

## Bank of Israel

Banking Supervision Department



Tel Aviv, August 25, 2009

h9905111

REG-179

To:

**The banks—attn. Chief Executive Officer**

### **Re: Traditional securitization of housing loans in Israel**

#### **Background**

1. Pursuant to requests from banks for our approval of securitization transactions in housing loans that they are planning, we were asked to express concisely our stances on main issues that arose as the responses to these banks were being prepared.
2. In the past, the Banking Supervision Department set down principles in the matter at hand:
  - a. in the Haimovitz-Asher Committee report,—Chapter 6, “Aspects of Banking and Banking Supervision” (hereinafter: “the Committee report”);
  - b. in our letter of December 24, 2006, to the chief accountants of the banks and members of the Institute of Certified Public Accountants’ liaison committee (ref. 068S6430, including the Committee report in the Appendix).
3. The attached document presents an integrated version of the Banking Supervision Department’s stances on traditional securitization of housing loans in Israel.

**Remark:** this document does not include reference to the implications of said securitization transactions for Proper Banking Management Directives generally and, in particular, the implications of securitization transactions that are not recorded as sales for Proper Banking Management Directive 336, concerning “Limits on Liens of Bank Assets.”

#### **New stances and revisions of previously presented stances of the Banking Supervision Department**

4.
  - a. **Relief period** (see Section 1 below)—the period during which securitization transactions may be performed under terms of capital relief was extended to December 31, 2011 (the original date was December 31, 2009).
  - b. **Application of sale accounting for capital relief** (see Section 2 below)—until such time as the U.S. securitization accounting rules and international standards stabilize, relief shall not be conditioned on a capital charge on account of securitized housing loans that apply sale accounting.
  - c. **Retroactive application of accounting rules** (see Section 3 below)—insofar as it is decided to adopt the international standards on securitization, said adoption shall begin in accordance with the accepted method of adopting international standards. This stance replaces the recommendation in the Committee report. It is important to emphasize that this change is not intended to prejudice the capital adequacy of banks that perform transactions

before the international standards are adopted, because at the present writing there is no requirement to classify the transaction as a sale under the accounting procedures as a condition for capital relief.

- d. **Legal opinion** (see Section 4 below)—the legal opinion should include, *inter alia*, reference to the recording of collateral, borrowers' interests, and borrowers' receipts.
- e. **Bank holdings of notes issued by an SPE** (see Section 6 below)—to mitigate moral hazard and apply the lessons of the recent global financial crisis, a securitizing bank shall hold at least 10 percent of each type of note that the SPE shall issue.
- f. **Transferor bank as servicer** (see Section 10 below)—
  - (1) In our letter of December 24, 2006, it was stated that the Supervisor shall confirm that servicer's discretion complies with the Report to the Public Directives, and an appendix was added explaining the stance of the Banking Supervision Department as to the conditions under which a bank's actions as a servicer of housing loans shall not infringe on the SPE (Special Purpose Entity) that acquired the housing loans as a QSPE (Qualified Special Purpose Entity). Pursuant to the publication of new U.S. accounting principles (FAS 166 and 167) that do away with the term "QSPE," the reference to servicer's discretion was deleted. The foregoing relates to the appendix and to requirements for the Supervisor's approval in respect of borrowers' rights.
  - (2) In our letter of December 24, 2006, we stated that the Supervisor shall approve the rate of consideration to be paid for servicing. In the current version, more explicit language is used, making it clear that the Supervisor's approval shall pertain to the recording of the imputation of said consideration in the books.
- g. **Composition of loan portfolio to be securitized** (see Section 11 below)—
  - (1) For the time being, the provisions of the Committee's recommendations pertaining to the revolving securitization of short-term credit, e.g., credit by means of credit cards, shall not apply.
  - (2) To avoid a state of conflict of interest between the bank and the holders of SPE-issued notes, it is stated that in the first securitization transactions, loans collateralized by means of collateral that, on the transaction date, also served as collateral for other loans that the bank issued shall not be securitized. This shall not apply to a loan securitized by a *pari passu* lien on behalf of the SPE and on behalf of the bank, if the bank treats it identically for both.

