# Banking Newsletter

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Financial Services Commission

## Loan Securitisation

### Introduction

1 This newsletter sets out the Banking Supervisor’s supervisory policy on the treatment of loan transfers and securitisation of revolving credits involving banks. A legal analysis is appended as Annex A to this newsletter.

### Coverage

2 The newsletter covers both the sale of single loans and the packaging, securitisation and sale of loan pools. It also covers the transfer of risk under sub-participation agreements. Although most references in the newsletter are to sales of loans, the policy in principle also applies to sales of other forms of assets, and to the transfer of risks under contingent items such as letters of credit and acceptance credits. It also covers the transfer of undrawn commitments.

### Implementation

3 The policy set out in this newsletter has immediate effect, but will not be applied to past sales or packaging schemes which are "grandfathered". This newsletter applies to all Gibraltar-incorporated institutions licenced under the Banking Ordinance 1992.

### Aims of the policy

4 The Banking Supervisor’s principal policy objectives are to ensure that:

(i) loan sales and packaging achieve their intended effect of passing rights and obligations from the seller to the buyer;

(ii) all the parties to the transaction fully understand the responsibilities and risks they have assumed or retained; and

(iii) any material risks to buyers or sellers are properly treated in the Banking Supervisor’s supervision of banks.

## PART I - LOAN TRANSFERS

### Method of transfer

5 The Banking Supervisor considers that the method of transfer of a loan can have an important bearing on the risks assumed by buyer and seller. An assessment of the implications of different methods under the laws of Gibraltar appears in Annex A.

6 The cleanest transfer of risk is achieved by novation, where the existing loan is cancelled and a new agreement substituted, which transfers all the seller’s rights and obligations to the buyer. A legal or equitable assignment, if properly structured, can also achieve an effective transfer of the seller’s rights and remedies available to him to enforce those rights. But the seller retains any outstanding obligations (for example, to advance further funds), while the buyer’s rights may be impaired by any rights of set-off that exist between the

borrower and the seller. Where the assignment is silent (i.e. the borrower is not notified), there may be additional risks for both buyer and seller - for the buyer because the absence of notice to the borrower removes some legal protection he would otherwise have; and for the seller, because as lender of record he will remain subject to requests to reschedule or renegotiate. The third most common technique, sub-participation, does not transfer any rights, remedies or obligations from seller to buyer, but is an entirely separate non-recourse funding arrangement, under which the buyer places funds with the seller in exchange for acquiring a beneficial interest in the underlying loan, but the loan itself is not transferred. In this case, the buyer assumes an exposure to the borrower, but is also at risk to the seller, because he has lent to him and because he relies on him to pass through funds received from the borrower.

Lenders against whom claims are made as a result of their liability for the quality of goods or equipment will usually have recourse to the manufacturer, which, provided the manufacturer has appropriate liability insurance, may limit the risk to the lender. In addition, the Banking Supervisor understands that the loss experience by lenders under such claims is historically very small. Nevertheless, the Banking Supervisor does not view the risk retained by the seller as unimportant. In particular, if defective goods were to cause personal injury, very substantial costs could arise. The Banking Supervisor believes that for assets to be viewed as off-balance sheet, sellers should either receive an indemnity from the buyer to cover any liability, or otherwise take steps to minimise the risk of loss (such as taking out insurance to cover the risk).

In addition to liabilities for the quality of equipment, institutions involved in the finance of equipment hire or leasing may have contractual obligations towards the borrower - for instance to arrange for the servicing or taxation of vehicles. Again, it will be difficult legally to transfer these obligations to the buyer along with the benefits of the asset (unless the transfer is done through novation). In situations where the seller is left with responsibilities of this kind, the Banking Supervisor has some concern over the position of the buyer (if the buyer is a bank). There is a clear possibility that the borrower will exercise a right to reduce or withhold payments on the loan to reflect his costs - for instance, the cost of repairing the vehicle - if the original lender fails to meet his obligations under the loan agreement. The Banking Supervisor reminds buying banks that risks of this nature need careful evaluation. Buyers should satisfy themselves of the seller's competence to fulfil its obligations towards the borrower in a timely manner.

## Supervisory treatment

7 The Banking Supervisor will apply the following treatment to a loan (or a part of a loan) transferred using the above methods, subject to the further conditions specified in paragraphs 8 and 14 below:

(i) a transfer through novation will be regarded as a clean transfer. The loan will therefore be excluded from the seller's risk asset ratio and included in the buyer's.

(ii) a transfer through an assignment duly notified to the borrower in accordance with Section 40 of the Contract and Tort Ordinance will be regarded as a clean transfer, provided that the buyer has taken reasonable precautions to ensure that his rights under the transfer are not impaired by an intervening right; for example, a right of set-off between seller and borrower. A minimum requirement should be a warranty from the seller that no such right of set-off exists.

