EMERGING TRENDS IN REGULATION AND SUPERVISION OF SECURITISATION ACTIVITIES OF BANKS

Discussion Paper

0. Introduction

0.1 In the Second Quarter Review of the Monetary Policy announced by Reserve Bank of India on October 27, 2009, in order to ensure that the originators do not compromise on due diligence of assets generated for the purpose of securitisation, it was proposed to stipulate (i) a minimum lock-in period of one year for all types of loans before these can be securitised and; (ii) a minimum retention by the originators of 10 per cent of the pool of assets being securitised. It was indicated that detailed guidelines, on these aspects would be issued keeping in view the international work currently in progress, especially the European Union and the USA.

0.2 Securitisation involves the pooling of assets and the subsequent sale of the cash flows from these asset pools to investors. The securitization market is primarily intended to redistribute the credit risk away from the originators to a wide spectrum of investors who can bear the risk, thus aiding financial stability and to provide an additional source of funding. The recent crisis in the credit markets has called into question the desirability of certain aspects of securitization activity as well as of many elements of the 'originate to distribute' business model, because of their possible influence on originators' incentives and the potential misalignment of interests of the originators and investors. While the securitization framework in India has been reasonably prudent, certain imprudent practices have reportedly developed like origination of loans with the sole intention of immediate securitization and securitization of tranches of project loans even before the total disbursement is complete, thereby passing on the project implementation risk to investors.

0.3. With a view to developing an orderly and healthy securitization market, to ensure greater alignment of the interests of the originators and the investors, as also to encourage the development of the securitization activity in the country in a manner consistent with the aforesaid objectives, several proposals for post-crisis reform are being considered internationally. Central to this is the idea that originators should retain a portion of each securitization originated, as a mechanism to better align incentives and ensure more effective screening of loans. In addition, a minimum period of retention of loans prior to securitization is also considered desirable, to give comfort to the investors regarding the due diligence exercised by the originator.

0.4 This Discussion Paper seeks to provide an update of the international work in the field which is still in progress, the rationale behind differing opinions and sets the background for proposals regarding Lock-in Period/Minimum Holding Period (MHP) and Minimum Retention Requirements (MRR) for Indian banks. The Paper is divided into three Sections. **Section I** discusses the issues and proposals relating to Lock-in Period/MHP. **Section II** is devoted to the issues surrounding MRR and related proposals. **Section III** outlines the modifications to existing guidelines proposed to be issued for banks operating in India.

Section I

Holding/Lock-in Period

1. Rationale for Lock-in period

When an originator makes a decision to extend credit for the purpose of transferring it instantly to an SPV via securitisation, there is the risk of credits being screened less effectively. The longer the period during which the underlying assets are held on the books of the originator before being securitised, the less this risk should be. According to CEBS, the holding period before the assets can be securitised is connected with the business model of the originator viz. (i) case of some investment banks where large portfolios are procured for the sole purpose of securitization (ii) case of traditional banks/FIs that know the end borrowers to a greater extent and wish to use securitisation as a way of securing additional funding/freeing up capital for doing further business. In reality, of course, there will be multiple institutions whose business models are a hybrid between these two extremes.

2. Generally, a requirement to keep the originated loans in its own books at least for some period until full disbursement of loans for an activity/purpose, acquisition of asset by the borrower, completion of project, as the case may be; OR, observing a minimum servicing of the loan by the borrower should ensure exercise of due diligence by the originating banks.

Section II

Issues Surrounding Minimum Retention Requirement

2.1. Work Initiated by European Union Commission

The major work in regard to minimum retention requirements is being undertaken by the European Union (EU). CEBS has on October 30, 2009 issued technical advice to the European Commission on the four alternative proposals for implementing the minimum retention requirement of 5% for the investors in securitization instruments. It may be mentioned that in view of the fact that significant investments were made by the EU banks in the instruments issued by non-EU forms on which EC cannot impose the retention requirement, the EC had decided to impose the requirement on the investing credit institutions. The requirement states that no credit institution would invest in a securitised instrument if the issuer has not retained a minimum of 5% exposure.

2.1.1 Gist of CEBS Advice

2.1.1.1 General Observations

(i) CEBS believes that minimum risk retention would contribute towards alignment of incentives. However, they are also of the view that increasing it beyond appoint would be futile as the originators would shed off the exposure by higher pricing.

(ii) CEBS acknowledges that minimum retention might conflict with Exposure Draft 2009/03 issued by IASB on De-recognition of Assets.

