

Covered Bonds and Guarantee Structures

Peter Marro

Principal Financial Sector Specialist

South Asia Department

Public Management, Financial Sector and Trade Division

Asian Development Bank

22 August 2014

Presentation Outline

- Introduction
- Covered Bond Basics
- The Global Picture
- Covered bonds in the Indian context
- Benefits of Covered Bonds
- Covered bonds and mortgage backed securities
- Overview of ADB's Guarantee Operations
- Various Guarantee Structures
- Potential use of ADB's guarantee product for covered bond issuances

What are covered bonds?

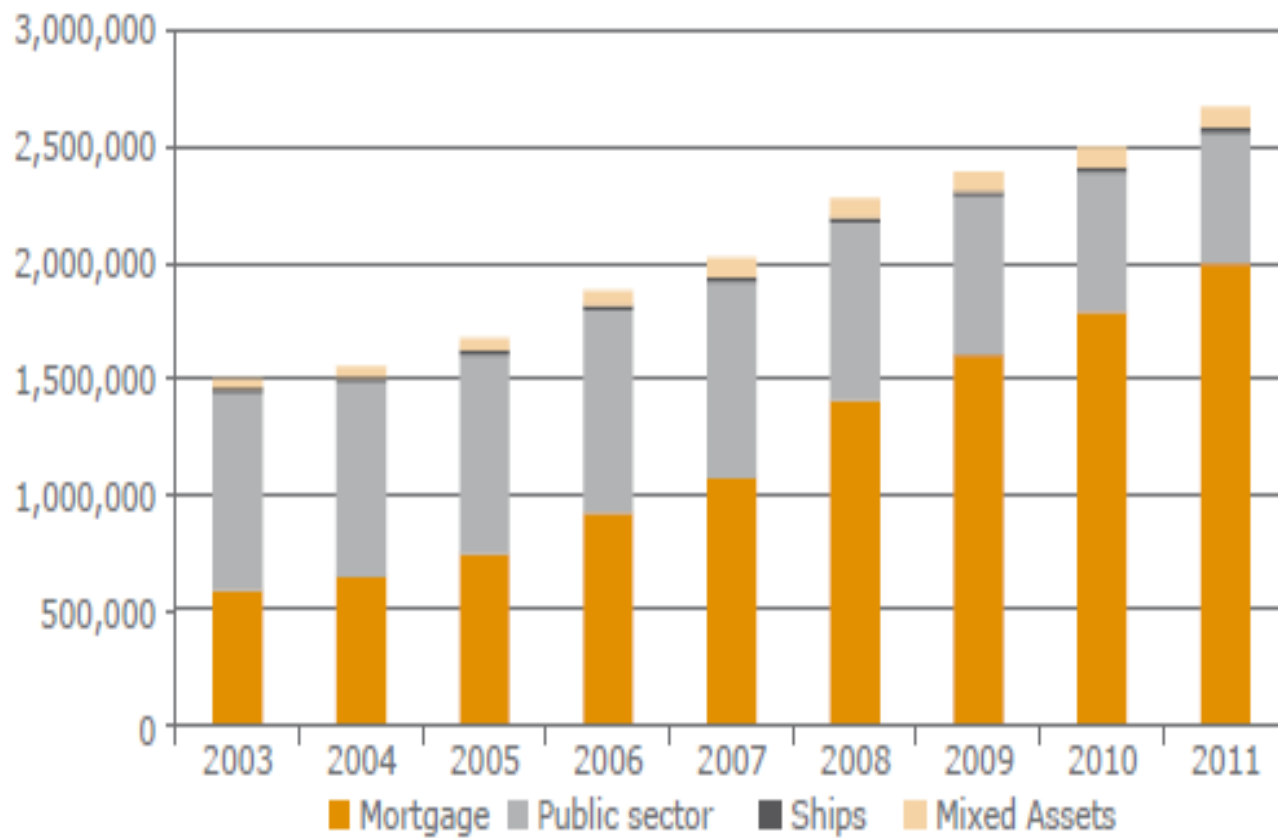
- Asset backed debt instrument secured by a cover pool of high quality assets.
- Fixed rate low risk yielding bearing, bonds with bullet maturity 1 to 30 years.
- Assets and related credit risk retained on issuer's balance sheet.
- Over-collateralized cover pool to preserve investors claim in the event of the issuer's insolvency.
- Dual Recourse
 - => Investors first recourse to the cover pool.
 - => Investors maintain an unsecured claim on the issuer.
- Interest Payment
 - => Issuer's cash flows are used to pay interest to the cover bondholders, while cover pool serves as secured collateral.

Covered Bonds In the Global Economy

- Covered Bonds in Developed Countries
 - More than Euro 2.5 trillion in 2011
 - 20 new issuers for a total of 306 issuers in Europe
 - Active markets in 25 European countries
 - => Japan, South Korea, New Zealand, Australia, US and others following suit.
- Covered Bond in Emerging Markets
 - Growing potential in Latin America and Asia

