THE NAME IS BOND………

COVERED BOND

Covered Bonds

An Alternative Source of Financing

Mortgage Lending

December 4, 2012

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Presentation Outline

- Introduction
- Covered Bond Basics
- Product Overview
- Issuer’s Motivation
- Investor’s Motivation
- Benefits to the Government
- Structures for the Issuance of Covered Bonds
- Considerations for a Covered Bond Framework
- Take Away/ Further Study

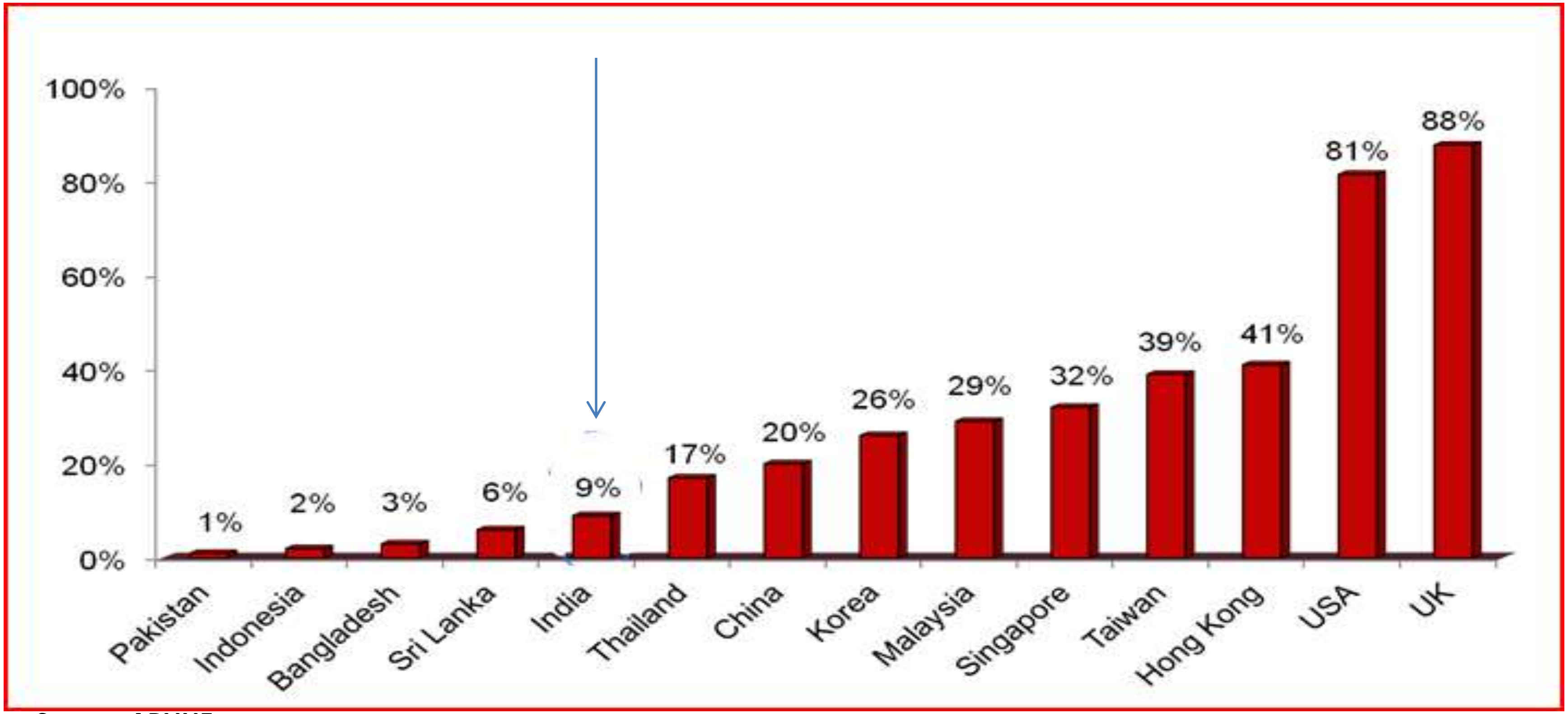
Challenge: How Do You Finance the Rising Demand for housing?

