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Guideline

Subject: **Asset Securitization**

Category: **Prudential Limits and Restrictions**

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1. Introduction

This guideline outlines the regulatory framework for asset securitization transactions. It applies to all federally regulated financial institutions (FRFIs)[1] on an enterprise-wide basis.

The capital requirements in this guideline are based on bank, trust and loan company, life insurance company, and P&C company capital rules. If OSFI finds the capital inadequate for the risks assumed or retained by virtue of asset securitization activities, OSFI may increase the institution's capital requirements beyond the minimum required in this guideline.

OSFI reserves the right to adopt a look-through approach to determine the originator of the assets. The look-through approach may also be used to ensure appropriate capital is maintained by a FRFI in a securitization transaction.

OSFI's accounting requirements for asset securitizations are set out in Guidelines D-4, *Transfers of Financial Assets* and D-8, *Accounting of Transfers of Receivables Including Securitizations*.

Accounting issues related to NHA mortgage-backed securities transactions are addressed in Guidelines D-3, *Accounting for NHA-insured MBS* and D-8, *Accounting of Transfers of Receivables Including Securitizations.*

The principles contained in this guideline and OSFI's Credit Derivatives – Capital Treatment; Appendix to Guideline A, Parts I and II, will be used to determine the appropriate regulatory treatment of synthetic securitization of assets on a case-by-case basis.

[1] For the purposes of this guideline, a FRFI refers to banks, and to federally regulated trust and loan companies, cooperative credit associations, life insurance companies and property and casualty insurance companies. Foreign bank branches should refer to OSFI's Guideline B-5A *Asset Securitization for Foreign Bank Branches*.

Canada

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2. Background

2.1 Securitization process

In its simplest form, asset securitization is the transformation of generally illiquid assets into securities that can be traded in the capital markets. The asset securitization process generally begins with the segregation of financial assets into pools that are relatively homogeneous with respect to their cash-flow characteristics and risk profiles, including both credit and market risks. These pools of assets are then sold to a bankruptcy-remote entity, generally referred to as a special-purpose entity (SPE), which issues asset-backed securities (ABS) to investors to finance the purchase. ABS are financial instruments that may take a variety of forms, including commercial paper and term debt and certificates of beneficial ownership. The cash flow from the underlying assets supports repayment of the ABS. Various forms of enhancement are used to provide credit protection for investors in the ABS.

Securitizations typically split up the risk of credit losses from the underlying assets into tranches that are distributed to different parties. The “first dollar”, or most subordinate, loss position is first to absorb credit losses (first loss protection); the most “senior” investor position is last; and there may be one or more loss positions in between (“second” or “subsequent dollar” loss positions). Each loss position functions as an enhancement if it protects the more senior positions in the structure from loss.

A FRFI may perform one or more functions in an asset securitization transaction. It may:

- invest in a debt instrument issued by an SPE (section 4.4);
- provide enhancements (sections 4.1 and 4.2);
- provide liquidity support (section 4.3);
- set up, or cause to be set up, an SPE (section 5.1);
- collect principal and interest payments on the assets and transmit those funds to an SPE, investors in the SPE securities or a trustee representing them (section 5.2); and/or
- provide clean-up calls (section 5.3).

2.2 Enhancement

An enhancement is an arrangement provided to an SPE to cover the losses associated with the pool of assets. Enhancement is a method of protecting investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the ABS in a timely manner. Enhancement is used to improve or support the credit rating on more senior tranches, and therefore the pricing and marketability of the ABS. The distinction between the types of enhancement - first loss and second or subsequent loss - is drawn to allow for an understanding of the underlying structure, differences in risk profiles and capital requirements.

2.2.1 First loss

A first loss enhancement is a facility[2] designed to cover the first level of losses or first level of financial support for the underlying assets in the pool, the performance of the entity, or the instruments issued to investors. Common examples of these facilities include overcollateralization; cash collateral; recourse provisions; senior/subordinated security structures; subordinated standby lines of credit; subordinated loans; third party equity; commitments to purchase assets in default; and any arrangement where recourse provisions are offset against retained interests such as spread accounts or interest-only strips. A first loss facility is often provided by the supplier of the assets but may be provided by a third party.

