

NHB(ND)/DRS/POL-No.10/2005-06
July 4, 2005

TO ALL REGISTERED HOUSING FINANCE COMPANIES (HFCS)

Dear Sir,

DRAFT GUIDELINES ON SECURITISATION OF STANDARD ASSETS

It has been decided to issue guidelines for securitisation of **standard assets** to ensure healthy development of the secondary market for residential mortgages. The guidelines on residential mortgage backed securitization as **applicable to Housing Finance Companies (HFCs)** are furnished in the **Annexure**.

2. These guidelines are being issued as a draft for feedback from all concerned. The draft will be open for comments for a period of three weeks from the date of this letter. Comments on the draft guidelines may be addressed to the undersigned at the address given below. Comments can also be sent by email to athmam@nhb.org.in.

Yours faithfully,

General Manager
Department of Regulation & Supervision
Encl: a/a

Draft Guidelines on Securitisation of Standard Assets

1. The regulatory framework provided in the guidelines covers securitisation of standard assets.
2. For a transaction to be treated as securitisation, it must follow a two-stage process. In the first stage there should be pooling and transferring of assets to a bankruptcy remote vehicle (SPV) and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the pool of assets to the third party investors should be effected.
3. For enabling the transferred assets to be removed from the balance sheet of the seller in a securitisation structure, the isolation of assets or 'true sale' from the seller or originator to the SPV is an essential prerequisite. The criteria of true-sale have been prescribed in **Attachment 1 and are illustrative but not exhaustive**. In the event of transferred assets not meeting the true-sale criteria the assets would be deemed to be an on-balance sheet asset of the seller who would be required to comply with all applicable accounting and prudential requirements in respect of those assets.
4. Arms length relationship between the originator / seller and the SPV shall be maintained as defined in **Attachment 1**.
5. The SPV should meet the criteria prescribed in **Attachment 2 to enable** originators to avail the off balance sheet treatment for the assets transferred by them to the SPV and also to enable the service providers and investors in the PTCs to avail of the regulatory treatment prescribed under these guidelines for their respective exposures in a securitisation structure,. In all cases of securitisation the securities issued by the SPV should be independently rated by an external credit rating agency and such ratings shall be updated at least every 6 months.
6. The regulatory **norms for capital adequacy, valuation, profit/loss on sale of assets, income recognition and provisioning** for originators and service providers like credit enhancers, liquidity support providers

as well as investors as also the **accounting treatment for securitisation transactions and disclosure norms** are given in **Attachment 3**.

- 7.** The originating HFC shall furnish a quarterly report to the Audit Sub-Committee of the Board as per format prescribed in **Attachment 4**.

†

The criteria for "True Sale " of assets by the Originator (HFCs)

- i. Transaction price for transfer of assets from the HFC (originator and seller) to the SPV should be market based/arrived at in a transparent manner and at an arm's length basis. The seller shall receive the consideration for sale of the securitised assets (either in the form of cash or otherwise) no later than at the time of the transfer of the assets;
- ii. The assets of the HFCs, after their transfer to SPV, should stand completely isolated from themselves i.e., put beyond their own as well as their creditors' reach, even in bankruptcy. The SPVs and holders of beneficial interests in their assets should obtain the unfettered right to pledge or exchange or otherwise dispose of the transferred assets free of any restraining condition, and shall have no recourse to the originator. The originator shall not enter into an agreement to repurchase (except to the extent and for the purpose indicated at iii below).
- iii. The HFCs [Originator and Seller] should not maintain effective control over the transferred assets through any agreement that entitles or obligates the HFCs to repurchase or redeem them before their maturity. Any agreement for repurchase or swapping of assets by the originator would vitiate the true sale criteria. However, 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 call option") could be retained by the HFCs and would not be construed to constitute 'effective control'.
- iv. Mere **provision of certain services** (such as credit enhancements which may include subscription of the Originator-cum-Seller in subordinated class of securities in a multi tranche senior, mezzanine or subordinate structure, provision of cash collaterals/reserves, guarantees, letters of credit, and other services such as underwriting, hedging, liquidity support, asset-servicing, etc.) by the HFCs in a securitisation transaction would not detract from the 'true sale' nature of the 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.
- v. All **risks and rewards** in respect of the assets **transferred** by HFCs should have been fully transferred to SPV. In case there is any **agreement** entitling the originator-cum-seller to any surplus income¹ on the securitised assets the criteria of true sale would be deemed to have been satisfied. Further, assumption of any risk relating to credit enhancement/ liquidity facility as envisaged in these guidelines is permitted.
- vi. An **opinion from the solicitors** of the originating HFCs should be kept on record signifying that all rights in the assets have been transferred to SPV and originator is not liable to investors in any way with regard to these assets. NHB would expect the HFCs acting as originators / service

