

An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ("clean up calls") could be retained by the originator and would not be construed to constitute 'effective control', provided:

- i) the purchase is conducted at arm's length, on market terms and conditions (including price/fee) and is subject to the originator's normal credit approval and review processes; and
- ii) the exercise of the clean-up call is at its discretion.

Comment: Most securitisation documents contain ROAPs – removal of accounts provisions. This is essentially done to retain flexibility for the borrower to switch between various schemes. For example, if a fixed interest borrower wants to switch over to a floating rate, the account is removed from the transaction and replaced by another account. This is a common feature, and clearly permitted by FAS 140.

Call options of the originator are prohibited when they are intended to control the profits of the buyer. A genuine repurchase other than for the purpose of controlling the assets should be permitted.

POLICY ON PROVISION OF CREDIT ENHANCEMENT FACILITIES

11. Detailed Policy

Credit enhancement facilities include all arrangements provided to the SPV that could result in a bank absorbing losses of the SPV or its investors. Such facilities may be provided by both originators and third parties. A bank should hold capital against the credit risk assumed when it provides credit enhancement, either explicitly or implicitly, to a special purpose vehicle or its investors. The entity providing credit enhancement facilities should ensure that the following conditions are fulfilled. Where any of the conditions is not satisfied, the bank providing credit enhancement facility will be required to hold capital against the full value of the securitised assets as if they were held on its balance sheet.

- 11.1 Provision of the facility should be structured in a manner to keep it distinct from other facilities and documented separately from any other facility provided by the bank. The nature, purpose, extent of the facility and all required standards of performance should be clearly

specified in a written agreement to be executed at the time of originating the transaction and disclosed in the offer document.

11.2 The facility is provided on an 'arm's length basis' on market terms and conditions, and subjected to the facility provider's normal credit approval and review process.

11.3 Payment of any fee or other income for the facility is not subordinated or subject to deferral or waiver.

11.4 The facility is limited to a specified amount and duration.

11.5 The duration of the facility is limited to the earlier of the dates on which:

- i) the underlying assets are redeemed;
- ii) all claims connected with the securities issued by the SPV are paid out; or
- iii) the bank's obligations are otherwise terminated.

11.6 There should not be any recourse to the facility provider beyond the fixed contractual obligations. In particular, the facility provider should not bear any recurring expenses of the securitisation.

11.7 The facility provider has written opinions from its legal advisors that the terms of agreement protect it from any liability to the investors in the securitisation or to the SPV/ trustee, except in relation to its contractual obligations pursuant to the agreement governing provision of the facility.

11.8 The SPV and/or investors in the securities issued by the SPV have the clear right to select an alternative party to provide the facility.

11.9 Credit enhancement facility should be provided only at the initiation of the securitisation transaction.

Comment: It is unclear as to what is the credit enhancement facility that the Guidelines have envisaged but one of the most common forms of enhancement is a subordinated security of the SPV. While it is understandable that credit enhancements by third party banks are done on arms length basis, credit enhancements by the originator are a part of the transaction of securitisation; there is nothing arms-length about it. Besides, such enhancements, in case of an originator, being approved by the normal credit review process of the bank does not make sense.

Comment: In fact, if the credit enhancement is by the originator himself, it is unlikely that the payments to him will be senior. It is clear from this language that the Guidelines seem to have been drafted from the viewpoint of an third party enhancer.

11.10 The amount of credit enhancement extended at the initiation of the securitisation transaction should be available to the SPV during the entire life of the securities issued by the SPV. The amount of credit enhancement shall be reduced only to the extent of draw downs to meet the contingencies arising out of losses accruing to the SPV or its investors. **No portion of the credit enhancement shall be released to the provider during the life of the securities issued by the SPV.**

Comment: This is another mindless stipulation. If the enhancement has come, for example, in form of either a cash reserve or subordination, it is quite common to provide for periodic reduction in the size of the enhancement. For example, a proportional repayment structure simultaneously pays down the subordinated investments as it pays senior investments. While there is nothing wrong in such a structure, a structure not providing for proportional paydown may, in fact, be economically unviable.

