



Introducing Covered Bonds in India

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About Covered Bonds

- Covered Bonds have been in existence for almost 200 years with zero default history.
- Covered Bonds are dual recourse instrument:
 - Investors have a primary claim against the issuer
 - If issuer defaults, investors have bankruptcy-protected claim against the “cover pool”
 - That is, the pool of cashflows that back up the bond.
- Covered bonds structures
 - legislative Covered Bonds:
 - Bankruptcy protection comes under a special law, such Pfandbrief law in Germany
 - Structured Covered Bonds
 - Securitization techniques are applied to isolate the pool
- Covered bonds have been one of the most popular refinancing instrument for mortgage lenders in Continental Europe:
 - Penetration rate is nearly 30% in some countries
 - Gained attention all over the world after subprime crisis



Some quick features of covered bonds

- On balance sheet instrument
 - Full skin-in-the-game
- There is dual recourse
 - Recourse on the ring fenced assets also called the cover pool
 - Recourse on the originator
- Based on a dynamic pool
 - Therefore, the uncertainties of pass-through structures completely avoided
- Prepayment protected
 - While issuer keeps a call option, prepayment risk absorbed on the treasury of the issuer
- Rating arbitrage
 - Ratings of covered bonds are typically between (higher than) corporate bonds, and (lower than) mortgage backed securities



Covered Bonds, corporate bonds and MBS

	Corporate bonds	Covered bonds	Mortgage backed securities
Linkage with the rating of the issuer	Completely linked	Partly linked; however, notching up of ratings possible	Completely delinked
Cost of sourcing funds	If rating not very good, quite high	If rating gets uplifted, comparatively lesser	Lower than corporate bonds, but higher than covered bonds, as investors take prepayment risk and uncertain payment schedule
Prepayment risk	Entirely with the issuer	Entirely with the issuer	Entirely with the investors
Nature of pool	Dynamic pool	Dynamic pool	Static pool
Asset liability mismatches	Entirely with the issuer	Controlled; since structure tries to align with the pool paydown	Entirely eliminated
Capital relief	None	None	Capital required to the extent of first loss support
Regulatory provisioning relief	None	None	Grants relief from provision for standard assets.
Scope for third party second loss support	Has to be substantially high, since there is insulation of risks of the pool from the rest of the business risks	May be low, due to insulation of the pool risks	May be low, due to insulation of the pool risks
Whether foreign portfolio investors permitted to invest	Yes, in case of listed bonds	Yes, in case of listed bonds	Not clearly permitted



Covered bonds in India

- NHB Working Group made elaborate recommendations on introduction of covered bonds in India
- Recommended primarily two structures
 - NHB-intermediated structure
 - NHB acts as a trustee-SPV, providing guarantee for repayment of covered bonds
 - Private-label structure
 - SPV gives guarantee for repayment, SPV has legal title over the pool assets
- While there is no specific regulation or legislation in India, it is generally opined that covered bonds are possible within the flexibility of common law structure in India



Why Covered Bonds in India

- Utmost need to lower the cost of funding for HFCs
 - Indian HFCs are lending on wafer-thin spreads of about 100-150 bps, while taking a long-term risk
 - Most HFCs do not have access to long-term fixed rate liabilities
 - Hence, the spreads between fixed rate and floating rate lending products are enormous
 - Government focus on affordable housing
 - However, affordable housing finance lenders do not have cost effective access to capital markets
 - Bond costs demonstrate dependence on rating and credit of the issuer
- The primary motive of covered bonds is to uplift the ratings:
 - Hence, ideal instrument for less-than-AAA –rated issuers to reduce borrowing costs by getting a notched-up rating
 - For AAA-rated issuers, costs can be brought down by third-party guaranteed bonds



Proposed Covered Bond Structures in India



Legal Issues

- As per the recommendations of the Report of the Working Committee on Covered Bonds there are three ways of introducing covered bonds in India:
 - Under extant legal and regulatory framework
 - With NHB intermediation
 - Basis specific legislation
- The Report by the Working Committee has recommended the draft of the Covered Bond regulations
 - The regulations are currently in the draft stage
 - So we intend to evaluate issuance of covered bonds under the extant regulatory framework



Key elements of SPV structures

- Commonly used in countries like UK, USA, Australia, New Zealand, Canada
- SPV acquires legal title over the cover pool
 - Though the cover pool still remains on the balance sheet of the issuer
 - This is due to full recourse transfer/mortgage of the pool to the SPV
- SPV gets its funding by way of a subordinated loan from the issuer
 - The loans get amortised from out of the mortgage pool collections
- The SPV appoints the trustee and the cover pool monitor (bond trustee and security trustee respectively) to protect the interest of the bondholders