2.2.2 Second or subsequent loss

A second or subsequent loss facility represents an enhancement providing a more senior tier of protection to the SPE or to investors in senior tranches. It is designed to absorb losses and reduce risks for investors and the liquidity provider(s). The share of risk of a second or subsequent loss facility depends on the coverage provided by any first loss facility. In order to limit the possibility of the second or subsequent loss facility carrying a disproportionate level of risk (hence a lower capital requirement), an enhancement facility is deemed a second or subsequent loss facility only if it explicitly benefits from the protection of a significant (see section 4.1) and subordinated first loss facility, i.e., the first loss facility should cover all of the types of risks to which the second or subsequent loss is exposed. Second or subsequent loss facilities may apply to specific assets of a single seller, a specific pool or pools of assets in a multi-seller entity, the performance of an entity, or the instruments issued to investors.

Common examples of these facilities include: recourse provisions; senior/subordinated security structures; subordinated standby lines of credit; subordinated loans; third party equity; swaps that are structured to provide an element of enhancement; and any amount of liquidity facilities in excess of 103% of the face value of outstanding paper. In addition, these facilities include any temporary financing facility, other than qualifying servicer advances, provided by a FRFI to an enhancer or to an SPE to bridge the gap between the date a claim is made against a third party enhancer and when payment is received.

2.3 Liquidity support

Liquidity support is a commitment to lend to, or purchase assets of, an SPE in order to provide investors with assurance of timely payment of principal and interest. Liquidity support may include a general market disruption clause. A general market disruption can be defined as a disruption in the Canadian commercial paper market resulting in the inability of Canadian commercial paper issuers, including the SPE, to issue any commercial paper, and where the inability does not result from a diminution in the creditworthiness of the SPE or any originator or from a deterioration in the performance of the assets of the SPE.

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2 If a facility is not subject to a maximum contract value, its value is deemed to equal the total amount of the pool of SPE assets.

3. OSFI's Expectations

A FRFI should understand the inherent risks of the activity, be competent in structuring and managing such transactions, and have adequate staffing of the functions involved in the transactions.

The terms and conditions of all transactions between the FRFI and the SPE should be at least at market terms and conditions (and any fees are paid in a timely manner) and meet the FRFI's normal credit standards. The Credit Committee or an equally independent committee should approve individual transactions.

A FRFI's capital and liquidity plans should take into account the potential need to finance an increase in assets on its balance sheet as a result of early amortization or maturity events. If OSFI finds the planning inadequate, it may increase the institution's capital requirements.

Securitization documentation should clearly state that early amortization cannot be precipitated by regulatory actions affecting the supplier.

The capital requirements for asset securitization transactions will be limited to those set out in this guideline if the FRFI provides only the level of support (enhancement or liquidity) committed to in the various agreements that define and limit the levels of losses to be borne by the FRFI.

4. Capital Requirements for Securitization Exposures[3]

4.1 First loss enhancements

A FRFI that provides a first loss enhancement is required to deduct the full amount of the facility from total capital for capital adequacy purposes. The amount of the deduction may be reduced by the amount of any provision, deferred gain, or recognized loss on sale, pursuant to Guidelines D-4 and D-8, that relates to that facility. This treatment applies whether or not the FRFI is the supplier of the assets to the SPE.

The amount deducted from the total capital of banks and trust and loan companies in calculating their risk-based capital adequacy and assets-to-capital multiple is limited to the capital that would have been required had the assets remained on the balance sheet, or otherwise been the property, of the institution.

The amount deducted from total capital by life and property and casualty insurance companies is limited to the capital that would have been required under OSFI's relevant risk-based capital adequacy requirements for a direct credit substitute of an amount equal to the assets protected by

[3] Includes senior tranches, enhancements and liquidity facilities.

the first loss enhancement. The counterparty factor used in this calculation will be the applicable factor for the underlying assets, subject to a minimum of 4%.

