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Development of a Secondary Mortgage Market in India:

Executing a Pilot Security - An Action Plan

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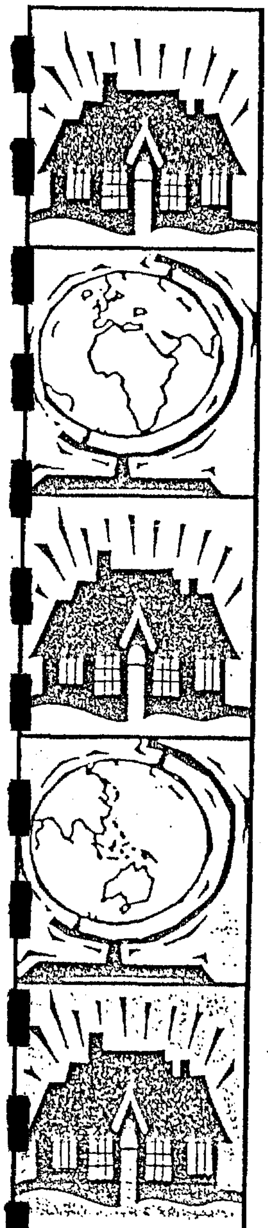

DEVELOPMENT OF A SECONDARY MORTGAGE IN INDIA

EXECUTING A PILOT SECURITY - AN ACTION PLAN

By

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Introduction

As part of the Indo-US Housing Finance Expansion Program, the author assisted Abt Associates, Indian consultants, and the National Housing Bank (NHB) in presenting a two-day seminar in Bombay, India. The seminar covered issues relating to funds mobilization, including a pass-through securitization of mortgages ("MBS") for sale on the capital markets.

The workshop provided information and gave participants the opportunity to recommend steps for continuing progress toward the development of a secondary market in India. This paper expands upon the steps identified by the participants at the end of the two-day program and contains three possible activities that are intended to be conducted simultaneously and to start as soon as feasible: standardization; creation of a pilot security; and, if needed, preparation of a decision paper.

The program organizers may want to consider developing a decision paper before proceeding with a pilot security. However, the participants appeared to be very interested in testing an MBS as quickly as possible, and the program organizers may not want to upset the momentum created by the seminar by delaying a pilot until a decision paper is prepared. The pilot offers a good way to identify any obstacles to creating MBS and a start for identifying those procedures and documents required for an MBS program.

Standardization

Scope

In order for an efficient housing finance system to occur, programs should be standardized. This is important even if a secondary market is not established; it is imperative if a secondary market is to be successful.

Standardization is needed in both of the major components of lending: underwriting/loan origination and servicing/reporting. It is also important for the support activities such as management information systems, risk management, and pricing.

The plan would involve developing recommended standards and guidelines for use by the Housing Finance Companies (HFCs) and required to be used if a secondary market institution or credit enhancer is involved. The activity could be provided by using the US AID- funded Housing Finance Expansion Program and bringing together Indian and US consultants with National Housing Bank (NHB) and HFC representatives.

The standards and guidelines would be applicable to all mortgage products. Initially, it is advisable to limit the number of different mortgage products intended for securitization in order to establish volume for market liquidity.

Steps for Standardization Process

- With input from Fannie Mae and HFCs, Abt and NHB staff determine the decision-making process for producing standardized requirements. This may include a committee consisting of representative HFCs and the NHB that would review the work product. This committee should select a subcommittee ("NHB/HFC Advisors") that would work directly with the US advisors to write these requirements and procedures.

- US and NHB/HFC Advisors visit one or more HFCs and document the process as it is currently being done. This will include reviewing:

  * Loan Origination Requirements and Procedures

    - policy & procedures in place
    - current credit decision-making process and required documentation
    - underwriting guidelines, including: verification of employment; verification of credit; verification of deposit; and verification of mortgage credit reports
    - forms and loan documents
    - stack-order (i.e. order of documents in the file)
    - legal issues such as title issues
    - loan approval levels of officers
    - closing and funding
    - forms and procedures for ancillary industries (e.g. appraisal)

  * Loan Servicing/Accounting Requirements and Procedures

    - servicing requirements and procedures including: billing; calculating monthly interest due (compounding); modifications; assumptions; pay-offs; taxes; insurance; reporting of information to borrowers; delinquencies; and foreclosures

- accounting controls including : records maintenance; and available reports

o Working with the NHB/HFC Advisors, US Advisors evaluate each procedure, form, etc. to see how it compares to the desired outcome and, if necessary, determine what changes need to be made to achieve the desired result. For example, does the information required to verify deposits use an adequate number of months of bank statements to demonstrate that the funds come from the borrower? If not, then the procedures for this information need to be revised.

o Working with the NHB/HFC Advisors, US Advisors develop standard credit decision-making guidelines and suggested procedures including signing authorities, credit committees, etc.

o Working with the NHB/HFC Advisors, US Advisors develop underwriting and servicing guidelines such that, if a mortgage loan meets these criteria, it would be investor quality.

o Working with the NHB/HFC Advisors, US Advisors develop standard origination forms, such as application forms, verifications, request for appraisal, appraisal form, approval and denial letters, and underwriting worksheets. These should be used for all mortgage programs.

o Obtain the Committee's approval of the standards and guidelines developed by the US and NHB/HFC Advisors.

o Train the users on the use of these new guidelines and forms.

o Define a process through which the standard requirements and procedures would be evaluated, updated, and, if necessary, enforced. The best entity to do this would be an institution which can require compliance in exchange for a benefit -- such as a secondary market institution or a mortgage/pool insurer. A regulator -- such as the NHB in its current role -- is another possibility.