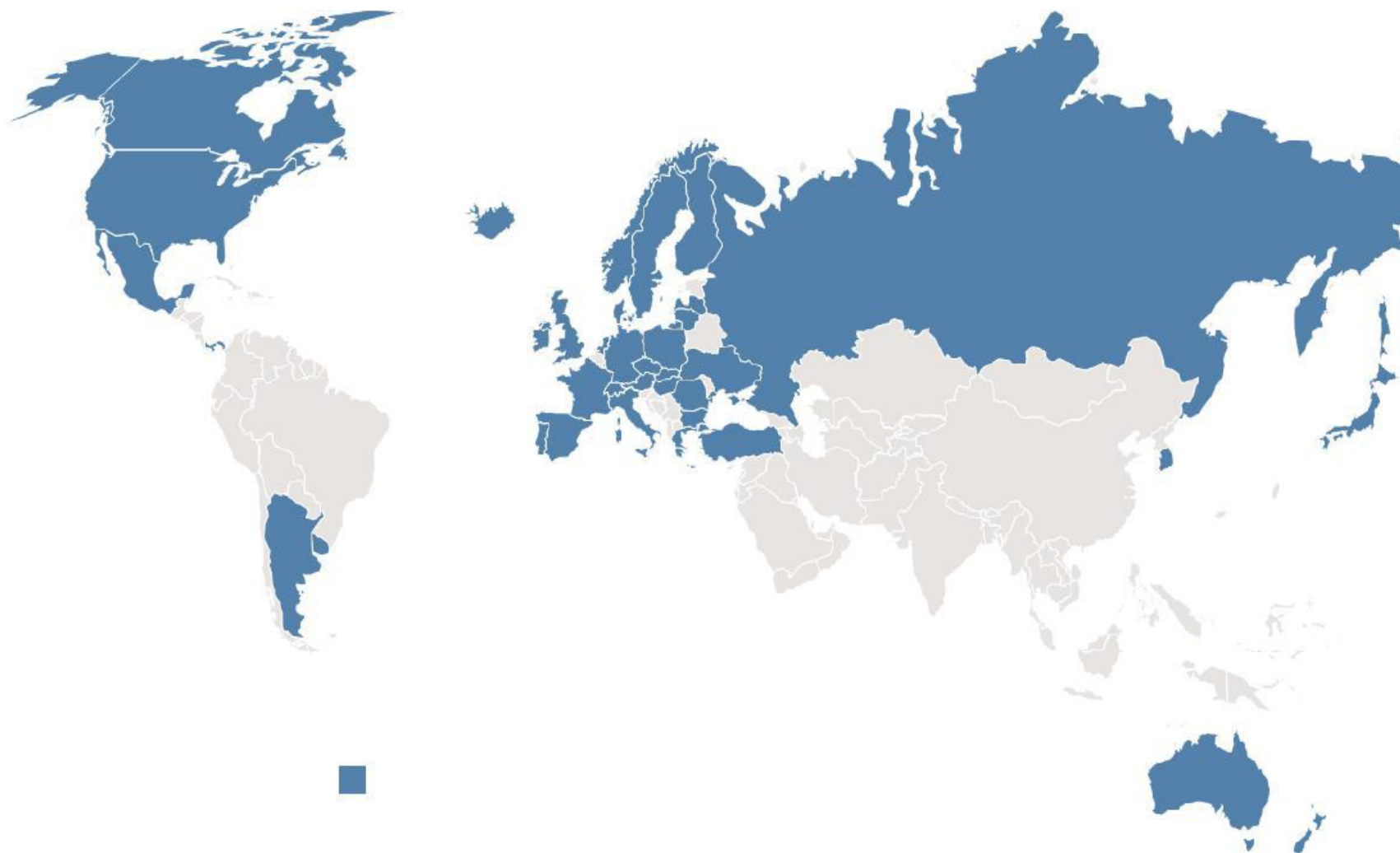
A growing market

Excluding Chile and Korea



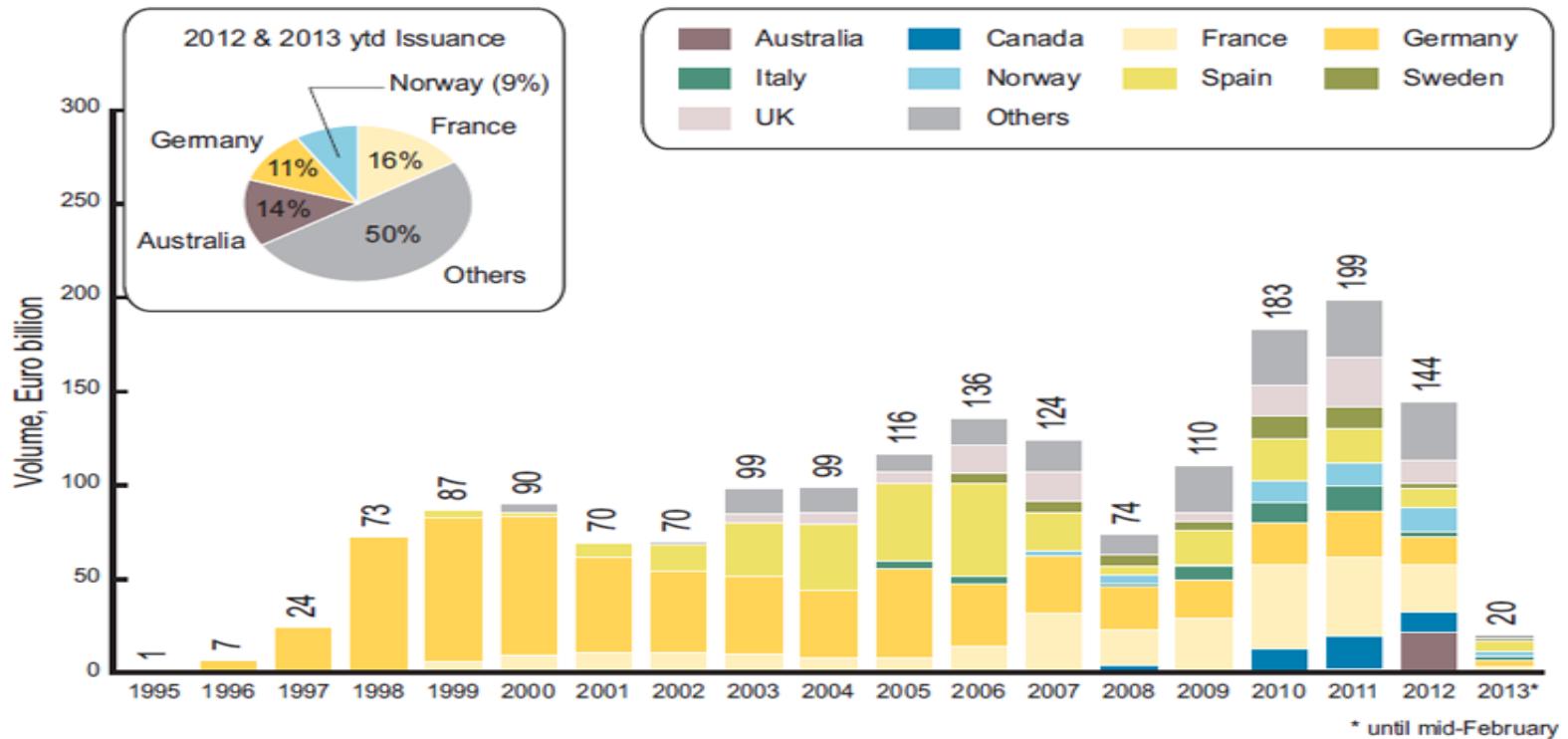
Outstanding amounts in Millions Euro – Source ECBC

The covered bond universe: Countries with covered bond structures in place



Covered bonds are mostly a European Affair

Benchmark Supply by Country



Challenge: How Do You Finance the Rising Demand for housing in India?

