Guideline

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This guideline outlines the regulatory framework for asset securitization transactions and for other types of asset transfers with recourse. The guideline is derived from the Asset Securitization guideline that applies to all other federally regulated financial institutions. However, the capital requirements of the Asset Securitization guideline

have been removed in order to recognize the fact that the capital adequacy requirements for authorized foreign banks in respect of their business in Canada - foreign bank branches (FBBs) are the capital adequacy rules of the authorized foreign bank's home jurisdiction.

The purpose of the guideline is to ensure that FBBs follow sound practices to protect themselves against risks arising as a result of asset securitization transactions and to insulate themselves to the extent possible from any moral recourse obligations. OSFI's accounting requirements for asset securitizations and for other transfers of financial assets with recourse are set out in guideline D-4.

The guideline does not apply to NHA-insured mortgage-backed securities transactions which are the subject of guideline D-3 Accounting for NHA-insured Mortgage-backed Securities.

Roles Performed by an FBB

Asset securitization involves pooling groups of assets, such as mortgages, trade or credit card receivables, automobile leases, and consumer loans, and financing them with securities that are sold to investors.

An FBB may assume one or more functions in an asset securitization transaction. It may:

- set up or cause to be set up a special purpose vehicle to purchase assets and issue securities;
- act as a servicing agent - i.e., structure the transaction, analyse the assets, perform due diligence and credit reviews, and monitor the credit quality of the portfolio;
- collect interest and principal payments on the assets and transmit those funds to investors (or a trustee representing them);
- be the supplier of the assets that are securitized;
- provide some form of credit support by such means as a guarantee, asset repurchase agreement, subordinated standby line of credit or subordinated debt; and
- provide liquidity support to the special purpose vehicle on an unsubordinated basis.

- Through its own trading and distribution activities or securities subsidiary, an FBB may also act as underwriter. This function is not addressed in this guideline.

Setting up a Special Purpose Vehicle

In a typical securitization transaction a special purpose vehicle is used to purchase assets and issue securities. To minimize its exposure to risk with respect to the special purpose vehicle, an FBB must meet the following conditions.

The FBB may not:

- own any share capital in a company, or be the beneficiary of a trust, used as a vehicle for purchasing and securitizing financial assets. For this purpose, share capital includes all classes of common and preferred share capital;
- include the name of the FBB in the name of a company, or trust, used as such a vehicle or imply any connection with the FBB, for example, by using a symbol closely associated with the FBB. If, however, the FBB is performing a specific function for a particular transaction or transactions (e.g., acting as the servicing agent or credit enhancer) this may be indicated in the offering circular (subject to the Name Use Regulations);
- have any of its directors, officers or employees on the board of a company used as such a vehicle unless the board is made up of at least three members. Where the board consists of three or more members, the FBB may not have more than one director. Where the special purpose vehicle is a trust, the beneficiary and the indenture trustee and/or the issuer trustee must be independent third parties;
- lend to the vehicle on a subordinated basis, except as otherwise provided herein; or
- support, except as provided for elsewhere in this guideline, any losses suffered by the asset securitization issue or investors in it or bear any of the recurring expenses of the scheme. However, the FBB may enter into interest or exchange rate swap, cap, floor or similar agreements at market terms with the vehicle.

The terms and conditions of all transactions between the FBB and the vehicle must be approved by the FBB's branch management to ensure that such transactions are at least at market terms and conditions (and paid in a timely manner).

Acting as a Servicing Agent

An FBB may act as servicing agent to a special purpose vehicle. In this role it structures transactions, analyses the assets, performs due diligence and credit reviews, and monitors the credit quality of the portfolio. An FBB acting as the servicing agent must comply with the conditions specified for an FBB setting up a special purpose vehicle. In addition, the FBB must:

- have evidence available in its records that its legal advisers are satisfied that the terms of the asset securitization issue protect it from any liability to investors in the scheme or the vehicle (except normal contractual obligations relating to its role as servicing agent);
- ensure that any offering circular contains a highly visible, unequivocal statement that the FBB, serving in this capacity, does not stand behind the issue or the vehicle and will not make good any losses in the portfolio; and
- ensure that a fee that is at least at market terms and conditions is charged for the services performed.