11.11 **Any utilization / draw down of the credit enhancement should be immediately written-off by debit to the profit and loss account.**

Comment: Isn't it quite painful to see the regulators writing accounting rules? Accounting rules require that the credit enhancement provider should project future losses and in fact should write off the anticipated losses (liabilities assumed in course of securitisation) right at the inception. Alternatively, as fair value rules are applicable to most financial instruments (not applicable in India at this time, but impairment rules certainly apply), the amount of apprehended loss may have been written off much before the actual drawn down.

11.12 When a first loss facility does not provide substantial cover a second loss facility might carry a disproportionate share of risk. In order to limit this possibility, a credit enhancement facility will be deemed to be a second loss facility only where:

- it enjoys protection given by a substantial first loss facility;
- it can be drawn on only after the first loss facility has been completely exhausted;
- it covers only losses beyond those covered by the first loss facility; and
- the provider of the first loss facility continues to meet its obligations.

If the second loss facility does not meet the above criteria, it will be treated as a first loss facility.

11.13 The first-loss facility would be considered substantial where it covers some multiple of historic losses or worst case losses estimated by simulation or other techniques. The second loss facility provider shall assess adequacy of first loss facility on an arm's length basis and shall review it periodically at least once in six months. The following factors may be reckoned while conducting the assessment as well as review:

- i) the class and quality of assets held by the SPV;
- ii) the history of default rates on the assets;
- iii) the output of any statistical models used by banks to assess expected default rates on the assets;
- iv) the types of activity in which the SPV is engaging in or is permitted

to engage in;

- v) the quality of the parties providing the first loss facility; and
- vi) the opinions or rating letters provided by reputable rating agencies regarding the adequacy of first loss protection.

Comment: Apparently, in the mind of the regulator, the type of credit enhancement facility is unfunded facility such as a guarantee or letter of credit. This is, in reality, most uncommon – most common forms of enhancement are acquisition of subordinated securities.

12. Treatment of credit enhancements provided by an originator

12.1 Treatment of First Loss Facility: The first loss credit enhancement provided by the originator shall be reduced from capital funds and the deduction shall be capped at the amount of capital that the bank would have been required to hold for the full value of the assets, had they not been securitised. The deduction shall be made 50% from Tier 1 and 50% from Tier 2 capital.

Comment: If a credit enhancement is provided by the originator himself, distinction between the first and second loss, unless related to ratings of the pieces, is meaningless. Notably, the Guidelines require upto 9% capital for the first loss and unlimited capital for the second loss. On the contrary, if the first and second loss pieces are held together, as a first loss piece, by the originator, the capital requirement is only 9%. In other words, it does not make any sense for the originator to split his retained subordinated interest into first and second loss piece.

12.2 Treatment of Second Loss Facility: The second loss credit enhancement provided by the originator shall be reduced from capital funds to the full extent. The deduction shall be made 50% from Tier 1 and 50% from Tier 2 capital.

In common securitisation transactions, the distinction is made to gain capital arbitrage due to lower risk weights for higher rated mezzanine pieces. As the guidelines do not allow for any such capital arbitrage, and rather, penalize the capital of the originator, there is no reason for such distinction to happen at all.

13 Treatment of credit enhancements provided by third party

13.1 Treatment of First Loss Facility: The first loss credit enhancement provided by third party service providers shall be reduced from capital to the full extent as mentioned in paragraph 12.1 above.

13.2 Treatment of Second Loss Facility: The second loss credit enhancement shall be treated as a direct credit substitute with a 100 per cent credit conversion factor and a 100 % risk weight covering the amount of the facility.

POLICY ON PROVISION OF LIQUIDITY FACILITIES

14 Detailed Policy on provision of liquidity support

A liquidity facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to investors. A liquidity facility should meet the following conditions to guard against the possibility of the facility functioning as a form of credit enhancement and/ or credit support. In case the facility fails to meet any of these conditions, it will be regarded as serving the economic purpose of credit enhancement and the liquidity facility provided by a third

party shall be treated as a first loss facility and the liquidity facility provided by the originator shall be treated as a second loss facility.