¹ surplus income refers to residual income generated by the underlying assets of the SPV after meeting all payment obligations of the securities issued, servicing and operating costs of the SPV, and/or losses or bad debts on the underlying assets.

providers to maintain documentary evidence on record that their legal advisors are satisfied that the terms of the scheme protect them from any liability to the investors in the scheme, other than liability for breach of express contractual obligations for e.g. credit enhancement/ liquidity facility.

- vii. The SPV should have **no formal recourse** to the originating HFCs for any loss except through the mechanism of credit enhancement, if extended by the HFCs, for which a written agreement should be entered into at the time of origination of securitisation.
- viii. The PTCs issued by the SPV shall not have any put or call options.
- ix. The originator-cum-seller shall not be obligated to make a market in securities issued by the SPV.
- x. The HFCs should not make any representation or provide a warranty in respect of the principal and / or future performance of the PTCs issued by SPV to investors as well as future credit worthiness of the underlying assets.
- xi. The transfer of assets from originator must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents (including from third parties, where necessary) should have been obtained to make transfer fully effective.
- xii. The originator should not be under any obligation to repurchase any asset sold except where the obligation arises from a breach of a representation or warranty², if any, given in respect of the nature of the assets at the time of transfer. A notice to this effect should be given to the SPV and the investors and they should have acknowledged the absence of such obligation on the part of the HFCs concerned.
- xiii. The originator should not purchase the Senior Classes of PTCs issued by the SPV, which are backed by its own assets sold. In case, however, the SPV issues the PTCs in a multi-tranche, senior, mezzanine or subordinate structure, the originator could purchase the senior-most tranche of the securities issued by the SPV at market price, for investment purposes provided, such purchase does not exceed 10% of the original amount of the issue and that senior-most tranche is at least "investment grade".
- xiv. The HFC (Originator-cum-Seller) may enter into interest rate or currency swap arrangements on market terms with the SPV, either directly or through a third party.
- xv. Any re-schedulement, restructuring or re-negotiation of the terms of the agreement, effected after the transfer of assets to the SPV, shall be done only with the express consent of the investors, providers of credit enhancement and other service providers. The altered terms would apply to the SPV and not to the originator.

² *The seller may give representation or warranty solely in respect of the nature or existing state of facts of the asset, that is capable of being verified, at the time of its transfer. In addition, the seller must undertake appropriate due diligence prior to giving any such representation or warranty.*

- xvi. 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 him, it shall be under no obligation to remit funds to the SPV/investors unless and until these are received from the borrower.

†

Criteria for SPV under Securitisation Guidelines

The SPV should meet the following criteria for originators to avail the off balance sheet treatment for the assets transferred by the originators for complying with the prudential guidelines on capital adequacy or for availing of regulatory treatment prescribed under these guidelines for any exposure assumed in a securitisation structure by other HFCs.