#### **New U.S. accounting principles**

- 5. In July 2009, the following two accounting standards were published in the United States:
  - a. FAS 166, concerning transfer of financial assets, amending FAS 140.
  - b. FAS 167, Amendments to FIN 46R, concerning Consolidation of Variable Interest Entities).

We intend to adopt these standards in the Report to the Public Directives at the time the standards are adopted in the U.S. and in the same manner. (In a separate document, we present a detailed proposal relating to the manner of adoption.) Banks that intend to execute securitization transactions should

take into account that the accounting treatment of such transactions is expected to change once the standards are adopted.

Respectfully,

Or Sofer  
Deputy Supervisor of Banks

cc. Mr. R. Hizkiyahu, Supervisor of Banks

## Stances of the Banking Supervision Department on Traditional Securitization of Housing Loans

1. **Size of securitization transactions that a bank may execute**—the size of securitization transactions that a bank may execute under capital-relief conditions during the period ending December 31, 2011, shall not exceed 6 percent of its housing loan portfolio.
2. **Use of sale accounting as a prerequisite for capital relief**

From the present writing to the day on which the U.S. accounting principles and international standards on securitization stabilize, capital relief for securitized housing loans shall not be conditioned on the use of sale accounting. Said relief shall be tested against the requirements set forth in the Basel II directives. After the accounting principles stabilize, the requirement of adding the use of sale accounting as a condition for capital relief shall be considered.

**Remark:** in this context, we should note that some supervisory authorities (e.g., those in the U.S.) require the use of sale accounting for capital relief and others do not.
3. **Retroactive application of Basel II directives and/or accounting principles**
  - 3.1 The ad hoc directive (Basel II) on capital allocation is based on the Basel Committee recommendations and, therefore, will be updated in accordance with changes therein.
  - 3.2 The Report to the Public Directives concerning securitization are based on the U.S. accounting principles (FAS 140). We intend to update the Report to the Public Directives in accordance with the way the corresponding U.S. principles are updated.
  - 3.3 Insofar as it is decided to adopt the international standards, there is room to apply the approach spelled out above, i.e., first, adoption in accordance with the accepted manner of adopting international standards. This stance replaces the recommendation in the Committee report.
4. **The legal opinion (required under the Basel II directives and/or accounting principles)** shall include, *inter alia*, reference to the following topics:
  - 4.1 Recording of collateral—insofar as collateral is not transferred to the acquiring company, we will ask that the opinion relate to the implications of this for the classification of the transaction as a sale transaction.
  - 4.2 Borrowers' rights—insofar as the borrowers' consent to the sale process is not obtained, we will ask that the opinion relate to the implications of this for the sale, if any.
  - 4.3 Borrowers' receipts—insofar as borrowers' payments are received by the securitizing bank and are not paid directly into a dedicated account kept by the SPE, or insofar as the borrowers' receipts are received at the SPE's dedicated account with the securitized bank, we will ask to have the legal opinion include a reference to the implications of this manner of payment for the classification of the transaction as a sale transaction.
5. **Mandatory legal opinions for use of sale accounting**

For a selling bank to be able to treat a securitization transaction as a sale for accounting purposes, it must ensure that the securitization transaction complies with the accounting principles set forth in Section 21 of our Directives. For this purpose, it must, *inter alia*, obtain a legal opinion from the external auditor

declaring that the accounting of the securitization transaction should be treated as a sale under Section 21 of the Report to the Public Directives.

6. **Bank holdings of SPE-issued notes**

To mitigate moral hazard and apply the lessons of the recent global financial crisis, a securitizing bank shall hold at least 10 percent of each type of note that the SPE shall issue.