(iii) a transfer through a silent assignment will usually be regarded as a clean transfer. However the seller must recognise that as he remains the lender of record he will be the focal point for pressure from the borrower to reschedule or renegotiate the terms of the loan, or advance further funds. The volume of loans to individual borrowers sold on a silent assignment basis needs to be subject to appropriate internal controls. Silent assignments may also pose additional risks for buyers (see paragraph 17 of Annex A), and these need to be kept under careful review. If he is not satisfied on these points the Banking Supervisor may disregard a transfer of a loan through a silent assignment in calculating the risk asset ratio of the seller.

(iv) a loan sub-participation, while not transferring in a legal sense the rights of the original lender, aims to have the same economic effect. Where a loan is funded in whole or in part via a sub-participation, the Banking Supervisor will recognise the transfer of credit risk by excluding it (or the relevant part) from the original lender's risk asset-ratio, and including it in the sub-participant's as a claim on the underlying borrower.

(v) where banks transfer undrawn commitments to lend (or part of them), the commitment (or part) will be excluded from the selling bank's risk asset ratio only when the transfer is either by novation, or by an assignment accompanied by formal acknowledgement from the borrower of a transfer of obligations from the seller to the buyer. A transfer by means of silent assignment or sub-participation will not lead to the exclusion of the commitment from the selling bank's risk asset ratio. Instead it will be treated as a transfer of the seller's exposure from the potential borrower to the buyer. The buyer's assumption of a commitment (or part) will be included in its risk asset ratio as a claim on the borrower, irrespective of the method of transfer used.

8 The above policy in relation to the method of transfer will be applied provided that the following conditions are satisfied.

A In the case of the transfer of a single loan (or part of a loan):

(i) The transfer does not contravene the terms and conditions of the underlying loan agreement and all the necessary consents have been obtained;

(ii) the seller has no residual beneficial interest in the principal amount of the loan (or that part which has been transferred) and the buyer has no formal recourse to the seller for losses;

(iii) the seller has no obligation to repurchase the loan , or any part of it, at any time (although he may retain an option to do so provided the loan remains fully-performing);

(iv) the seller can demonstrate, to the satisfaction of the Banking Supervisor, that it has given notice to the buyer that it is under no obligation to repurchase the loan2 nor support any losses suffered by the buyer and that the buyer has acknowledged the absence of obligation;

(v) the documented terms of the transfer are such that, if the loan is rescheduled or renegotiated, the buyer and not the seller would be subject to the rescheduled or renegotiated terms;

(vi) where payments are routed through the seller, he is under no obligation to remit funds to the buyer unless and until they are received from the borrower. Payments voluntarily made by the seller to the buyer in anticipation of payments from the borrower must be made on terms under which they can be recovered from the buyer if the borrower fails to perform.

B Packaging schemes

9 The process of packaging loans together and selling them as a block or pool can compound risks which are often negligible when a single loan is transferred. For example a seller - or originator - of a pool of loans is more at risk from his misrepresentation as to their quality than if only one of those loans is involved.

10 Sellers - or originators - of loans who continue to administer (or "service") them as a securitised portfolio in order to maintain borrower relationships or to earn fees can also run explicit operational risks. Their continued identification with the loans can mean that their commercial reputation is committed and a completely clean break is not achieved. The Banking Supervisor is concerned that banks in this position may come under pressure to support losses incurred by the investors/buyers and may be inclined to do so in order to protect their name.

11 These operational and "moral" risks will be present where a bank originates and/or services a portfolio of loans whether they were ever on its balance sheet or not. They apply both to vehicle and pool participation schemes.

12 In the past the risks associated with loan administration have not warranted special treatment as the capital required to cover credit risk helps to protect a bank against other risks as well. This would no longer be the case, however, where functions have been unbundled so that the credit risk lies with a third party.

13 The Banking Supervisor believes that the risks from close association with a securitisation scheme can assume material proportions. The arrangements controlling the association should be carefully assessed and monitored, and subject to internal audit. The Banking Supervisor will take into account any significant operational risks not related to balance sheet items when setting a bank's minimum permissible risk asset ratio. In exceptional cases it may wish to apply an explicit capital requirement against this sort of risk.

14 In addition to conditions (i) to (vi) in paragraph 8, the Banking Supervisor will require the following conditions to be met by a bank acting as servicing agent of loan packaging schemes, in order to ensure that its role is not seen as being more than acting as an agent. The Banking Supervisor will also require the following conditions to be met by banks which are originators of assets being transferred under packaging schemes, whether or not they retain the servicing role.

(vii) The Banking Supervisor will expect the servicing agent to have evidence available in its records that its auditors and legal advisers are satisfied that the terms of the scheme protect it from any liability to investors in the scheme, save where it is proved to have been negligent;

(viii) the servicing agent must be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged nor will feel impelled to support any losses suffered by the scheme or investors in it. Any offering circular should contain a highly visible, unequivocal statement that the servicing agent does not stand behind the issue or the vehicle and will not make good any losses in the portfolio.