A first loss enhancement is considered significant if it meets the following conditions:

- there is a documented and reliable credit history for the specific type of asset in each underlying pool;
- the FRFI's credit process properly assesses the credit and other risks of the facility in accordance with its standard credit policy for arm's-length counterparties; and
- the facility adequately covers the expected losses, for example, the facility raises the rating of the next senior tranche to at least BBB.

4.2 Second or subsequent loss enhancements

Where a FRFI provides a second or subsequent loss enhancement, the facility will qualify for treatment as a direct credit substitute (or an on-balance sheet asset at its face value) under the relevant capital adequacy rules if the facility is fully protected by a significant first loss enhancement and meets any of the following conditions:

- at least 25% of the facility is participated to an independent third party;
- the facility is explicitly rated at least BBB; or
- an independent third party provides the first loss enhancement.

If it does not meet at least one of these conditions, the facility will be considered a first loss enhancement.

A second or subsequent loss enhancement is considered significant if it meets the following conditions:

- the rating of the facility indicates a lower risk of loss than that of the underlying pool(s) and any first loss facility; and
- the size of the facility is sufficient to achieve a higher rating on more senior rated tranches.

4.3 Eligible liquidity facilities [4]

To qualify as an eligible liquidity facility, OSFI expects a facility to meet the following criteria:

- the facility documentation must clearly identify and limit the circumstances under which it may be drawn;
- the facility has full protection of first and second or subsequent loss facilities as available to senior investors in the SPE/pool/series;
- draws under the facility must be limited to the amount that is likely to be repaid fully from the liquidation of the underlying exposures and any enhancements;
- the facility cannot be drawn after all applicable first and second or subsequent loss facilities from which the liquidity would benefit have been exhausted;
- the facility cannot be used to provide credit support (even on a temporary basis), or serve as permanent funding for the securitization;
- the facility must not cover any losses incurred in the underlying pool of exposures prior to a draw, or be structured such that draw-down is certain (as indicated by regular or continuous draws);
- funds advanced to repay investors in the senior tranches or the SPE/pool/series are fully secured by at least an equal value of underlying performing assets;
- repayment of funds advanced must rank at least *pari passu* with the claims of investors of the senior tranches;
- the facility must be subject to an asset quality test that precludes it from being drawn to cover credit risk exposures that are in default and includes a clause that causes it to be reduced or terminated if the quality of the assets deteriorates; and
- if the exposures that a liquidity facility is required to fund are externally rated securities, the facility can only be used to fund securities that are externally rated investment grade at the time of funding.

Where these criteria are not met, the facility may be treated as first loss or second or subsequent loss enhancement subject to meeting the conditions outlined in section 4.1 or 4.2.

Where these criteria are met, the following options for capital treatment apply. See Annex 2 for a summary of the options in diagram form.

[4] In any SPE where a FRFI provides second or subsequent loss enhancements or liquidity facilities, the 25% participation rule applies separately at the level of the SPE and at the level of the individual pools within the SPE.

4.3.1 Where a FRFI provides an eligible liquidity facility under the following conditions:

- an independent third party provides a facility that qualifies as a significant first loss enhancement; and
- the second or subsequent loss enhancement provided is **significant**,

the liquidity facility will be treated as described at the end of section 4.3.3 (see box) for any one of the following scenarios:

- another independent third party provides the second or subsequent loss enhancement;
- the second or subsequent loss enhancement provided is explicitly rated at least BBB;
- the FRFI provides the second or subsequent loss enhancement that is at least 25% participated; or
- the FRFI provides the second or subsequent loss enhancement and at least 25% of the liquidity facility is participated.