Demand for Housing Finance is steadily growing:

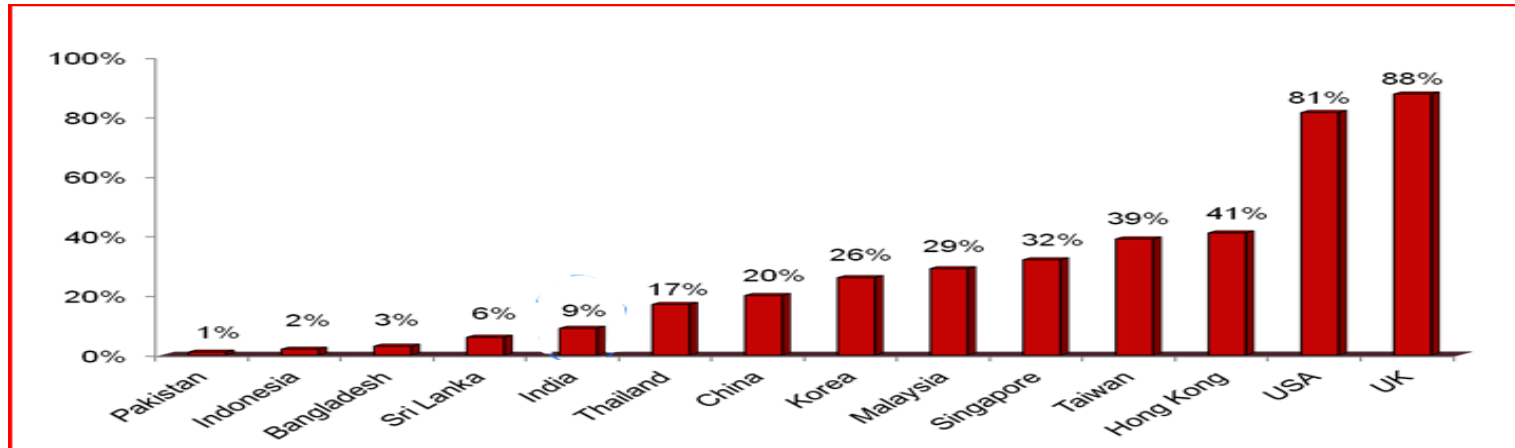
- Sustained economic growth
- Rapid urbanization
- Rise in disposable income
- Emerging middle class
- Tax incentives

Realities on the Ground:

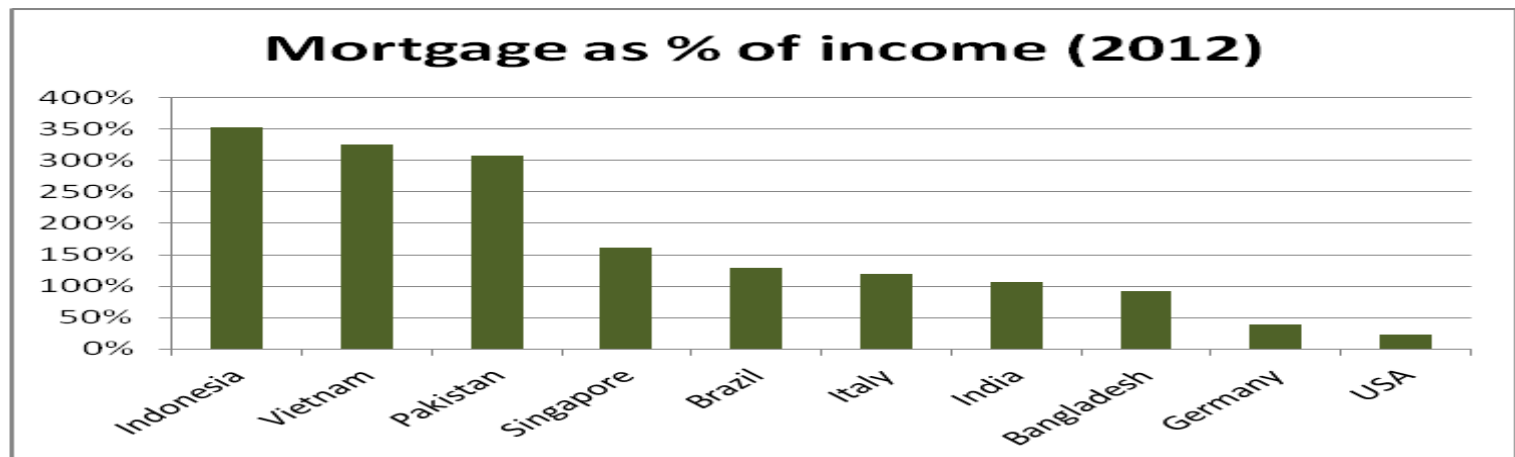
- Housing Shortage: 26.53 million units by end of 2012 (NHB)
- Housing Finance Shortage: >200 billion US dollars (NHB)
 - => Need for long-term financing