7. **Credit enhancement for note maturity**

7.1 A bank that transfers financial assets in a securitization transaction shall measure, at point of transfer, retained interests in the transferred financial assets at relative fair value. If retained interests are subordinated to more senior interests in the assets transferred (hereinafter: subordinated retained interests), this fact should be kept in mind in measuring the fair value of said retained interests.

7.2 The fair value of subordinated retained interests shall be calculated on the basis of reasonable and conservative assumptions that may be objectively grounded. Accurate documentation shall be kept in support of the suitability of the fair value calculation and its underlying assumptions, according to the standards set forth by the U.S. banking supervision authorities. If the fair value calculation cannot be objectively grounded, the subordinated retained interests shall be written off at once.

7.3 After first recognition of subordinated retained interests, the on-balance-sheet balance of subordinated retained interests shall be amortized using the straight-line method across their payback period, but within no more than a thirty-six month period from origination. (The balance shall be amortized by 1/36 at the end of the first month, by 1/35 at the end of the second month, and so on.)

7.4 On every reporting date, the need to record a provision on account of the impairment of subordinated interests shall be examined.

7.5 If after securitization some of the subordinated retained interests are sold to non-affiliates of the transferor,<sup>1</sup> the remaining subordinated interests shall be measured in accordance with Generally Accepted Accounting Principles.

7.6 Until the ad hoc directive (Basel II) is implemented, a bank shall not invest in notes emanating from the securitization transactions of a non-affiliate, with the exception of highest-tranche notes.

8. **Prohibition of buy-back of loans transferred by a bank to an SPE**

8.1 A transferor bank shall not buy back, directly or indirectly, a loan that it sold to an SPE, except in extraordinary cases of fraud. However, when the life of a loan portfolio sold to an SPE is very close to expiration (e.g., in the last year of ten years or when the portfolio balance falls to 10 percent of its original balance), and if the agreements governing the securitization transaction so permit, the transferor bank may perform a cleanup and buy

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<sup>1</sup> Transferor affiliates are the following:

- 1) An affiliate as set forth in FAS 57: a controlling principal in the bank, a party controlled by the bank, or a party jointly controlled with the bank, directly or indirectly, by means of one or several intermediators.
- 2) Provident funds and mutual funds managed by the transferor or by affiliates thereof as defined in Section 1 *supra*.

back the balance of the loans from the SPE at their fair value, to allow saving on the cost of managing securitized loan portfolios.

8.2 It is stated for clarity that the restrictions applying under Section 8.1 *supra* shall also apply to:

8.2.1 affiliates of the selling bank;

8.2.2 the purchase, after the transfer date, of beneficiary interests in the SPE by the selling bank or by affiliates thereof.

8.3 Notwithstanding the provisions of Section 8.1 *supra*:

A selling bank (or its affiliates) may give a borrower a loan for the purpose of early payback of a loan that it sold if, at the time of said early payback, both of the following conditions are satisfied:

8.3.1 the loan is not delinquent;

8.3.2 the loan does not satisfy conditions that, under the terms of the securitization transactions, allow the removal of loans from the portfolio that was sold (e.g., if the bank elected at point of sale to remove from the portfolio sold loans that are temporarily delinquent, the selling bank may not issue a loan for the purpose of early payback of a loan that is temporarily delinquent at the time of said early payback).

**9. Injunction against bolstering SPE liquidity**

In the event of a liquidity problem at the SPE, a transferor bank and its affiliates may not make sources available, directly or indirectly, to bolster the SPE's liquidity. Liquidity risk, if it occurs, shall devolve fully upon the holder of the notes or to third parties that are not affiliates of the transferor bank (e.g., entities that provide "liquidity enhancement" instruments for notes).

**10. Transferor bank as servicer**

In respect of loans sold to an SPE in a securitization transaction, the transferor bank may continue to act as a servicer only.