- 14.1 All conditions specified in paragraphs 11.1 to 11.8 above.
- 14.2 The securitised assets are covered by a substantial first loss credit enhancement.
- 14.3 The documentation for the facility must clearly define the circumstances under which the facility may or may not be drawn on.
- 14.4 The facility should be capable of being drawn only where there is a sufficient level of non-defaulted assets to cover drawings, or the full amount of assets that may turn non-performing are covered by a substantial credit enhancement.
- 14.5 The facility shall not be drawn for the purpose of
 - a) providing credit enhancement;
 - b) covering losses of the SPV;
 - c) serving as a permanent revolving funding; and
 - d) covering any losses incurred in the underlying pool of exposures prior to a draw down.
- 14.6 The liquidity facility should not be available for (a) meeting recurring expenses of securitisation; (b) funding acquisition of additional assets by the SPV; (c) funding the final scheduled repayment of investors and (d) funding breach of warranties.
- 14.7 Funding should be provided to SPV and not directly to the investors.
- 14.8 When the liquidity facility has been drawn the facility provider shall have a priority of claim over the future cash flows from the underlying assets, which will be senior to the claims of the seniormost investor.
- 14.9** When the originator is providing the liquidity facility, an independent third party, other than the originator's group entities, should co-provide at least 25% of the liquidity facility that shall be drawn and repaid on a

pro-rata basis. The originator must not be liable to meet any shortfall in liquidity support provided by the independent party. During the initial phase, a bank may provide the full amount of a liquidity facility on the basis that it will find an independent party to participate in the facility as provided above. The originator will have three months to locate such independent third party.

Comment: This is an extremely strange and quite out-of-reality requirement. Liquidity facilities are most common in case of ABCP conduits, which do not exist in India today. But expecting a multiple liquidity facility, both from the originator and from a third party, will be an unrealistic expectation.

There is no such requirement under Basle II.

In addition, based on a strict reading of the Guidelines, even servicer advances will be treated as a liquidity facility. However, there is no question of having such facility backed by a third party facility as well.

15 Treatment of liquidity facility

15.1 The commitment to provide liquidity facility, to the extent not drawn would be an off- balance sheet item and attract **100% credit conversion factor** as well as 100 % risk weight. The extent to which the commitment becomes a funded facility, it would attract 100 % risk weight.

Comment: Notably, the CCF under Basle II is 25% for a facility upto 1 year and 50% for other facilities.

15.2 Since the liquidity facility is meant to smoothen temporary cash flow mismatches, the facility will remain drawn only for short periods. **If the drawings under the facility are outstanding for more than 90 days it should be classified as NPA and fully provided for.**

Comment: This will also make any liquidity facility for a securitisation transaction completely impractical. The only way out of this is an evergreening device whereby the facilitator recovers the facility from out of the next month's collections, and then provides the facility again.

POLICY ON PROVISION OF UNDERWRITING FACILITIES

16. General Policy

An originator or a third-party service provider may act as an underwriter for the issue of securities by SPV and treat the facility as an underwriting facility for capital adequacy purposes subject to the following conditions. In case any of the conditions is not satisfied, the facility will be considered as a credit enhancement and treated as a first loss facility when provided by a third party and a second loss facility when provided by an originator.

16.1 All conditions specified in paragraphs 11.1 to 11.8 above.

16.2 The underwriting is exercisable only when the SPV cannot issue securities into the market at a price equal to or above the benchmark predetermined in the underwriting agreement.

16.3 The bank has the ability to withhold payment and to terminate the facility, if necessary, upon the occurrence of specified events(e.g. material adverse changes or defaults on assets above a

specified level); and

16.4 There is a market for the type of securities underwritten.

17.1 Underwriting by an originator

An originator may underwrite only investment grade senior securities issued by the SPV. The holdings of securities devolved through underwriting should be sold to third parties within three-month period following the acquisition. During the stipulated time limit, the total outstanding amount of devolved securities will be subjected to a risk weight of 100 per cent. In case of failure to off-load within the stipulated time limit, any holding in excess of 10 per cent of the original amount of issue, including secondary market purchases, shall be deducted 50% from Tier 1 capital and 50% from Tier 2 capital.

17.2 Underwriting by third party service providers

A third party service provider may underwrite the securities issued by the SPV. The holdings of securities devolved through underwriting should be sold to third parties within three-month period following the acquisition. During the stipulated time limit, the total outstanding amount of devolved securities will be subjected to a risk weight of 100 per cent. In case of failure to off-load within the stipulated time limit, the total outstanding amount of devolved securities which are at least investment grade will attract a 100% risk weight and those which are below investment grade will be deducted from capital at 50% from Tier 1 and 50% from Tier 2.

