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PART A OVERVIEW

1. Introduction

1.1 While significant benefits may be derived from securitisation activities, the nature of securitisation that un-bundles traditional banking roles into several limited functions has the potential for exposing banking institutions to heightened levels of risk. In this regard, Bank Negara Malaysia (the Bank) has issued the Prudential Standards on Securitisation Transactions¹ (Prudential Standards), applicable to both traditional and synthetic securitisations², with the objectives of:

- i. outlining the role and responsibilities of the board of directors and the senior management of banking institutions involved in securitisation activities; and
- ii. specifying best practices with respect to the general risk management framework in relation to securitisation activities.

Capital adequacy requirements, including the operational requirements to be met in order to exclude securitised exposures from the calculation of risk-weighted assets, are addressed within the respective capital adequacy frameworks³.

1.2 Banking institutions are required to observe all general requirements. While the general risk management requirements are in most cases more relevant to banking institutions that assume primary roles in securitisation transactions, banking institutions that assume only secondary roles shall also observe the

¹ Previously known as Prudential Standards on Asset-Backed Securitisation Transactions, first issued in March 2003 and last updated in October 2007.

² The requirements of the Prudential Standards are applicable to all banking institutions involved in securitisation activities, including in instances where capital relief is not sought (e.g. where securitisation is conducted for funding purposes and not to transfer credit risk), and also where assets are transferred to SPVs with no corresponding credit tranching.

³ Risk-Weighted Capital Adequacy Requirement (Basel I – Risk-Weighted Assets Computation) and Risk-Weighted Capital Adequacy Requirement (Basel II – Risk-Weighted Assets Computation).

general requirements where applicable. In most instances, banking institutions should be able to leverage on their existing infrastructure to comply with the requirements. Banking institutions should comply with all requirements outlined in the Prudential Standards on an ongoing basis, unless an exemption or deviation from a specific requirement is given by the Bank.

- 1.3 In relation to synthetic securitisations, the Prudential Standards should also be read together with relevant components of the following guidelines:
- i. Guidelines on Regulatory Treatment for Credit Derivatives Transactions;
 - ii. Guidelines on Introduction of New Products; and
 - iii. Minimum Standards on Risk Management Practices for Derivatives.

2. Applicability

- 2.1 The Prudential Standards are applicable to all banking institutions licensed under the Banking and Financial Institutions Act 1989.

3. Legal Provision

- 3.1 The Prudential Standards is issued pursuant to Section 126 of the Banking and Financial Institutions Act 1989, and in relation to the Banking and Financial Institutions (Exemption) Order 2002 (Exemption Order) gazetted on 18 April 2002.

PART B SUPERVISORY EXPECTATIONS RELATING TO SECURITISATION TRANSACTIONS

4. Roles and Responsibilities of Board of Directors

- 4.1 It is the duty of the board of directors to understand and set the scope and purpose of the involvement of a banking institution in asset securitisation activities and be aware of the risks and other implications associated with the securitisation activities undertaken.
- 4.2 The board is responsible for approving significant policies (such as the policy on disposal of assets) with respect to securitisation activities to be undertaken by the banking institution. The policies must be consistent with the banking institution's overall business strategies and management expertise.
- 4.3 The board must also ensure that:
- i. all policies related to securitisation set by the board are effectively implemented by senior management;
 - ii. the board is informed and updated on potential exposures arising from securitisation activities where the banking institution is extensively involved;
 - iii. senior management has a good understanding and the necessary skills and capacity to evaluate and control risks involved;
 - iv. a competent and independent internal audit function is in place to verify the effectiveness of procedures and controls to manage risks involved as well as the reliability of information submitted to the board.

5. Role and Responsibilities of Senior Management

- 5.1 The senior management of banking institutions is responsible for carrying out all policies set by the board and ensures compliance with all applicable laws

and regulations pertaining to securitisation activities. In ensuring the proper conduct of risk management processes, management must ensure that:

- i. significant policies relating to securitisation activities are properly documented;
- ii. internal system and controls are adequate, and operational policies and procedures are commensurate with roles assumed in securitisation schemes;
- iii. the banking institution's performance and risk exposures in relation to its involvement in asset securitisation are evaluated on a continuing basis; and
- iv. expertise within the banking institution is adequate to undertake the activities.