- (a) Any transaction between the Originator and the SPV should be strictly on arm's length basis.
- (b) The originating HFCs transferring the assets to the SPV, should not hold substantial interest in the Trustee Company. The term substantial interest for the purpose of these guidelines would mean holding of a beneficial interest in the shares thereof the amount paid up on which exceeds Rs. 5 lakh or 10% of the capital of the Trustee Company, whichever is less. The originator may, however, have one member on the board of the trustee company.
- (c) The Trustee Company should not resemble in name or indicate any relationship with the originator of the assets in its title or name.
- (d) The Trustee Company should only perform trusteeship functions in relation to the SPV and no other functions or undertake any other business.
- (e) SPV should be a non-discretionary trust and the deed of Trust should lay down, in detail, the functions to be performed by the trustee in relation to the assets placed in trust (SPV) and should not provide for any discretion to the trustee as to the manner of disposal and management or application of the trust property i.e. to say SPV should hold on assets passively.
- (f) The Senior Classes of PTCs issued by the SPV shall compulsorily be rated at investment grade 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.
- (g) A copy of the registered trust deed and the accounts and statement of affairs of the SPV should be made available to the NHB, if required to do so.
- (h) The SPV should provide disclosures regarding 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, including details of the individual obligors, information about originator, transaction structure, service arrangement, credit enhancement details, risk factors etc.
- (i) The SPV 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 PTC holder individually through registered post at periodic intervals (maximum 6 months or more frequent). In case the PTC holders are more than 100 in number then the memorandum may also be published in a national financial daily newspaper. The contents of the memorandum would be as under:

- i) Collection summary of previous collection period.
- ii) Asset pool behaviour - delinquencies, losses, prepayment etc. with details.
- iii) Drawals from credit enhancements.
- iv) Distribution summary.
- v) Current rating of the PTCs and any migration of rating during the period.
- vi) Any other material / information relevant to the performance of the pool.

(i) The SPV should also provide a disclaimer clause stating that the PTCs do not represent deposits liabilities of the originator, servicer, SPV or the trustee, and that they are not insured. The Trustee / originator / servicer / SPV does not guarantee the capital value of PTCs or collectability of receivables pool, except in cases where guarantee/credit enhancements are provided by Trustee/SPV operating at arms length distance independent of the originator.

†

Regulatory norms for capital adequacy, valuation, profit/loss on sale of assets, income recognition and provisioning and accounting treatment for securitisation transactions and disclosure norms

1. Capital adequacy for the originator

1.1 In case the assets are transferred to the SPV from the originating HFCs in full compliance with all the conditions of true sale given in Attachment 1, 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. However, NHB may, in certain exceptional circumstances, regard the assets removed from the balance sheet of a HFC through securitisation, as carrying some residual risk to the originator HFC even where the scheme meets the foregoing conditions and may still require regulatory capital thereagainst. Such circumstances might include inadequate segregation of the pool of assets from originator's other assets, comingling of cash flows arising therefrom, etc.

1.2 The originating HFCs could also invest in Senior Classes of PTCs backed by the assets originated by it provided the securitised paper carries a minimum investment grade rating. However, the aggregate investment in such securitised paper should not, at any time, exceed 5 per cent of its total advances or 20% of its total networth, whichever is lower. In case of multiple-tranche issue of the PTCs, the investment should be confined only to the highest/ senior-most tranche provided it has at least investment grade. Any investment in excess of the above ceiling (regardless of its rating), shall be deducted from the Tier 1 capital of the investing HFC.

2. Capital adequacy for Service Providers

2.1 A HFC could provide a variety of services such as, underwriting, credit enhancement and liquidity support for a proprietary or a third-party securitisation transaction. For the capital adequacy of the service providers, these facilities would receive the treatment as detailed below.

2.2 For credit enhancers

2.2.1 A HFC may provide credit enhancement for the PTCs issued by the SPV to absorb losses of the SPV or investors in the PTCs or other participants in a securitisation structure in the specified contingencies. The credit enhancement could be structured in a variety of forms, of which the more common are subordinated cashflows in respect of the underlying loans to the SPV, over-collateralisation or spread accounts. The entity providing credit enhancement facilities should ensure that the following conditions are fulfilled:

- i. The purpose of the credit enhancement is to mitigate the credit risk inherent in the financial assets and it should be structured in a manner to keep it distinct from other facilities especially the liquidity facility. The nature of the credit enhancement provided to a transaction should be clearly specified in a written agreement at the time of originating the transaction and disclosed in the offer document. There should not be any recourse to the enhancer beyond the fixed contractual obligations so specified. In particular the enhancer should not bear any recurring expenses of the securitisation.
- ii. The facility should be provided on an 'arm's length basis' and is subject to enhancer's normal credit approval and review process. The facility should be provided on market terms and conditions.
- iii. The facility is limited to a specified amount and duration.
- iv. In case where the enhancer is the seller, the credit enhancement facility must be documented in a way that clearly separates it from any other facility provided by the seller.
- v. Credit enhancement should be undertaken only at the initiation of the scheme except in the event of a scheme having subsequent tranches of assets being placed in to the SPV.
- vi. Where any of the above conditions is not satisfied the enhancer is required to hold capital against the full value of all the securities issued by the SPV.
- vii. The credit enhancement in the form of guarantees will be treated as commitment and converted at 100% conversion factor.
- viii. The duration of the facility is limited to the earlier of the dates on which:
 - the underlying assets are redeemed;
 - all claims connected with the securities issued by the SPV are paid out; or
 - the HFC's obligations are otherwise terminated.

2.2.2 Where all of these conditions are satisfied, the capital treatment to be applied to credit enhancement facilities is as set out below.

(i) First Loss Facility

(a) A “first loss facility” represents the first level of protection against loss to the investors, SPV or others in a securitisation scheme. 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 (i.e., some multiple of historic losses or worst case losses estimated by simulation or other techniques) associated with the assets held by the SPV or the PTCs issued there against.

(b) Where first loss credit enhancement is provided then the credit enhancement should be reduced from the capital to the full extent from the books of the provider whether it is originator or third party.

(ii) Second Loss Facility

(a) A “second loss facility” represents credit enhancement that provides a second tier of protection to the investors, SPV or others in a securitisation transaction against potential losses.

(b) 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:

- it enjoys protection from a substantial first loss facility; **and**
- it can be drawn on only after the first loss facility has been exhausted.

(c) Any HFC 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:

- (i) the class and quality of the assets held by the SPV;
- (ii) the history of default and loss rates on the assets;
- (iii) the output of any statistical or other models used to assess expected losses on the assets;
- (iv) the types of activity permitted to the SPV;
- (v) the quality of the parties providing the first loss facility; or
- (vi) the opinions provided by reputable third parties (such as rating agencies) regarding the adequacy of the first loss protection.

Where a HFC 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.

2.3 Capital adequacy for liquidity support providers

2.3.1 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 in the securities it has issued. The liquidity facility must not provide for bearing any of the recurring expenses of securitisation.

2.3.2 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 of facility provided to a SPV should be clearly specified in a written agreement at the time of origination of the securitisation transaction and disclosed in any offering document. There must be no recourse to the provider beyond the fixed contractual obligation.
- (b) the facility is limited to a specified amount and duration. A fixed termination date need not be specified if the HFC 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 HFC;
- (d) the documentation for the facility must clearly define the circumstances under which the facility may or may not be drawn on;
- (e) The facility should not be capable of being drawn for the purpose of credit enhancement.
- (f) Any drawdown under the facility cannot be used to provide permanent revolving funding;
- (g) Drawings under the facility, if not repaid within 90 days, should be fully provided for.
- (h) Repayments of any drawdown under the facility cannot be subordinated to the interests of the investors
- (i) The provider must not bear any of the recurring expenses of securitisation.
- (j) The facility should be reduced or terminated should a specified event relating to deterioration in the asset quality occur.
- (k) Funding should be provided to SPV and not directly to the investors.
- (l) Funding under liquidity facility shouldn't be used to cover losses of the SPV. In addition the facility must not cover any losses incurred in the underlying pool of exposures prior to a draw or be structured in a way that a draw down is certain.

2.3.3. There must be substantial credit enhancement in place. 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.

2.3.4. 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 would attract 100 % risk weight.