(ix) the servicing agent (or any other group entity covered by the Banking Supervisor's consolidated supervision of a group of which the servicing agent is a part) may not own any share capital in any company used as a vehicle for the scheme; nor in any other form hold a proprietary interest in or control over that company either directly or indirectly. For this purpose "Share capital" includes all classes of ordinary and preference share capital.

(x) The Board of a company used as vehicle for a scheme must be independent of the servicing agent, although the latter may have one director representing it.

(xi) The name of a company used as vehicle for a scheme must not include the name of the servicing agent or imply any connection with it.

(xii) The servicing agent must not bear any of the recurring expenses of the scheme. However, the agent may make a one-off contribution to enhance the credit worthiness of a vehicle. It may also lend on a long term subordinated basis to the vehicle provided that the loan is only repayable following winding up of the scheme. Any transactions under these headings must be undertaken at the initiation of the scheme and disclosed in any offering circular. They will be deducted from capital for capital adequacy purposes.

(xiii) The servicing agent may not intentionally bear any losses arising from the effect of interest rate changes on the scheme. However the agent may enter into interest rate swap agreements at market prices with the vehicle. There should be provision for unintended temporary losses arising form normal administrative delays in changing mortgage rates to be recovered by the servicing agent as soon as possible.

(xiv) A servicing agent may not fund a vehicle or scheme (except within the terms of condition xii above) and in particular may not provide temporary finance to a scheme to cover cash shortfalls arising from delayed payments or non-performance of loans which it administers.

(xv) A servicing agent may not retain an option to repurchase (or refinance) loans except where the loan portfolio has fallen to less than 10% of its maximum value and the option extends only to fully-performing loans.

15 If any of the above conditions is not satisfied, the assets administered by the servicing agent will be consolidated with its balance sheet for risk asset ratio purposes.

# PART II - SECURITISATION OF REVOLVING CREDITS

1 The term revolving credits refers to loan facilities which permit borrowers to vary the drawn amount within an agreed limit.

2 Repayment may be at the borrower's discretion, subject in some cases to a minimum amount per payment period, or by fixed schedule.

3 Securitisation of such receivables therefore involves issuing notes of a fixed amount and term against the backing of assets of a fluctuating amount and indefinite maturity. Typically, schemes insulate investors in the notes from the effects of fluctuating balances by assigning shares in the receivables that are the subject of the securitisation both to the investors (the investor interest) and to the originating bank (the seller interest). The amount of the investor interest in the outstanding balances normally stays fixed at the amount of their funding (until the notes start to amortise), whereas the amount assigned to the selling bank goes up or down as borrowers make net drawings or repayments. Schemes are given a fixed maturity by dividing their life into a revolving (or interest-only) period and an amortisation period. During the revolving period, the investors receive their share of interest payments, but their share of principal repayments by borrowers is reinvested in the pool; during the amortisation period, the investors' share of principal repayments is used to redeem the securities, with the result that at the end of the scheme the full interest in the outstanding balances has reverted to the originating bank.

4 Compared with other types of securitisation, schemes to securitise revolving credits introduce the possibility of increased legal risk and moral pressure arising from the complexity of the arrangements, the shared interest of the bank and investors, and the eventual reversion in full to the originating bank of the pool of accounts. If carefully structured, however, such schemes can result in the originating bank successfully transferring the risk on the share of the pool assigned to the investors. This newsletter outlines the conditions that the Banking Supervisor requires to be met in order for the securitised assets to be given off balance sheet treatment for supervisory purposes.

## Basic principles

5 It is important to ensure both that adequate standards apply to the structure of securitisation schemes, and that the implications of securitisation for the bank's risks generally are adequately handled.

6 In setting the conditions for off balance sheet treatment of the share of the balances funded by investors, the Banking Supervisor considers it a fundamental principle that the arrangements for the securitisation should ensure the full sharing of interest, principal, expenses, losses and recoveries on a clear and consistent basis. This principle implies, among other things, a requirement for full loss-sharing on the stock of receivables in the pool throughout the revolving period of the securitisation, since the investors' share of the receivables is removed in full from the originating bank's balance sheet for the whole of that period.

## Features of schemes

7 There are a number of commonly seen features of schemes for the securitisation of revolving credits. Schemes typically involve the transfer of a pool of receivables into a Trust. The Trust directs the flows on the accounts to the originating bank and to a special purpose vehicle (SPV) according to the proportion of the funding that they are providing. The SPV in turn directs the flows to the investors who hold the securities. The Banking Supervisor has judged that these arrangements form the basis of an acceptable structure to allow the share of the balances funded by the SPV to be removed from the originating bank's balance sheet for supervisory purposes.

8 Schemes usually contain provisions concerning the selection of the original pool of receivables from the assets on the originating bank's balance sheet and the subsequent replenishment, as necessary, of the pool of accounts.

9 Schemes incorporate one of two main approaches concerning the payments received by the SPV in respect of the pool of accounts transferred. Under the first (the aggregated) approach, the payments received during a period are aggregated and in distributing them shares are applied to that aggregate, treating the receivables as a homogeneous pool. Under the other (the disaggregated) approach, the amounts paid to investors and the originating bank are linked to particular receivables that they have financed. Schemes using either approach may be eligible for off balance sheet treatment by the Banking Supervisor.