(iii) Restriction to be applied to investors, rather than originators. The reason is that EU banks have invested significantly in the securitized instruments issued by non-European banks.

2.1.1.2 Four Options

The Directive issued by European Commission provides four methods of meeting the 5% retention requirement:

a. retention of each tranche sold or transferred to investors;

b. retention of an originator's interest in securitisations of revolving exposures;

c. retention of equivalent exposures on balance sheet; or

d. retention of a first loss tranche.

(i) <u>Options (a) and (b)</u>

- These options would create 'pari-passu' exposures with the investors.
- The main argument in support of the 'vertical slice' in the case of tranched structures and 'originators' interest' in the case of revolving exposures, as retention exposures is their ability to create 'cradle to grave' exposures. The originator is bound to remain interested in the securitised assets till last amount due is recovered, as it would share the losses proportionately.
- However, major shortcoming of this option is that a 5% pari passu interest does not provide a strong amount of economic exposure to the assets; for instance, if the underlying assets suffer a 5% loss, the seller would only suffer a 5% loss on its 5% vertical slice (compared to a 100% loss under option (d), i.e. first loss retention). Second, to the extent that the assets in a vehicle are of sufficiently low quality and to the extent that the excess spread from such assets can still flow to the originator after making payments to both the bondholders there may still be an incentive for an originator to originate poor quality assets and place them in the vehicle.
- Consequently, a vertical slice may not necessarily single-handedly guard against the potential origination of lower quality assets.

(ii) Option (c)

- This option requires the originator to retain 5% of equivalent exposures on its balance sheet.

- The retention of exposures outside of the securitisation structure (rather than inside the structure) raises two types of issues. *Firstly*, the somewhat subjective judgement of what is an "equivalent" exposure. *Secondly*, the determination of whether the originator's non-involvement in the structure could be detrimental to investors even though the originator still has exposure to similar underlying assets. It is these issues that differentiate option (c) from options (a) and (b).

- Difficulties in ensuring randomness of exposures selected for securitization.

- On the other hand, there are offsetting benefits to this option in terms of alignment of interest. For instance, to the extent an originating institution is holding an equivalent retained exposure outside of the structure it will have fewer incentives to influence or tamper with certain events (for instance, breaches or avoidance of triggers) within the structure in order to optimise cash flows to the positions or tranches it has retained itself.

- This option is effectively already prevalent in the business and funding models of many European lenders, in particular those in which the originator is not originating assets purely for onward distribution of risk to investors, but instead is undertaking securitisation as one element of a broader funding strategy.

- It would be possible to mitigate many of the risks that arise from this differentiation. Such mitigants include:

  a) ensuring that the selection process of assets from among the eligible pool is truly random;

  b) having a third-party examine and attest to the equivalence of the securitised pool and the assets remaining on balance sheet both in quantitative terms (for instance, weighted averages and stratification tables of collateral) and in qualitative terms (for instance, that both pools of assets arose from an origination process that is demonstrably similar);

c) ensuring simultaneous disclosure of the collateral attributes of the securitised pool and the assets remaining on balance sheet at the time of securitisation;

d) ensuring on-going disclosure of the collateral performance of the securitised pool and the assets remaining on balance sheet post securitisation; and

e) ensuring that the management and servicing process of the securitised pool is the same as that of the assets remaining on balance sheet post securitisation.

(iii) Option (d)

- Where the originating institution retains a share (e.g. vertical slice) in the transaction, it should always have an incentive to ensure a more optimal performance of the assets until the very last loan has either defaulted or paid off. This is clearly not the case with retention of the first loss piece, which has the potential to be eroded due to realised losses on the assets.

- The alignment (or misalignment) created by the first loss option will depend greatly on the firm's loss expectation, the regulatory capital treatment of the underlying assets, how control is aligned with seniority in the structure and the servicing approach to the underlying assets. On the other hand, retention of a first loss piece creates greatest alignment of interest in economic terms. Therefore a uniform approach across all assets that does not consider the different degrees of risk within each securitisation and the impact on the alignment may not always be appropriate when applying option (d).

- Originator would lose interest in proper servicing of loans once the losses exceed the first loss piece.

- There is probably a trade-off to be made between the vertical slice and the first-loss piece: whereas the vertical slice may align the incentives with respect to servicing and arrears management decisions during the lifetime of the transaction, it may be less effective than the first-loss piece in guaranteeing asset quality at the point of origination.