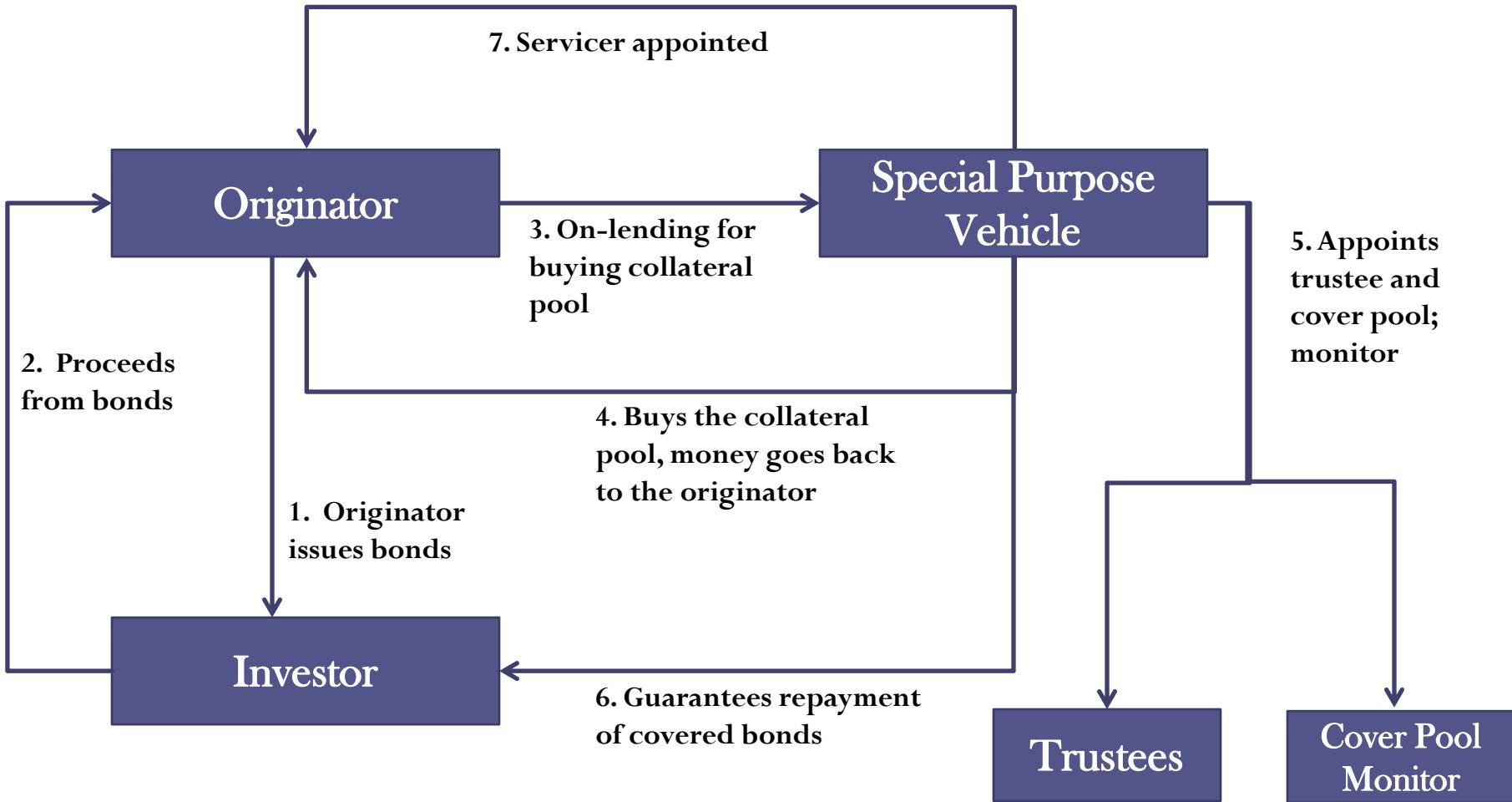


Key elements of SPV structures

- Issuer repays the bonds from out of its own cashflows
 - There are limited asset liability mismatches with the cashflows from the underlying pool
- With bankruptcy-protected right over the mortgage pool, the issuance may get ratings a few notches above the rating of the issuer
 - For example, an A-rated issuer may be issue AAA bonds