10 Schemes also include provisions concerning the amortisation of the securities issued. These typically cater for the scheduled amortisation of the securities - the feature that allows for the outstanding balance of receivables to revert to the originating bank after a scheduled date fixed in the terms of the securitisation - and for the possibility of the early amortisation of the securities, i.e. the early repayment of the investor interest (before the start of the scheduled amortisation) should a trigger event described in the terms of the securitisation occur.

## Treatment of these features

### Pool selection and replenishment

11 The Banking Supervisor has decided that it is acceptable for a bank to take back the full financing of a pool if there is no reason to assume that its performance will have deteriorated in the meantime. For a scheme to be acceptable, therefore, the Banking Supervisor will need to be convinced that it contains no features - for example for the substitution of higher-quality accounts into the scheme - as a result of which the performance of the pool systematically favours the investor interest. Adequate seasoning of the accounts transferred into the pool - so that they are likely to display the characteristics of fully operational accounts - will usually be required; together with the random selection of the assets transferred into the pool, this should normally ensure that investors are not systematically advantaged. In addition, the scheme's documentation should ensure that servicing practices are applied consistently to securitised and unsecuritised loans.

### Scheduled amortisation

12 The need to ensure full loss-sharing on the stock of receivables throughout the revolving period of a securitisation has implications for the rate at which schemes may be amortised at the end of that period. If an SPV were able to a large extent to derive repayment flows from borrowers who turned over their balances quickly, and had relatively little reliance on borrowers who paid only the minimum amount each month, it might be able to make a very rapid exit from the scheme. And if the borrowers who paid their debts slowly had different risk characteristics from those repaying and renewing credit at a fast rate, this might allow the investors to avoid their full share of losses on the pool at the end of a revolving period.

13 A repayment arrangement under which the investor interest was not eliminated until each borrower in whose debts the SVP had shared had made sufficient principal payments to cover the balances outstanding at the end of the revolving period - or these had been recognised as in default - would meet this concern; so a scheme based on the disaggregated approach provides an acceptable structure in this respect, as long as any assumption that it includes about the length of the amortisation period is reasonable. For a scheme using

the aggregated approach, the Banking Supervisor has concerns in cases where the SPV may be able to exit from the scheme while a substantial proportion of the total debt outstanding at the start of the scheduled amortisation period remains outstanding. This may be the result of a scheme in which, after the start of the amortisation period, investors are repaid from a fixed share of the repayments arising form the aggregate gross flows on the accounts, including repayments of new borrowings incurred during the amortisation period. So when a scheme incorporates the aggregated approach, the Banking Supervisor will require the originating bank to demonstrate (either on a theoretical basis or on the basis of historical statistics) that by the end of the scheduled amortisation period borrowers in the pool should have made sufficient payments to ensure that in aggregate at least 90% of the total debt outstanding at the beginning of the amortisation period will have been repaid or recognised as in default. The pace of repayment during any set amortisation period must not in normal circumstances be more rapid than would be allowed by straight-line amortisation over the period. In addition, aggregated structures that limit principal repayments in respect of the investor interest to amounts derived from actual account balances at the start of the amortisation will be acceptable, provided the receipts are shared between the investor and seller interest on a floating pro-rata basis according to their respective interests.

14 Amortisations providing for a clean-up call - by which an originating bank has the option to buy back remaining securitised assets - will be permitted so long as the clean-up can occur only when 10% or less of the receivables at the start of amortisation remain outstanding.

## Early amortisation

15 Early amortisation triggers provide for the repayment of the investor interest to be brought forward in certain defined circumstances. Various early amortisation triggers have been included in past securitisations. They may be divided into two main kinds: "economic" and "non-economic" triggers. "Economic" triggers activate early amortisation because of a deterioration in the performance of the pool of receivables: for example, a fall below a certain level in the yield of the pool net of provisions, interest and other expenses. In some cases, such triggers allow investors to reduce their participation once they begin to experience losses and commit the originating bank to taking back the full financing in these circumstances. Because the Banking Supervisor is seeking to ensure full loss-sharing, he applies conditions on the inclusion of "economic" triggers if the assets securitised are to be given off balance sheet treatment. The conditions are intended to prevent the inclusion of such triggers providing, in effect, implicit credit support: the aim is to ensure that investors share in losses for as long as these remain unusually high or until the originating bank decides, and feels able, to run down its portfolio in line with the amortisation of the investor interest.

16 "Economic" triggers will, therefore, be permissible in acceptable schemes only if:

(a) there is full sharing of interest, principal, expenses, losses and recoveries on the balances outstanding at the start of the amortisation period, using either the disaggregated approach or the aggregated approach applying the same conditions as outlined in paragraphs 12 and 13 above; and

(b) the Banking Supervisor is convinced that at the point that early amortisation is triggered losses on the pool will have reached a level where the bank will feel able, if necessary and without putting its reputation at risk, to reduce its new lending broadly in line with the amortisation of the investor interest.