Demand for Housing Finance is steadily growing

- Sustained Economic Growth
- Rapid Urbanization
- Rise in Disposable Income
- Emerging middle class
- Tax Incentives

India has one of the lowest Penetration of Housing Finance

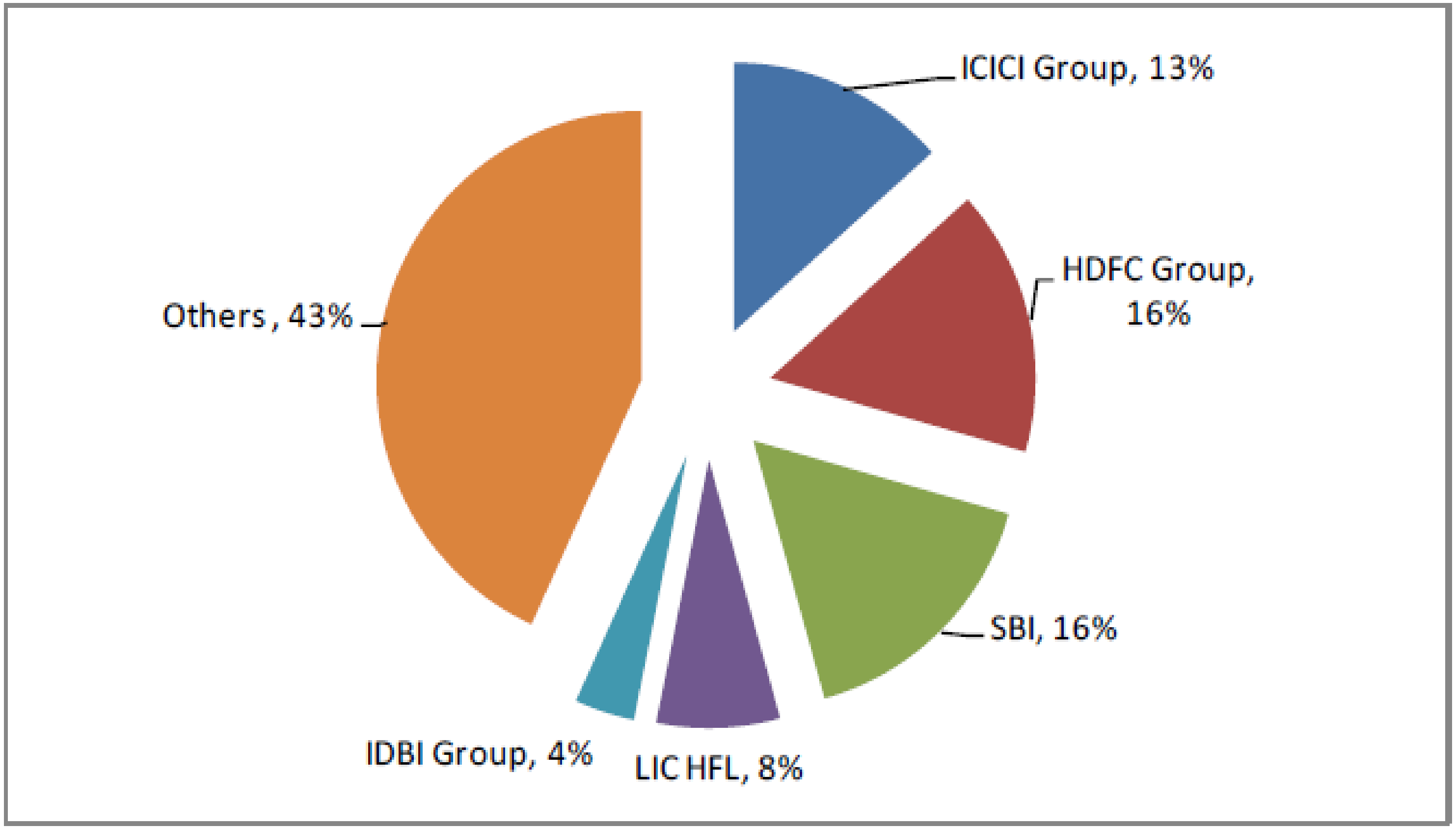
- Mortgage Loans as a Percentage of GDP



Source: **APUHF**

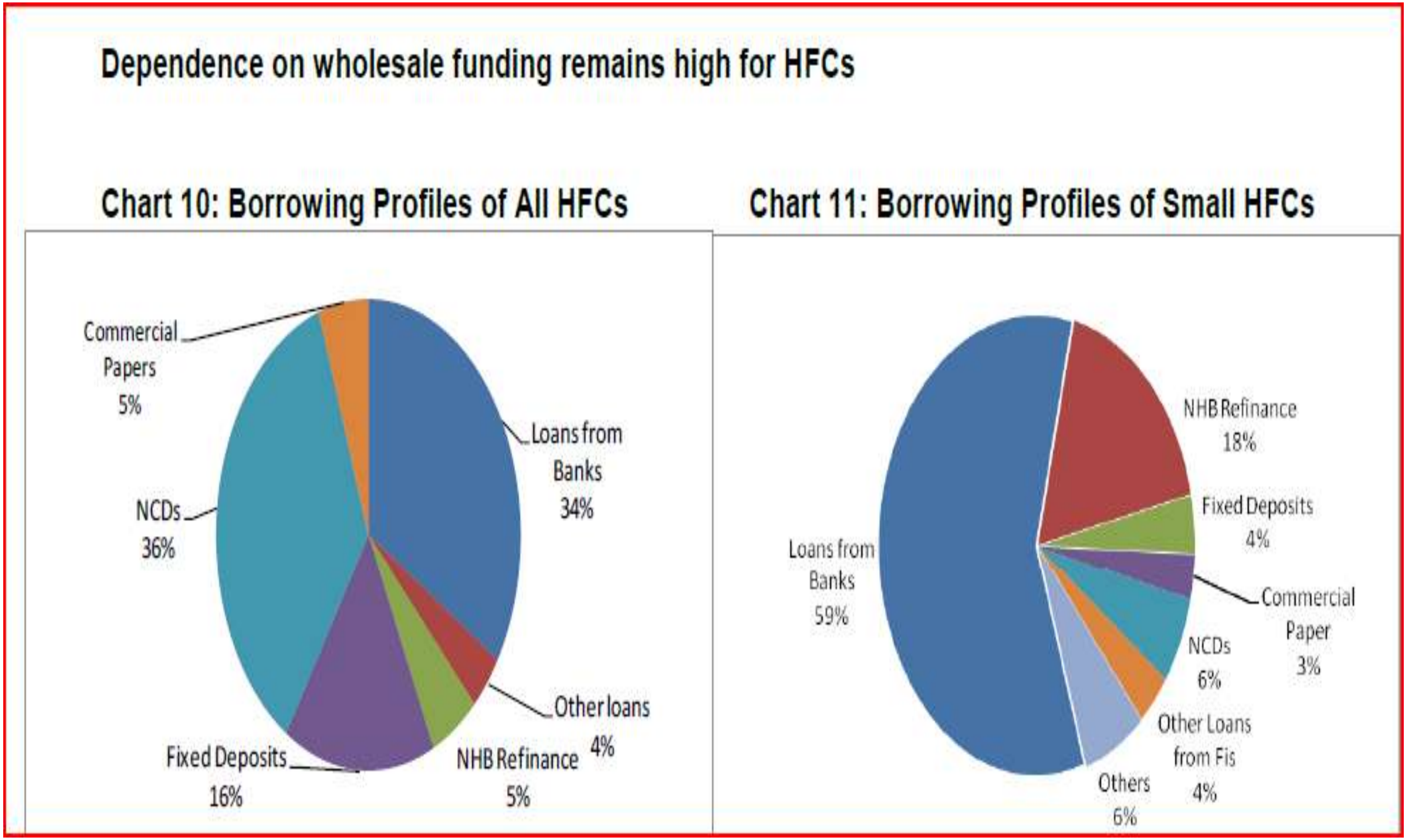
Few Dominant Players in Mortgage Lending

Chart 3: Market Shares of Various Players as of December 31, 2009



Source: Quarterly Results of various Mortgage Lenders and ICRA Estimates

HFCs Largely Dependent on banks for Funding Needs



Gap in Housing Units and Funding

- Housing Shortage :26.53 million units by end 2012 (NHB estimate)
- Housing Finance Shortage: >200 billion US dollars (NHB estimate)
- Need For Long term Financing

Addressing the Funding Gap through Long Term Financing

- Unsecured Debt

  Issuance of unsecured corporate debt

- Mortgage Securitization

  Securitize mortgages by dicing cash flows

- Covered Bonds

Global Challenges in Mortgage Securitization

- Subprime loans were used as collateral.
- Originate-to-Distribute model : Moral Hazard
- Servicing conflicts.
- Overreliance on mathematical models.

India: Mortgage Securitization Challenges

Preference for Direct Issuance

- High Stamp Duty
- No secondary market
- Lack of proper interest rate for benchmark issuance
- Investor Prefer only AAA paper
- Lack of Standardization in documentation

WHAT ARE COVERED BONDS?

- Asset backed debt instrument secured by 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.

WHAT ARE COVERED BONDS?

- Dual Recourse

  Investors first recourse to the cover pool.

  Investors maintain an unsecured claim on the issuer.

- Interest Payment

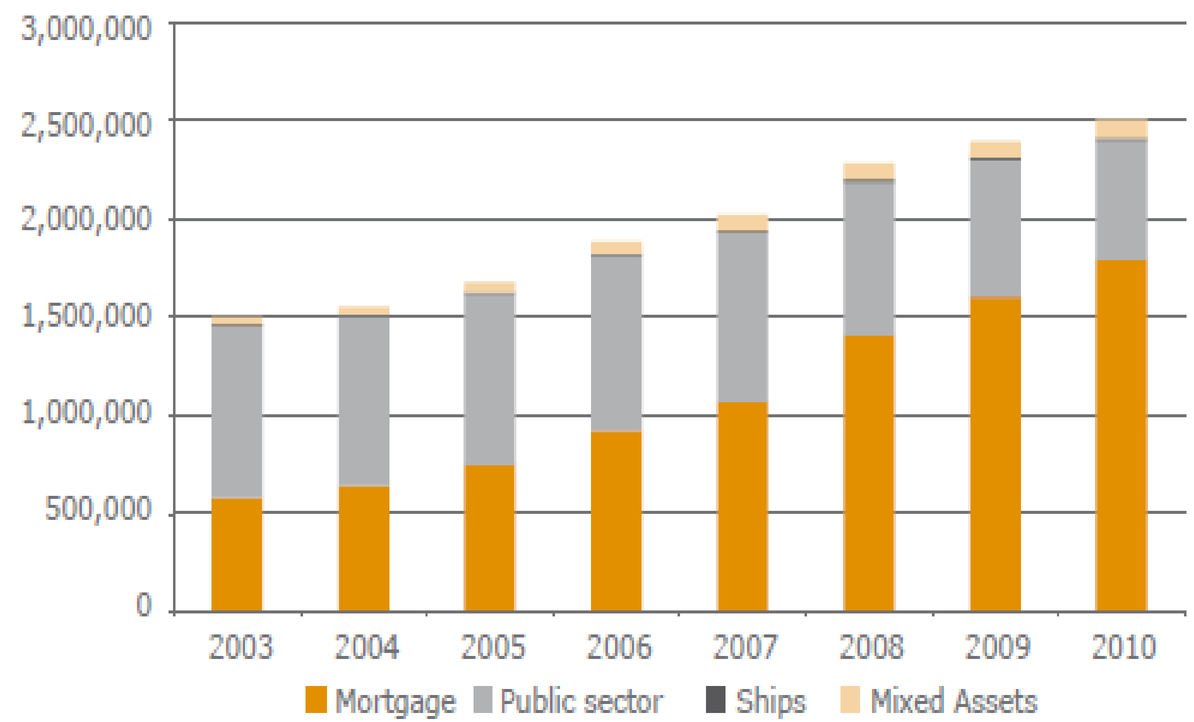
  Issuer’s cash flows are used to pay interest to the cover bond holders, while cover pool serves as secured collateral.

Covered Bonds In the Global Economy

- Covered Bonds in Developed Countries
  - Euro 2.5 trillion in 2010
  - 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
- Covered Bond Market in the US
  - Special Legislation pending

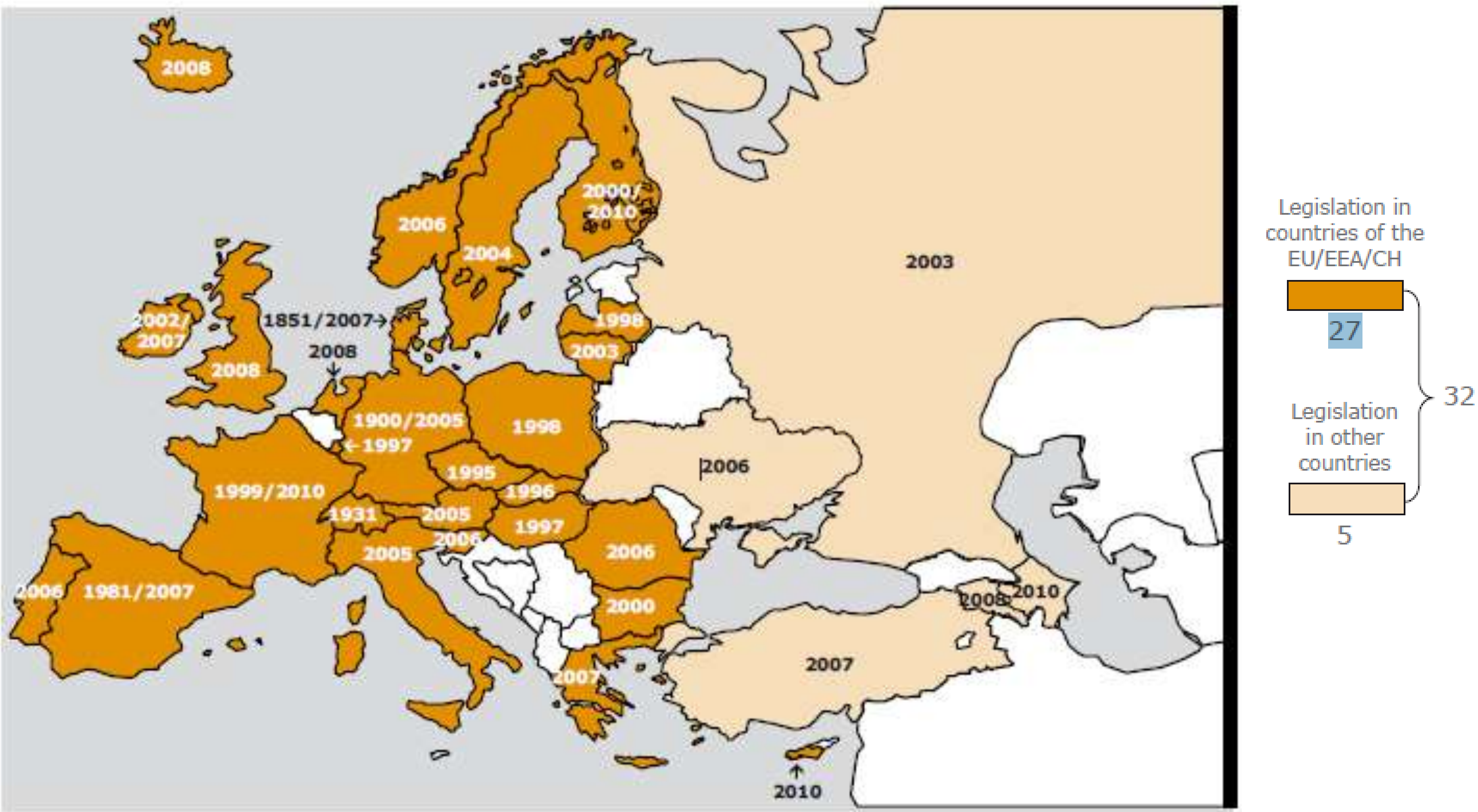
Outstanding Covered Bonds by Underlying Assets, 2003-2010

TOTAL OUTSTANDING COVERED BONDS BY UNDERLYING ASSETS, 2003 TO 2010



Source: EMF/ECBC - Covered bonds outstanding at the end of 2009

Covered Bond Legislation in Europe (as of June 2011)



Regulatory Framework

- European Regulatory Framework

  Direct issuance structure with legislation
  - Special treatment under bankruptcy law to investor
  - Special treatment under the banking laws that provide favorable risk weighting in comparison to the issuer's unsecured debt for the benefit of bond issuer

- US Regulatory Framework

  Issuance through SPV
  - synthetic two-tier structure to replicate the protections afforded by legislation

What Are Key Features of Covered Bonds? Protecting the Investors

- Priority claim of the Covered Bondholders against a dedicated pool of collateral or its proceeds.

- Covered Bondholders have full recourse to the issuer.

- Covered Bonds are backed by a revolving / dynamic pool of qualifying collateral.

How is Full Recourse Accomplished?

- Recourse to the cover pool:
  - Recording of the collateral in a register.(e.g. Austria, Denmark, Germany, Norway)
  - Assigning collateral to a guarantor. (e.g. Canada, Italy, UK)
  - In addition some countries have their unique recourse mechanism (e.g. France, Greece, Spain).
- Recourse to the issuer:
  - Full recourse to the issuer. (Canada, France, Spain, UK e.g.)
  - Limited recourse to the issuer. (France, Italy, Portugal, US)

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

Covered Bond vs MBS: Comparison

	Covered Bond	Residential Mortgage Backed Security
Accounting	On-Balance Sheet	On/Off Balance Sheet
Issuer	Financial Institution/SPV	SPV
Collateral	As defined under the special Covered Bond legislation. Issuer earmarks the collateral.	As defined under the transaction structure. Originator/s usually sells the collateral to the SPV.
Cover Pool	Dynamic Collateral. In case of issuer insolvency cover pool becomes static.	Usually static. But can be dynamic.
Recourse	Dual recourse. Recourse to the underlying assets transferred to SPV as well as against the issuer.	Recourse to the assets transferred to SPV. Cash Flows from assets repay bonds.

Covered Bond vs MBS: Comparison

Rating	Rating depends on the credit rating of the sponsor bank (issuer), originator/s, third-party service provider/s; it is usually higher than the sponsor bank's (issuer's) senior uns. debt rating.	Bond rating does not necessarily depend on the credit strength of the seller of the collateral, Rating, Repayment
Repayment	Typically soft bullet structure. Issuer makes coupon and redemption payments from its operating cash flow or refunding. In case of issuer insolvency, cash flow from the collateral in the cover pool is used to satisfy the claims of investors.	Typically pass-through structure. Coupon and redemption payments to RMBS investors are met by the cash flows from the collateral; junior tranches can absorb losses without interrupting contractual payments to more senior tranches.
Over Collateralization (OC)	OC requirement is higher to achieve triple A ratings to cover credit risk as well as market risk that arises due to mismatch between cover pool assets and outstanding fixed bullet bonds. E.g. Spanish Cedulas require over 20%.	Senior tranches can achieve AAA rating with less OC in comparison. e.g. Spanish RMBS have credit enhancement of only 6-10%

Key Design Features of the Regulatory Framework

- Legal Framework enforced through either specific Covered Bond legislation or contractual law
- Eligibility Criteria for an Issuer
- Cash Flow Matching – At all times CB must be secured by cover assets of at least equal nominal amount and yielding at least equal interest
- Collateral Requirements
- Insolvency Protection
- Supervision

Rating Criteria

- Effective Segregation of cover assets i.e. ability to protect investor in the event of insolvency.

- Collateral Quality and Stress Scenario for
  - Probability of default and loss
  - Cash Flow mismatches

- Over-Collateralization

- Bankruptcy and counterparties

Risk-weighting under BASEL II/BASEL III

- Legislative Covered Bonds are likely to achieve a lower risk weighting than structured non-legislative Covered Bonds.

- Under Basel II, Covered Bonds meeting the UCITS Article 22(4) criteria can achieve risk weighting of 10%, relative to issuer's unsecured bonds (about half)

- Under Basel III proposals, Covered Bonds will have an increased advantage over securitizations.

Issuer's Motivation

- Low cost of Issuance
- Long term financing
- Diversification of Funding Sources

Investor's Motivation

- Simplicity of Structure
- High Collateral Quality
- Dual recourse
- Protection in the event of insolvency and market regulation
- Potential for lower capital requirement

Benefits to the Government

- Financial Stability
- Bond Market Development
- Tool for Central Banking Operations

Structures for the Issuance of Covered Bonds

- The Legislative Covered Bond

  Under specific legislation that ensures bond holders have a priority claim on assets in the cover pool

  Legal frameworks that comprehensively address their issuance and their treatment

- Structured (Non-Legislative) Covered Bond

  Issuance of structured Covered Bonds takes place under general law through contractual arrangements involving a Special Purpose Vehicle (SPV)

Covered Bond Framework for India

- **Non-Legislative Option: Interim Solution**

  In the absence of dedicated legislation , issuance of structured Covered Bonds through contractual arrangement under general law could be an interim solution until specific legislation is passed

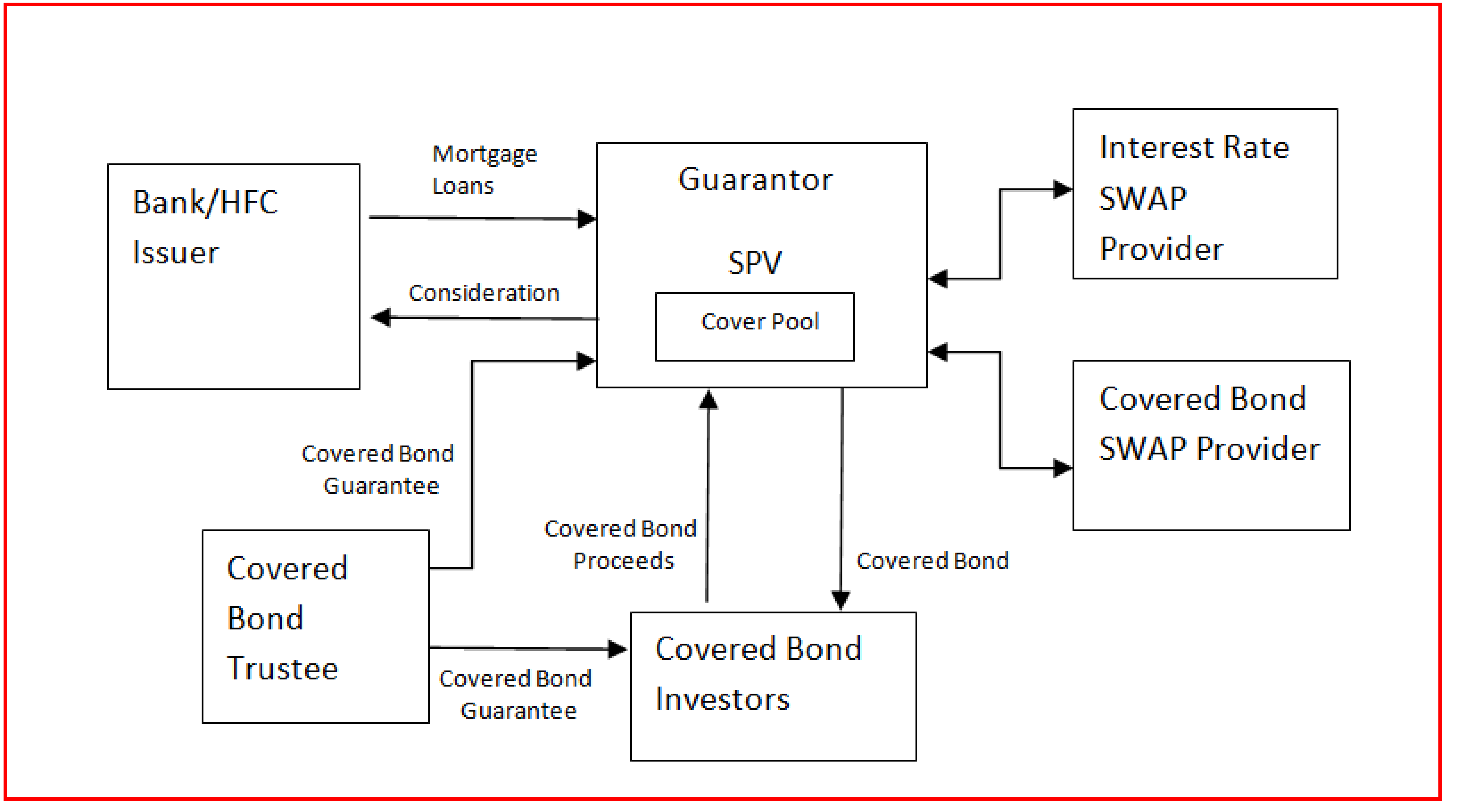
- **Best Practices Guide**
  - Uniformity and Standardization
  - A template for the market participants without implying a government guarantee, either implicit or explicit.

Structure: Non-Legislative Option

- A regulated Indian bank or Housing Finance Company (HFC) can establish a Covered Bond program with a contractual framework under the common law

- A Covered Bond issuance model with an SPV as a guarantor is recommended

The Model


Bank/HFC
Issuer
Mortgage
Loans
Consideration
Guarantor
SPV
Cover Pool
Interest Rate
SWAP
Provider
Covered Bond
SWAP Provider
Covered Bond
Guarantee
Covered Bond
Proceeds
Covered Bond
Covered
Bond
Trustee
Covered Bond
Guarantee
Covered Bond
Investors

Best Practices Guidelines

- **SPV**
- **Consideration for Sale: Eligible Issuer:**
- **Eligibility Requirements of Primary Lending Institutions:**
- **Maturity:**
- **SEBI Registration**
- **Regulatory Authorization**
- **Restriction on Issuance**

Best Practices Guidelines

- **Security**
- **Over Collateralization (OC)**
- **Asset Coverage**
- **Collateral**
- **SWAP Contracts**
- **Disclosure**
- **Supervision**

Legislative Option: Long term Solution
Rationale for Legislation

- Competition in the Global Bond Market
- Broad Investor Base
- Favorable Treatment by the Rating Agencies
- Financial Stability

  Tackles the issue of investors claim under issuer's insolvency situation with more certainty and clarity

Policy Considerations
Key Issues for Regulatory Framework

- Limit on the Issuance – 4%
- Registration of the issuance
- Cover assets to be Held by SPV (the Guarantor)
- Asset Monitor to be Appointed
- Legislative Amendments in Case of Insolvency of the Issuer
  - Expensive but provides for a clearer and simpler post-insolvency process since cover assets are already segregated in a bankruptcy-remote vehicle.

Policy Considerations
Cover Assets: Eligibility, Valuation & LTV

Performing mortgages

More stringent eligibility than stipulated under MBS policy guidelines

Policy Considerations
Asset Liability Management

The ‘cover-principle:

Outstanding Covered Bonds must at all times be secured by cover assets of at least equal nominal amount and yielding at least equal interest.

- Risk Mitigation

  Overcollateralization - liquidity risk.

  Reserve Fund - protection under downgrades

- Hedging

  Swap contracts -currency and interest rate risks

Policy Considerations
Cover Pool Monitoring and Bank Supervision

- Special supervision by RBI/NHB

  Special body?

- Cover Pool Audit

  Independent Asset Monitor performs

  Asset coverage Test on a monthly basis

Policy Considerations
Capital Adequacy Provisions

- Risk Weighting

  Can be treated as senior unsecured debt

- Capital Requirement

  Credit risk remains with the issuer therefore consolidated capital requirement.

Policy Considerations
Disclosure

- Information Disclosure
  - the issuer
  - Issuer's Covered Bond program
  - Rating
  - Event of Default
  - Results of cover pool audit
  - Summary of assets in the cover pool

Policy Considerations
Role of the Regulator

- Assess application
- Monitor level and quality of assets
- Guidance – operation, implementation of regulation
- Regular stress testing of collateral, monitor over collateralization requirement
- Supervision
- Oversight

TAKEAWAY

- Covered Bond has a potential to play complimentary role to MBS in the Indian context
- A solid foundation in legal frame work
  - collateral transparency, foreclosure, repossession, and bankruptcy law
- Issuers must see advantage over alternative sources of funding
- Investors ability to invest, capital requirement, desirability of long term funding
- Gateway to global capital markets since investors find Covered Bonds safer to invest than MBS.

Next Step
Further Study

- Paper is a starting point for the discussion
- In depth study – Legal and regulatory issues, Assessment of demand and supply
- Alignment of interest of stakeholders
- A trade association/council for Covered Bond
- Consult paper (RBI/NHB)

Thank You
for the Opportunity

- ICIRER
- Distinguished Guests