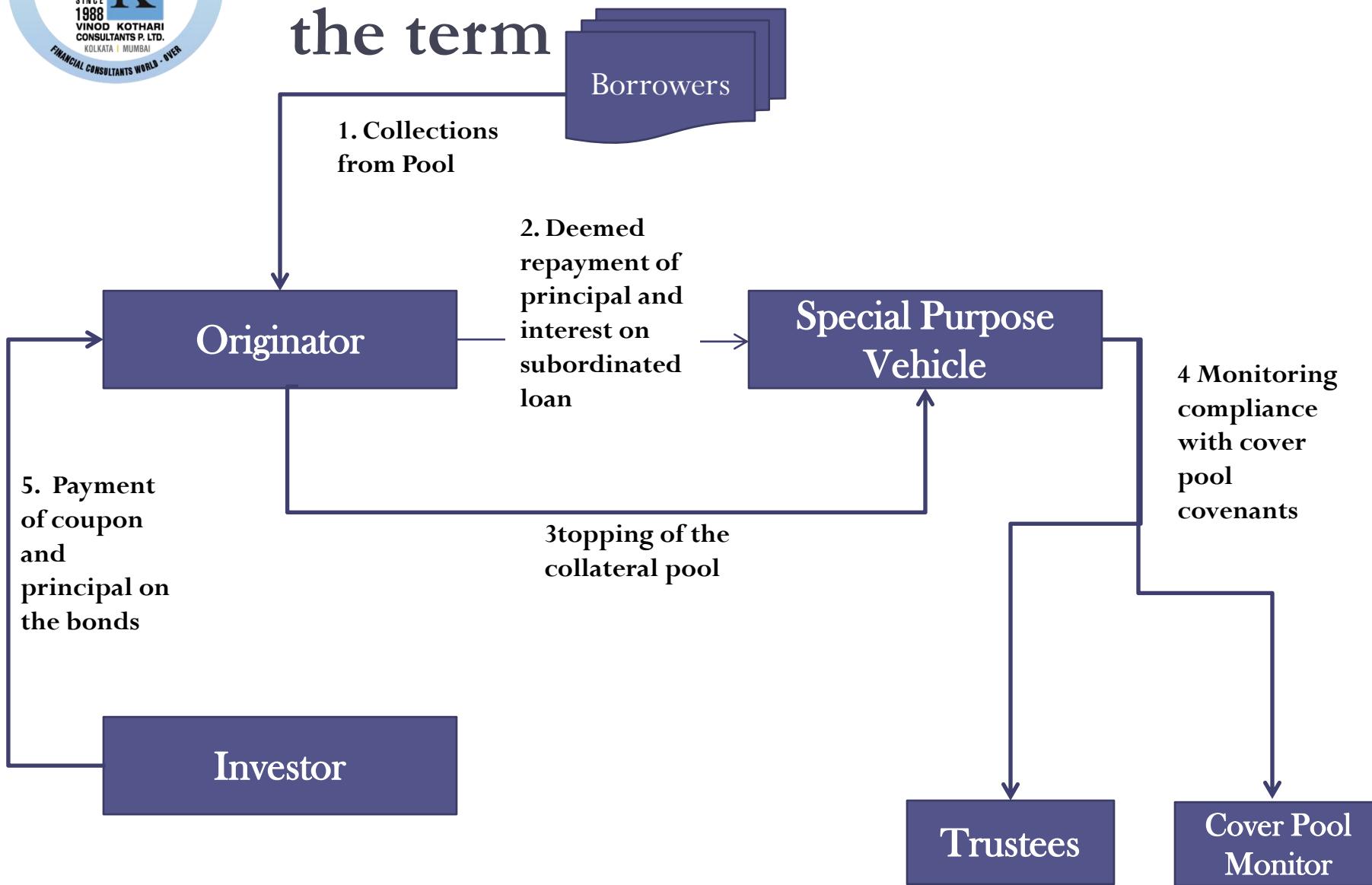


Covered Bonds with SPV structure: at inception



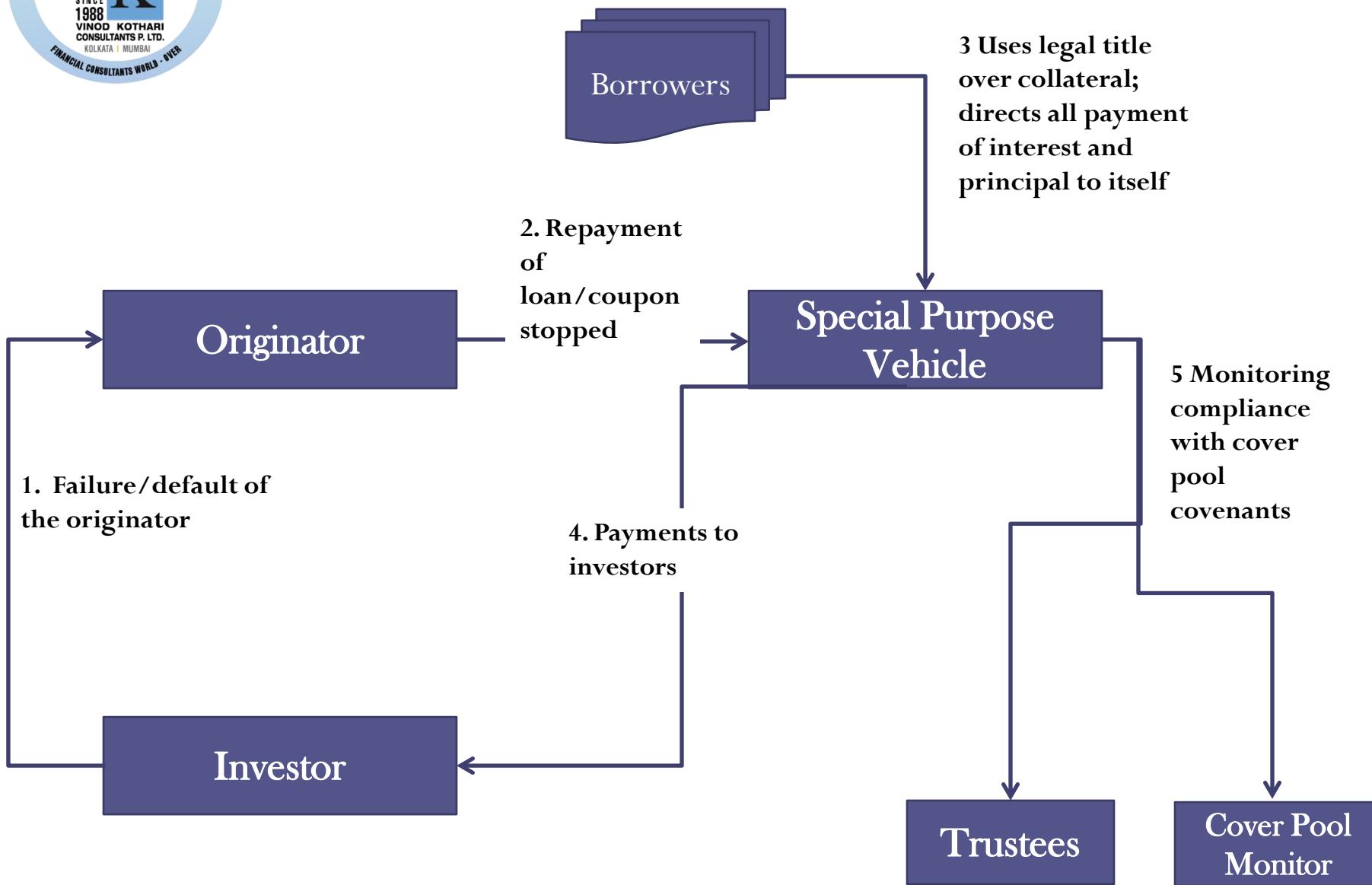


SPV structure: cashflows during the term





SPV structure: in case of default



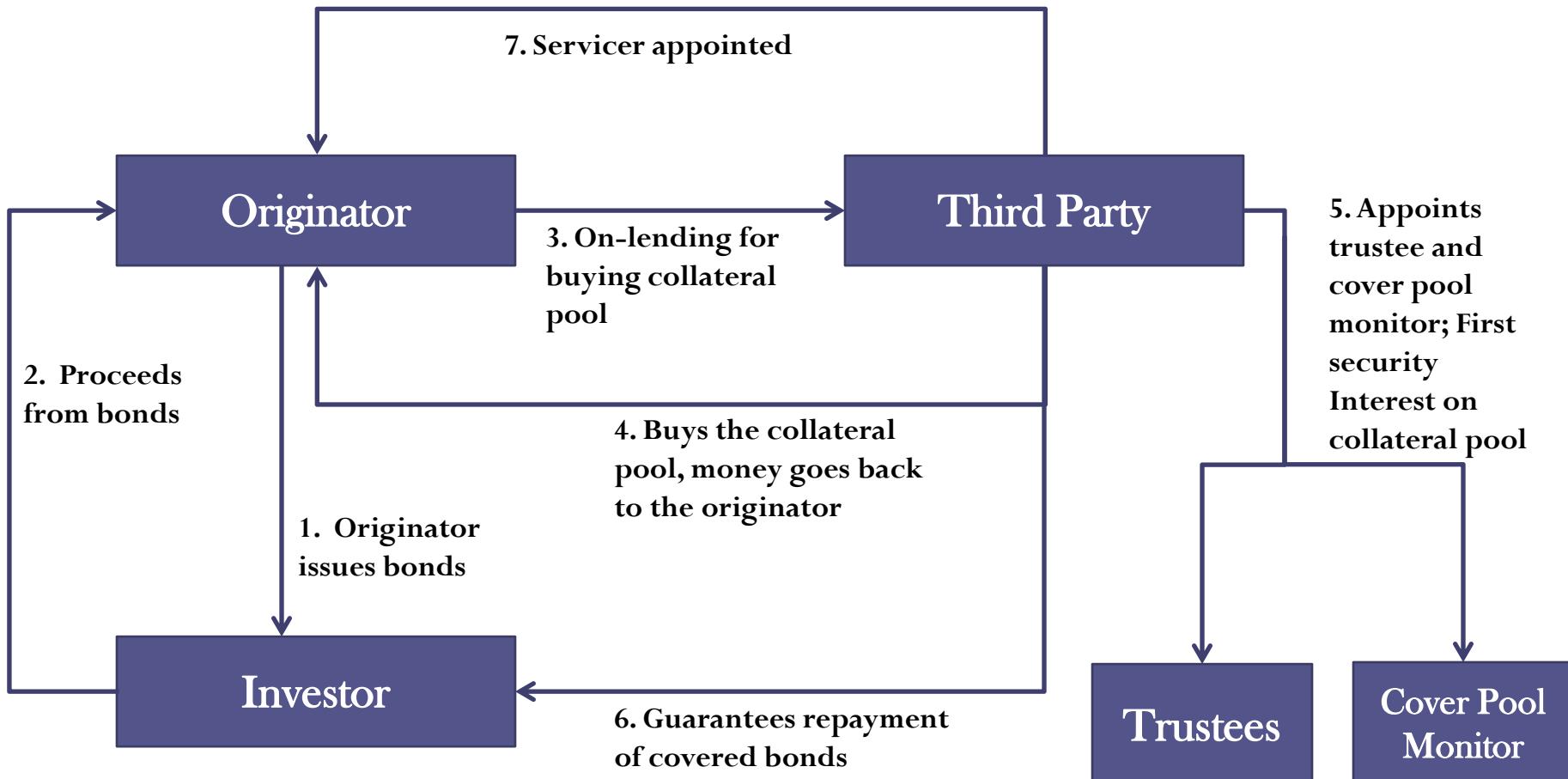


Key elements of third party guarantee

- Instead of an SPV, a third party provides the guarantee
- Third party, in turn, gets legal title over the mortgage pool to support it, should there be a default on the part of the issuer
 - In essence, the support provided by the third party is a second-loss support
 - First recourse is against the issuer
- If the creation legal title over the mortgage pool is proper, the guarantor may recover from the mortgage pool
- The guarantor shall appoint the trustee and the cover pool monitor to protect the interest of the bond holders
- Thus, essentially, the guarantor lends his own credit for that of the issuer
- Advantage
 - Cost savings due to credibility of the guarantor



Covered Bonds structure with Third Party Guarantee





Role of a cover pool monitor

- The bond trustee and the security trustee can be the same entities.
- The role of a cover pool monitor is executive. The cover pool monitor shall:
 - Administer the pool
 - Ensure that the cover is maintained at all times
 - Selection criteria for cover is met
 - Segregation of the cover pool from rest of the assets of the originator-issuer
 - Obtaining servicing reports
- The cover pool monitor cannot:
 - Approve amendments or corrections to the transaction documents and bond terms (with or without the consent of the bond holders)
 - Terminate or appoint agents and servicers
 - Convene bond holders meetings



Legal issues of proposed structures

- There is true sale of the receivables/ cover pool
 - The receivables are sold to the SPV
 - The sale is a legal true sale and not from accounting parlance
- The security interest created on the receivables is recognised, perfected and subject to interest of bondholders
 - Since legally the SPV is the owner of the assets, the creditors of the originator-issuer do not have the right over the assets
 - The trustees will ensure that in the event of bankruptcy of the issuer the proceeds from the cover will go directly to the bondholders
 - More preferable structure to avoid any claw back by the creditors' of the originator



