



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Prudential Standards on Securitisation Transactions for Islamic Banks

Issued on: 27 June 2013

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PART A OVERVIEW

1. Introduction

1.1 While significant benefits may be derived from involvement in securitisation exposures, securitisation may expose Islamic banking institutions to potential risks. In this regard, this standards which is applicable to activities¹ that give rise to securitisation exposures², has the following objectives:

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

1.2 While the risk management requirements are in most cases more relevant to Islamic banking institutions that assume primary roles in securitisation transactions, Islamic banking institutions that assume only secondary roles and as investors shall also observe the requirements where applicable. In most instances, Islamic banking institutions should be able to leverage on their existing infrastructure to comply with the requirements. Islamic banking institutions should comply with all requirements outlined in the standards on an ongoing basis, unless an exemption or deviation from specific requirements is given by the Bank.

¹ The requirements of the standards are applicable to all Islamic banking institutioning institutions involved in traditional 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.

² Securitisation exposures as defined in Part F of the Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets) and shall include, among others, Islamic banking institutioning institution's involvement in the structuring of securitisation (be it primary role such as originator or secondary role such as providing risk mitigation) as well as investors in asset-backed securities (ABS).

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- 1.3 The standards shall be read alongside the Capital Adequacy Framework for Islamic Banks (Capital Components) and Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets) which provide the capital adequacy treatment as well as the operational requirements in order to apply the appropriate capital treatment.

2. Applicability

- 2.1 The standards are applicable to all:
- i. Islamic banking institutions licensed under section 3(4) of the Islamic Banking Act 1983 (IBA); and
 - ii. Banking institutions carrying on Islamic banking or financial business under section 124 of the Banking and Financial Institutions Act 1989 (BAFIA) in accordance with the Guidelines on *Skim Perbankan Islam*.

For the purpose of the standards, the institutions above are hereafter referred to as “Islamic banking institutions”.

- 2.2 The standards shall apply on both entity (i.e. global³) and on consolidated basis.

3. Legal provision

- 3.1 The standards are issued pursuant to Section 53A of the IBA and section 37 of the BAFIA.

³ Compliance on an entity (i.e. global) basis would include the Islamic banking institutions’ exposures in local and overseas branch operations, and in Labuan banking subsidiaries for which an explicit guarantee has been provided by the Islamic banking institutioning institutions

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PART B SUPERVISORY EXPECTATIONS RELATING TO SECURITISATION EXPOSURES

4. Roles and Responsibilities of Board of Directors

- 4.1 It is the duty of the board of directors (BOD) to understand and set the scope and purpose of the involvement of securitisation activities and be aware of the risks and other implications associated with the securitisation activities undertaken.
- 4.2 The BOD is responsible for approving significant policies (such as the policy on disposal of assets) with respect to securitisation activities to be undertaken by the Islamic banking institution. The policies must be consistent with the Islamic banking institution's overall business strategies and management expertise.
- 4.3 The BOD must also ensure that:
- i. all policies related to securitisation set by the board are effectively implemented by senior management;
 - ii. the BOD is informed and updated on potential securitisation exposures arising from activities where the Islamic 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. processes and procedures on Shariah compliance are in place to effectively mitigate potential Shariah non-compliance risk as explained under paragraph 6; and
 - v. a competent and independent internal audit function is available to verify the effectiveness of procedures and controls as well as the reliability of information submitted to the board.

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5. Role and Responsibilities of Senior Management

5.1 The senior management of Islamic banking institutions is responsible for carrying out all policies set by the BOD 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 activities;
- iii. the Islamic banking institution's performance and risk exposures, where necessary, are evaluated in relation to its involvement in securitisation; and
- iv. expertise within the Islamic 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 activities.
 - 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 Islamic 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, accounting and Shariah requirements on the Islamic banking institution's current or future securitisation transactions. Key observations and conclusions should be reported to senior management;

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- ii. adequate system (as and where necessary) for measuring risks; and
- iii. comprehensive review and reporting processes to the various levels of management and the BOD with respect to the securitisation activities where the Islamic banking institution is extensively involved (assuming several roles or key role, in particular, origination).

6. Shariah Requirements

- 6.1 Islamic banking institutions are required to establish appropriate processes and procedures to mitigate potential Shariah non-compliance risk which may arise from securitisation activities, in line with the requirements in the Shariah Governance Framework for the Islamic Financial Institutions.
- 6.2 The Shariah Committee is required to have sufficient knowledge and understanding of securitisation structures and processes. In this regard, the senior management shall ensure appropriate information and disclosure is made to the Shariah Committee to facilitate effective discharge of its duties.
- 6.3 The following aspects shall be considered in enhancing Shariah compliance on securitisation activities:
- i. the features of Sukuk created via securitisation shall be consistent with the principles of the underlying Shariah contract;
 - ii. requirements with regard to the underlying pool of asset, true sale transaction and ownership transfer of the asset shall fulfill Shariah requirement; and
 - iii. all features involved in securitisation transactions including credit enhancements, servicing and liquidity facilities that are provided or received by the Islamic banking institution are conducted in Shariah compliant manner.

