Guideline

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1. Introduction

This guideline sets out OSFI's general expectations with respect to asset securitization transactions. The guideline supplements the *Life Insurance Capital Adequacy Test* (LICAT), the *Minimum Capital Test* (MCT) and the *Mortgage Insurer Capital Adequacy Test* (MICAT), and specifies the capital treatment for securitization exposures in addition to those arising from investing in se curitizations as a third party. It applies to all insurersFor purposes of this guideline, "insurers" refers to all federally regulated insurers, including Canadian branches of foreign life companies and foreign property and casualty companies, fraternal benefit societies, regulated insurance holding companies, and non-operating insurance companies, as well as mortgage insurers. on an enterprise-wide basis.

2. Scope

Insurers should apply the capital treatment in this guideline to traditional securitizations, synthetic securitizations, and other securitization structures that contain features common to both. Since securitizations may be structured in many different ways, the capital treatment of a securitization will be determined on the basis of its economic substance rather than its legal form. Similarly, OSFI will look to the economic substance of a transaction to determine whether it is subject to this guideline. Insurers should consult OSFI when there is uncertainty about whether a given structure or transaction is a securitization that falls within the scope of this guideline.

Insurers' credit risk exposures to any securitization are referred to in this guideline as "securitization exposures". Securitization exposures include, but are not restricted to:

1. Exposures related to asset-backed securities (ABS), including:
    a. mortgage-backed securities (MBS),
    b. asset-backed commercial papers (ABCP),
    c. collateralized debt obligations (CDO),
    d. collateralized loan obligations (CLO),
    e. certificates of beneficial ownership,
2. Other securitization components such as:
    a. credit enhancements,
    b. liquidity facilities,
    c. interest rate or currency swaps,
    d. credit derivatives and
    e. tranched covers.

Reserve accounts, such as cash collateral accounts recorded as an asset by an originating insurer, are also treated as securitization exposures.

Structures that do not entail any tranching of risk are excluded from the definition of securitization exposures. Such structures include securities that pass through the cash flows from the underlying assets unchanged, and senior/subordinated loan structures where all securities must always be performing or in default simultaneously (and seniority is used only to determine the order of proceeds in liquidation). It is not necessary for a vehicle to issue more than one tranche of securities for there to be a tranching of risk and for the resulting exposures to be considered securitization exposures. Asset-backed structures such as ABCP where the sponsor provides or acquires first loss protection (including overcollateralization), credit enhancement, and/or liquidity support for the underlying assets are considered to be securitization exposures. An insurer may be considered to have a securitization exposure if it provides support to an asset-backed structure that would otherwise not be considered a securitization.

The type of assets underlying a structure does not determine whether a securitization exposure exists. For example, a full flow-through structure backed by financial assets might not give rise to a securitization exposure, while a securitization exposure might arise from a structure backed by physical assets.

An insurer may perform one or a number of functions in a securitization transaction, including:

1. investing in a debt instrument issued by a special purpose entity (SPE);
2. acting as an originator by securitizing its own assets;
3. providing enhancements;
4. providing liquidity support;
5. setting up, or causing to be set up, an SPE;
6. collecting principal and interest payments on assets and transmitting those funds to an SPE, investors in the SPE securities, or a trustee representing them; or

7. providing clean-up calls.

Each function is associated with specific OSFI expectations and capital implications.

3. Exposures subject to capital requirements

Insurers are required to hold regulatory capital against all of their securitization exposures, including those arising from the provision of credit risk mitigation to a securitization transaction, investments in ABS, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement, as set forth in the following sections. Repurchased securitization exposures must be treated as retained securitization exposures. OSFI will look to the economic substance of a transaction to assess whether an insurer maintains appropriate capital in a securitization transaction.

The capital requirements for asset securitization transactions will be limited to those set out in this guideline if the insurer provides only the level of support (enhancement or liquidity) committed to in the various agreements that define and limit the levels of losses to be borne by the insurer.

Where an insurer originates a securitization, the maximum capital requirement for the resulting securitization exposures is limited to the capital requirement that would have been calculated for the underlying exposures had they not been securitized. If a securitization meets all of the criteria in this guideline for risk transfer (e.g. exclusion of the SPE, no implicit support), then the maximum capital requirement for the securitization exposures is limited to:

1. The highest percentage of any tranche within the securitization to which the insurer retains an exposure, multiplied by
2. the capital requirement that would have been calculated for the total underlying pool of assets had they not been securitized.

3.1 Requirements for exclusion of an SPE

OSFI expects an insurer that securitizes its own exposures to minimize its exposure to risk arising from its relationship with the securitization SPE. An insurer that sets up, or causes to be set up, an SPE should hold capital against all debt instruments issued to third parties by the SPE unless all of the following conditions are met:

1. The insurer does not own any share capital in a corporation used as the SPE for purchasing and securitizing financial assets, nor is it the beneficiary of a trust used for such a purpose. Share capital in this context includes all classes of common and preferred share capital.