Pilot Security

Scope

To minimize and overcome any obstacles or problems with issuing a pass-through mortgage-backed security, the seminar participants agreed on the goal of a pilot security issue. Seasoned loans would be pooled from the portfolios of perhaps four lenders and NHB would guarantee the timely payment of the cash flow from the mortgages to the purchaser of the security. The US AID-funded program could provide "seed money" support to finance some of the work that must be done to develop this security.

Steps for Creating a Pilot Security

- The pilot security team led by an Indian consultant and including US consultant/advisors and representatives from selected HFCs, NHB, and possibly the Ministry of Finance agree on the type of security and the credit enhancement for the security. As noted, the seminar participants recommended a pass-through security (MBS) with credit enhancement from the NHB. This agreement should be reviewed by legal, credit rating, and tax advisors and, based upon this review, the team should confirm or modify, if necessary, the structure.

- The team develops a list of tasks and a timeline under headings person/organization responsible for the specific tasks. A sample high level step-by-step process outline is attached.

- The team develops the pricing (guarantee fee paid to the NHB) and procedures for securitization, including the procedures for pooling loans from several HFCs. (For example, the team might use the Fannie Mae Majors program as a model or it might create a single-purpose vehicle or SPV that purchases the loans before issuing an MBS, as long as the latter can be accomplished without costly "Stamp Act" impact.)

- The team determines the parameters of the seasoned mortgages that would be eligible for inclusion in the pilot MBS. The team assists the participating HFCs in identifying eligible loans for the MBS (i.e. due diligence). The team then determines which loans are to be pooled together to form the pilot MBS.

- The team (or the Indian consultant) identifies an investor for the pilot security.

- Until the items in the first bullet are confirmed, details of the next steps are somewhat hypothetical. However, based upon the seminar discussions, the NHB creates an SPV to issue the MBS and identifies a Custodian to hold and review the necessary mortgage documents.

- The HFCs deliver loans to the SPV. After receiving confirmation from the Custodian that the mortgage documents are acceptable, the SPV issues an MBS with a unique identification number and with necessary legal documentation.

- The investor purchases the MBS, paying the SPV which passes the proceeds back on a pro-rata share to the HFCs.

- The HFCs continue to service the loans, passing through to the SPV on a specific date each month scheduled or actual (depending upon decisions made earlier) principal and interest. The SPV acting as a Master Servicer takes its guarantee fee and then passes the cash flow due on the MBS to the investor. The SPV would also be responsible for maintaining information for the investor.

o The team produces a report describing any issues arising from the pilot and identifying the steps required to convert the pilot project to a broader program (e.g. forms, procedures, compliance control, disclosure, audit, etc.).

Decision Paper

Unless there is a definite decision upfront by the Indian government that the pilot approach is the approach that they want to use in a permanent program, the program organizers should consider producing a decision paper. The primary reasons for this recommendation are:

o One privately-placed MBS may not demonstrate market acceptance of a publicly-sold MBS market. Fannie Mae's experience, as the largest MBS issuer in the world, is that it takes time (possibly several years) to develop a liquid MBS market (i.e. a publicly-traded market).

  Once the pilot program is completed, additional privately-placed MBS could be issued. However, until there is sufficient experience with mortgages and investor acceptance to support a publicly-traded MBS market, the Indians may want to consider other ways to use the capital markets to raise funds for housing. These alternatives may be better suited for the immediate and near future and may be used in conjunction with MBS in the long-term.

o The credit enhancement proposed during the seminar for the pilot security requires NHB guarantees. Although this is highly recommended, it does require serious consideration by the Indian government -- particularly the Ministry of Finance-- before it can be assumed that all MBS would receive a NHB guarantee. The standardization and pilot components will enhance the execution of a secondary mortgage market. However, there are many alternative ways to structure this activity. Decisions on which alternative and commitments to implement the chosen alternative must occur at the highest levels, most likely by officials at the Reserve Bank of India, the Ministry of Finance and the NHB. Without this additional effort, a consolidated and coordinated secondary mortgage market will not likely develop.

The decision paper would provide a description of the options proposed during the seminar and a discussion on the pros and cons of each option. The analysis of the options should be based on international experience as well as be the result of further analysis of the Indian market. The result should be a paper that provides sufficient information in a succinct manner to allow the critical players to make a decision.

Options to be further analyzed may include:

- NHB subsidiary or NHB/lender consortium as the secondary mortgage market institution that could buy and securitize loans. Because NHB is involved, there would be a Government of India (GOI) implicit guarantee.

- A lender consortium SPV that would issue securities. The NHB or a subsidiary would provide pool insurance on these securities as long as they met NHB criteria.

- A GOI chartered secondary mortgage institution that is privately-stockholder owned. The market would perceive this as an implicit guarantee, especially if the GOI gave the institution certain benefits. The institution could buy or securitize loans.

- A lender consortium SPV that would issue securities. The securities would be rated by a private credit rating company.

- Individually-lender issued bonds -- possibly mortgage-backed bonds - that would be rated by a private credit rating company.

- Individually-lender issued mortgage-backed securities that would be rated by a private credit rating company.