17 "Non-economic" early amortisation triggers relate to changes, other than in the performance of the securitised assets, which have significant implications for the securitisation. Past examples include tax-event and legal-change triggers, triggers relating to the originating bank's material non-performance in its role as servicing agent to the SPV, and triggers relating to the insolvency of the originating bank or SPV. In the Banking Supervisor's view, the presence of such triggers does not amount to credit support. The inclusion of such early amortisation triggers will therefore be permissible in acceptable schemes, and in these limited cases a form of rapid amortisation - by which the investor interest may be repaid as fast as is allowed by its share of the inflow of principal payments - will be allowed. The Banking Supervisor will need to be convinced of the case for allowing any other forms of "non-economic" early amortisation trigger.

## Implications of schemes for a bank's general risks

### Systems

18 The Banking Supervisor will need to be satisfied that an originating bank has adequate systems in place to deal with all aspects of revolving-credit securitisations, including the identification of loans and payments, and the monitoring of the portfolio's performance.

### Liquidity

19 The eventual return in full of the revolving-credit balances to the bank's balance sheet - as a result of either their scheduled or early amortisation - means that such securitisations raise particular issues for originating banks' management of their liquidity. These liquidity implications must be handled within a bank's normal liquidity management. Before the Banking Supervisor will allow such assets to be treated as off balance sheet, he will need to be satisfied that the bank can deal with these liquidity implications. Each scheme should be included in a bank's liquidity management assuming, in normal circumstances, that during its amortisation the bank may be required to find replacement funding for the full amounts previously provided by the investor interest, because it may not be possible to arrange a replacement securitisation, and an across the board withdrawal or reduction of borrowers' facilities would put its reputation at risk. In each case, the Banking Supervisor will consider whether an extra margin based on the likely maximum net growth in lending should be added to the funding requirement, and will, if necessary, set this margin in consultation with the bank. In the case of securitisations of credit-card (and similar) receivables, this approach will be combined with the Banking Supervisor's normal liquidity approach for credit cards.

20 So far as scheduled amortisations are concerned, before off balance sheet treatment is agreed, banks will be required to outline how they expect to manage their liquidity, including at the appropriate maturities the cash outflows resulting from the scheduled repayments to investors plus any additional growth margin decided on. Banks will be required to satisfy the Banking Supervisor that their liquidity arrangements could cope with the additional requirement for funding and, where appropriate, that they would build up additional liquid assets for the periods covering amortisation payments. The Banking Supervisor will examine banks' proposals to ensure that schemes do not unwind at times and in amounts that would pose difficulties for the bank concerned.

21 The presence of early amortisation triggers in a securitisation scheme raised additional complications, since they render uncertain the timing of the potential need for replacement funding. For a bank originating a scheme incorporating an early amortisation trigger or triggers, it is a condition for off balance sheet treatment that the Banking Supervisor be convinced that it has adequate funding plans in place to cope with their implications. Where schemes include early amortisation triggers, the Banking Supervisor will wherever possible agree with the originating bank "warning indicators" that early amortisation might be triggered: for example if the scheme allows early amortisation to be triggered after three successive months of negative net yield on the portfolio, a warning indicator might be one month of negative net yield. Following a signal from one of these warning indicators, the maturity of the scheme will be advanced in the bank's liquidity reporting; in the example just given, its presumed maturity immediately after the warning indicator would be two months. For those banks operating using the stock liquidity approach, the Banking Supervisor will where appropriate agree additional liquidity requirements to be applied in the event of a signal from a warning indicator.

22 Where a scheme includes an early amortisation trigger that does not permit any warning indicator, the originating bank will likewise be required to explain how it would cope with the liquidity implications of its being triggered.

23 There is additional liquidity risk in the case of originators of more than one securitisation with the same early amortisation trigger(s) (whether "economic" or "non-economic"). Because the potential liquidity demand on such banks is multiplied if the early amortisation triggers in each can be triggered at the same time, in such cases the Banking Supervisor will require further liquidity reassurance before being able to agree off balance sheet treatment of subsequent issues.

24 In order for a bank to satisfy the Banking Supervisor that it can deal with the liquidity implications of the amortisation of schemes, it may be required to arrange committed facilities to be drawn down to the extent necessary to fund receivables returning to its balance sheet. The rules governing these committed facilities will generally be those used elsewhere in the Banking Supervisor's liquidity approach. Likewise the Banking Supervisor will follow his normal approach on the question of the weighting of such committed facilities for capital adequacy purposes. Since such commitments need to be available in circumstances where a replacement securitisation does not prove possible, they should not include a material adverse change condition in relation to the bank.

## Capital

25 For a bank carrying out revolving-credit securitisations amounting to a high percentage of its solo capital base - and particularly where the presence of common early amortisation triggers makes it possible that a significant volume of assets could revert to the bank at the same time - the Banking Supervisor will monitor and where appropriate discuss with a bank's management the potential capital implications of its involvement in the securitisation market. Its consideration here will take account of the size and development of that market.

