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SUMMARY OF STRUCTURAL ISSUES FOR A PILOT MORTGAGE-BACKED SECURITY FOR INDIAN HOUSING FINANCE COMPANIES

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THE PILOT MORTGAGE-BACKED SECURITY

FOR INDIAN HOUSING FINANCE COMPANIES

February 7, 1996
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For Indo-U.S. Housing Finance Expansion Program

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SUMMARY

Individual vs. Pooled Mortgage-Backed Security ("MBS")

- The proposed structure is applicable to both Pooled MBS and Individual MBS.
- In a Pooled MBS, two or more housing finance companies ("HFCs") may decide, at their option, to pool their loans into a single securitization vehicle, which will issue MBS.
- In an Individual MBS, a single HFC will issue MBS through a securitization vehicle established solely to securitize its loans.
- Under either alternatives, the allocation of risk and the cash flow mechanics will be substantially the same.
- Pooled MBS will introduce certain additional issues and legal costs, the effect of which could be offset by cost sharing arrangements among the HFCs.

SUMMARY (*continued*)

Transfer of Loans

- Each HFC will transfer (or sell) a pool of housing loans, along with the underlying collateral, to a securitization vehicle ("Issuer").

- The Issuer will either be a wholly-owned, special-purpose subsidiary of the HFC or an unaffiliated special-purpose company held by a trust.

- The HFC will receive a sales price equal to the aggregate unpaid principal balance of the loans, assuming the weighted average coupon of the loans is at least equal to the MBS coupon plus servicing fee.

Servicing of Loans

- Each HFC will continue to service the loans as before as an agent of the Issuer and will receive a servicing fee every month. The HFC will continue to collect monthly payments from the borrowers on behalf of the Issuer and will deposit the amount collected in a trustee bank.

- Each month, the trustee bank will use the amount received from the servicer to pay servicing fee to the servicer (i.e., the HFC) and interest and principal to the holders of the MBS.

Class A MBS

- To fund the purchase of the loans, the Issuer will issue two classes of MBS - Class A MBS and Class B MBS.

- Class A MBS will be senior ranking to Class B MBS, and will be sold as a listed instrument in the domestic capital market.

- Class A MBS will be guaranteed unconditionally by National Housing Bank ("NHB") as to the full and timely payment of interest and principal. Therefore, Class A MBS will carry a rating at least as high as that of NHB.

- Class A MBS will pay interest and repay principal monthly pursuant to a pre-determined schedule.

Class B MBS

- Class B MBS will not be listed, guaranteed or rated, and will be purchased by the HFC.

- Class B MBS will pay interest and repay principal (but not pursuant to a pre-determined schedule), only after payments of interest and principal on Class A MBS and servicing fee have been made by the Issuer.

SUMMARY (*continued*)

- Accordingly, credit losses suffered by the loans in the future will reduce the amount available to pay Class B MBS. It is important to note that this arrangement will not increase the amount of risk to the HFC since the HFC presently incurs all of the credit risk associated with the loans, and securitization will not alter this risk exposure.

- The breakdown between Class A MBS and Class B MBS will be different for each HFC, and will be determined by the rating agencies based on their risk assessment of the loans, the servicer, and the level of credit protection desired by NHB as guarantor for Class A MBS.

SELECTION OF LOAN POOL

- Each HFC will identify, as of a certain date ("Cutoff Date"), all loans that meet certain "Loan Eligibility Criteria" (as described later). These loans will be referred to as "Eligible Loans."
- If the aggregate Unpaid Principal Balance ("UPB") of the Eligible Loans is greater than the amount the HFC wishes to securitize ("Target Amount"), then some of the Eligible Loans will be removed randomly until the aggregate UPB of the remaining Eligible Loans approximates the Target Amount.
- These surviving Eligible Loans will comprise the "Loan Pool," which will be securitized.
- These loans will then be identified (or flagged) electronically on the HFC's management information system ("MIS") as having been securitized.

TRANSFER OF LOAN POOL

- Pursuant to a "Transfer Agreement," each loan comprising the Loan Pool and the underlying "Collateral" (security interest in the property, personal guaranty, etc.) will be "Transferred" by each HFC, without recourse, to the Issuer.

- Issuer(s) may be established separately (for Individual MBS) or jointly (for Pooled MBS).

- The formalities and documentation of the Transfer will be based on detailed legal, regulatory and tax analysis to be conducted by experts, and must meet with the requirements of the credit rating agencies. Generally, the Transfer must satisfy the following requirements.