4.3.2 Where a FRFI provides an eligible liquidity facility under the following conditions:

- an independent third party provides a facility that qualifies as a significant first loss enhancement; and
- the second or subsequent loss enhancement provided is **insignificant**,

the liquidity facility will be treated as described at the end of section 4.3.3 (see box) for the following scenario:

- another independent third party provides the second or subsequent loss enhancement and at least 25% of the liquidity facility is participated.

A liquidity facility that does not meet any of the conditions or fit within the scenarios described in sections 4.3.1 and 4.3.2 will be considered a <u>direct credit substitute</u> under the relevant capital adequacy rules.

4.3.3 Where a FRFI provides an eligible liquidity facility under the following conditions:

- the FRFI provides a facility that qualifies as a significant first loss enhancement; and

- the second or subsequent loss enhancement provided is **significant**,

the liquidity facility will be treated as described at the end of this section (see box) for any one of the following scenarios:

- an independent third party provides the second or subsequent loss enhancement;
- the second or subsequent loss enhancement provided is explicitly rated at least BBB; or
- the FRFI provides the second or subsequent loss enhancement that is at least 25% participated.

An eligible liquidity facility that is in compliance with the conditions and scenarios described in sections 4.3.1, 4.3.2, and 4.3.3 is subject to the following capital treatment: • for a facility that is available in the event of a general market disruption, a 0% credit conversion factor (CCF) applies; • for a facility with an original maturity of one year or less <u>or</u> that is unconditionally cancellable at any time without prior notice, a 10% CCF applies; or • for a facility with an original maturity of more than one year, a 50% CCF applies

4.3.4 Where a FRFI provides an eligible liquidity facility under the following conditions:

- the FRFI provides a facility that qualifies as a significant first loss enhancement;
- the second or subsequent loss enhancement provided is **insignificant**; and
- the liquidity facility is at least 25% participated,

the liquidity facility will be treated as a <u>direct credit substitute</u> under the relevant capital adequacy rules in any of the following scenarios:

- an independent third party provides the second or subsequent loss enhancement;
- the second or subsequent loss enhancement provided is explicitly rated at least BBB; or
- the FRFI provides the second or subsequent loss enhancement that is at least 25% participated.

A liquidity facility that does not meet any of the conditions or fit within the scenarios described in sections 4.3.3 and 4.3.4 will be considered a <u>first loss enhancement</u>.

4.4 Ratings-based approach

A FRFI investing in or holding senior tranches or providing second or subsequent loss enhancements (that meet the conditions in section 4.2) may be able to use a ratings-based approach to determine the capital requirements for these exposures. The approach uses credit ratings from widely recognized rating agencies[5] to measure relative exposure to credit risk and determine the associated risk-based capital requirement. For rated exposures that qualify for the ratings-based approach, Annex 1 provides the risk weights and factors that correspond to the various external credit ratings.

A FRFI may not use the ratings-based approach for first loss enhancements; capital requirements for first loss enhancements are described in section 4.1.

For second or subsequent loss enhancements or liquidity facilities explicitly rated BBB[6] and above, the 25% participation requirement[7] is deemed to have been met through the rating process.

5. Capital Requirements for Other Roles Performed by a FRFI

5.1 Setting up, or causing to be set up, an SPE

OSFI expects a FRFI to minimize its exposure to risk arising from its relationship with an SPE. A FRFI that sets up, or causes to be set up, an SPE will not have to hold capital as a result of this activity if the following conditions are met:

- the FRFI does not own any share capital in a company, nor is it the beneficiary of a trust, used as an SPE for purchasing and securitizing financial assets. For this purpose, share capital includes all classes of common and preferred share capital;
- the FRFI's name is not included in the name of a company or trust used as an SPE, nor is any connection implied with the FRFI by, for example, using a symbol closely associated with the FRFI. If, however, the FRFI is performing a specific function for a particular transaction or transactions (e.g., collecting and transmitting payments or providing enhancement), this may be indicated in the offering circular (subject to the *Name Use Regulations*);
- the FRFI does not have any of its directors, officers or employees on the board of a company used as an SPE, unless the SPE's board has at least three members. Where the board consists of three or more members, the FRFI may not have more than one director.