Collecting and Transmitting Payments

- The conditions specified for an FBB acting as a servicing agent also apply to an FBB that collects interest and principal payments on the underlying assets and transmits these funds to investors (or a trustee representing them). In addition, the FBB, in taking on this function, must:
- be under no obligation to remit funds to the special purpose vehicle or the investors in the securities unless and until they are received from the obligor; and

- not provide temporary finance to cover cash shortfalls arising from non-performance of loans it administers or delayed payments, except for reasons of mechanical disruptionA mechanical disruption is defined as a breakdown resulting from a "force majeure" such as an interruption in the power supply, a computer system failure or an act of nature. in the payment system.

Acting as the Supplier of the Assets

When an FBB transfers its own assets to a special purpose vehicle for securitization, the transfer can be treated as a sale and the assets removed from the balance sheet if the transaction meets the Office's general criteria for sales treatment (See guideline D-4.) An FBB that does not meet the criteria must keep the assets on its books for reporting purposes. In addition, an FBB that is the supplier of the assets may need to finance an increase in assets on its balance sheet as a result of early amortization or maturity events. If OSFI finds the FBB's planning inadequate, it will bring its concerns to the attention of branch management who should take appropriate action to correct the deficiency.

Early amortization cannot be precipitated by regulatory actions affecting the supplier.

Providing First Loss Protection Facilities

First loss protection (first loss facility) is a facility 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 vehicle or the instruments issued to investors. Common examples of these facilities include overcollateralization, 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 that defers receipt of sales proceeds such as spread accounts. A first loss facility is often provided by the supplier of the assets but may be provided by a third party.

Pursuant to Guideline B-5, banks and trust and loan companies providing first loss facilities are required to deduct the amount of each facility from total capital for capital adequacy purposes to the extent that there has not been a provision, or a deferral of a gain or the recognition of a loss on sale, under guideline D-4. The amount deducted

from total capital for banks and trust and loan companies in calculating the risk based capital adequacy and the assets-to-capital multiple requirements, will be limited to the capital that would have been required under each test had the assets remained on the balance sheet, or otherwise been the property, of the institution.

As an FBB does not have its own capital, it is required to adjust its on-balance sheet assets by an amount equivalent to the assets that would have to remain on its balance sheet or otherwise be its property based on the application of the approach described in the previous paragraph.

A first loss facility would be considered significant if it meets the following conditions:

- there is a documented and reliable credit history of at least a full business cycle for the specific type of assets in each underlying pool;
- the FBB's credit process properly assesses the credit and other risks in accordance with its standard credit policy for arm's-length counterparties; and
- the facility adequately covers the expected losses in any foreseeable situation.

Providing Enhancement Facilities

An enhancement facility (enhancement) is a facility that is designed to absorb losses and reduce risks for investors and the liquidity provider. It must explicitly benefit from the protection of the subordinated first loss facility. To explicitly benefit from the protection of a first loss facility, the first loss facility must cover all of the risks to which the credit enhancement is exposed. Enhancements may apply to specific assets of a single seller, pools of assets in a multi-seller vehicle, the performance of a vehicle 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 and third party commitments to purchase assets in default. Enhancements may be provided by the supplier of the assets or a third party.

Where the FBB is not the supplier of the assets

Where an FBB that is not the supplier of the assets provides an enhancement, the facility can be considered a direct credit substitute (or an on-balance sheet asset at its face value) if it is protected by a significant first loss facility provided by an independent party. If this facility does not meet this condition it will be considered a first loss facility.

Where the FBB is the supplier of the assets

Where an FBB that is the supplier of the assets, or where a regulated affiliate of the FBB that is the supplier of the assets, provides an enhancement, or both a first loss facility and an enhancement, the facilities will be considered first loss facilities.