5.2 In addition, senior management will be responsible for ensuring:

- i. clear lines of responsibility for managing risks. This should include dedicated personnel being assigned to maintain overall responsibility for implementing/managing the securitisation scheme. The personnel involved should possess the skills and experience to understand the various components of securitisation, as well as the roles and responsibilities to be assumed by the banking institution (both primary and secondary roles). The personnel should also be able to understand the impact of changes in internal policies or legal, regulatory and accounting requirements on the banking institution's current or future securitisation transactions. Such assessments should be reported to senior management;
- ii. adequate systems are in place for measuring risks; and
- iii. comprehensive review and reporting processes to the various levels of management and the board with respect to the securitisation activities where the banking institution is extensively involved (assuming several roles or key role, in particular, origination).

6. Risk Management Process

6.1 Securitisation activities shall be undertaken within the overall risk management framework of the banking institution. The banking institution should have an integrated infrastructure for effective risk management to ensure that potential risks arising from securitisation activities are sufficiently captured and managed. Such an infrastructure should support sound assessments and impact analyses, clearly define lines of responsibility, be subject to effective audit reviews and oversight, facilitate continuing assessment of performance as well as address proper documentation and disclosures.

Assessment/impact analysis

6.2 Proper evaluation and potential impact analysis is crucial particularly, where a banking institution is extensively involved in any securitisation transaction. Such institutions should identify specific personnel/unit to undertake an assessment of the securitisation scheme. This may include assessments on:

- i. the appropriateness and effectiveness of the securitisation structure;
- ii. the methods to measure, monitor and control potential risks;
- iii. necessary system enhancements and modifications required (if any) to monitor and control risks arising from securitisation transactions;
- iv. accounting, tax, regulatory or legal implications; and
- v. other risk management issues (for example, reporting structure and management of liquidity risk).

Documentation and disclosure

6.3 Banking institutions which are originators and/or servicers should be in a position to supply accurate and timely information on the underlying assets to parties relevant to the transactions, including rating agencies, trustees and arrangers.

Review of performance

- 6.4 Although the originating banking institutions may have sold the ownership rights and control of the assets, their role as an underwriter, servicer or provider of credit enhancements and liquidity facilities may expose them to potential credit risks or operational risks. Where there is such extensive involvement of the banking institutions, senior management should be in a position to assess the performance of the underlying asset pools.
- 6.5 The assessment of performance may involve analysing periodic reports on the securitisation transaction. The results and conclusion of such analyses may, when necessary and appropriate, form part of reports/updates to the board. As a guide, the following information could be relevant in the assessment:
- i. Charge-off rate / written-off rate – amount that has been taken out from the pool and treated as irrecoverable;
 - ii. The net portfolio yield – the rate of return on the portfolio minus the provision for charge-off;
 - iii. Delinquencies (aged) – the outstanding payment which is overdue;
 - iv. Rate of principal prepayment; and
 - v. Outstanding principal compared to original security size for all tranches of the securitisation structure.
- 6.6 In the case of securitisation involving revolving cashflows, the following information may be relevant:
- i. Base rate - investor coupon rate plus servicing fees;
 - ii. Monthly excess spread – the spread between rate of return from the pool and the cost of issuing the securities such as interest paid and fees (A smaller spread is an indication of a possible deterioration in the quality of the pool);
 - iii. Rolling three-month average excess spread – the monthly excess spread shall determine the three-month average spread; and

- iv. Monthly payment rate of outstanding pool balance – this indicates the amount of new receivables to be brought in to maintain the minimum outstanding balance.

Independent audit review and oversight

- 6.7 Risk management processes should be independently monitored and evaluated by the internal audit unit or an independent risk control function. The evaluation should consider the various roles undertaken by the banking institution a in securitisation, paying special attention to the origination and servicing functions. The objective of the process is to determine whether internal controls are in accordance with the overall risk management policies, adequate and commensurate with the risk level assumed.
- 6.8 The independent unit should be informed of the securitisation schemes early, preferably during the initial due diligence process, together with the rating agencies and accountants. The unit should be involved in assessing the effectiveness of the monitoring functions throughout the securitisation transaction.