- First, the Transfer must survive an eventual insolvency of the HFC. In other words, if the HFC were to become insolvent after the Transfer date, creditors of the insolvent HFC must not be able to make a claim on the Loan Pool and the Collateral that were Transferred to the Issuer.

- Second, the Transfer must be structured such that no materially adverse transfer tax, stamp duty, etc. would arise.

- Third, the Transfer must not impose undue administrative burden on the HFC.

- Fourth, the Transfer must not require that "consent" be obtained from each of the borrowers underlying the Loan Pool. However, the Transfer may require that the borrowers be "notified" of the transfer of his/her loan to the Issuer.

- Fifth, the Transfer must not result in any adverse tax consequences for the borrowers, such as losing partial or full deductibility of interest (and capital?).
- Sixth, the Transfer must not result in the HFC losing any of its tax benefits, such as the exemption of a certain portion of its income from taxes.
- Seventh, the Transfer must not result in weakening the position of the HFC to collect on a loan in the Loan Pool that may subsequently become delinquent or to foreclose on a property underlying a defaulted loan.
- Eighth, the Transfer must comply with the HFC's "negative pledge" covenants.
- Finally, the Transfer must comply with applicable consumer protection and data protection laws.

ISSUER

- Depending upon further legal, regulatory and tax analysis, the Issuer might be set up as either -
    - A "bankruptcy remote," wholly-owned, nominally-capitalized subsidiary of the HFC, or
    - A nominally-capitalized private limited company, whose shares are held in trust by a professional trust company.
- If two or more HFCs decide to undertake a Pooled MBS transaction, then the first alternative will not be feasible.
- A bankruptcy-remote subsidiary means a subsidiary whose assets and liabilities will not be consolidated with those of its parent in the event the parent were to become insolvent.
- In other words, creditors of the parent will not have any legal right to make a claim on the assets of the subsidiary in the event the parent became insolvent.

ISSUER (*continued*)

- The Issuer must be established in a manner that would make the entire transaction tax neutral. This can be accomplished by -
  - Consolidating the Issuer with the HFC for tax purposes, or
  - Establishing the Issuer as a tax-exempt entity, or
  - Ensuring that the Issuer's income is fully offset by its interest and other expenses.
- Extensive input from domestic tax experts will be needed on this issue.

SERVICING

- Each HFC will continue to service and administer its Loan Pool in the same manner as before pursuant to a "Servicing Agreement."
- Each HFC, as "Servicer," will covenant not to treat, for servicing and administering purposes, the loans comprising the Loan Pool any differently from the loans that have not been securitized.
- The HFC will receive a "Servicing Fee," payable each month by the Issuer at a rate of __ percent per year, applied on the aggregate unpaid principal balance of the Loan Pool outstanding at the beginning of the month.
- All interaction with the borrowers (underlying the Loan Pool) will be performed by the HFC (as Servicer for the Issuer), and neither the Issuer nor any other party will have direct access to the borrowers unless the HFC fails to perform in accordance with the Servicing Agreement.
- If the HFC fails to perform according to the Servicing Agreement, the Trustee will have the right to terminate the HFC as the Servicer and appoint a "Successor Servicer."
- The Successor Servicer could be another HFC capable and willing to service the Loan Pool in return for the Servicing Fee.
- The Successor Servicer will take over all of the servicing responsibilities related to the Loan Pool, including interacting directly with the borrowers.

CUSTODY OF LOAN DOCUMENTS

- To maintain legal validity of the Transfer, it is likely that each HFC will have to hand over the physical possession of certain key documents pertaining to each loan comprising the Loan Pool to a "Custodian."

- NHB could consider acting as the Custodian. NHB could also, at its option, subcontract out the actual custodial functions to another institution as long as NHB remained legally responsible as the Custodian.

- These loan documents could be returned, in limited numbers at a time, to the HFC on an "as needed" basis.

REPRESENTATIONS AND WARRANTIES

- Each HFC will make certain standard representations and warranties related to the characteristics of the loans comprising the Loan Pool as of the Cutoff Date.

- The representations and warranties will cover -

    - Certain qualitative and quantitative descriptions of the loans,

    - Information on historical credit performance of the loans,

    - Description of the underwriting criteria pursuant to which the loans were granted, and

    - Description of the procedures generally followed to service the loans.

- The representations and warranties will not include predictions as to the future credit performance of the loans.

- If any one of these representations and warranties were found to be untrue subsequent to the Transfer, and such breach of representations and warranties had a "material adverse impact" on the credit performance of the Loan Pool, then NHB (as Guarantor for Class A MBS) will have the right to require the HFC to purchase the loan(s) for which such breach occurred.