POLICY ON PROVISION OF SERVICES

18. A servicing bank administers or services the securitised assets. Hence, it should not have any reputational obligation to support any losses incurred by the SPV and should be able to demonstrate this to the investors. A bank performing the role of a service provider for a proprietary or a third-party securitisation transaction should ensure that the following conditions are fulfilled. Where the following conditions are not met, the service provider may be deemed as providing liquidity facility to the SPV or investors and treated accordingly for capital adequacy purpose.

18.1 All conditions specified in paragraphs 11.1 to 11.8 above.

18.2 The service provider should be under no obligation to remit funds to the SPV or investors until it has received funds generated from the underlying assets except where it is the provider of an eligible liquidity facility.

18.3 The service provider shall hold in trust, on behalf of the investors, the cash flows arising from the underlying and should avoid co-mingling of these cash flows with their own cash flows.

19. PRUDENTIAL NORMS FOR INVESTMENT IN THE SECURITIES ISSUED BY SPV

19.1 As the securities issued by SPVs would be in the nature of non-SLR securities, banks' investment in these securities would attract all prudential norms applicable to non-SLR investments prescribed by RBI from time to time

19.2 Limits on investment in securities by the originator

The aggregate investment by the originator in securities issued by SPV would be as given in para 7.13.

19.3 Exposure norms for investment in the PTCs

The counterparty for the investor in the securities would not be the SPV but the underlying assets in respect of which the cash flows are expected from the obligors / borrowers. These should be taken into consideration when reckoning overall exposures to any particular borrower/borrower Group, industry or geographic area for the purpose of managing concentration risks and compliance with extant prudential exposure norms, wherever the obligors in the pool constitute 5% or more of the receivables in the pool or Rs.5 crore, whichever is lower.

19.4 Income recognition and provisioning norms for investors in the PTCs

As the securities are expected to be limited-tenor, interest bearing debt instruments, the income on the securities may normally be recognised on accrual basis. However, if the income (or even the redemption amount) on securities remains in arrears for more than 90 days, any future income should be recognised only on realisation and any unrealised income recognised on

Comment: The guidelines make a repeated reference to pass through certificates. By nature pass through certificates are not debt type securities – they are equity-type as they represent proportional beneficial interest. A beneficial interest is not debt but beneficial ownership.

If the securities of the SPV have to be debt, then there are several implications – the securities are treated as bonds, implying stamp duty, deduction of tax at source, etc. This casual statement might do a lot of damage to the tax transparency of securitisation transactions.

accrual basis should be reversed. In case of pendency of dues on the securities appropriate provisions for the diminution in value of the securities on account of such overdues should also be made, as already envisaged in the extant RBI norms for classification and valuation of investment by the banks.

20 ACCOUNTING TREATMENT OF THE SECURITISATION TRANSACTIONS

20.1 Accounting in the books of the originator

In terms of these guidelines banks can sell assets to SPV **only on cash basis** and the sale consideration should be received not later than the transfer of the asset to the SPV. Hence, any loss arising on account of the sale should be accounted accordingly and reflected in the Profit & Loss account for the period during which the sale is effected and **any profit/premium arising on account of sale should be amortised over the life of the securities issued** or to be issued by the SPV.

Comment: See our comments before.

- i) In case the securitised assets qualify for derecognition from the books of the originator, the entire expenses incurred on the transaction, say, legal fees, etc., should be expensed at the time of the transaction and should not be deferred.
- ii) Where the securitised assets do not qualify for derecognition the sale consideration received shall be treated as a borrowing.

Comment: This is clearly accounting rules – in India, IAS as well as US GAAPs. Para 20.2 below suggests that as for assets covered by the Guidelines, the RBI wants to override accounting standards – this is assumption of powers over a field which is not the RBI's domain.

20.2 The accounting treatment of the securitisation transactions in the books of originators, SPV and investors in securities will be as per the guidance note issued by the ICAI with reference to those aspects not specifically covered in these guidelines.