India has one of the lowest Penetration of Housing Finance but high % of income

Mortgage Loans as a Percentage of GDP

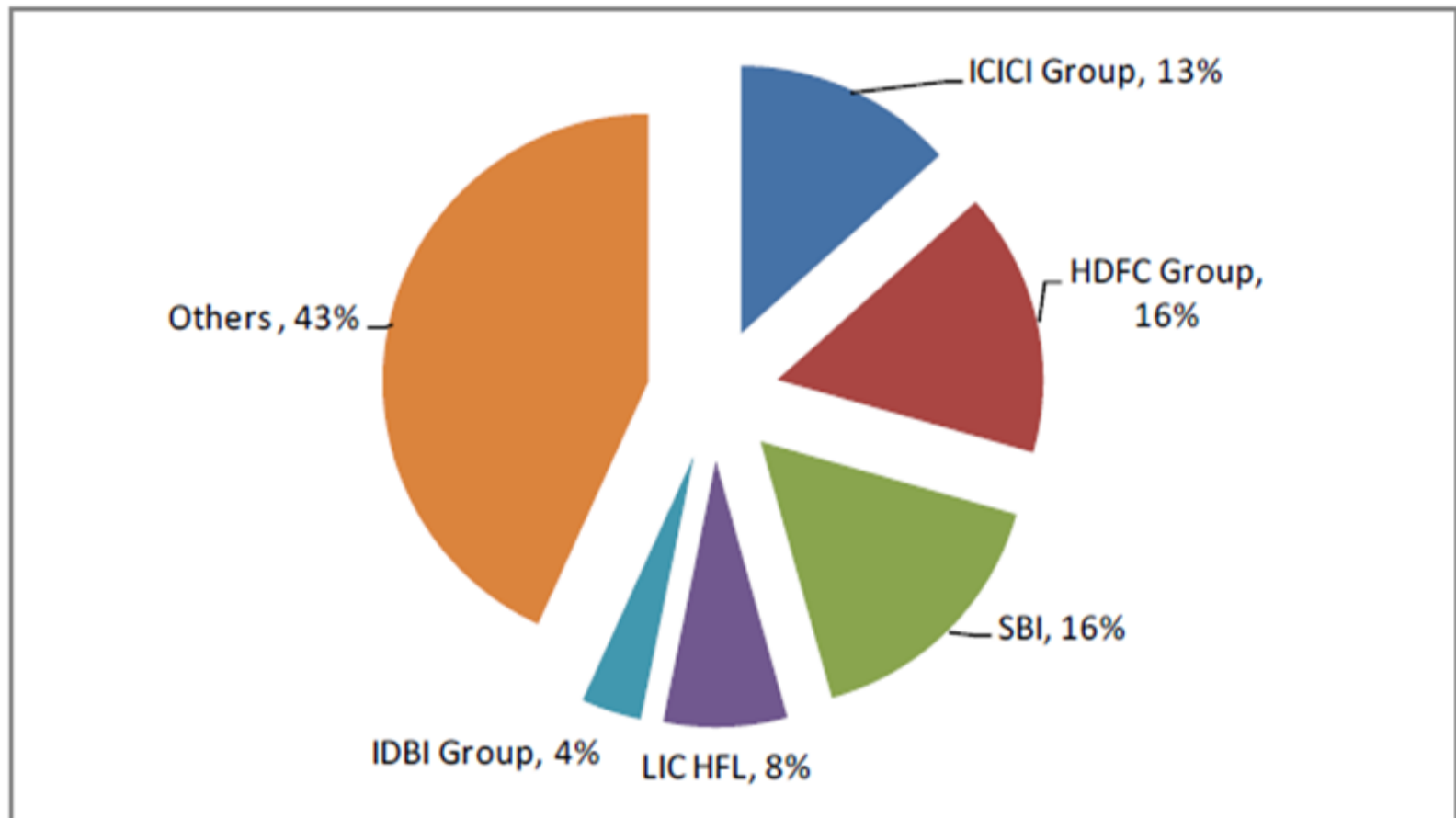


Mortgage as % of Income



Few Dominant Players in Mortgage Lending

Market Shares of Various Players

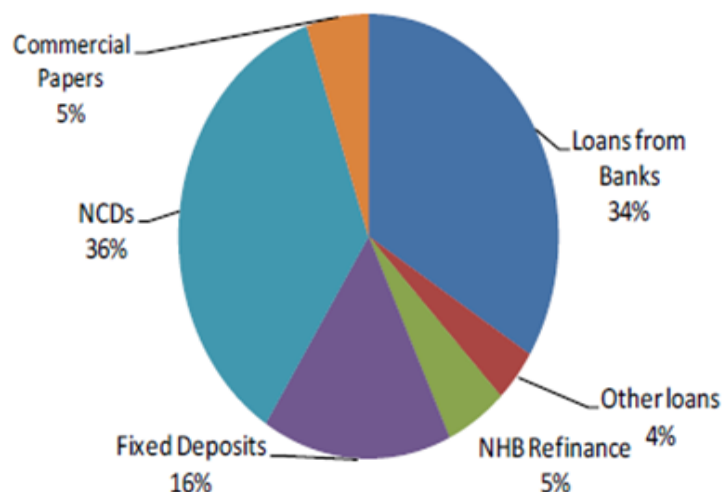


Source: Quarterly Results of various Mortgage Lenders and ICRA Estimates

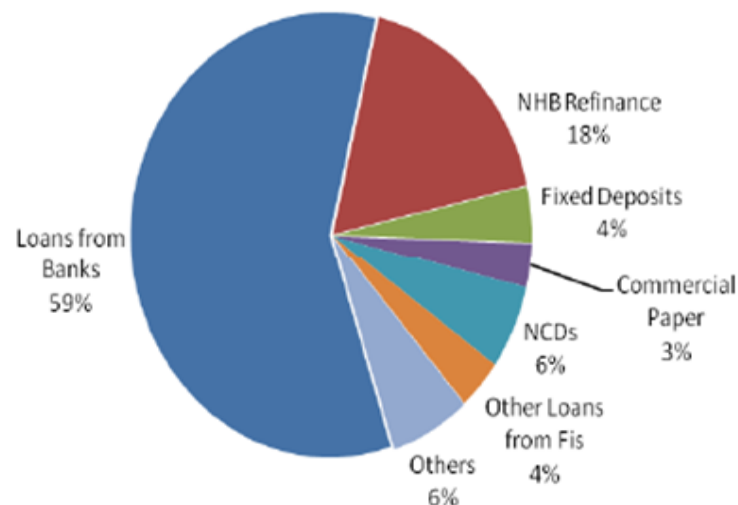
HFCs Largely Dependent on banks for Funding Needs

Dependence on wholesale funding remains high for HFCs

Borrowing Profiles of All HFCs



Borrowing Profiles of Small HFCs

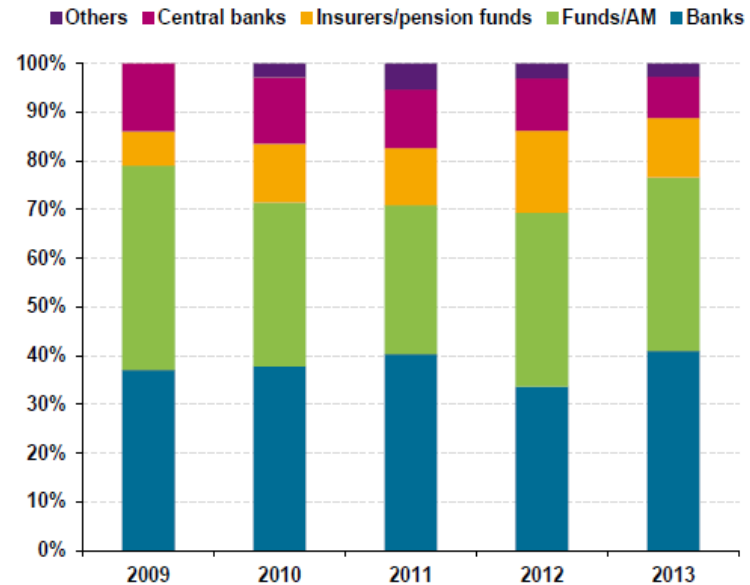


Who Invests in Covered Bonds?

Small private investors to large institutional investors seeking low risk and long maturities such as:

- Central banks
- Pension funds
- Insurance companies
- Asset managers
- Bank treasuries