- To offset the greater degree of risk that is assumed by the first-loss piece, it frequently benefits from any excess spread (i.e. residual cash flows in a transaction after all other payments have been made). It may consequently be argued that the greater degree of risk assumed by the first-loss piece is

offset to some extent by the greater potential rewards it can accrue, thus negating any potential benefits in terms of incentive alignment versus options (a) and (b). However, this stance does not necessarily always hold, as excess spread need not always flow to the holder of the first-loss tranche, and transactions could be structured for such excess spread to flow to any tranche or to a vertical slice holder.

2.1.1.3 "L- shaped Option"

CEBS in its advice to EC, suggested another alternative, called 'L-shaped Retention. It involves retention of two types of exposure from among those listed above, and more specifically to require the retention of both a first loss piece and a vertical slice.

a) This has the advantage of ensuring the optimal form of retention, as the specific distortions and abuses that both the first loss option and the vertical slice option generate disappear when the combination of both is employed.

b) The disadvantage is that it effectively dictates an L-shaped retention structure (first loss plus vertical slice) across the market regardless of capital structure and asset class, as opposed to allowing the market to decide which of the options is most suitable according to the capital structure and asset class of individual transactions.

2.2 Work done by US Government: Financial Regulatory Reforms: A New Foundation

US Department of Treasury issued the captioned document in 2009 wherein the need for minimum risk retention by banks was recognised. Relevant proposals are reproduced below:

2.2.1 The federal banking agencies should promulgate regulations that require loan originators or sponsors to retain **five percent** of the credit risk of securitized exposures.

2.2.2 The regulations should prohibit the originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain under these

regulations. This is critical to prevent gaming of the system to undermine the economic tie between the originator and the issued ABS.

2.2.3 The federal banking agencies should have authority to specify the permissible forms of required risk retention (for example, first loss position or pro rata vertical slice) and the minimum duration of the required risk retention. The agencies also should have authority to provide exceptions or adjustments to these requirements as needed in certain cases, including authority to raise or lower the five percent threshold and to provide exemptions from the "no hedging" requirement that are consistent with safety and soundness.

2.2.4 The agencies should also have authority to apply the requirements to securitization sponsors rather than loan originators in order to achieve the appropriate alignment of incentives contemplated by this proposal.

2.3 Consultative Paper on Asset-Backed Securities Issued by Securities and Exchange Commission, USA

SEC, USA issued the captioned paper on April 7, 2010 wherein it has articulated the following stance regarding the MRR:

2.3.1 SEC proposes a minimum risk retention of 5%.

2.3.2 SEC believes that the proposed risk retention requirement for shelf eligibility would distinguish the types of securities that are of a sufficient quality and character to be shelf eligible while avoiding the possibility of undue reliance on ratings.

2.3.3 SEC gives two options:

- Vertical Slice: Retention of a minimum of five percent of the nominal amount of each of the tranches sold or transferred to investors, net of hedge positions directly related to the securities or exposures taken by such sponsor or affiliate; or

- in the case of revolving asset master trusts, retention of the originator’s interest of a minimum of five percent of the nominal amount of the securitized exposures, net of hedge positions directly related to the securities or exposures taken by such sponsor or affiliate, provided that the originator’s interest and securities held by investors are collectively backed by the same pool of receivables, and payments of the originator’s interest are not less than five percent of payments of the securities held by investors collectively.

2.3.4 SCE considered option (c) of CEBS but felt that it would be both difficult and potentially costly for investors and regulators to verify that exposures were indeed selected randomly, rather than in a manner that favoured the sponsor.

2.3.5 “Horizontal risk retention” in the form of retention of the equity or residual interest could lead to skewed incentive structures, because the holder of only the residual interest of a securitization may have different interests from the holders of other tranches in the securitization and, thus, not necessarily result in higher quality securities.

2.3.6 Different forms of risk retention, such as retention of the equity piece, may lead issuers to screen assets that go into the pool differently. **Fender and Mitchell** observe that if the equity piece is too thin or down turn is more likely in the immediate future, then the originators retaining exposure through equity piece would not have incentive to screen the borrowers as that much loss would almost be certain in any case and there would be no further loss to the originator. In such a case, vertical slice would create better incentive. On the other hand, if equity piece is thick or the default profiles are back-loaded, equity piece may create good incentive.

2.3.7 SCE feels a small horizontal equity piece is unlikely to provide enough incentives to the originators to do proper due diligence.