Providing Liquidity Facilities

A liquidity facility for the purposes of this guideline must explicitly benefit from the protection of a significant subordinated enhancement and should include a clause that causes it to be reduced or terminated if the quality of the assets deteriorates. Liquidity support to the special purpose vehicle provides investors with assurance of timely payment in case of market disruption. A common example of a liquidity facility is a commitment to lend to the vehicle during the normal course of business. It can be provided by an independent third party or a party that assumes another function in the transaction. An independent party must be involved in the provision of the liquidity facility and/or the enhancement to ensure that there is a clear separation between them.

Where the FBB is not the supplier of the assets

Where an FBB is not the supplier of the assets and there is a significant enhancement provided by a third party that meets the conditions for treatment as an enhancement and protects the liquidity facility from loss, the facility will be recorded based on the definitions for off-balance sheet instrumentsAs defined in the Capital Adequacy Guideline..

Where an FBB is not the supplier and there is no enhancement or it is insignificant, the liquidity facility will be recorded based on the definitions for off-balance sheet instrumentsAs defined in the Capital Adequacy Guideline. if

the following conditions are met:

- at least 25% of the liquidity facility is participated to an independent third party on a pro-rata basis; and
- the first loss facility provided by an independent third party protects the liquidity facility from the risk of loss in any situation.

If these conditions are not met the liquidity facility will be considered equivalent to an enhancement if it meets the conditions specified above for an FBB providing an enhancement. If it does not meet the conditions for treatment as an enhancement, the liquidity facility will be considered to be a first loss facility.

Where an FBB is not the supplier of the assets and provides both the enhancement and the liquidity under separate facilities, the enhancement will be treated as an enhancement if it meets the conditions for that facility, is significant and it protects the liquidity facility from loss. The liquidity facility will be treated as an off-balance sheet instrument Pursuant to the capital adequacy rules set forth in the Capital Adequacy Guideline. under the capital adequacy rules as long as:

- at least 25% of the liquidity facility or at least 25% of the enhancement is provided by an independent third party; or
- at least 25% of the liquidity facility is participated to an independent third party on a pro-rata basis (pro-rata participation) and at least 25% of the enhancement is provided by other parties, and the amount of enhancement provided by other parties represents a distinct layer of enhancement, coming after the first loss protection and the lead institution's enhancement.

If this is not done, the liquidity facility may qualify to be an enhancement if it meets the conditions for that facility.

Where an FBB is not the supplier of the assets in a multi-seller vehicle and provides both the enhancement and the liquidity under separate facilities, an enhancement for one pool of assets (direct enhancement) may cross-collateralize other pools of assets in the vehicle. The level of the direct enhancement must be consistent across all pools of assets based on their risk profile and the direct enhancement must be significant and protect the cross-collateralized amount from loss. If these conditions are met, the above pro-rata participation requirements will

apply on an individual pool basis exclusive of any cross-collateralization. If these conditions are not met, the cross-collateralized amount will be included in applying the pro-rata participation requirements.

Where the FBB is the supplier of the assets

Where an FBB is the supplier of the assets and an enhancement is provided by a third party, at least 25% of the liquidity facility must be participated to an independent third party on a pro-rata basis to be treated as an off-balance sheet instrument. If there is no pro-rata participation the liquidity facility will be considered to be a first loss facility.

Where an FBB is the supplier of the assets and there is no enhancement and an FBB or regulated affiliate provides liquidity support or where the FBB or affiliate provides both an enhancement and liquidity, these facilities would be considered first loss facilities.

Where an FBB is the supplier of the assets and there is no enhancement the liquidity facility will be recorded based on the definitions for off-balance sheet instrumentsAs defined in the Capital Adequacy Guideline. if the following conditions are met:

- at least 25% of the liquidity facility is participated to an independent third party on a pro-rata basis; and
- the first loss facility provided by an independent third party protects the liquidity facility from the risk of loss in any situation.

If these conditions are not all met, the liquidity facility will be considered to be a first loss facility.