To assure the upholding of borrowers' rights in a securitization transaction, it shall be determined that when a servicer is replaced, the replacement servicer shall also be a corporation to which the Supervisor's directives concerning borrowers' rights apply.

Until appropriate experience is amassed, the Supervisor shall review securitization transactions and certify that service/service-obligation assets for the provision of service were recorded at point of transaction at fair value.

**11. Composition of loan portfolio sold to SPE and prevention of "cherry picking"**

11.1 At this stage, a bank may securitize only housing loans as defined in the report to the Public Directives and may not enter into transactions that do not constitute traditional securitization. Accordingly, the contents of the Committee's recommendations relating to revolving securitization of short-term credit shall not apply.

11.2 To avoid a state of conflict of interest between the bank and the holders of SPE-issued notes, it is stated that in the first securitization transactions, loans collateralized by means of collateral that, on the transaction date, also served as collateral for other loans that the bank has issued shall not be securitized. The foregoing shall not apply to a loan securitized by a *pari passu* lien on behalf of the SPE and on behalf of the bank, if the bank treats it identically for both (e.g., identical maturities, collection arrangements, etc.).

11.3 To avoid impairment of the quality of the transferor bank's credit portfolio, selective sale of "good" loans to the SPE ("cherry picking") shall not be allowed. However, a bank may sell loan portfolios that are randomly selected from a certain category (e.g., loans indexed to the U.S. dollar exchange rate, indexed to the Consumer Price Index, nonindexed, etc.) to an SPE—provided that the quality of the loan sold shall not be a criterion for its inclusion in or exclusion from the portfolio for sale. Notwithstanding the foregoing, at point of sale of a portfolio of housing loans for which the loan loss provision is calculated using a depth of delinquency method, a transferor bank may exclude from a portfolio randomly chosen for sale such loans that, on the date of performance of a securitization transaction, are considered delinquent.

11.4 Notwithstanding the provisions of Section 11.3 *supra*, a bank that sells a housing loan portfolio may also exclude the following from the portfolio sold:

11.4.1 in respect of first securitization transaction only, loans on which the original interest rate is lower than a certain interest rate;

11.4.2 loans that appear on the bank's balance sheet during a period of at least twelve months from point of securitization;

11.4.3 loans that are temporarily delinquent or delinquent for less than three months at point of securitization;

11.4.4 loans previously delinquent; and also

11.4.5 loans in which the government is a participant.

**12. Limitation on transactions with affiliates**

Affiliates of the transferor bank (e.g., provident and mutual funds that it owns or manages) may not acquire notes issued by the SPE as part of a securitization transaction in which the bank is a participant.

**13. Maturity mismatch**

The transfer of risk by means of the securitization transaction shall not be recognized as a sale if the effective term to maturity of the notes is shorter than the effective term to maturity of the credit securitized, e.g., notes with an effective three-year maturity and a loan portfolio that is securitized to an effective six-year maturity.

**14. Borrowers' rights**

The rights of borrowers from banks are determined under general law, special laws that apply to certain bank borrowers, Proper Conduct of Banking Business Directives of the Supervisor of Banks, and banks' existing practices.

The situation of borrowers, e.g., those who received housing credit collateralized by a mortgage on a dwelling, shall not be worsened due to sale by a bank of their loan as part of a securitization transaction. In any securitization transaction, appropriate arrangements for the specific transaction, designed to assure the rights of borrowers whose loans are securitized, shall be set forth.

**Effect—capital requirements of a bank that participates in a securitization transaction as other than an investor**

A bank that participates in a securitization transaction as other than an investor (i.e., as the originator of a securitization transaction or as a third party that provides hedging or enhancement for securitization exposures) shall act in accordance with

Sections 538–605 of the Ad Hoc Directive (Basel II), including on account of transactions to be carried out during 2009.

In any event, a bank in this situation must turn to the Banking Supervision Department for prior approval of the capital treatment that it intends to assign to the securitization exposures.