2. The insurer's name is not included in the name of a corporation or trust used as the SPE, nor is any connection implied with the insurer by, for example, using a symbol closely associated with the insurer. If, however, the insurer is performing a specific function for a particular transaction or transactions (e.g. collecting and transmitting payments or providing enhancement), this may be indicated in the offering circular in accordance with the *Name Use In Securities-Related Transactions Regulations*.

3. The insurer does not have any of its directors, officers or employees on the board of directors of a corporation used as the SPE, unless the SPE's board has at least three members. Where the board consists of three or more members, the insurer may not have more than one director. Where the SPE is a trust, the beneficiary and the indenture trustee and/or the issuer trustee must be third parties independent of the insurer.

4. The insurer does not lend to the SPE on a subordinated basis unless the loan is:

    i. for the purpose of covering initial transaction or set-up costs;
    ii. capped at its original amount;
    iii. amortized over the life of the securities issued by the SPE;
    iv. not available as a form of enhancement to the assets or securities issued; and
    v. classified within the highest risk category (section 4.2) for capital purposes.

5. The insurer does not support, except as provided elsewhere in this guideline, any losses suffered by the SPE, or investors in it, or bear any of the recurring expenses of the SPE.

3.2 Requirements for exclusion of traditionally securitized exposures

An originating insurer may exclude securitized exposures from the calculation of required capital only if all of the following conditions have been met. Insurers meeting these conditions should still hold capital against any securitization exposures they retain.

a. Significant credit risk associated with the securitized exposures has been transferred to third parties, and the originating insurer has established policies and procedures to ensure that the amount of risk retained and transferred is assessed on an ongoing basis, with all operational requirements being met for all securitized assets. These policies must include how the risk transfer will be assessed on an ongoing basis, and should be available for review by OSFI upon request. Additionally, the capital requirement for exposures retained by the originating insurer in the securitization structure following issuance must be no more than 30% of the capital requirement applicable to the pool of assets supporting all tranches of the securitization structure, i.e. the reduction in capital requirements is at least 70%.

b. The originating insurer does not maintain effective or indirect control over the transferred exposures. The assets are legally isolated from the insurer in such a way that the exposures are put beyond the reach of the insurer and its creditors, including in the event of bankruptcy or receivership (e.g. through the sale of assets or through sub-participation). These conditions must be supported by an opinion that is provided by a qualified legal counsel, and is acceptable to OSFI.

   The insurer is deemed to have maintained effective control over the transferred credit risk exposures if it: (i) is able to repurchase from the transferee the previously transferred exposures in order to realize their benefits; or (ii) is obligated to retain the risk of the transferred exposures. The insurer's retention of servicing rights to the exposures does not, by itself, constitute indirect control of the exposures.

c. The securities issued are not obligations of the originating insurer. Thus, investors who purchase the securities only have claim to the underlying pool of exposures.

d. The entity to which the credit risk exposures are transferred is an SPE, and the holders of the beneficial interests in that entity have the right to pledge or exchange them without restriction.

e. Any clean-up calls satisfy the conditions set out in section 3.4.

f. The securitization does not contain clauses that (i) require the originating insurer to systematically alter the underlying exposures such that the pool's weighted average credit quality is improved unless this is achieved by selling assets to independent and unaffiliated third parties at market prices; (ii) allow for increases in a retained first loss position or credit enhancement provided by the originating insurer after the transaction's inception; or (iii) increase the yield payable to parties other than the originating insurer, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool.

g. There are no termination options or triggers except for eligible clean-up calls (as defined in section 3.4) or termination for specific changes in tax and regulation.

3.3 Requirements for exclusion of synthetically securitized exposures

For synthetic securitizations, the use of credit risk mitigation techniques (i.e. collateral, guarantees and credit derivatives) for hedging the underlying exposure may be recognized for capital purposes only if the conditions outlined below are satisfied:

a. The credit risk mitigation complies with all of the requirements set out for such mitigation in the relevant sections of the applicable insurance capital guideline, including those around eligible collateral and eligible guarantors. However, SPEs are not recognized as eligible guarantors.

b. The insurer has transferred significant credit risk associated with the underlying exposure to third parties, as specified in paragraph 3.2(a).

c. The instruments used to transfer credit risk do not contain terms or conditions that limit the amount of credit risk transferred, including:

    a. clauses that materially limit the credit protection or credit risk transference (e.g. significant materiality thresholds below which credit protection is deemed not to be triggered even if a credit event occurs or those that allow for the termination of the protection due to deterioration in the credit quality of the underlying exposures);
    b. clauses that require the originating insurer to alter the underlying exposures to improve the pool's weighted average credit quality;
    c. clauses that increase the insurer's cost of credit protection in response to deterioration in the pool's quality;
    d. clauses that increase the yield payable to parties other than the originating insurer, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the reference pool; or
    e. clauses that provide for increases in a retained first loss position or credit enhancement provided by the originating insurer after the transaction's inception.

d. An opinion, acceptable to OSFI, has been obtained from a qualified legal counsel that confirms the enforceability of the contracts in all relevant jurisdictions.

e. Any clean-up calls satisfy the conditions set out in section 3.4.