Allocation by type

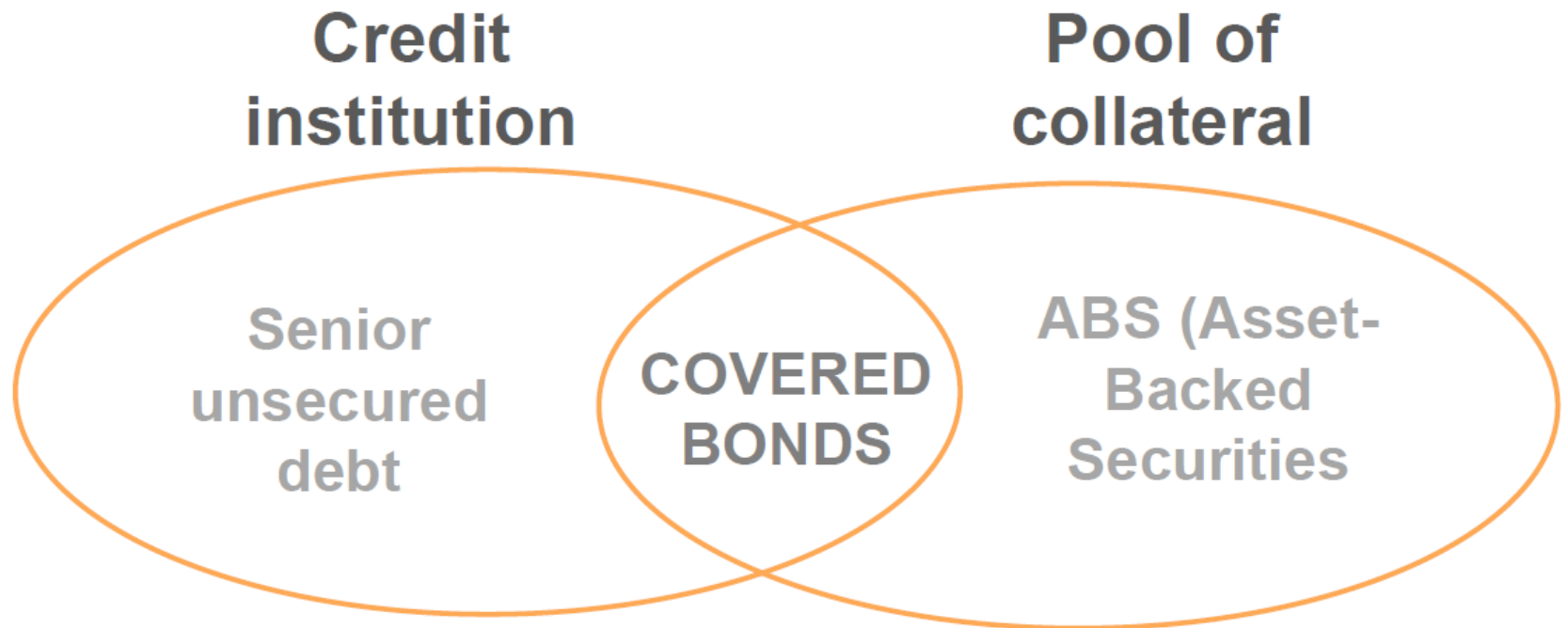


How to address the Funding Gap through Long-Term Financing?

Primarily 3 funding options:

1. Unsecured Debt
 - Issuance of unsecured corporate debt
2. Mortgage Securitization
 - Securitize mortgages by dicing cash flows
3. Covered Bonds

Covered Bonds – A dual Recourse Instrument



Benefits of Covered Bonds

- **For issuers**
 - Long-term funding, fixed rates available
 - Long term financing
 - Rating enhancement can be significant (several notches possible)
 - Cost effective, cheaper than securitization
- **For investors**
 - High level of security
 - Dual recourse
 - Market liquidity: No valuation problems, large volumes
 - Simplicity of structure
 - Potential for lower capital requirement
- **From a macro perspective: financial stability factor**
 - Financial stability
 - Bond market development
 - Long-term investments
 - Extremely low default rate

ADB's Guarantee Products

- Partial Risk Guarantees (*political risk insurance*) - PRG
 - Transfer Restriction
 - Expropriation
 - Political Violence
 - Breach of Contract
 - Denial of Justice and Arbitration Award Default
- Partial Credit Guarantees - PCG
 - Covers commercial and political risks
 - Non-honoring of a Sovereign Guarantee or Sovereign Borrower
 - Covers sovereign/government payment risks

Eligible Operations for ADB Guarantees

Guarantees are available for:

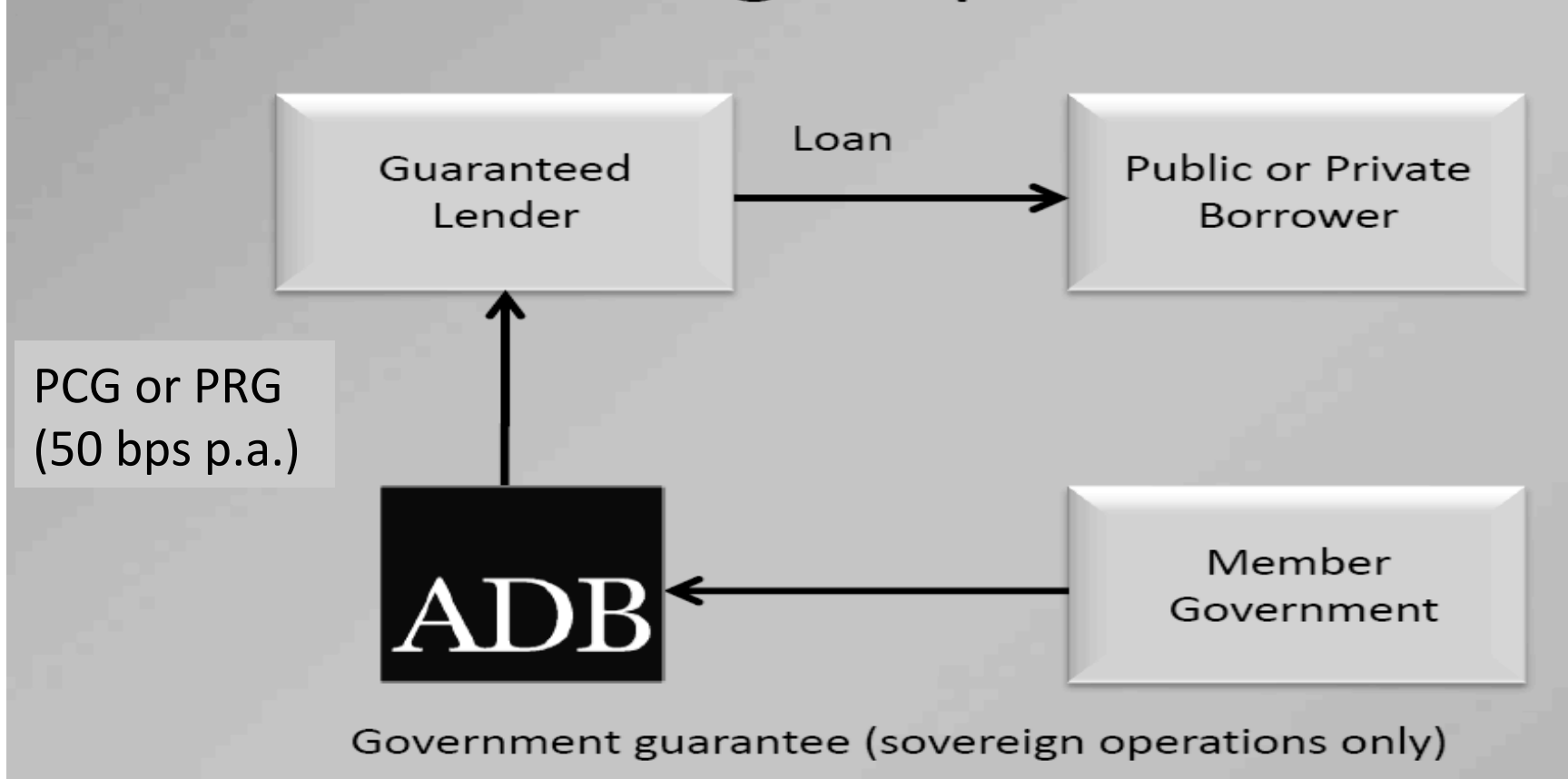
- Sovereign Operations (with sovereign counter-guarantee)
- Non-Sovereign Operations (without sovereign counter-indemnity)