2.4 Conflict between minimum retention criteria and de-recognition of securitised assets as per ED 2009/03 issued by IASB in March 2009

2.4.1 As per ED-2009/03-**Derecognition of Assets**,

17A An entity shall derecognise the Asset if:

(a) the contractual rights to the cash flows from the Asset expire;

(b) the entity transfers the Asset and has no continuing involvement in it; or

(c) the entity transfers the Asset and retains a continuing involvement in it but the transferee has the practical ability to transfer the Asset for the transferee's own benefit.

2.4.2 The ED makes it clear from the undernoted example given in para AG52L that retention of interests in the form of investments in the securities issued by SPV including that as credit enhancements would **disallow** the de-recognition:

(c) *Transfer of a financial asset with a subordinated interest in the asset.* As part of a transfer of a financial asset, a transferor may provide the transferee with credit enhancement by subordinating some or all of its interest retained in a transferred asset. For such transfers, 'the Asset' is the entire financial asset because the performance of the interest retained depends on that of the interest transferred. Through the interest retained and the subordination of that interest, the transferor has an interest in the future performance of the entire financial asset and thus has continuing involvement in the Asset. Also, because of the transferor's retained interest, the transferee will not have the practical ability to transfer the Asset to an unrelated third party for its own benefit. As a result, control of the Asset has not passed to the transferee. The transferor recognises a liability for the proceeds received and continues to recognise the Asset; the transferee recognises a receivable for the cash paid to the transferor.

However, it is not clear whether the credit enhancements through off-balance sheet exposures would also constitute retained interest/continuing involvement.

2.4.3 Perusal of comment letters on the IASB's website on ED 2009/03 revealed that:

(i) Almost all the comments have rejected the criteria of 'practical ability of the transferee to transfer the assets' as the basis for inferring control and thus deciding on the derecognition.

(ii) It appears from para 17(c) of the ED that intention of IASB is not to base the de-recognition on complete absence of continuing involvement. However, in the situation of continuing involvement, it wants to be sure that the entity does not have any control on the assets and this absence of control it wants to be demonstrated through the practical ability of the transferee to transfer the assets further. But, the general impressions among the market participants seems to be that in many cases it would be difficult to demonstrate that the transferee has ability to transfer the assets and, therefore, only the cases where there is no continuing involvement would qualify for derecognition.

(iii) BCBS and CEBS, in their comments to IASB have highlighted the direct conflict between the ED 2009/03 and the EU retention requirement of 5%.

(iv) Many commenting organizations including BCBS and CEBS believe that it is not necessary that there should be 100% absence of continuing involvement of the transferor in order to de-recognise the assets. They feel that the existing requirement – *'substantial transfer of risks and rewards'* has not been rendered ineffective during the crisis and should therefore not be replaced by *'full transfer of risks and rewards'*. However, as stated above there is ambiguity in the interpretation and many commenting organizations have not highlighted this issue, perhaps placing reliance on para 17(c) which allows continuing involvement subject to demonstration of the transferee's ability to transfer the assets. These entities have accordingly chosen to attack the test of ''practical ability of the transferee to transfer the assets' rather than attacking '100% absence of continuing involvement'.

2.4.4 Implications of the Conflict

(i) Given the firm move towards stipulation of minimum retention requirement in USA and European Union, it is felt that the minimum retention requirement is going to be put in place at least in these

countries, and there is high chance that other countries would also follow suit.

(ii) The 5% seems to be the most agreed level of retention requirement.

(iii) IASB's intention is not to disallow any form of retained interest. It would also not be practicable. There is very little chance that the minimum retention requirement would be dropped, because:

- Para 17(c) of ED/2009/03 does allow scope for continuing involvement. It is only the replacement of the notion of 'risk and reward' with the 'practical ability of transfer the assets by the transferee' to establish control which has spurred the debate. Based on comments and suggestions received, this issue is expected to be sorted out.

- There is substantial difference between the risk profile of a bank when it has assets on its balance sheet and when it has transferred assets through securitization and has retained some risk through credit enhancement etc. In the former case, even where capital requirement may be a few percentage points of exposure say 8%, the bank can potentially lose the entire exposure. However, in the case of latter, its loss is capped by the amount of its exposure to the securitised assets, even though the capital requirements may be the same, slightly more or slightly less. Thus, banks have to be given benefit of securitization, at least, by not consolidating the transferred assets.

- If the proposal, as it is understood, is implemented by IASB, it would disallow credit enhancements and underwriting by originators. This would almost certainly kill the securitization market the world over, as the originators would not like the assets to be consolidated back. This may also encourage revival of the securitization market by encouraging third parties to give credit enhancements. Then, the originators will not have a 'skin in the game' and in that case the issues raised by the crisis are not being addressed.

- At present, it is the investors who are considered to be controlling the SPV. In an SPV structure the 75% investors can take many crucial decisions about the underlying assets. This is also a normal rule in all fund/trust structures such as Mutual funds, VCFs, PEFs. In that case, how can any accounting standard conclude that the

originator holding 5% assets would be deemed to be controlling the SPV?

- Apparently, both IASB and EU"s minimum retention seek to address the deficiencies highlighted in the crisis. Then why so much conflict? The main issue is to take a view as to whether the crisis is attributed to – *'originators not having skin in the game'* or '*transferring assets, getting capital relief but actually retaining the substantial amount of risk of assets'*. It is felt that the crisis has highlighted both the issues. OTD model leading to creation of CDOs with poor assets as underlying suggests that originators should have skin in the game. On the other hand, failure of Northern Rock suggests that extreme care needs to be taken before allowing de-recognition of assets. It needs to be appreciated that the problem similar to that faced by Northern Rock cannot be avoided merely by absence of credit enhancement or liquidity support. Such situations are rightly being addressed by amending IAS 27 where control is being defined carefully to cover the situations when there is no equity investment but still 100% dependence of the sponsor on the SIV's functioning.

Section III

Proposals for India

In the backdrop of the international work as discussed in the preceding two Sections, it is proposed to issued guidelines to banks regarding the MHP and MRR as per draft circular annexed. RBI's approach in formulating these guidelines is summarized below:

3.1 Minimum Holding Period (MHP)

The main concern in India has been very quick securitization of loans after origination, sometimes within a week. This practice raises doubt about the quality of due diligence performed by the originating banks, and, therefore, has the potential of causing misalignment between the incentives of the originators and investors. It is felt that MHP would contribute towards ensuring that:

a) the asset has actually been created; and
b) the borrower has begun to service the loan and thereby the originating bank is exposed to credit risk prior to securitisation.

It is believed that the MHP would help in alignment of the incentives of the originators and investors.

3.2 Minimum Retention Requirement (MRR)

3.2.1 The minimum retention requirement may be fixed at 5%, consistent with that being proposed in USA and EU.

3.2.2 In terms of economic impact, 5% equity piece is not equal to 5% vertical piece. In the former, on an exposure of Rs.100, Rs. 5 can be lost even if total loss on the pool is just Rs. 5. In the case of the latter, Rs. 5 will be lost by the originator, if the entire Rs. 100 is lost. Therefore, this needs to be kept in view while allowing choices.

3.2.3 Equity piece is more suitable when the horizon is short and the originator's long term involvement is not envisaged. However, for long term exposures where originators act as servicing agents, vertical slice will be more appropriate. Though Fender and Mitchell argue that the appropriateness of option depends upon whether the downturn is more likely or not in the near future, it is not possible to predict the down turns correctly. Then why to base the option on such a prediction?

3.2.4 There is no agreement on the appropriate method of retention which can be mandated uniformly. It is likely that in European Union more than one options may be permitted. However, in USA, considering the SEC Paper the inclination seems to be towards vertical retention.

3.2.5 It is intended to base the minimum retention requirements for banks in India on the following principles:

- The MRR should vary as per maturity of the loan, and MRR should be higher for longer duration loans due to greater risk in such loans and need for long time involvement of originators in such securitisations as servicers.

- For securitisation not involving any tranching or credit enhancements, the retention has to be in the form of pari-passu investments.

- For short term securitisations involving tranching, the MRR in the form of investment in equity/subordinate piece is more appropriate. However, for long term securitisations additional layer of a pari-passu exposure(L- shaped retention) suggested by CEBS) seems to be more appropriate.

- The total MRR is being capped at 10% and total exposure to SPV in all forms except interest rate swaps and currency swaps at 20%. As explained later, it is being done in view of the IASB's preference to 'no continuing involvement of originators' with the securitised assets if they want to avoid consolidation of the SPVs with them.