3.4 Treatment of clean-up calls

For securitization transactions that include a clean-up call, no additional capital will be required due to the presence of a clean-up call if the following conditions are met:

i. the exercise of the clean-up call is not mandatory, in form or in substance, but rather is at the discretion of the originating insurer;

ii. the clean-up call is not structured to avoid allocating losses to credit enhancements or positions held by investors or otherwise structured to provide credit enhancement; and

iii. the clean-up call is only exercisable when 10% or less of the original underlying portfolio, or securities issued remain, or, for synthetic securitizations, when 10% or less of the original reference portfolio value remains.

Any clean-up call that permits the remaining loans to be repurchased when their balance is greater than 10% of the original pool balance or permits the purchase of non-performing loans is considered to be a retained first-loss (and thus non-senior) exposure.

Securitization transactions that include a clean-up call that does not meet all of the criteria stated above will result in a capital requirement for the securitized assets. For a traditional securitization, the underlying exposures must be treated as if they were not securitized. Additionally, insurers should classify any gain on sale as highest-risk in accordance with section 4.2. For synthetic securitizations, an insurer purchasing protection should hold capital against the entire amount of the securitized exposures as if it did not benefit from any credit protection. If a synthetic securitization incorporates a call (other than a clean-up call) that effectively terminates the transaction and the purchased credit protection on a specific date, the insurer should treat the transaction in accordance with the section of the applicable insurance capital guideline that specifies the treatment of maturity mismatches.

If a clean-up call, when exercised, is found to serve as a credit enhancement, the exercise of the clean-up call must be considered a form of implicit support provided by the insurer and should be treated in accordance with section 3.6.

3.5 Servicer cash advance facilities

3.5.1 Collecting and transmitting payments

If an insurer's only involvement with a particular asset securitization transaction is to collect interest and principal payments on the underlying assets and transmit these funds to the SPE or investors in the SPE securities (or a trustee representing them), and the insurer is under no obligation to remit funds to the SPE or the investors unless and until the funds are received from the obligors, then there is no capital requirement for this activity.

An insurer that is collecting interest and principal payments on the underlying assets and transmitting these funds to the SPE or investors in the SPE securities (or a trustee representing them) may also:

1. structure transactions;
2. analyze the underlying assets;
3. perform due diligence and credit reviews;
4. monitor the credit quality of the portfolio of underlying assets; and
5. provide servicer advances (see the conditions outlined in section 3.5.2).

In this role, if an insurer is not making servicer advances, there is no capital required for this activity provided the insurer:

1. complies with the conditions specified for setting up an SPE;
2. obtains and keeps on record evidence that its legal advisers are satisfied that the terms of the asset securitization protect it from any liability to investors in the SPE (except normal contractual obligations relating to its role in collecting and transmitting payments), and is able to make such evidence available to OSFI on request; and
3. includes in any offering circular a highly visible, unequivocal statement that, while serving in this capacity, the insurer does not stand behind the issue or the SPE, and will not make good on any losses in the portfolio.

In this role, where an insurer does not meet the above three conditions, it is required to maintain capital against all debt instruments issued to third parties by the SPE.

3.5.2 Making servicer advances

An insurer may be contractually obligated to provide funds to an SPE to ensure an uninterrupted flow of payments to investors in the SPE's securities, solely under the unusual circumstance that payments from the underlying assets have not been received due to temporary timing differences. An insurer that provides such support is typically referred to as a servicing agent, and the funds provided are typically referred to as servicer advances. Where an insurer acts as a servicing agent, it may treat undrawn facilities as off-balance sheet commitments and drawn facilities as on-balance sheet loans only if the following conditions are met:

1. Servicer advances are not made to offset shortfalls in cash flow that arise from assets in default;
2. The credit facility under which servicer advances are funded is unconditionally cancellable by the servicing agent;
3. The total value of cash advances is limited to the total amount transferable for that collection period;
4. Servicer advances rank ahead of all claims by investors in SPE securities, expenses and other cash allocations;
5. The repayment of servicer advances comes from subsequent collections or the available enhancement facilities;
6. Servicer advances are repaid within 31 calendar days from the day of the advance;
7. The servicing agent performs an assessment of the likelihood of repayment of servicer advances prior to each advance, and such advances are made only if prudent lending standards are met; and
8. The three conditions in section 3.5.1 are met.