21. DISCLOSURES

21.1 Disclosures to be made by the SPV/Trustee

- i) The SPV/ trustee should make available/ provide to RBI or other regulators, as and when required, a copy of the trust deed, the financial accounts and statement of affairs, its constitution,

ownership, capital structure, size of issue, terms of offer including interest payments/yield on instruments, details of underlying asset pool and its performance history, information about originator, transaction structure, service arrangement, credit enhancement details, risk factors etc.

- ii) Investor should be informed in writing that :
 - a) their investments do not represent deposits or other liabilities of the originator, servicer, SPV or the trustee, and that they are not insured;
 - b) the trustee / originator / servicer / SPV does not guarantee the capital value of securities and/or performance of the securities issued, or collectability of receivables pool; and
 - c) their investments can be subject to investment risk, including prepayment risk, interest rate risk, credit risk, possible delays in repayment and loss of income and principal invested.

iii) The SPV/trustee should provide continuing disclosures by way of a Disclosure Memorandum, signed and certified for correctness of information contained therein jointly by the servicer and the trustee, and addressed to each securities holder individually through registered post/email/courier/fax at periodic intervals (maximum 6 months or more frequent). In case the securities holders are more than 100 in number then the memorandum may also be published in a national financial daily newspaper. In addition to the above, data may be made available on websites of the SPV/trustee. The contents of the memorandum would be as under:

- a) collection summary of previous collection period;
- b) asset pool behaviour - delinquencies, losses, prepayment etc. with details;
- c) drawals from credit enhancements;
- d) distribution summary:
 - (i) in respect of principal and interest to each class of security holders;
 - (ii) in respect of servicing and administration fee, trusteeship fee etc;
- e) payments in arrears;

- f) current rating of the securities and any migration of rating during the period; and
- g) any other material / information relevant to the performance of the pool.

iv) The SPV/trustee should publish a periodical report on any re-schedulement, restructuring or re-negotiation of the terms of the agreement, effected after the transfer of assets to the SPV, as a part of disclosures to all the participants at Quarterly/Half yearly intervals. The authorisation of investors to this effect may be obtained at the time of issuance of securitised paper.

v) SPV should obtain signed acknowledgment from investors indicating that they have read and understood the required disclosures.

21.2 Disclosures to be made by the originator

The originator should make the following disclosures, as notes to accounts, presenting a comparative position for two years:

- (i) total number and book value of loan assets securitised;
- (ii) sale consideration received for the securitised assets and gain/loss on sale on account of securitisation; and
- (iii) form and quantum (outstanding value) of services provided by way of credit enhancement, liquidity support, post-securitisation asset servicing, etc.

In addition to the above balance sheet disclosures, originating banks of the securitisation transactions should provide disclosures to the Audit Sub-Committee of their Board, on quarterly basis, as per the format prescribed in the Attachment.

Attachment

Format of Quarterly Reporting to the Audit Sub Committee of the Board by originating banks of the Securitisation Transactions

1. Name of the originator:
2. Name and nature of SPV & details of relationship with originator and service providers (including constitution and shareholding pattern of SPV):
3. Description and nature of asset transferred:
4. Carrying cost of assets transferred and percentage of such assets to total assets before transfer:
5. Method of transfer of assets:
6. Amount and nature of consideration received:
7. Objects of the securitisation offer:
8. Amount and nature of credit enhancement and other facilities provided by the originator (give details each facility provided viz., nature, amount, duration, terms and conditions,):
9. Information regarding third party service providers (e.g. credit enhancement, liquidity support, servicing of assets, etc.) giving the details, facility-wise, viz. name & address of the provider, amount, duration and terms and conditions of the facility:
10. CRAR of transferor:

<u>Before transfer</u>	<u>After transfer</u>
Tier I	
Tier II	
11. Type and classes of securities issued by SPV with ratings, if any, of each class of security, assigned by a rating agency:

12. Name and address of holders of 5% or more of securities (if available):

13. Investment by the originator in the securitised paper, issuer wise:

Name of the issuer Class of security No. of securities held Total amount

14. Details of hedging arrangements (IRS/ FRAs), if any, giving amount /maturity date, name of counter parties, etc.:

15. Brief description (including diagrammatic representation of the structure) of the scheme denoting cash and process flows):

16. Date and method of termination of the scheme including mopping up of remaining assets: