Risk Weight on Housing Finance and Mortgage Backed Securities

DBOD No. BP. BC. 106/21.01.002/2001- 02

May 24, 2002

All Commercial Banks
(excluding RRBs/LABs)

Dear Sir,

<u>Risk Weight on Housing Finance and Mortgage Backed Securities</u>

Please refer to paragraphs 78 to 80 regarding Housing Loan and Mortgage Backed Securities in the "Statement on Monetary and Credit Policy for the year 2002-03" enclosed to Governor's letter No. MPD.BC.214/07.01.279/ 2002-03 dated April 29, 2002.

2. At present, banks' loans and advances secured by mortgage of residential property and also commercial property are assigned risk weight of 100 per cent for capital adequacy purpose. So far, no explicit risk weight has been prescribed for banks' investment in housing loan securitised papers. With a view to further improving the flow of credit to the housing sector, it has been decided to liberalise the prudential requirement on risk weight for housing finance by banks and encourage investments by banks in Mortgage Backed Securities (MBS) of Housing Finance Companies (HFCs) which are recognised and supervised by NHB. Accordingly, banks extending housing loans to individuals against the mortgage of residential housing properties would be permitted to assign risk weight of 50 per cent instead of the existing 100 per cent. Loans against the security of commercial real estate would continue to attract 100 per cent risk weight as hitherto. The investments in MBS of residential assets of HFCs would be eligible for risk weight of 50 per cent for the purpose of Capital Adequacy.

3. However, banks' investments in Mortgage Backed Securities (MBS) should satisfy the following terms and conditions **:**

(a) The right, title and interest of a HFC in securitised housing loans and receivables thereunder should irrevocably be assigned in favour of a Special Purpose Vehicle (SPV) / Trust.

(b) Mortgaged securities underlying the securitised housing loans should be held exclusively on behalf of and for the benefit of the investors by the SPV/Trust.

(c) The SPV or Trust should be entitled to the receivables under the securitised loans with an arrangement for distribution of the same to the investors as per the terms of issue of MBS. Such an arrangement may provide for appointment of the originating HFC as the servicing and paying agent. However, the originating HFC participating in a securitisation transaction as a seller, manager, servicer or provider of credit enhancement or liquidity facilities **:**

i. shall not own any share capital in the SPV or be the beneficiary of the trust used as a vehicle for the purchase and securitisation of assets. Share capital for this purpose shall include all classes of common and preferred share capital;

ii. shall not name the SPV in such manner as to imply any connection with the bank;

iii. shall not have any directors, officers or employees on the board of the SPV unless the board is made up of at least three members and where there is a majority of independent directors. In addition, the official(s) representing the bank will not have veto powers;

iv. shall not directly or indirectly control the SPV; or

v. shall not support any losses arising from the securitisation transaction or by investors involved in it or bear any of the recurring expenses of the transaction.

(d) The loans to be securitised should be loans advanced to individuals for acquiring/constructing residential houses which should have been mortgaged to the HFC by way of exclusive first charge.

(e) The loans to be securitised should be accorded an investment grade credit rating by any of the credit rating agencies at the time of assignment to the SPV.

(f) The investors should be entitled to call upon the issuer - SPV - to take steps for recovery in the event of default and distribute the net proceeds to the investors as per the terms of issue of MBS.

(g) The SPV undertaking the issue of MBS should not be engaged in any business other than the business of issue and administration of MBS of individual housing loans.

(h) The SPV or Trustees appointed to manage the issue of MBS should have to be governed by the provisions of Indian Trusts Act, 1882.

4. If the issue of MBS is in accordance with the terms and conditions stated in paragraph **3** above and includes irrevocable transfer of risk and reward of the housing loan assets to the Special Purpose Vehicle (SPV)/Trust, investment in such MBS by any bank would not be reckoned as an exposure on the HFC originating the securitised housing loan. However, it would be treated as an exposure on the underlying assets of the SPV / Trust.

5. Please acknowledge receipt.

Yours faithfully,

(M.R. Srinivasan)
Chief General Manager-in-Charge