Introducing Covered Bonds for Indian housing finance companies

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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
- 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 in India

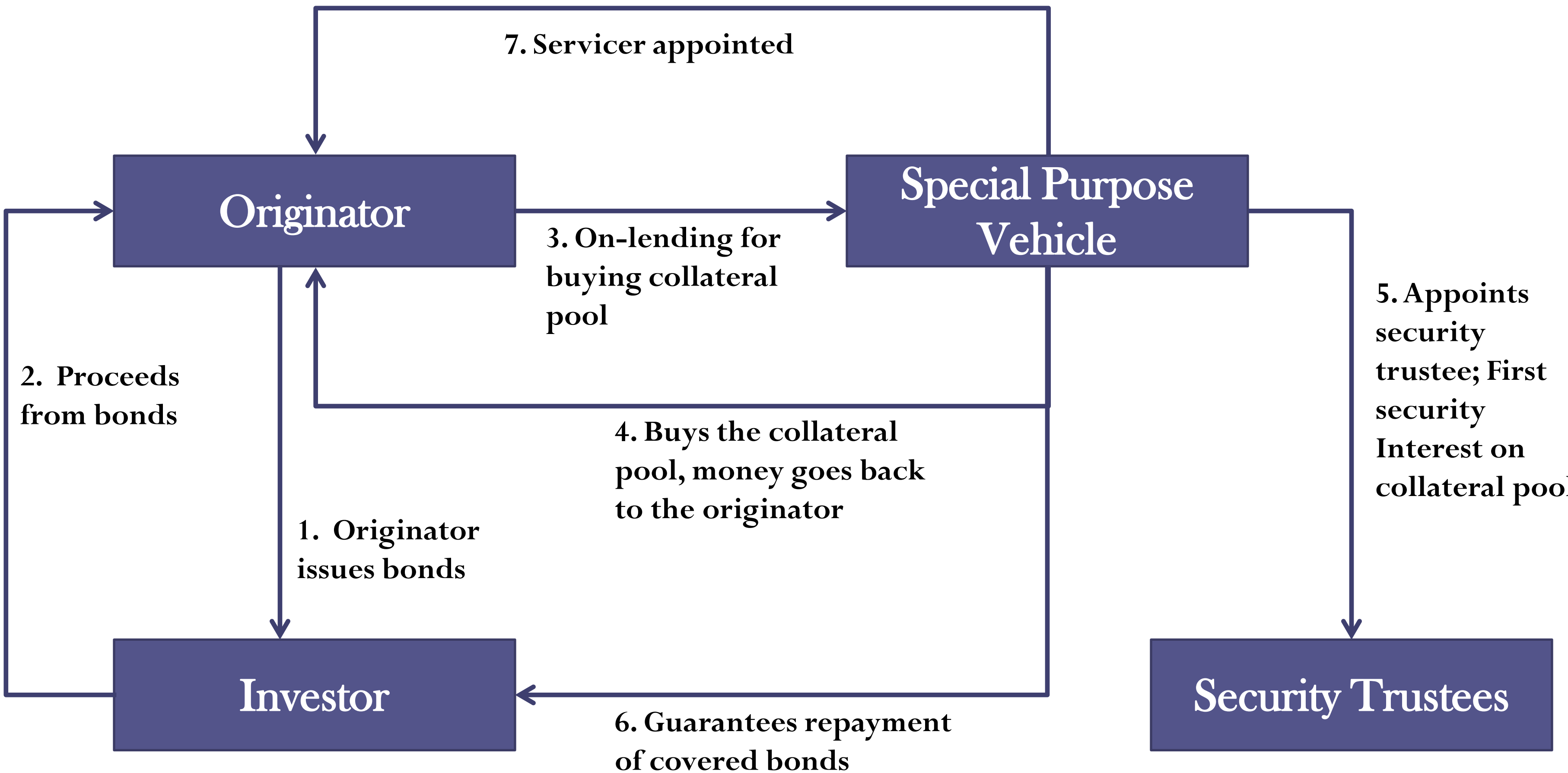
- NHB Working Group made elaborate recommendations on introduction of covered bonds in India
- Recommended primarily two structures
  - NHB-intermediated structure
    - NHB acts as a trustee-SPV, providing guarantee for repayment of covered bonds
  - Private-label structure
    - SPV gives guarantee 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

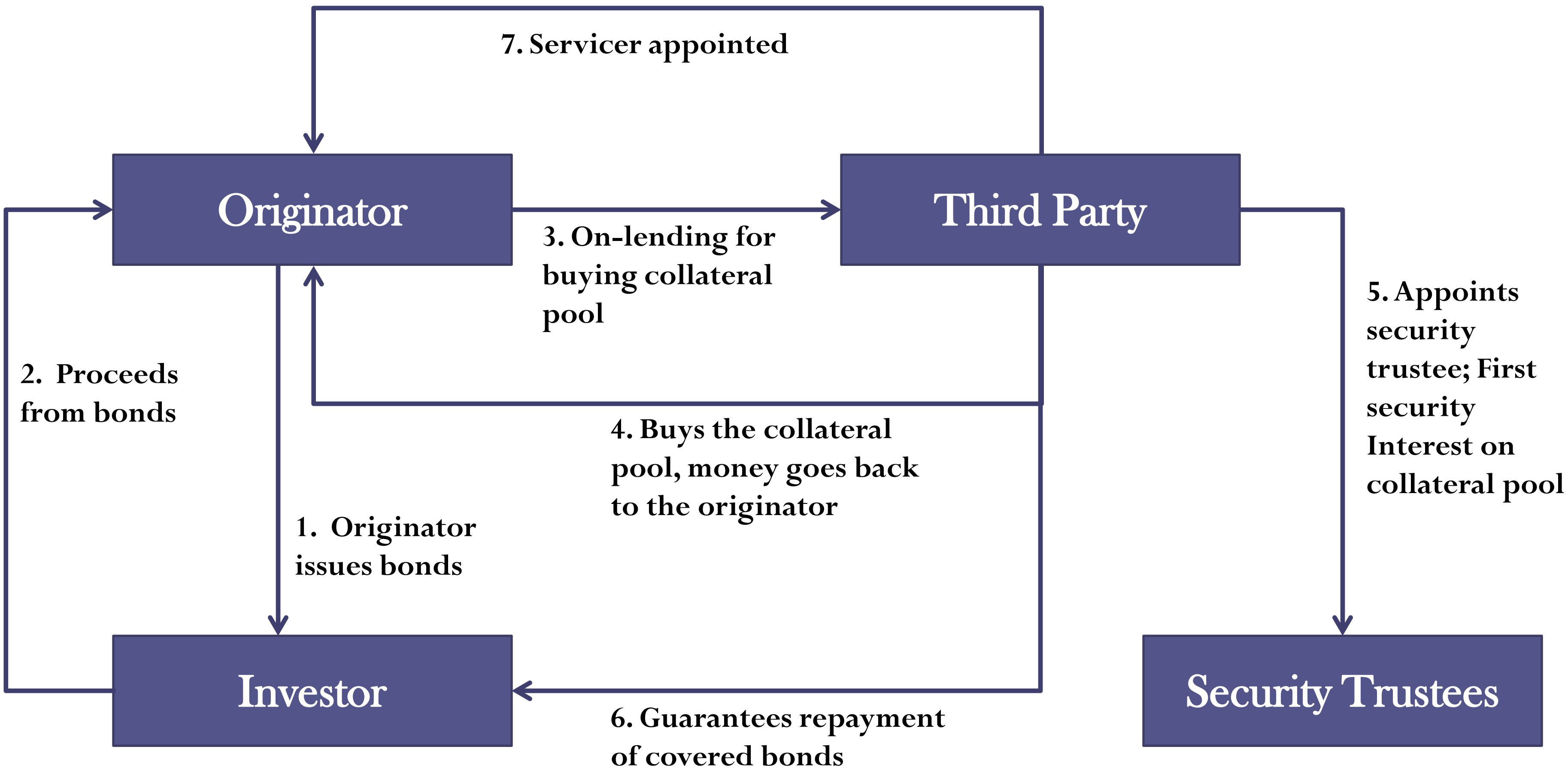
Covered Bonds structure with SPV Guarantee



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 gets amortised from out of the mortgage pool collections
- 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 structure with Third Party Guarantee



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
- Thus, essentially, the guarantor lends his own credit for that of the issuer
- Advantage
  - Cost savings due to credibility of the guarantor

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

Potential issues

- High stamp duty on transfer of mortgage loans from Originator to SPV
- 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.