7. Risk Management Issues Relating to Specific Roles in Securitisation Transactions

Credit enhancements

- 7.1 Banking institutions may provide credit enhancement facilities in order to improve the credit attractiveness of a securitisation scheme. These facilities may be in the form of first or second loss facilities that include but are not limited to arrangements such as subordinated loan facilities, over-collateralisation or cash collaterals.
- 7.2 A banking institution providing a credit enhancement should ensure that:
 - i. The facility has a finite amount and duration, specified at the outset of the transaction;

- ii. There is no recourse to the banking institution beyond the fixed contractual obligations under the facility;
- iii. The SPV and/or investors have the right to select an alternative party to provide the facility;
- iv. The facility is documented separately from any other facility provided by the banking institution;
- v. The details of the facilities are disclosed in the offering information memorandum or prospectus; and
- vi. The facility is provided on an arm's length basis and is subject to the banking institution's normal credit approval and review.

Servicing and liquidity facilities

7.3 A banking institution may become a service provider or servicer to the SPV directly, assuming a number of obligations such as transaction processing, performance reporting and collections in an asset securitisation scheme. A banking institution acting as a servicer should be under no obligation to remit funds to the SPV or investors, except for funds provided under a liquidity facility until it has received funds generated from the underlying assets.

7.4 While a banking institution may provide liquidity facilities to cover short-term cash flow disruptions (for example, delay in payments in a pass-through structure) to the securitisation, this should not be confused with the credit loss protection that has been made available separately. In acting as service provider and provider of liquidity facilities, banking institutions should ensure that such facilities are not also being used to provide credit enhancements or guarantees, hence exposing the institutions to substantial risks. To ensure the facilities are not used as a form of credit enhancement, the following criteria should be observed:

- i. A facility must be separately documented and provided to an SPV, not to the investors, at arm's length and subject to the banking institution's normal credit approval and review processes;
- ii. The SPV/trustee must have an explicit right to be able to select a third party to provide the facility;

- iii. A facility must be fixed in amount and duration, with no recourse to the banking institution beyond the fixed contractual obligations provided for in the facility;
- iv. The term of the facility must clearly identify and limit the circumstances under which it may be drawn and, in particular, the facility must not be used to provide credit support, cover losses sustained, or act as a revolving fund; and
- v. The repayment of drawings under the facility and fee for the facility should not be subordinated to the interests of the noteholders or subject to any waiver or deferral.

Replenishment of assets

- 7.5 An originating banking institution may, as agreed at the outset of the issue, be required to place further tranches of assets into the security pool in cases where the cashflow from the existing portfolio is altered due to reasons other than deterioration in the quality of the underlying assets (for example, prepayment, re-scheduling etc). In such cases, the originating banking institution must ensure that all conditions spelt out for such replenishment are complied with. Steps must also be taken to address any potential adverse impact on the quality of assets remaining on the balance sheet where material.

8. Prudential Requirements

- 8.1 Banking institutions may invest in asset-backed securities (ABS) subject to the following:
- i. Investments in ABS are done at the sole discretion of the banking institution, on market terms and conditions and are subject to the institution's normal credit approval and review processes;
 - ii. The amount of ABS held is included in the computation of the single counterparty exposure limit prescribed under Section 61 of BAFIA. If as a result of acting as an underwriter for securities issued by an SPV, a

banking institution holds more than its single counterparty exposure limit, it is given a maximum of 90 days to rationalise exposures in compliance with this limit. Nevertheless, one-day credit exposures arising from primary collateralized loan obligation (PCLO) transactions by banking institutions are excluded from the calculation of this limit; and

- iii. Investments in ABS must be accorded a minimum rating of BBB, or equivalent, from an recognised external credit assessment institution (ECAI) recognised by the Bank (for banking institutions remaining under Basel I)⁴.

⁴ Banking institutions that have adopted Basel II are not subject to this minimum rating requirement.