Guarantee Approvals 1988 - 2013

	Sovereign	Non-Sovereign	Total Guarantees
No. of Projects	15 PCG 6 PRG	15 PCG 10 PRG	30 16
Guaranteed Amount	\$3,307 b	\$2,266 b	46

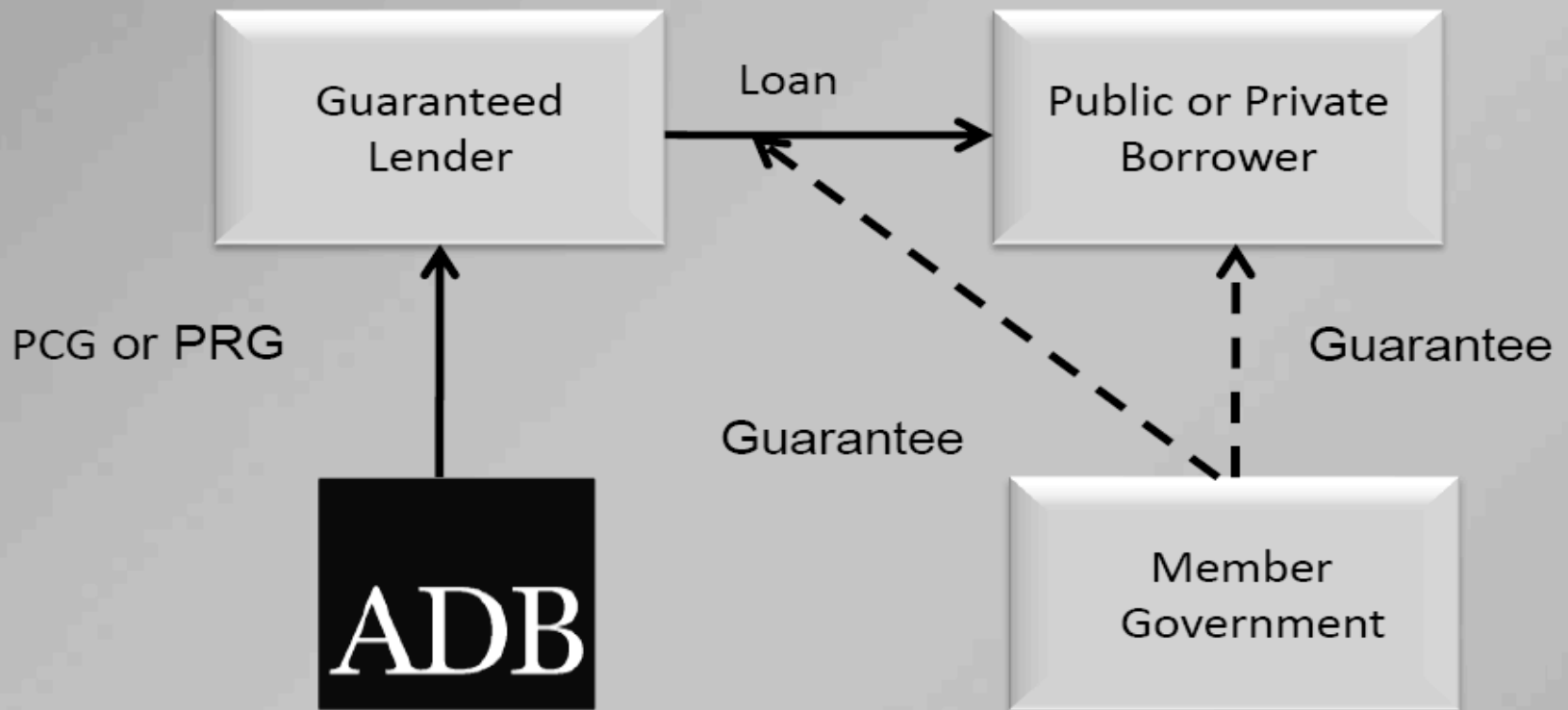
Typical Guarantee Structure

Sovereign Operation



Typical Guarantee Structure

Nonsovereign Operation



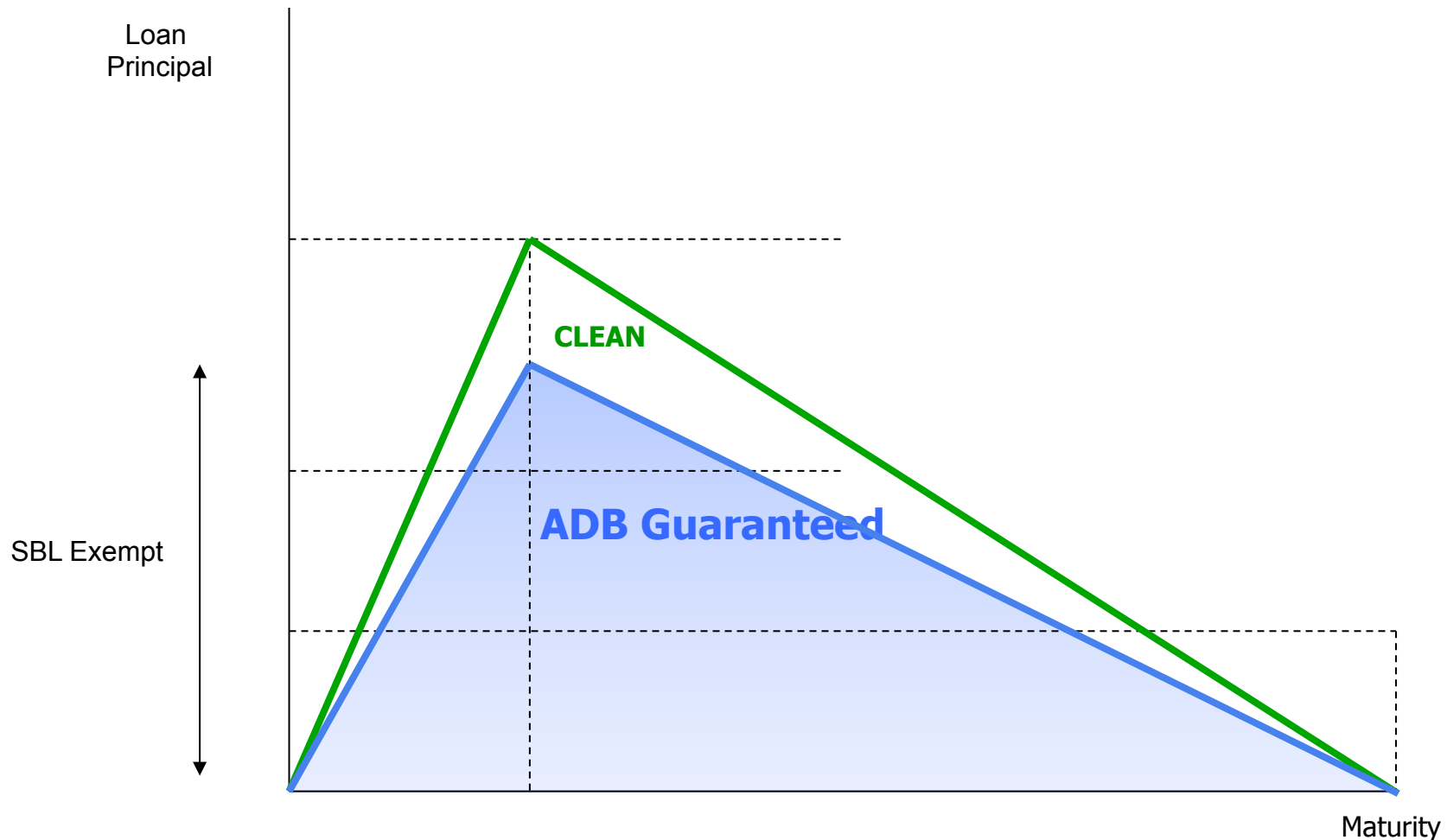
Eligibility Criteria

- Trade and investment
- Any type of debt (bank loans, bonds, shareholder loans)
- Guarantees in local currency or foreign exchange
- Guarantee holders can be investors and lenders from the host country, or foreign
- Guaranteed percentage can be up to 100%, but encourage risk sharing
- Long tenor (matches the terms of the guaranteed loan)