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[5] For the purposes of this guideline, OSFI recognizes the following agencies: DBRS, Moody's, Standard and Poor's, and Fitch.

[6] Or equivalent rating by DBRS, Moody's, Standard and Poor's, or Fitch.

[7] The 25% participation (on a pari passu basis with an independent third party) requirement is intended to validate the assessment by the originating FRFI of the risk of the enhancement or liquidity facilities.

Where the SPE is a trust, the beneficiary and the indenture trustee and/or the issuer trustee must be third parties independent of the FRFI;

- the FRFI does not lend to the SPE on a subordinated basis, except as otherwise provided herein[8]; and
- the FRFI does not support, except as provided elsewhere in this guideline, any losses suffered by the SPE, or investors in it, or bear any of the recurring expenses of the SPE.

Where a FRFI does not meet all of these conditions, it is required to hold capital against all debt instruments issued to third parties by the SPE.

5.2 Collecting and transmitting payments

A FRFI whose only involvement with a particular asset securitization transaction is to collect interest and principal payments on the underlying assets and transmit these funds to the SPE or investors in the SPE securities (or a trustee representing them) should be under no obligation to remit funds to the SPE or the investors unless and until the funds are received from the obligors. Where this condition is met, this activity does not attract any capital.

A FRFI that is collecting interest and principal payments on the underlying assets and transmitting these funds to the SPE or investors in the SPE securities (or a trustee representing them) may also:

- structure transactions;
- analyse the underlying assets;
- perform due diligence and credit reviews;
- monitor the credit quality of the portfolio of underlying assets; and/or
- provide servicer advances (see conditions outlined in section 5.2.1).

In this role, a FRFI should:

- comply with the conditions specified for a FRFI setting up an SPE;
- have evidence available in its records that its legal advisers are satisfied that the terms of the asset securitization protect it from any liability to investors in the SPE (except normal contractual obligations relating to its role in collecting and transmitting payments); and

8 A loan provided by a FRFI to a SPE to cover initial transaction or set-up costs is a deduction from capital as long as the loan is capped at its original amount; amortized over the life of the securities issued by the SPE; and the loan is not available as a form of enhancement to the assets or securities issued.

- ensure that any offering circular contains a highly visible, unequivocal statement that the FRFI, serving in this capacity, does not stand behind the issue or the SPE and will not make good any losses in the portfolio.

Where a FRFI that is not making servicer advances meets all these conditions, this activity does not attract any capital.

Where a FRFI does not meet all these conditions, it is required to maintain capital against all debt instruments issued to third parties by the SPE.

5.2.1 Making servicer advances

A FRFI may be contractually obligated to provide funds to an SPE to ensure an uninterrupted flow of payments to investors in the SPE's securities, solely under the unusual circumstance that payments from the underlying assets have not been received due to temporary timing differences. A FRFI that provides such support is typically referred to as a servicing agent and the funds provided are typically referred to as servicer advances. Where a FRFI acts as a servicing agent, OSFI expects the following conditions to be met:

- servicer advances are not made to offset shortfalls in cash flow that arise from assets in default;
- the credit facility under which servicer advances are funded is unconditionally cancellable by the servicing agent;
- the total value of cash advances is limited to the total amount transferable for that collection period;
- servicer advances rank ahead of all claims by investors in SPE securities, expenses and other cash allocations;
- the repayment of servicer advances comes from subsequent collections or the available enhancement facilities;
- servicer advances are repaid within thirty one[9] business days; and
- the servicing agent performs an assessment of the likelihood of repayment of servicer advances prior to each advance and such advances should only be made if prudent lending standards are met.

Where these conditions and the conditions in section 5.2 are all met, FRFIs should treat undrawn facilities as off-balance sheet commitments. Drawn facilities will be treated as on-balance sheet loans.

In all other circumstances, the facilities will be treated as first loss enhancements.

[9] This means 31 business days from the day the cash is advanced.