# Annex A - Methods of transfer

1 This annex contains a brief review of the position under the laws of Gibraltar in relation to the disposal of loan assets. The Banking Supervisor wishes to stress that:-

(i) except where indicated, this annex deals only with the position under the laws of Gibraltar; the position in other jurisdictions may differ;

(ii) the annex does not consider the tax position of transfers, in particular stamp duty ;

(iii) the legal position is complex and reliance should not be placed on this annex; where appropriate, independent legal advice should be taken.

2 The annex does not cover the transfer of any security which may support a transferred loan. It is nevertheless important that buyers should ensure that they acquire the full benefit of any security.

## Transfer methods

3 Strictly speaking, loans cannot be "sold" in the same straightforward way as tangible assets (e.g. cars, equipment etc); a technical but important point. There are, however, three basic methods of transferring the rights and/or the obligation under a loan - novation, assignment and participation - and, throughout this annex, the shorthand "seller" and "buyer" is used: "seller" referring to a bank which is disposing of an asset, by whatever means; and "buyer" referring to the new lender, transferee, assignee or participant.

### Assignment

4 In general, a lender may assign his rights under a loan agreement to a third party; i.e. his rights to interest and principal.

5 A loan agreement may, however, impose restrictions on assignability and it is likely that, if they were breached, the buyer would gain no direct rights against the borrower and may have difficulty in enforcing the assignment against the seller.

6 It is also uncertain whether a buyer can take an assignment of the benefit of certain typical clauses in a loan agreement; e.g. a provision for grossing-up or for payment of increased costs. Such obligations of the borrower may be construed as personal to the original lender and, as such, unassignable. Even if this is not the case and the loan agreement extends the relevant clauses to assignees of the original lender, it is arguable that an assignee cannot obtain greater rights than those of the original seller; i.e. that the buyer can claim the benefit of, say, a grossing-up clause or an increased costs clause save in circumstances, and to the extent that, the original lender could have claimed the benefit of such clauses.

7 More significantly in the supervisory context, a lending bank may not "assign" its obligations under a loan (or any other) agreement, since these can be transferred only with the consent of all other parties (including the borrower). In order to get over this, an "assignee" of obligations (as well as rights) will sometimes undertake to meet the assignor's obligations as a condition of the assignment. But this does not actually release the assignor from those obligations to the borrower (or any other parties to the loan agreement), it merely reduces the risks arising out of them.

8 A seller/assignor therefore remains liable to the borrower in respect of any unperformed obligations under the original loan agreement. So that, for example, the undrawn part of a facility may not be transferred by assignment. Similarly, assignment can be an imperfect means of selling multicurrency loans, where the primary lender has continuing obligations throughout the term of the loan to switch its currency in certain circumstances.

9 Even where a loan is fully drawn down and the original lender has no outstanding obligations to the borrower, the original lender may still have obligations to other parties (e.g. in a syndicated loan, to indemnify the agent and/or to share recoveries with the other lenders). These obligations will remain on the original lender notwithstanding an assignment. The buyer may agree to be liable to indemnify the seller in respect of such liabilities and may (although this is less clear) be liable directly to the other parties on the basis that the buyer is not entitled to take the benefit of a contract without the burdens.

10 Subject to any provisions to the contrary, assignments are made (and taken) subject to equities. An assignee's rights may therefore be subject to , for example, any rights of set-off which the borrower may have against the assignor whether arising out of the loan agreement itself, any associated transactions or any other transactions entered into prior to the borrower receiving notice of the assignment. An assignee's claim on the borrower would be impaired by any such rights of set-off.

## Types of assignment

11 Assignments for the purpose of disposing of assets may fall into two basic legal categories:-

- statutory (or legal) assignments, transferring both legal and beneficial title
- equitable assignments, transferring "only" beneficial title.

### (a) Statutory assignment

12 A statutory assignment will "pass and transfer" from the seller to the buyer all the legal rights to principal and interest and, in most circumstances, all the legal remedies available against the borrower to ensure discharge of the debt. That is, the buyer acquires the full legal and beneficial interest in the loan and is accordingly able (for instance) to sue the borrower directly without having to join the seller/assignor.

13 In order to be a statutory assignment, a transfer must satisfy the conditions of Section 40 of the Contract and Tort Ordinance (see the Appendix to this Annex for the relevant part of Section 40). In particular, it must:-

(i) be in writing and signed by the seller

(ii) be absolute - that is, unconditional and not merely by way of security

(iii) cover the whole of the loan

(iv) be completed by notice in writing to the borrower (and any other obligors, e.g. a guarantor).

## (b) Equitable assignment

14 An equitable assignment, by contrast, transfers only beneficial not legal rights. In consequence a buyer may not be able to proceed directly against a borrower. Instead, the seller must be joined in any action. This is purely procedural; the seller is not liable for the debt.

