

Requirements for Banks Providing Servicing, Credit Enhancement and/or Liquidity Facilities

I. Servicing

1. A bank may undertake the role of servicer where the following are satisfied:
 - (a) there is a written agreement which specifies the services to be provided and any required standards of performance. There shall be no recourse to the servicer beyond the specified contractual obligations;
 - (b) the duration of the agreement is limited to the earlier of:
 - the date on which all claims connected with the securities issued by the SPV are paid out; or
 - the bank's replacement as servicer.However, a fixed termination date need not be specified if the servicer is able, at its absolute discretion, to withdraw from its commitments at any time with a reasonable period of notice;
 - (c) the facility is documented in a fashion which clearly separates it from any other facility provided by the bank; and
 - (d) the servicer has written opinions from its external auditors and legal advisors that the terms of agreement protect it from any liability to investors in the securitisation transaction or the SPV (except normal contractual obligations relating to its role as servicing agent).
2. The servicer shall not be under any obligation to remit funds to the SPV or investors until they are received from the underlying assets, unless otherwise provided for in the terms of a separate liquidity facility under conditions stipulated in section III of this Annex.
3. The servicer may receive a performance-related payment (or benefit from any surplus income generated⁵), in addition to its base fee, provided that the base fee is on market terms and conditions and any performance-related payment does not commit it to any additional

⁵ This refers to any surplus income generated by the underlying assets of the SPV after meeting all payment obligations of the securities issued, operating costs of the SPV, and/or losses or bad debts on the underlying assets.

obligation. Such payment should be recognised for profit and loss purposes only after it has been irrevocably received.

4. Where any of the above conditions is not satisfied, the servicer will be required to hold capital against the assets it is servicing as if they were held on its balance sheet.

II. Credit Enhancement Facilities

5. A bank may provide credit enhancement facilities to support a proprietary or third party securitisation transaction. These facilities include all arrangements that, in form or substance, provide for the bank to absorb the losses of the SPV or investors.

6. Any bank that provides credit enhancement facilities shall ensure the following conditions are fulfilled:

- (a) the nature and extent of any undertaking provided to the investors or SPV are clearly specified in a written agreement. There must be no recourse to the bank beyond the specified contractual obligations;
- (b) the facility is limited to a specified amount;
- (c) the duration of the facility is limited to the earlier of the date on which:
 - the underlying assets are redeemed;
 - all claims connected with the securities issued by the SPV are paid out; or
 - the bank's obligations are otherwise terminated.

However, a fixed termination date need not be specified if the bank is able, at its absolute discretion, to withdraw from its commitments at any time with a reasonable period of notice;

- (d) the facility is documented in a fashion which clearly separates it from any other facility provided by the bank; and
 - (e) the facility is given at the initiation of the securitisation transaction, and the related details are clearly disclosed in any offering circular or other appropriate documentation.
7. Where any of the conditions in paragraph 6 is not satisfied, the bank will be required to hold capital against the securitised assets as if they were held on its balance sheet. Where all of these conditions are satisfied,

the capital treatment to be applied to credit enhancement facilities is as set out below.

First Loss Facility

8. A “first loss facility” represents the first level of financial support to the SPV or investors in a securitisation transaction. The seller of the assets often provides this facility but a third party may also be involved. The providers of first loss facilities bear substantial risks associated with the assets held by the SPV or the securities issued.
9. Any bank which provides a first loss facility will be required, for capital adequacy purposes, to deduct the amount of the credit enhancement facility from its capital base. The deduction will be capped at the amount of the capital that the seller would have been required to maintain for the full value of the assets, had they not been securitised.

Second Loss Facility

10. A “second loss facility” represents credit enhancement that provides a second tier of protection to the SPV or investors in a securitisation transaction against potential losses.
11. Depending on the coverage provided by any first loss facility, a second loss facility might carry a disproportionate share of risk to the scheme. In order to limit this possibility, a credit enhancement facility will be deemed to be a second loss facility only where:
 - (a) it enjoys protection from a substantial first loss facility; and
 - (b) it can be drawn on only after the first loss facility has been exhausted.
12. Any bank providing a second loss facility should assess the adequacy of the first loss facility on an arm’s length basis in accordance with its normal credit approval and review processes. A review of a first loss facility may refer to one or more of the following factors:
 - (a) the class and quality of the assets held by the SPV;
 - (b) the history of default and loss rates on the assets;
 - (c) the output of any statistical or other models used to assess expected losses on the assets;
 - (d) the types of activity permitted to the SPV;

- (e) the quality of the parties providing the first loss facility; or
 - (f) the opinions provided by reputable third parties (such as rating agencies) regarding the adequacy of the first loss protection.
13. Where a bank provides a second loss facility, the facility will be treated as a direct credit substitute for capital adequacy purposes with a 100 per cent risk weight covering the amount of the facility.

III. Liquidity Facilities

14. Liquidity facilities may be 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 of the securities it has issued.
15. Where a liquidity facility fails to meet any of the following conditions, it will be regarded as serving the economic purpose of a credit enhancement facility and therefore be treated in the same manner as a credit enhancement for capital adequacy purposes:
- (a) the nature and extent of any undertaking provided to the SPV are clearly specified in a written agreement. In particular, the purpose of the facility must be clearly specified and must be consistent with paragraph 14 above. There must be no recourse to the bank beyond the specified contractual obligations;
 - (b) the facility is limited to a specified amount and duration. A fixed termination date need not be specified if the bank is able, at its absolute discretion, to withdraw from its commitments at any time with a reasonable period of notice;
 - (c) the facility is documented in a fashion which clearly separates it from any other facility provided by the bank;
 - (d) the funding is provided to the SPV, and not directly to investors;
 - (e) the documentation for the facility must clearly define the circumstances under which the facility may or may not be drawn on;
 - (f) the facility must not be capable of being drawn on for the purpose of credit support or to support losses of the securitisation transaction or investors involved in it;
 - (g) any drawdown under the facility cannot be used to provide permanent revolving funding;

- (h) the facility must provide for the repayment of any drawdown within a reasonable time period; or
 - (i) repayments of any drawdown under the facility cannot be subordinated to the interests of the investors.
- 16. In addition to the requirements under paragraph 15, there must be substantial credit enhancement⁶ in place before a bank providing a liquidity facility may treat such facility as a commitment to provide finance for capital adequacy purposes.
- 17. In the absence of substantial credit enhancement, the liquidity facility shall be regarded as a credit enhancement for capital adequacy purposes. An exception may be given where the underlying assets of the SPV are of very high quality. In such a situation, the Authority will consider treating the liquidity facility as a commitment to provide finance for capital adequacy purposes, provided that:
 - (a) the activities of the SPV are restricted to solely that of issuing securities and the SPV may only hold assets of very high quality; and
 - (b) the agreement for the liquidity facility expressly provides that the bank may reduce (and ultimately withdraw) its funding if the quality of the SPV's assets deteriorate below some appropriate and specified level.

⁶ Should the quality of the securitised assets deteriorate to a level where the level of credit enhancement is no longer sufficient, the liquidity facility will be treated as a credit enhancement for capital adequacy purposes.