Capital Adequacy Norms - Risk Weight for Housing Loans and Mortgage Backed Securities

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August 31, 2002

The CEOs of the All-India Term-Lending and Refinancing Institutions

Dear Sir,

Capital Adequacy Norms - Risk Weight for Housing Loans
<u>and Mortgage Backed Securities</u>

Under the extant capital adequacy norms, the loans granted by the FIs against the mortgage of residential houses as well as commercial properties attract 100% risk weight except the loans granted to their own employees fully secured by superannuation benefits and the mortgage of flats / houses which attract 20% risk weight. Also, the norms do not prescribe any specific risk weight or special dispensation for the investment by the FIs in the Mortgaged Backed Securities (MBS) issued against the housing loans granted by the Housing Finance Companies

2. In order, therefore, to liberalise the prudential norms in keeping with the international practice, it has been decided, with immediate effect, that:

a) the housing loans extended by the FIs to **individuals** against the mortgage of **residential** housing properties would attract a risk weight of 50% (as against the 100% risk weight at present); and

b) the investments by the FIs in the Mortgage Backed Securities (MBS) would attract a risk weight of 50% (in addition to the 2.5% risk weight for market risk) provided -

? the assets underlying the MBS are the **residential** loan assets of the Housing Finance Companies which are recognised and supervised by the National Housing Bank; and

? the MBS satisfy the terms and conditions listed in the Annexure.

Thus, the loans granted by the FIs against the security of **commercial** real estate would continue to attract 100% risk weight. Further, if the assets underlying the MBS also include **commercial** properties, then FIs' investment in such MBS would attract 100% risk weight. The risk weights for the housing loans granted by the FIs to their own employees would, however, remain unchanged.

3. The investment of the FIs in MBS which fully comply with the terms and condition listed in the Annexure, would NOT constitute an exposure to the Housing Finance Company originating the housing loan which was securitised. However, the investors in the MBS would get exposed to the pool of assets / mortgages / obligors underlying such securities. The investing institution, therefore, should guard against the concentration of exposure to a particular industry / sector, institution or a geographical area. In case of a large number of underlying obligors, the exposure may be treated against the sector to which the pool of assets belongs.

4. Please acknowledge receipt.

Yours faithfully,

(Rajesh Verma)
General Manager-in-Charge

Encl.: Two sheets

ANNEXURE

Terms and Conditions to be satisfied by the Mortgage Backed Securities
for being eligible for a reduced risk weight of 50 per cent

The Mortgage Backed Securities (MBS) should satisfy the following terms and conditions:

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

(b) The housing properties (initially mortgaged to HFCs) 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 HFC;

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 HFC on the Board of the SPV will not have veto powers;

iv. shall not directly or indirectly control the SPV;

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 emanating from individual housing loans.

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