5.3 Providing clean-up calls

A clean-up call is an option that permits a FRFI that is the supplier of the assets or collecting and transmitting payments to wind-up an SPE before all of the underlying credit exposures have been repaid. This is generally accomplished by repurchasing the remaining securitization exposures once the pool balance has fallen below a specified level. This level is established at origination and is set to trigger when the amount of assets is too low for the SPE to economically issue securities.

An agreement that permits a FRFI to purchase the remaining assets in a pool when the balance of those assets is equal to or less than 10 percent of the original pool balance is considered a clean-up call and no capital is required. However, a clean-up call that permits the remaining loans to be repurchased when their balance is greater than 10 percent of the original pool balance or permits the purchase of non-performing loans is considered a first loss enhancement.

5.4 Investor

A FRFI investing in the most senior tranches may be able to use explicit external credit ratings to determine the capital requirement. Annex 1 provides the risk weights and factors that correspond with the various external credit ratings.

When an explicit external credit rating is not available, a FRFI holding the most senior tranches should determine its capital requirement based on the relevant capital adequacy rules for similar investments. (See tab 3 of *Capital Adequacy Requirements*, section 3-4-1 of *Minimum Continuing Capital and Surplus Requirements*, or tab 2-4 of *Minimum Capital Test*.)

For all other exposures, investors should refer to section 4 for the appropriate capital treatment.

ANNEX 1

Banks, Trust and Loan Companies

Long-term rating category*

External Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ and below or unrated
Risk Weight	20%	50%	100%	Deduction from capital

* The rating designations used in the following charts are for illustrative purposes only and do not indicate any preference for, or endorsement of, any particular external assessment system.

Short-term rating category

External Credit Assessment	A1/P1/R1H	A2/P2/R1M	A3/P3/R1L	All other ratings or unrated
Risk Weight	20%	50%	100%	Deduction from capital

Life Insurance Companies

Short-term securities (original maturities of less than one year)

Factor		Commercial Paper
Regular	**Qualifying Participating**	
0.25%	0.125%	Rated R1 (H), A-1 or equivalent
0.50%	0.25%	Rated R1 (M), A-2 or equivalent
2%	1%	Rated R1 (L), A-3 or equivalent

Bonds/Loans/Private Placements

Factor		Bonds
Regular	**Qualifying Participating**	
0.25%	0.125%	AAA, A++ or equivalent
0.5%	0.25%	AA, A+ or equivalent
1%	0.5%	A, A or equivalent
2%	1%	BBB or equivalent
8%	4%	All other ratings or unrated[10]

P&C Companies

Risk Factors for Investment Grade* On- and Off-balance sheet positions

Factor	On-Balance Sheet Assets Investments: Term Deposits, Bonds and Debentures (includes Treasury Bills and Commercial Paper)	Off-Balance Sheet Exposures
0.50%	Expiring or redeemable in one year or less	Structured Settlements, Letters of Credit, Derivatives
2.00%	Expiring or redeemable in more than one year	Other

* A security is treated as Investment Grade if its rating meets or exceeds the rating listed below.