In all other circumstances, the facilities are treated as first-loss (and thus non-senior) securitization exposures.

3.6 Implicit support

When an insurer provides implicit support to a securitization, it should hold, at a minimum, capital against all of the exposures associated with the securitization transaction as if they had not been securitized. Additionally, the insurer should disclose publicly 1) that it has provided non-contractual support and 2) the capital impact of providing such support.

When an originating insurer believes that its past or future actions with respect to a securitization structure may constitute implicit support, the insurer should advise OSFI and seek a determination of the appropriate regulatory capital treatment. In determining the capital treatment, OSFI will consider, at a minimum, the rationale for any structural change to the securitization and any change in the credit quality of the asset pool.

If OSFI determines that an insurer has or will be providing implicit support to a securitization structure backed by a pool of securitized assets, the insurer will be ineligible to exclude the securitized assets from the calculation of required capital. Additionally, the insurer will be ineligible to exclude any of its concurrently existing securitized assets from the calculation of required capital for the longer of two years, or until all notes issued benefiting from the implicit support have matured. If OSFI finds that an insurer has provided implicit support on more than one occasion, it will be ineligible to exclude any of its securitized assets from the calculation of required capital for a minimum of five years, and will be subject to the disclosure requirements noted above.

4. Measurement of exposures and required capital

With the two exceptions noted below, the capital requirement for a securitization exposure is calculated by multiplying the exposure amount by the appropriate credit risk factor contained in the applicable insurance capital guideline. The exposure amount of a securitization is the sum of the on-balance sheet amount of the exposure – net of purchase discounts, writedowns, and specific provisions the insurer has taken on the exposure – and the off-balance sheet exposure amount, if applicable. The treatment of credit risk mitigation instruments that are sold or purchased by the insurer is covered in section 4.5. With the exception of undrawn servicer cash advance facilities meeting the conditions described in section 3.5.2, the exposure amount for all off-balance sheet securitization exposures is its notional amount multiplied by a credit conversion factor of 100%.

The exceptions to the above treatment are:

1. Securitization exposures deemed to be in the highest risk category under section 4.2; and
2. Securitization exposures undertaken by mortgage insurers through the sale of mortgage insurance for which the capital requirement is specified as a component of insurance risk in the applicable insurance capital guideline. No additional capital is required for such exposures under this guideline.

4.1 Use of ratings

4.1.1 Operational requirements for use of external credit assessments

The following operational criteria concerning the use of external credit assessments apply to securitizations that are used for capital purposes:

a. The external credit assessment must take into account and reflect the entire amount of credit risk exposure an insurer has with regard to all payments owed to it. For example, if an insurer is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with timely repayment of both principal and interest.

b. The external credit assessment must be from an eligible rating agency listed in the applicable insurance capital guideline. The rating agency's procedures, methodologies, assumptions and the key elements underlying the assessment must be publicly available on a non-selective basis and free of charge. The assessment must be published in an accessible form and included in the rating agency's transition matrix. Additionally, loss and cash flow analysis as well as sensitivity of ratings to changes in the underlying rating assumptions should be publicly available. Ratings that are made available only to the parties to a transaction do not meet these requirements.

c. The rating agency must have a demonstrated expertise in assessing securitizations, which may be evidenced by strong market acceptance.

d. An insurer should apply external credit assessments from eligible rating agencies consistently across a given type of securitization exposure. Furthermore, an insurer may not use the credit assessments issued by one rating agency for one or more tranches and those of another rating agency for other positions (whether retained or purchased) within the same securitization structure that may or may not be rated by the first rating agency. Where two or more eligible rating agencies can be used and these assess the credit risk of the same securitization exposure differently, the section of the applicable insurance capital guideline that specifies the treatment of multiple ratings will apply.

e. Where credit risk mitigation is provided directly to an SPE by an entity that qualifies as an eligible guarantor under the applicable capital guideline, and the risk mitigation is reflected in the external credit assessment assigned to the securitization exposure(s), the capital charge associated with that external credit assessment should be used. In order to avoid any double counting, no additional capital recognition is permitted. If the credit risk mitigation provider is not recognized as an eligible guarantor under the applicable insurance capital guideline and nonetheless used in a credit assessment, the credit assessment cannot be used.

f. In the situation where credit risk mitigation is not obtained by the SPE but rather is applied to a specific securitization exposure within a given structure (e.g. one tranche of an ABS), an insurer that holds such an exposure must treat it as if it is unrated and then use the treatment for credit risk mitigation specified in the applicable insurance capital guideline to recognize the hedge.

g. An insurer is not permitted to use any external credit assessment for capital purposes if the assessment is at least partly based on unfunded support provided by the insurer itself. For example, if an insurer buys ABCP and simultaneously extends unfunded support to the ABCP programme (e.g. through a liquidity facility or credit enhancement), and that support plays a role in determining the credit assessment of the ABCP, the insurer should treat the ABCP as if it were not rated. Additionally, the insurer should continue to hold capital against the support it provides (e.g. against the liquidity facility and/or credit enhancement).