3.3 Total exposure to SPV and/or underlying assets

3.3.1 At present, total investment by the originator (including its group entities) in PTCs through underwriting or otherwise is limited to 20% of the total PTCs issued. Credit enhancement, liquidity support, and counterparty credit exposures in the case of interest rate swaps/currency swaps with the SPV are outside this limit. However, though not stipulated, it is expected that to comply with the Basel II requirements (para 554 (a) - there should be a transfer of significant credit risk associated with the securitised exposures to the third parties- a bank should not retain total exposure exceeding 50% of the loan amount.

3.3.2 Given that IASB (ED 2009/03) is giving a lot of importance of reducing continuing involvement of originators with the securitised assets as discussed above, it is likely that in the final standard, strict limits are placed for such retentions. Therefore, it is considered appropriate to limit the total exposure of banks to the SPV and/or securitised assets in the following forms to **20%**:

- Investments in equity/subordinate/senior tranches of securities issued by the SPV including through underwriting commitments.
- Credit enhancements including cash and other forms of collaterals including over-collateralisation
- Liquidity support

3.3.3 Credit Exposure on account of interest rate swaps/currency swaps may be excluded as these would not be within the control of the bank.

3.4 Hedging of Minimum Risk Retention not permitted

Banks should not hedge the credit risk in the retained exposures counting towards the minimum retention requirements.

3.5 Securitisation Activities/Exposures not Permitted in India

It is proposed to clarify that the banks in India are not permitted to undertake the securitisation activities or assume securitisation exposures as mentioned in para 3.5.1 to 3.5.3 below. Therefore, all banks operating in India should not undertake above transactions.

3.5.1 Re-securitisation of Assets

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

3.5.2 Synthetic Securitisations

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

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

These involve exposures where the borrower is permitted to vary the drawn amount and repayments within an agreed limit under a line of credit (e.g. credit card receivables and corporate loan commitments). Typically, revolving structures will have non-amortising assets such as credit card receivables, trade receivables,

dealer floor-plan loans and some leases would support non-amortising structures, unless these are designed to include early amortization features. Early amortisation means repayment of securities before their normal contractual maturity. At the time of early amortisation there are three potential amortisation mechanics: (i) Controlled amortisation (ii) Rapid or non-controlled amortisation (iii) Controlled followed by a subsequent (after the completion of the controlled period) non-controlled amortisation phase.

3.6 Other related issues (not addressed in this Discussion Paper and the proposed circular)

3.6.1 Capital Adequacy and other Rules for Transfer of Loans through Modes other than Securitisation

It may be recalled that RBI's guidelines on securitisation of standard assets were issued on February 1, 2006. These guidelines define securitisation as a process by which a single performing asset or a pool of 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. Hence, these guidelines are applicable to those transactions which involve bankruptcy remote SPV. The intention of securitisation by a bank may be transfer of credit risk, regulatory capital relief, raising of funds, liquidity etc. All these objectives may well be achieved by a bank by assignment/sale of a whole loan/ portfolio of loans to another bank without any SPV coming into picture. It has been observed that banks in India are resorting to such sales of loan assets. The applicability of RBI's guidelines on securitisation to such transactions is not directly established since definition of securitisation and criteria of true sale are laid down only in case of transfer through SPV. Provisioning and capital adequacy requirements become open to interpretation in such cases of loan transfer without SPV route. Since these transactions also raise issues concerning true sale, retention of residual risk for the originator and also need for laying down proper risk management framework, there is a need to evolve explicit capital adequacy norms for such transactions.

There is considerable merit in applying the same capital adequacy framework to other modes of credit risk transfer as is applicable to securitization transactions, *albeit* with suitable modifications to take care of certain specific aspects of transfers to SPVs.

Separate instructions would be issued to address these issues.

3.6.2 Applicability of guidelines to investors in securitised instruments and foreign subsidiaries/branches of banks

As discussed in para 2.1 in the EU the MRR is being imposed on the investing banks, not the originating banks considering the specific situation faced in that market (most EU banks had invested in the securitized paper issued by entities over which EU has no regulatory authority). A similar situation would be faced by all regulators in the context of internationally active banks. Perhaps, it may be appropriate to apply the restrictions both at the originator and investor level and also the origination and investments made by the foreign subsidiaries/branches of banks. However, a careful thought needs to be given to this issue.

3.6.3 Applicability of the MHP and MRR to NBFCs

In order to have the level playing field and remove undesirable arbitrage opprirtunities, *prima facie* it appears appropriate to apply the MHP and MRR restrictions to NBFCs also. However, this needs to be examined further keeping in view specific situations of NBFCs.

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