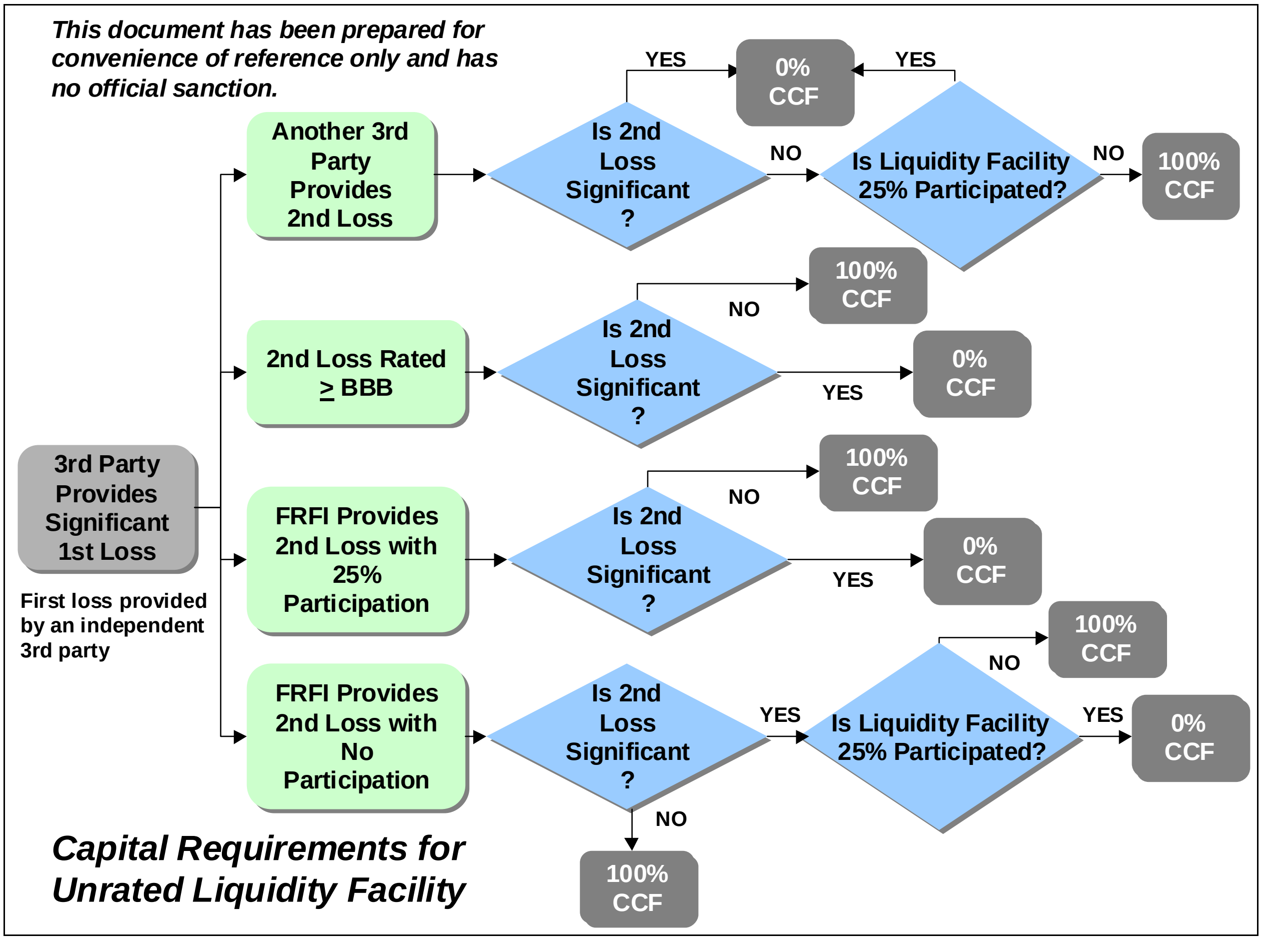
Asset/Guarantor Ratings

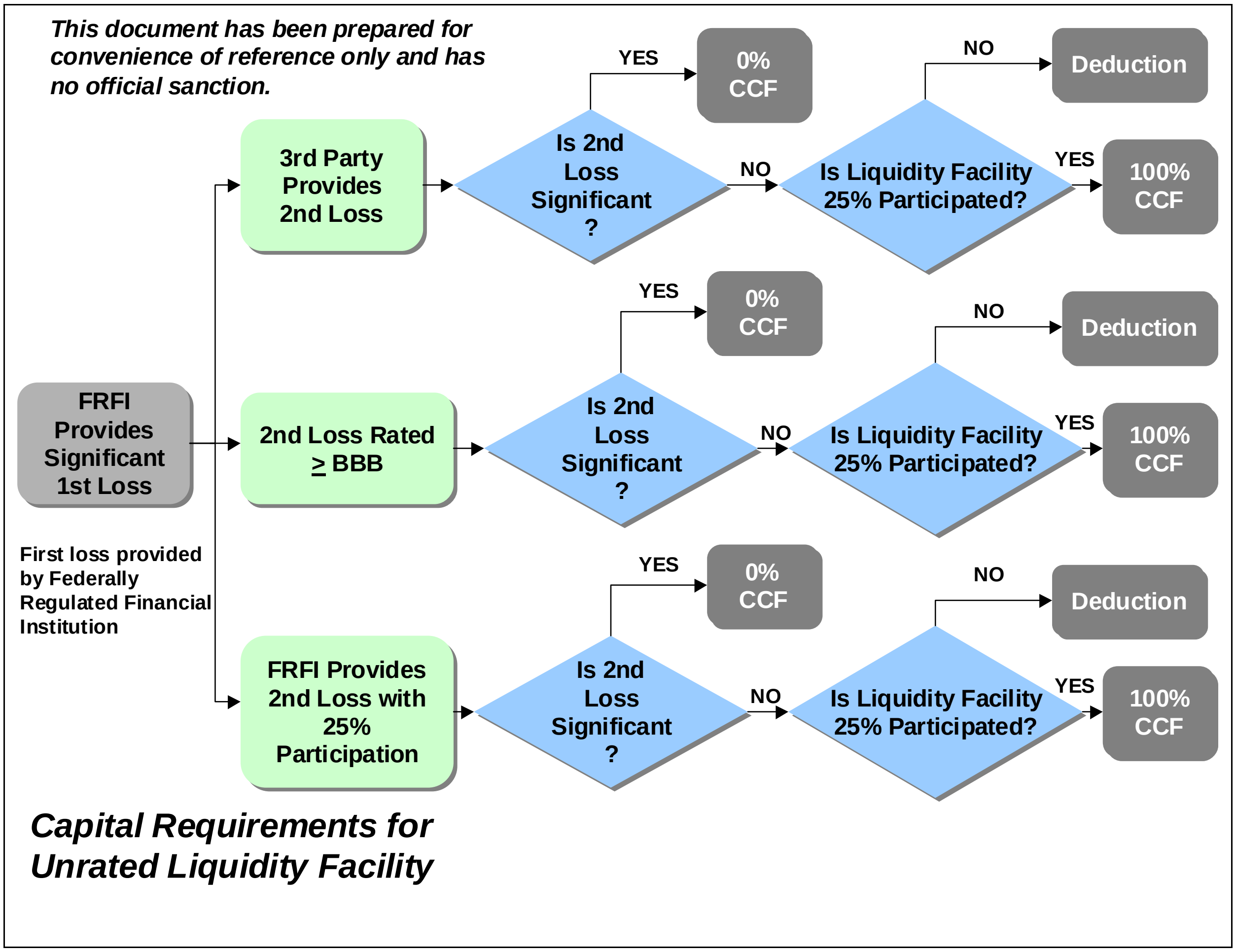
Rating Agency	Commercial Paper	Bonds & Debentures (at least as high as)	Preferred Shares
Moody's Investors Service	P-1	A	Aa
Standard and Poor's Corporation	A-1	A	AA
Dominion Bond Rating Service	R-1 (low)	A	Pfd-2

[10] Does not apply to first loss enhancement.

ANNEX 2

Note: The 0% CCF in both diagrams is for illustrative purposes only. Please refer to section 4.3 of this guideline and OSFI's Capital Adequacy Requirements for details.




This document has been prepared for convenience of reference only and has no official sanction.
FRFI Provides Significant 1st Loss
First loss provided by Federally Regulated Financial Institution
3rd Party Provides 2nd Loss
2nd Loss Rated ≥ BBB
FRFI Provides 2nd Loss with 25% Participation
Is 2nd Loss Significant ?
YES
0% CCF
NO
Is Liquidity Facility 25% Participated?
NO
Deduction
YES
100% CCF
Capital Requirements for Unrated Liquidity Facility