- Procurement: *Good from ADB member countries and economy and efficiency*

Size of the ADB Guarantee

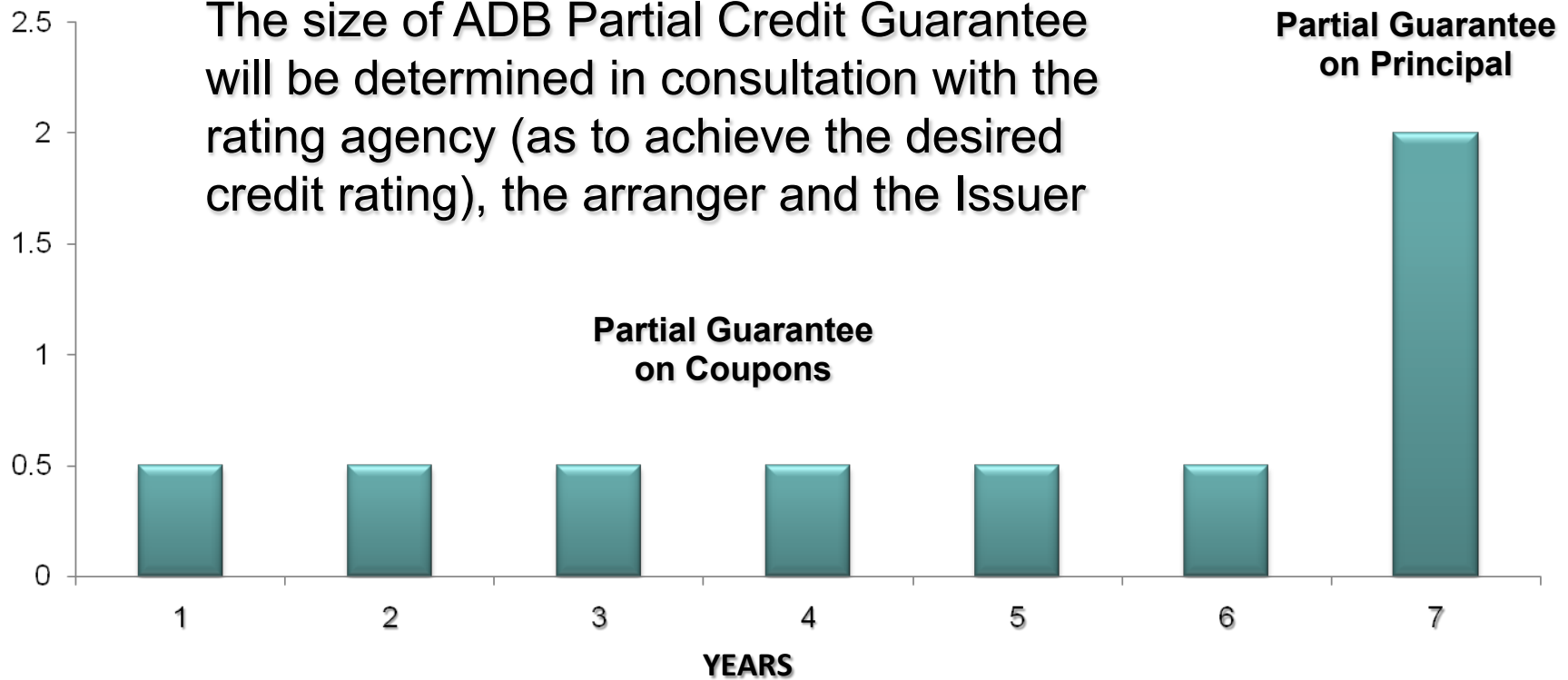
- PRG
 - Lesser of 40% of project costs or \$400 million (net)
- PCG
 - Lesser of 25% of project costs or \$250 million (net)
- Additional amount can be obtained through guarantee syndications with public and private insurers and guarantors

Guarantee of Fixed Portion of Principal and Interest



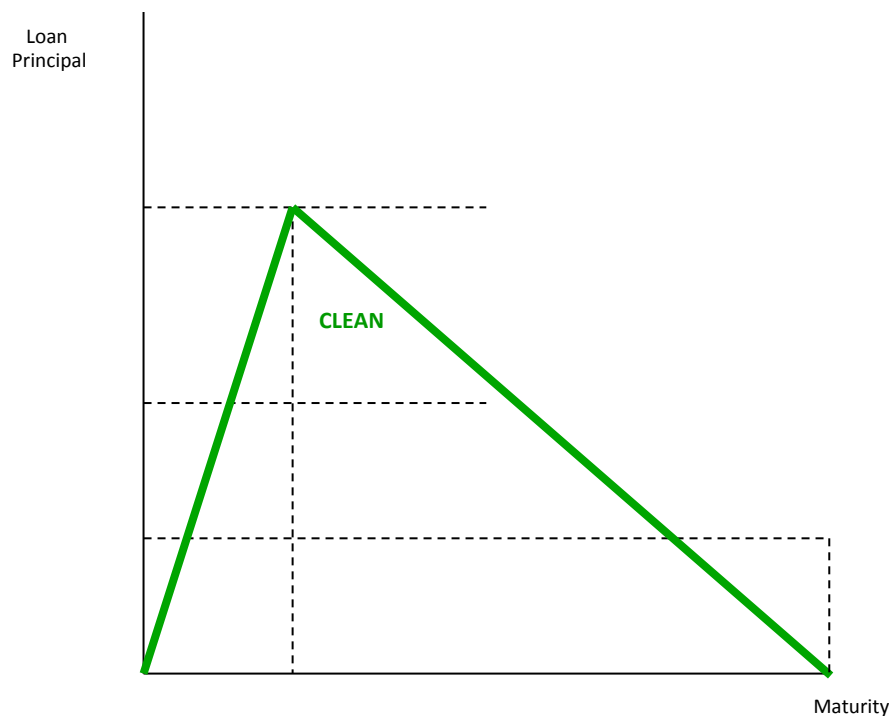
Partial Guarantee on a Bond

The size of ADB Partial Credit Guarantee will be determined in consultation with the rating agency (as to achieve the desired credit rating), the arranger and the Issuer