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7. Risk Management Process

7.1 Securitisation activities shall be undertaken within the overall risk management framework of the Islamic banking institution. The Islamic banking institution should have an integrated infrastructure for an effective risk management to ensure that potential risks arising from securitisation activities are sufficiently identified and managed. Such an infrastructure should address issues such as those relating to assessments and impact analysis, line of responsibility, audit review and oversight, assessment of performance as well as documentation and disclosure.

Assessment/impact analysis

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

- i. the appropriateness and effectiveness of the securitisation structure. In circumstances where a particular securitisation structure involves the use of multiple Shariah contracts, Islamic banking institutions shall ensure that each contract used is effective in achieving the intended overall results at all times;
- ii. the methods to measure, monitor and control potential risks;
- iii. necessary system enhancements and modifications to be required (if any);
- iv. accounting, tax, regulatory, or legal ; and
- v. other risk management issues (for example, reporting structure and monitoring of cash flow performance).

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Documentation and disclosure

- 7.3 Islamic 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.
- 7.4 Adequate disclosure on the Shariah contracts used shall be made to ensure appropriate level of clarity to all relevant parties in order to facilitate understanding on the risk and return profile of the securitisation transaction.

Review of Performance

- 7.5 Although the originating Islamic 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 Islamic banking institutions, senior management should be in a position to assess the performance of the underlying asset pools.
- 7.6 Assessment of performance may involve analysing periodic reports on the securitisation transaction. Significant conclusion or inference from such analysis may, when necessary and appropriate, form part of the report/update to the BOD. 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

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- v. outstanding principal compared to original security size for all classes of the securitisation structure.

7.7 In the case of securitisation involving revolving cash flows, the following information may be relevant:

- i. base rate - investor returns rate plus servicing fees;
- ii. monthly excess spread – the spread between rate of return from the pool and the cost of issuing the sukuk such as returns 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

7.8 Risk management processes should be independently monitored and evaluated by the internal audit unit or an independent risk control function. 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.

7.9 The independent unit should evaluate various roles undertaken by the Islamic banking institution in securitisation, paying special attention to the origination and servicing functions. The unit should be informed of the securitisation activities 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, including those involving significant investments in asset-backed sukuk (ABS).

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8. Risk management issues relating to specific roles in securitisation transactions

Credit enhancement

8.1 Islamic 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 financing facilities, over-collateralisation or cash collaterals.

8.2 An Islamic banking institution providing credit enhancement must 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 Islamic 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 Islamic 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 Islamic banking institution's normal credit approval and review.

Servicing and liquidity facilities

8.3 An Islamic 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. An Islamic banking institution acting as a servicer should be under no obligation to remit funds to the SPV or investors, except for funds provided

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as a liquidity facility until it has received funds generated from the underlying assets.

8.4 While an Islamic banking institution may provide liquidity facilities to cover short-term cash flow disruptions (for example, delay in payments in a pass-through structures) to the securitisation, this should not in any way be confused with the credit loss protection that has been made available separately. In acting as service provider and provider for liquidity facilities, Islamic banking institutions must ensure that such facilities are not being used as a credit enhancement or guarantee, hence exposing themselves to substantial risks. To ensure the facilities are not used as a form of credit enhancement, the following criteria must 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 Islamic 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 Islamic 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. The facility must therefore provide for repayment of advances within a maximum of 90 days; 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 a waiver or deferral.

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Replenishment of assets

8.5 An originating Islamic 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 cash flow 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 Islamic 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.

Investment in ABS

8.6 Investments in asset-backed Sukuk should be done at the sole discretion of the Islamic banking institution, on market terms and conditions and are subject to the Islamic banking institution's normal credit approval and review processes.

8.7 Islamic banking institutions must have a good understanding of the risk profile of an asset-backed Sukuk by assessing its terms and conditions before investing in such instruments. Islamic banking institutions should pay particular attention on areas which would materially impact the performance of the asset-backed Sukuk such as the risk characteristics and composition of the underlying asset as well as the structural features of the asset-backed Sukuk such as the Shariah contract used, waterfall mechanism, credit enhancements, liquidity facilities, definitions of default and triggers involved.

8.8 Islamic banking institutions shall assess the legal, Shariah, regulatory and accounting requirements in a particular jurisdiction before investing in the asset-backed Sukuk issued or asset-backed Sukuk with underlying assets in that jurisdiction. Consequently, Islamic banking institutions shall have in place

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the processes to effectively mitigate potential risks and losses across jurisdictions.