Exposures referred to in (g) above, such as ABCP, are to be treated as unrated securitization exposures for regulatory capital purposes unless the overlapping exposure treatment described in section 4.4 is applicable.

4.1.2 Operational requirements for inferred ratings

An insurer may infer a rating for an unrated securitization exposure if the exposure ranks *pari passu* or senior in all respects to an externally rated reference exposure. If it is possible to infer a rating for an unrated exposure from a reference exposure, then the unrated exposure may be treated as having the same rating as that of the reference exposure. The following operational requirements must be satisfied in order to infer a rating from an externally rated reference securitization exposure:

a. The reference securitization exposure (e.g. ABS) must rank *pari passu* or be subordinated in all respects to the unrated securitization exposure. Credit enhancements, if any, must be taken into account when assessing the relative subordination of the unrated exposure and the reference securitization exposure. For example, if the reference securitization exposure benefits from any third-party guarantees or other credit enhancements that are not available to the unrated exposure, then the unrated exposure may not be assigned an inferred rating based on the reference securitization exposure.

b. The maturity of the reference securitization exposure must be equal to or longer than that of the unrated exposure.

c. On an ongoing basis, any inferred rating must be updated continuously to reflect any subordination of the unrated position or changes in the external rating of the reference securitization exposure.

d. The external rating of the reference securitization exposure must satisfy all of the requirements for recognition of external ratings in section 4.1.1.

4.2 Highest-risk securitization exposures

The following securitization exposures are classified within the highest risk category of securitization exposures. Refer to the applicable insurance capital guideline for the capital treatment of exposures falling within this category.

For insurers acting as originators:

1. Any increase in equity capital resulting from a securitization transaction, such as that associated with expected future margin income, that results in a gain on sale that is included in a component of regulatory capital;
2. Credit-enhancing interest-only strips, net of any increases in equity capital that have been captured under 1);
3. Retained securitization exposures (including synthetically securitized exposures) that are rated BB or below, or that are unrated;
4. Subordinated loans to SPEs that do not meet condition 4) in section 3.1;

5. Retained exposures that have been securitized synthetically, for which the risk remains unmitigated due to a maturity mismatch (see section 3.3);
6. Retained exposures for which the insurer has not met the due diligence requirements of section 5.2.

For insurers acting as third-party investors:

1. Investments in securitization exposures with long-term credit ratings of B or below, and in unrated exposures;
2. Investments in securitization exposures with short- term credit ratings below S3, and in unrated exposures;
3. Investments in securitization exposures for which the insurer has not met the due diligence requirements of section 5.2.

An exception to the assignment of unrated securitization exposures to the highest risk category is made in section 4.3 for senior exposures.

4.3 Unrated senior exposures

If a senior exposure in a securitisation is unrated and the composition of the underlying pool is known at all times, an insurer that holds or guarantees such an exposure may determine the capital requirement using the "look-through" approach instead of classifying the exposure within the highest risk category. The look-through approach may not be used to determine credit risk factors for resecuritizations, or for securitization investments received as collateral.

Under the look-through approach, the unrated senior position receives the average credit risk factor under the applicable insurance capital guideline for the underlying exposures. Where the insurer is unable to determine the capital factors for the underlying credit risk exposures, the unrated position must be classified within the highest risk category (section 4.2).

4.4 Overlapping exposures

For the purpose of calculating capital requirements, a first exposure overlaps a second exposure if in all circumstances the insurer will not incur any losses on the second exposure if it fulfills its obligations with respect to the first exposure. For example, if an insurer provides full credit support to some notes and holds a portion of these notes, its full credit support obligation precludes any loss from its exposure to the notes. If an insurer can verify that fulfilling its obligations with respect to the first exposure will preclude a loss from the second exposure under all circumstances, the insurer is not required to hold capital for the second exposure.

To arrive at an overlap, an insurer may, for the purpose of calculating capital requirements, split or expand its exposures.Splitting an exposure means partitioning it into portions that overlap with another exposure held by the insurer and other portions that do not; and expanding an exposure means assuming for capital purposes that obligations with respect to the exposure are larger than those established contractually. The latter could be done, for example, by expanding either the trigger events to exercise the facility and/or the extent of the obligation. For example, a liquidity facility may not be contractually required to cover defaulted assets or may not fund an ABCP programme in certain circumstances. For capital purposes, such a situation would not be regarded as an overlap to the notes issued by that ABCP conduit. However, the insurer may elect to calculate required capital for the liquidity facility as if it were expanded (either in order to cover defaulted assets or in terms of trigger events) to preclude all losses on the notes. If the insurer does so, it is only required to hold capital for the expanded liquidity facility, and not for the notes.