15 An "equitable assignment" includes an assignment which fails to satisfy one of the Section 40 conditions. An assignment will therefore be equitable where inter alia:-

(i) part only of a loan is assigned - for example, where a loan is split between a group of buyers; or

(ii) it is not in writing; or

(iii) written notice is not given to the borrower (e.g. for "commercial reasons").

16 As to (iii), where the borrower is not notified of the transfer, although the assignment is valid as between the seller and the buyer, the seller remains the lender of record, the lender in the mind of the borrower and repayments will be made by the borrower to the seller (who can give a good discharge).

17 Moreover, notice (written or oral) secures some important protections for the buyer. For example:-

(i) if notice is given, the borrower must make payments to the assignee/buyer (unless directed otherwise); without notice, the assignee/buyer has to give credit to the borrower for any payments to the assignor/seller made in ignorance of the assignment.

(ii) notice gives the assignee/buyer some protection against intervening equities (in particular those independent of the agreement assigned); without notice, further equities and, in particular, rights of set-off, may arise between the borrower and the assignor/seller: this could happen with major corporates which have an active trading relationship with the selling bank - Bank A assigns to Bank B a loan to Corporate X but without notice; Corporate X subsequently places money with Bank A; Corporate X may be able to set-off the two amounts if Bank A does not repay.

(iii) notice prevents the assignor/seller and borrower from varying the underlying contract.

(iv) where there are successive assignments of the same loan, the priority of the assignee/buyer can be determined by the order in which written notice was given to the borrower; notice may therefore protect a buyer against subsequent (accidental or dishonest) assignments.

18 It would accordingly seem to be good practice to give written notice and, if practicable, to obtain confirmation from the borrower that:-

- there is agreement on the amount of the debt
- the borrower has no notice of any other assignment
- the borrower has no right of set-off against the assignor
- the contract between the borrower and assignor/seller has not been varied (for example by a side letter).

19 It should be noted that an equitable assignment of a legal interest in a loan (i.e. of a legal chose in action) creates an equitable interest in the debt (or an equitable chose in action). Any on-sale by way of a further equitable assignment is therefore an equitable transfer of an equitable chose in action, and is in consequence subject to different provisions from the original sale (in particular Section 9 of the Statute of Frauds Act 1677 might apply, in which case the assignment would have to be in writing and signed by the assignor).

## Novation

20 The cleanest way of selling a loan and the only way of effectively transferring both rights and obligations is novation. This entails cancelling the original rights and obligations, and substituting new ones in their place, although the only substantive difference is the identity of the lender. The buyer steps into the shoes of the original lender/seller who ceases to have any obligations to the borrower.

21 The technique can be somewhat cumbersome, however, as the consent of all the parties to the original loan is needed; i.e. the borrower, any other lenders and possibly even the guarantor in the case of a syndicated facility. Steps have been taken to overcome this - see "Transferable loan facilities" below (paras 31 to 33).

22 Novation avoids the difficulties of assignment in relation to "transfer" of obligations and whether the buyer can be entitled to greater rights than the original lender/seller. However, difficulties may arise in particular in relation to secured loans, priorities, consents and questions as to the value given by the buyer (e.g. to avoid problems in relation to preferences and invalidation of floating charges under the Companies Ordinance and Bankruptcy Ordinance).

## Sub-participation

23 Unlike "novation" and "assignment", the terms "participation" and "sub-participation" are not terms of art as a matter of the laws of Gibraltar. Rather, they are market expressions applied to the "sale" of a loan by way of a back-to-back non-recourse funding arrangement: the buyer deposits a sum of money (equal to the whole or part of the underlying loan) with the seller on terms under which the monies are repayable (and interest is payable) if and only if the seller receives payments of principal (and interest) from the underlying borrower, and subject to a maximum of the amount received. (This is sometimes called a funded sub-participation or a sub-loan.)

24 The sub-participation, as customarily documented, is a separate legal agreement from the underlying loan, creating a debtor-creditor relationship between buyer and seller. The buyer does not (or at least is not intended to) acquire any legal or beneficial interest in the underlying loan, nor any contractual relationship with the ultimate borrower. In consequence, in contrast to novations and assignments, the buyer does not have any direct recourse to the borrower and is not able to exercise any of the seller's rights against the borrower. Nor can the buyer benefit from any of the other provisions of the underlying loan contract (such as grossing-up in the event of the imposition of withholding tax). The buyer's rights are against the seller and he can benefit only from the provisions of the sub-participation agreement.

**(a) Types of participation agreements**

25 Some banks use standard documentation for sub-participations. A medium term agreement may be used for individual loans and may be drawn widely so as to cover simple bank loans, syndicated credits, guaranteed loans, multicurrency loans, and loan facilities which are wholly or partly drawn.

26 A "short-term master participation agreement" may be used for a series of short-term loans made under a rollover facility. Technically, each loan is repaid at the end of each interest period, notwithstanding the fact that a new loan is immediately and (in practice) automatically advanced, often without an actual movement of funds. The commercial effect can be equivalent to interest period stripping - as the buyer purchases the interest earned on a short term loan. Such sub-participation agreements tend to be drafted to cover all participations during the life of the facility.