2.4 Guidelines for Service Providers

A service provider will normally assume obligations such as collection from obligors, payment to the investors, reporting on the performance of the pool etc., in an asset securitisation scheme. These functions may continue to be performed by the professional organisations having the desired skills. A regulated entity may act as a servicer for fees for the SPV provided that:

- i. There is formal written agreement in place that specifies the services to be provided and standards of performance required from the servicer. There should not be any recourse to the servicer beyond the fixed contractual obligations specified in the agreement;
- ii. The services are provided on an arm's length basis, on market terms and conditions;
- iii. The Trustee to the PTC and/or investors have the clear right to select an alternative party to provide the facility;
- iv. 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 HFC's replacement as servicer.
- v. The facility is documented separately from any other facility provided by the HFC;
- vi. Its operational systems (including internal control, information system and employee integrity) and infrastructural facilities are adequate to meet its obligations as a servicer.

The servicer should be under no obligation to remit funds to the SPV or investors until it has received funds generated from the underlying assets. 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. Where the conditions as above are not met the service providers may be deemed as providing liquidity facility to the SPV or investors and treated in the same manner for capital adequacy purpose.

3. Capital adequacy for investors in the PTCs

The capital charge for credit and market risk for HFCs investing in PTCs will be governed by the extant NHB guidelines issued from time to time.

4. Valuation of PTCs

Investments in PTCs backed by housing loans shall be regarded as long term investments and be valued in accordance with the Accounting Standard issued by ICAI.

5. Exposure norms for investment in the PTCs

The counterparty for the investor in the PTCs would not be the SPV but the underlying assets in respect of which the cash flows are expected from the obligors / borrowers. The investors should accordingly monitor their exposure to the individual borrowers and the borrower groups as per the credit exposure norms of NHB wherever the obligors in the pool constitute 5% or more of the receivables in the pool or Rs.5 crore, whichever is lower.

6. Income recognition and provisioning norms for investors in the PTCs

As the PTCs are expected to be limited-tenor, interest bearing debt instruments, the income on the PTCs may normally be recognised on accrual basis. However, if the income (or even the redemption amount) on PTCs remains in arrears for more than 90 days, any future income should be recognised only on realisation and any unrealised income recognised on accrual basis should also be reversed. In case of pendency of dues on the PTCs, appropriate provisions for the diminution in value of the PTCs on account of such overdues should also be made, as already envisaged in the extant NHB norms for classification and valuation of investment by the HFCs.

7. For the originators - treatment at the time of sale

a) On transfer of the assets to the SPV, the book value of the loan asset, net of the provisions held, should be reduced by the amount of consideration received from the SPV. If the resultant is a **positive value**, it should be accounted for by debit to the Profit & Loss account during the same accounting year in which the sale is effected.

b) In case, however, the resultant is a **negative value**, it could be recognised during the same accounting year by credit to the Profit & Loss account.

c) Where the consideration is received partly in cash and partly in kind the treatment specified in paragraph 8 of the Guidance note on Accounting for Securitisation of Assets issued by the ICAI should be followed.

8. Accounting treatment of the securitisation transactions

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

9. Public disclosures in respect of securitisation transactions

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

- a. Total number and book value of loan assets securitised
- b. Sale consideration received for the securitised assets and gain / loss on sale on account of securitisation
- c. Form and quantum (outstanding value) of services provided by way of credit enhancement, liquidity support, post-securitisation asset servicing, etc.

Format of Quarterly Reporting to the Audit Sub Committee of the Board by originating HFCs 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 % 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. Classification (as per NHB norms) of assets transferred:
9. 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,):
10. 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.
11. CRAR of transferor:

<i>Before transfer</i>		<i>After transfer</i>
Tier I		
Tier II		
12. Type and classes of securities issued by SPV with ratings, if any, of each class of security, assigned by a rating agency:
13. Name and address of holders of 5% or more of securities (if available):
14. Investment by the originator in the securitised paper, issuer wise:

<u>Name of the issuer</u>	<u>Class of security</u>	<u>No. of securities held</u>	<u>Total amount</u>
15. Details of hedging arrangements (IRS/ FRAs), if any, giving amount /maturity date, name of counter parties, etc.:
16. Brief description (including diagrammatic representation of the structure) of the scheme denoting cash and process flows):
17. Date and method of termination of the scheme including mopping up of remaining assets.