4.5 Treatment of credit risk mitigation for securitization exposures

Credit risk mitigation includes guarantees, credit derivatives, and collateral. Collateral in this context refers to collateral that is used to hedge the credit risk of a securitization exposure rather than the underlying exposures of the securitization transaction.

In order for an insurer to take account of credit risk mitigation in calculating the capital requirement for a securitization exposure, the mitigation must comply with all of the requirements set out for such mitigation in the relevant sections of the applicable insurance capital guideline, including the requirements around eligible collateral and eligible guarantors. However, an insurer may not recognize an SPE as an eligible guarantor.

Eligible credit risk mitigation techniques that hedge securitization exposures (including techniques that give rise to maturity mismatches) are treated in the capital calculation according to the relevant sections of the applicable insurance capital guideline. When the exposures being hedged have different maturities, the longest maturity should be used. In synthetic securitizations, maturity mismatches may arise when, for example, an insurer uses credit derivatives to transfer part or all of the credit risk of a specific pool of assets to third parties. When the credit derivatives unwind, the credit protection will terminate. This implies that the effective maturity of the tranches of the synthetic securitization may differ from that of the underlying exposures. Insurers that originate synthetic securitizations should treat such maturity mismatches by classifying all unmitigated retained positions that are unrated or rated BB or below within the highest risk category (section 4.2).

When an insurer that is not the originator provides credit protection to a securitization exposure, it should calculate a capital requirement on the covered exposure as if it were an investor in that securitization. If an insurer provides protection to an unrated credit enhancement, it should treat the credit protection provided as if it were holding the unrated credit enhancement directly.

5. Sound business practices

5.1 Origination

Insurers that securitize exposures using either traditional or synthetic securitization should adhere to the following practices:

1. The insurer should understand the inherent risks of the activity, be competent in structuring and managing such transactions, and have adequate staffing of the functions involved in the transactions.
2. The terms and conditions of all transactions between the insurer and the SPE should be at least at market terms and conditions (and any fees are paid in a timely manner) and meet the insurer's normal credit standards. The insurer`s Credit Risk Committee or an equally independent committee should approve individual transactions.

3. The insurer's capital and liquidity plans should take into account the potential need to finance an increase in assets on its balance sheet as a result of early amortization or maturity events.

5.2 Due diligence

Insurers should have the information described below for each of their securitization exposures. If an insurer cannot perform this required level of due diligence for a securitization exposure, the exposure is classified within the highest risk category under section 4.2.

i. The insurer should, on an ongoing basis, have a comprehensive understanding of the risk characteristics of its individual securitization exposures, whether on balance sheet or off-balance sheet, as well as the risk characteristics of the pools underlying its securitization exposures.

ii. The insurer should be able to access performance information on the underlying pools on an ongoing basis in a timely manner. Such information may include, as appropriate: exposure type; percentage of loans or receivables 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification. For resecuritizations, insurers should have information not only on the underlying securitization tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches.

iii. The insurer should have a thorough understanding of all structural features of a securitization transaction that would materially impact the performance of the insurer's exposures to the transaction, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

Appendix A: Definitions

A.1 Traditional securitizations

A *traditional securitization* is a structure in which the cash flows from an underlying pool of exposures are used to service at least two classes or tranches of securities that have different degrees of credit risk or different maturities Investment exposures to mortgage-backed securities (MBS) that do not involve the tranching of credit risk (e.g. NHA MBS) are not considered securitization exposures under this guideline. . Payments to the investors depend on the performance of the underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. The tranches that characterize securitizations differ from ordinary senior/subordinated debt instruments in that junior securitization tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas in a senior/subordinated debt structure, the failure to properly service debt may be an event of default that causes payments on other debt to be accelerated and losses incurred relative to investors' respective priority of claims in liquidation.

Traditional securitizations transform generally illiquid assets into securities that can be traded in the capital markets. The asset securitization process usually begins with the segregation of financial assets into pools that are relatively homogeneous with respect to their cash flow characteristics and risk profiles, including both credit and market risks. These pools of assets are then typically sold to a bankruptcy-remote entity, generally referred to as a special-purpose entity/vehicle (SPE / SPV), which issues ABS to investors to finance the purchase. The cash flows from the underlying assets support repayment of the ABS. Various forms of enhancement are used to provide credit protection for investors in the ABS.

Underlying instruments in the pool being securitized may include, but are not restricted to, the following: loans, commitments, asset-backed and mortgage-backed securities, corporate bonds, premium receivables, equity securities, and private equity investments. The underlying pool may include one or more items.