**(b) Double credit risk for buyer**

27 An important feature of many sub-loans is the double jeopardy of the buyer; that is, that the buyer has a credit exposure to both the seller and the underlying borrower. Say Bank A makes a loan to Corporate X which it "sells" to Bank B by way of sub-loan. If Corporate X fails and the liquidator recovers 50p in the £, Bank B gets 50p in the £.

28 If Bank A fails and the liquidator pays out 1p in the £, Bank B has a contingent claim in the liquidation. If the Corporate X loan is repaid in full, Bank B still gets only 1p in the £. If Corporate X also fails and nothing is recovered, Bank B gets nothing.

29 A possible remedy for buying Bank B is for its sub-loan to be secured by way of mortgage or charge over Bank A's loan to Corporate X. But banks appear to be reluctant to grant such charges, perhaps in part because they may need to be registered with the Registrar of Companies.

## Risk participations

30 Risk participations are used for the undrawn part of a loan facility. Basically, the participant undertakes to fund any drawings on the facility by way of a non-recourse sub-loan. Risk participation is accordingly a commitment (i) to finance the lending bank and (ii) to take on the credit exposure to the borrower.

## Transferable loan facilities

31 Many loans are now structured to ease transfer. Essentially, the borrower (and other parties to the loan) agree in advance that the loan - or parts of a loan - may be transferred freely or subject to conditions. The transfer is generally executed between the buyer and seller but with some registration procedure involving an agent bank. Buyers are able to make subsequent transfers and thus the transferable loan facility ("TLF") should help to increase the liquidity of the underlying asset.

32 There are three basic varieties of TLF: the Transferable Loan Certificate ("TLC"), which is based on novation; the Transferable Loan Instrument ("TLI"), which is based on legal assignment and the use of debentures (and thus can only be used where a loan is fully drawn); and the Transferable Participation Certificate ("TPC"), which combines TLC "technology" with sub-participation.

33 The TPC is designed in part to avoid multi-tiered sub-participations: i.e. a sub-participant "on-selling" the loan to another sub-participant so that in effect Bank 3 is funding Bank 2 which is funding Bank 1 which holds the underlying loan. The use of the TPC should enable Bank 3 to step cleanly into the shoes of Bank 2 and thus to have a direct contractual relationship with Bank 1.

## Other legal issues affecting transfers

34 Whatever the method, transfers are complex legal transactions needing great care and professional advice. For example, as already noted, successive equitable assignments may be subject to slightly different conditions.

**(a) Local law**

35 In addition, it is important that all parties to a sale should recognise that, although the novation, assignment or sub-participation may be made under the laws of Gibraltar, the effectiveness of the transfer may depend on the laws of other countries. The following can all be relevant:-

- the law governing the underlying debt
- the law of the place of incorporation or residence of the borrower or any guarantor
- the law to which the buyer or sub-participant is subject
- the law of the place where the debt is to be paid
- the law applicable to any other parties to the loan - e.g. the law of incorporation of the agent bank
- the law of the place(s) in which any secondary market operates

36 On the whole, novation and assignment are more likely than sub-participation to be affected by local law considerations.

37 Issues which may arise include:-

- priorities may be forfeited in some jurisdictions if the transfer is by way of novation
- consents and notices may be necessary to make the transfer fully effective; e.g. exchange control consents may need replacing if transfer is by novation or assignment
- formalities may need to be observed; this can be particularly important when the borrower is from a civil law country - for example, in France notice of assignment may need to be served by a "huissier"
- withholding tax may arise in relation to the buyer.

**(b) Bankers' duty of confidentiality**

38 The simple issue here is that, if a seller discloses to a buyer information about the borrower which was provided in connection with the loan, the seller may have breached its duty of confidentiality to the borrower unless the borrower has consented (in the loan agreement or otherwise) to such disclosure. In consequence, sellers have to exercise great care. Since this may have the effect of limiting the information available to buyers, it could help to ensure that buyers make their own independent credit assessment, which is very important as a matter of general prudence.

# Appendix to Annex A - Section 40 of the Contract and Tort Ordinance

The following is the text of the relevant part of section 40 of the Contract and Tort Ordinance:

"40 Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice -

(a) the legal right to such debt or thing in action;

(b) all legal and other remedies for the same; and

(c) the power to give a good discharge for the same without the concurrence of the assignor.

Provided that, if the debtor, trustee or other person is liable in respect of such debt or thing in action has notice -

(a) that the assignment is disputed by the assignor or any person claiming under him; or

(b) of any other opposing or conflicting claims to such debt or thing in action,

he may, if he thinks fit, either call upon the persons making claim thereto to interplead concerning the same, or pay the debt or other thing in action into court under the provisions of the Trustee Ordinance."

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Financial Services Commission,
Suite 943, Europort,
PO Box 940,
Gibraltar.

Email : info@fsc.gi
http://www.fsc.gi

Tel (+350) 40283
Fax (+350) 40282

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