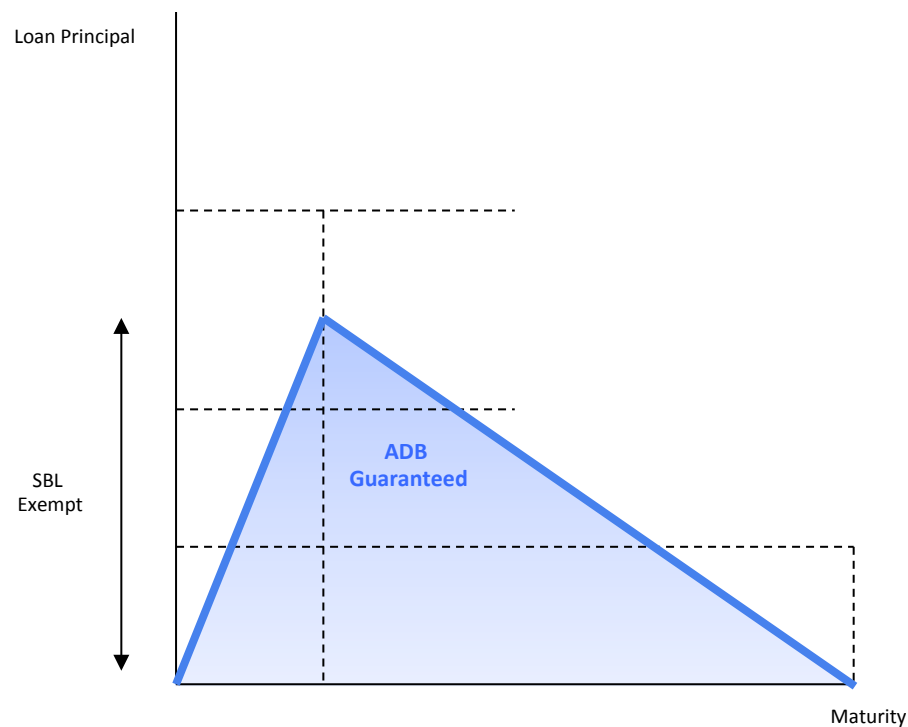


Separate Tranches – With and Without ADB Guarantee

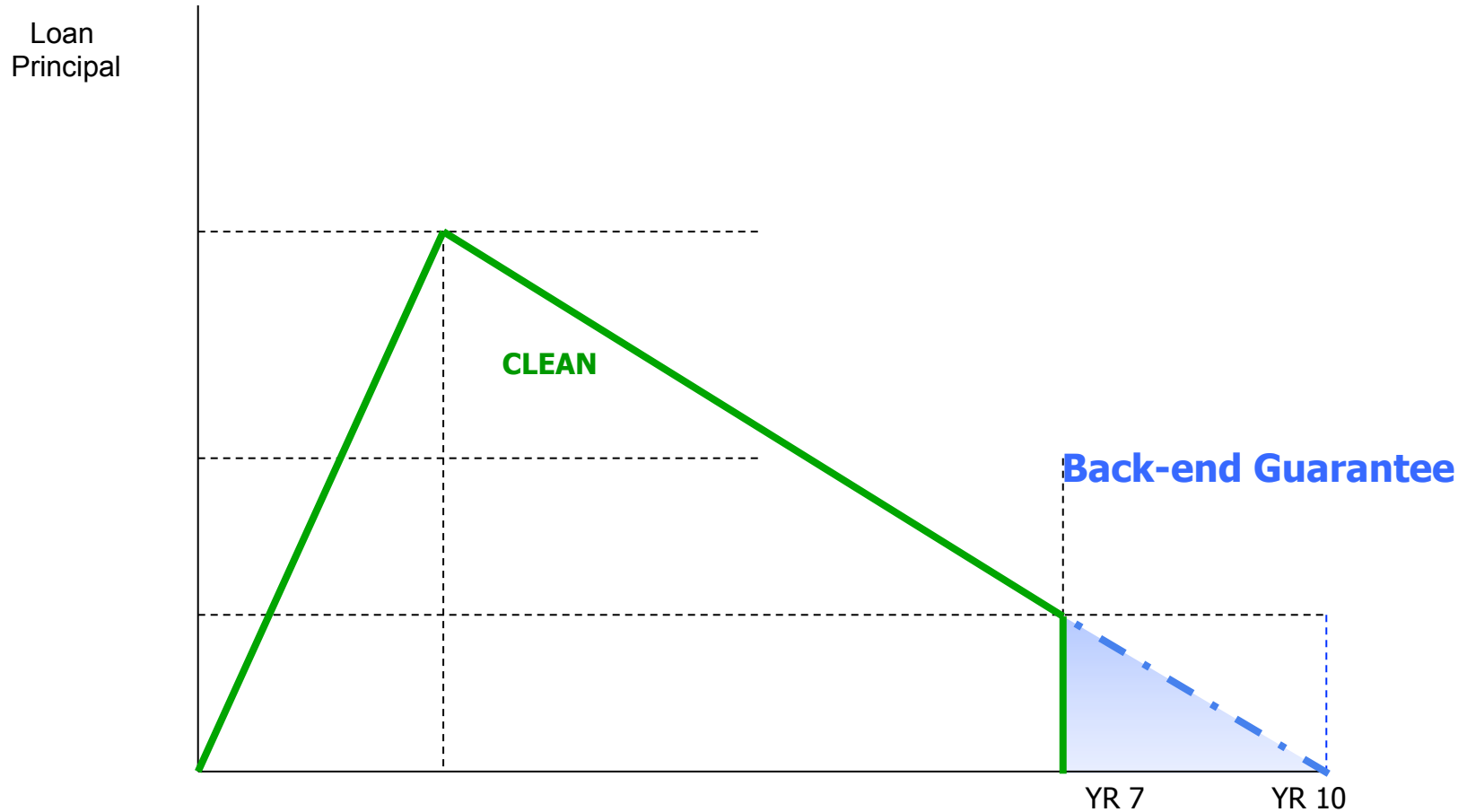
Uncovered commercial debt



ADB guaranteed debt



Back-end Guarantee



The Proposed Guarantee Structure