Traditional securitizations typically split the risk of credit losses from the underlying assets into tranches that are sold to different investors. Each tranche with its loss position functions as an enhancement if it protects a more senior tranche in the structure from loss.

A.2 Synthetic securitizations

A *synthetic securitization* is a structure with at least two different stratified risk positions or tranches that reflect different degrees of credit risk, where the credit risk associated with an underlying pool of exposures is transferred, in whole or in part, through the use of funded (e.g. credit-linked notes) or unfunded (e.g. credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. Accordingly, the investor's potential risk is dependent upon the performance of the underlying pool.

A.3 Resecuritizations

A resecuritization exposure is a securitization exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitization exposure. In addition, an exposure to one or more resecuritization exposures is itself a resecuritization exposure. An exposure resulting from retranching of a securitization exposure is not a resecuritization exposure if the insurer is able to demonstrate that the cash flows to and from the insurer could be replicated under all circumstances and conditions by an exposure to the securitization of a pool of assets that contains no securitization exposures.

The key factor in determining whether an exposure is a resecuritization exposure is the presence of two different levels of credit risk tranching in the structure, that is, one or more of assets to which the investors are ultimately exposed is itself a securitization exposure. The existence of two or more layers of special purpose entities does not, in itself, cause a structure to be a resecuritization.

Examples of resecuritizations include:

1. Collateralized debt obligations (CDOs) of ABS;
2. A tranched exposure to a pool of underlying loans and a single tranche of an ABS; or
3. A credit derivative whose performance is linked to one or more resecuritization exposures.

A.4 Origination

For the purpose of this guideline, an insurer is considered to be an originator with regard to a securitization if it meets either of the following conditions:

a. The insurer directly or indirectly supplies the underlying exposures included in the securitization; or

b. The insurer serves as a sponsor of an ABCP conduit or similar programme that acquires exposures from third-party entities. In the context of such programmes, an insurer would be considered a sponsor and, in turn, an originator if it, in fact or in substance, manages or advises the programme, places securities into the market, or provides liquidity and/or credit enhancements.

An insurer is a supplier of assets in any of the following circumstances:

1. the assets are held on the balance sheet of the insurer at any time prior to being transferred to an SPE;

2. the insurer lends to an SPE in order for that SPE to grant a loan to a borrower as though it were the insurer This method of lending is also known as remote origination. The insurer is regarded as the supplier because the SPE is creating an asset that is branded by the insurer. The insurer may incur reputational risk through its association with the product. ; or

3. the insurer enablesFor example by providing credit approvals or administrative support. an SPE to directly originate assets that are financed with ABS.

A look-through approach should be used to determine the supplier of the assets.

A.5 Asset-backed commercial paper programme

An ABCP programme predominately issues commercial paper with an original maturity of one year or less that is backed by assets or other exposures held in an SPE.

A.6 Clean-up call

A clean-up call is an option that permits the securitization exposures (e.g. ABS) to be called before all of the underlying exposures or securitization exposures have elapsed. In the case of traditional securitizations, this is generally accomplished by repurchasing the remaining securitization exposures once the pool balance or outstanding securities have fallen below a pre-specified level. In the case of a synthetic transaction, the clean-up call may take the form of a clause that extinguishes the credit protection.

A.7 Credit enhancement

A credit enhancement is an arrangement provided to an SPE to cover the losses associated with the pool of underlying assets. Providing enhancements is a method of protecting investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the ABS in a timely manner. Enhancements are used to improve or support the credit rating on more senior tranches, and therefore improve the pricing and marketability of the ABS.

Common examples of enhancements include: recourse provisions; senior/subordinated security structures; subordinated standby lines of credit; subordinated loans; third party equity; swaps that are structured to provide an element of enhancement; and any amount of liquidity facilities in excess of 103% of the face value of outstanding paper. In addition, enhancements include any temporary financing facility, other than servicer advances that are exempt from a capital requirement under section 3.5, provided by an insurer to an enhancer or to a SPE to bridge the gap between the date a claim is made against a third party enhancer and when payment is received.

A.8 Credit-enhancing interest-only strip

A credit-enhancing interest-only strip(I/O) is an on-balance sheet asset that (i) represents the value of cash flows related to future margin income, and (ii) is subordinated.

A.9 Excess spread

Excess spread (or future margin income) is defined as gross finance charge collections and other income received by the trust or SPE minus certificate interest, servicing fees, charge-offs, and other senior trust or SPE expenses.

A.10 Implicit support

Implicit support is made evident when an insurer provides support to a securitization in excess of its predetermined contractual obligation. Such support signals to the market that the insurer has not distanced itself from the securitized assets. When an insurer provides such support, it cannot exclude securitized assets from its calculation of regulatory capital.