Accounting aspects of proposed structures

- While legally the cover pool/ receivables are sold to the SPV, the risks and rewards pertaining to the receivables continue to be that of the originator-issuer
 - Issuer liable to top up the cover pool to the extent of defaults/repayment/prepayment
 - The bond holders have a full recourse on the issuer
- Hence from accounting parlance, the assets remain on the balance sheet of the issuer.
 - Under IAS 39 or FASB 167 off-balance sheet treatment by way of de-recognition would be denied
 - Denial of off-balance sheet treatment would mean recognition of gains on sale would also not be permitted
 - RBI guidelines on securitisation of performing assets also say, off balance sheet will not be permitted in case risks/rewards are not transferred



Does the law recognise a “true sale”, though with full recourse

- While case law in the USA points to a true sale being denied in case of a full recourse transfer, UK common law tradition goes by the intent of parties
- If the intent of the parties is clear that legal title is getting transferred, risks/rewards are not crucial in termination of a legal sale
- Major precedents:
 - George Inglefield
 - Welsh Development
 - Lloyds vs Scottish Finance
 - HK ruling in Hallmark Cards vs Yun Choy – has discussed all major UK and US caselaw and upheld true sale despite full recourse



Listing of covered bonds

- We are *prima facie* of the view that listing of covered bonds may be done under Issue and Listing of Debt Securities Regulations of SEBI
 - Covered bonds are obligations of the issuer
 - They are secured by a charge created by the SPV



Motivations for covered bonds issuers

- Provide additional source of leverage
- Rating of the covered bonds can be 6 notches higher than the rating of the issuer
 - Permits rating arbitrage
- Higher rating lowers costs
 - For AAA rated issuers, there can be lower costs for issuance of AAA rated covered bonds
- Better asset liability matching
- Access to capital markets
- Lower capital requirements
- Under Basel III norms covered bonds qualify for liquidity coverage ratio maintenance
- Currently the tax regime for PTCs and regulatory framework for bilateral assignments under securitisation are dis-incentivising use of the financial instruments
- The issues of pass-through status do not arise
 - The beneficial interest in the receivables is not acquired by the SPV
 - The SPV acquires the legal title over the assets



Motivations for Covered Bonds Investors

- Dual recourse
 - On the cover pool
 - On the originator-issuer
- Default and prepayment risks are retained by the originator-issuer
- The investors have the bankruptcy protected right over the cover pool
 - There is segregation of assets from insolvency estate of the issuer
 - Currently there are no special rights under the extant legal framework under which the cover pool is immune from the conflicting or overriding interests of the issuer's creditors
 - This should be mitigated by a security interest recognised and perfected on the cover pool



Potential Investors

- Covered bonds are the structured debt obligations of the issuer
- The potential investors in Covered Bonds can be:
 - Banks
 - NBFCS
 - Mutual funds
 - FPIs (covered bonds will be listed)
 - Insurance companies (can invest in asset backed securities with underlying housing loans; under approved investments for the purpose of section 27B of the Insurance Act)



Potential issues

- Stamp duty on “true sale”
 - Stamp duty may be applicable to the “instrument” that transfers legal interest in the receivables
 - Mortgage may be retained with the issuer as a trustee for the SPV
- SARFAESI Act action
 - Since there is full recourse against the seller in case of defaults, we suggest that the sale is reversed in case of a default
- There is a legal true sale of the cover pool but the pool remains on the balance sheet of the originator-issuer and concurrent issues with regard to bankruptcy protection of the pool
 - The dichotomy may be difficult to understand.



Covered Bonds and Vinod Kothari Consultants Pvt. Ltd.



Covered Bonds and VKCPL

- VKCPL is the frontrunner in introducing covered bonds in India.
- “Guide to Structured Finance”, by Vinod Kothari has a separate chapter on Covered Bonds.
- There is a separate section dealing with covered bonds on www.vinodkothari.com - http://vinodkothari.com/covered_bonds/.
- Vinod Kothari was a part of the NHB's working group on covered bonds and NHB's report on Covered Bonds has a substantial contribution of VKCPL.
- VKCPL was retained by NHB for introducing covered bonds in India.
- VKCPL was a part of the steering group formed by NHB.
- VKCPL has currently been engaged by Asian Development Bank for conducting a study of covered bonds in India.
- VKCPL is currently engaging with various regulators to make covered bonds a reality.