Manifest examples of implicit support include:

- the purchase of deteriorating credit exposures,
- purchasing assets from the underlying pool at above-market prices,
- increasing the originator-provided first loss position, and
- achieving the same results as above indirectly via other lending arrangements.

Implicit support is established when an insurer conveys an intention to provide extra-contractual support, for example by indicating that it may support a securitization. In the event that an insurer provides support in excess of its contractual obligations to trusts or SPEs, for the purpose of determining capital requirements, the insurer will be considered to have established implicit support to other trusts and SPEs with which it has a similar relation. Implicit support may also exist if the insurer has not clearly indicated to investors that it does not intend to provide support in the event of a shortfall, and previous support provided by peers or other originators would cause a reasonable investor to believe that support will be forthcoming.

Credit-enhancing clean-up calls (section 3.4) constitute a form of implicit support.

A.11 Senior securitization exposure (tranche)

A securitization exposure (or tranche) is considered to be a senior exposure (tranche) if it is effectively backed or secured by a first claim on the entire amount of the assets in the underlying securitized pool.If a senior tranche is retranched or partially hedged (i.e. not on a *pro rata* basis), only the new senior part is treated as senior for capital purposes. While this generally includes only the most senior position within a securitization transaction, in some instances there may be claims that, technically, are more senior in the waterfall (e.g. a swap claim), but which may be disregarded for the purpose of determining which positions are senior. Different maturities of several tranches that share *pro rata* loss allocation have no effect on the seniority of these tranches, since they benefit from the same level of credit enhancement. The material effects of differing tranche maturities are captured by maturity adjustments to the credit risk factors assigned to the securitization exposures.

The following examples illustrate the foregoing:

a. An unrated tranche may be treated as a senior tranche if a rating can be inferred for it (in accordance with the conditions in section 4.1.2) from a lower tranche that meets the definition of a senior tranche.

b. In a securitization where all tranches above the first-loss tranche are rated, the most highly rated position may be treated as a senior tranche. When there are several tranches that share the same rating, only the most senior tranche in the cash flow waterfall may be treated as senior unless the only difference among the tranches is maturity. When different ratings of several senior tranches are due only to differences in maturity, all of the tranches may be treated as senior.

c. Usually, a liquidity facility supporting an ABCP program is not the most senior position within the program – the commercial paper, which benefits from the liquidity support, is typically the most senior position. However, a liquidity facility may be viewed as covering all losses on the underlying pool that exceed the amount of overcollateralization/reserves provided by the seller, and as being most senior if it is sized to cover all of the outstanding commercial paper and other senior debt supported by the pool, so that no cash flows from the underlying pool can be transferred to other creditors until any liquidity draws are repaid in full. In such a case, the liquidity facility may be treated as a senior exposure. Otherwise, if these conditions are not satisfied, or if for other reasons the liquidity facility constitutes a mezzanine position in economic substance rather than a senior position in the underlying pool, the liquidity facility should be treated as a non-senior exposure.

A.12 Special purpose entity/vehicle (SPE/SPV)

An SPE is a corporation, trust, or other entity organized for a specific purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE, and the structure of which is intended to isolate the SPE from the credit risk of an originator or seller of exposures. SPEs are commonly used as financing vehicles in which exposures are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust.

Appendix B Rating Mappings

Long-term rating

Rating Category	DBRS	Fitch	Moody's	S&P	KBRA	JCR	R&I
AAA	AAA	AAA	Aaa	AAA	AAA	AAA	AAA
AA	AA(high) to AA(low)	AA+ to AA-	Aa1 to Aa3	AA+ to AA-	AA+ to AA-	AA+ to AA-	AA+ to AA-
A	A(high) to A(low)	A+ to A-	A1 to A3	A+ to A-	A+ to A-	A+ to A-	A+ to A-
BBB	BBB(high) to BBB(low)	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	BBB+ to BBB-	BBB+ to BBB-	BBB+ to BBB-
BB	BB(high) to BB(low)	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	BB+ to BB-	BB+ to BB-	BB+ to BB-
B	B(high) to B(low)	B+ to B-	B1 to B3	B+ to B-	B+ to B-	B+ to B-	B+ to B-
Lower than B	CCC or lower	Below B-	Below B3	Below B-	Below B-	Below B-	Below B-

Short-term rating

Rating Category	DBRS	Fitch	Moody's	S&P	KBRA	JCR	R&I
S1	R-1(high) to R-1(low)	F1+, F1	P-1	A-1+, A-1	K1+, K1	J-1	a-1
S2	R-2(high) to R-2(low)	F2	P-2	A-2	K2	J-2	a-2
S3	R-3	F3	P-3	A-3	K3	J-3	a-3
All other	Below R-3	Below F3	NP	Below A-3	Below K3	NJ	Below a-3