PURCHASE PRICE

- Each HFC will receive a price equal to the aggregate unpaid principal balance of the Loan Pool, if the weighted average coupon ("WAC") of the Loan Pool is at least equal to the "Base Rate."
- The Base Rate is equal to the sum of Class A MBS coupon, servicing fee, and certain other nominal administrative expenses.
- The above assumes that Class A MBS is sold at par (which would make its yield equal to its coupon).
- If the WAC of the Loan Pool is lower than the Base Rate, then the sales price received by the HFC will be lower than the aggregate unpaid principal balance.
- In this case, the sales price will be equal to the sum of the present value of each of the loan in the Loan Pool, discounted at a yield equal to the Base Rate.
- The present value will be calculated by projecting the remaining amortization schedule for each loan (over its remaining life) based on reasonable assumptions on prepayments (both partial and full), delays, and defaults.
- The resulting amortization schedule will be known as the "Projected Loan Amortization Schedule."

FINANCIAL ACCOUNTING IMPLICATIONS

- We believe that a strong argument can be made to characterize the Transfer of the Loan Pool to an unaffiliated Issuer as a "sale" for domestic financial accounting (GAAP) purposes.
- The purchase of Class B MBS by the HFC should not alter the sale treatment.
- The HFC will make a reasonable estimate of the amount by which Class B MBS could be written down because of its exposure to credit losses due to its subordinate position.
- By definition, this amount should not be different from the amount of reserves currently set aside by the HFC for the Loan Pool.
- Therefore, if the HFC were to maintain the same level of reserves after the Transfer (as before the Transfer), a sale argument would become even stronger.
- If the total purchase price were to be less than the book value of the Loan Pool as recorded on the balance sheet of the HFC, the HFC might wish to have the securitization transaction be treated as a financing, rather than a sale, in order not to record a loss which would arise if the transaction were treated as a sale.
- Domestic accounting professionals need to be consulted on these issues.

REGULATORY ACCOUNTING IMPLICATIONS

- It is likely that the HFC's continued exposure to the "risk of loss" from holding Class B MBS will disqualify it from treating the transaction as sale for regulatory accounting purposes.

- In other words, the entire Loan Portfolio will most likely continue to remain on the regulatory balance sheet of the HFC in calculating its "risk-weighted" assets for the purposes of determining its "risk-based" capital requirement.

- The above interpretations are based on international practice. Domestic bank regulatory bodies will need to be consulted regarding their views on this matter.

STRUCTURE OF THE MBS

Class A MBS

- The Issuer will issue two classes of MBS - Class A MBS and Class B MBS.

- Class A MBS will be senior ranking to Class B MBS, and will be sold as a listed instrument in the domestic capital market.

- Class A MBS will be guaranteed unconditionally by NHB as to the full and timely payment of interest and principal.

- Therefore, Class A MBS will carry a rating at least as high as that of NHB.

- Class A MBS will pay interest and repay principal monthly pursuant to a pre-determined schedule ("Class A Contractual Amortization Schedule").

STRUCTURE OF THE MBS (*continued*)

Class B MBS

- Class B MBS will not be listed, guaranteed or rated, and will be purchased by the HFC.
- Class B MBS will pay interest and repay principal (but not pursuant to a pre-determined schedule), only after payments of interest and principal to Class A MBS holders and Servicing Fee have been made by the Issuer.
- Accordingly, credit losses suffered by the Loan Pool in the future will reduce the amount available to pay Class B MBS.

LIQUIDITY FACILITY

- A committed Liquidity Facility will be made available by highly-rated bank(s) for the benefit of Class A MBS.

- The Trustee will draw on the Liquidity Facility whenever Collections (1/) are insufficient, due to temporary factors such as an increase in delinquencies, to pay Servicing Fee and interest and principal on Class A MBS.

- If the Liquidity Facility is drawn, the Liquidity Facility provider will enjoy the same rights as those of Class A MBS, including benefiting from NHB Guaranty.

- The term of the Liquidity Facility must match the term of Class A MBS.

- The Liquidity Facility will cost __ percent per year on the undrawn amount and ___ percent (equal to Class A MBS coupon) on the drawn amount.

- The size of the Liquidity Facility (in relation to the size of Class A MBS) will be determined by the rating agencies.

1/ As defined in section "Collection and Allocation of Cash."

YIELD SUPPLEMENT FACILITY

- The purpose of the Yield Supplement Facility is to enable the HFC to securitize lower coupon loans as long as their weighted average yield is greater than the Base Rate.

- A highly rated bank, which could be NHB, will make available a Yield Supplement Facility for the benefit of Class A MBS.

- If NHB elects not to provide the Yield Supplement Facility, then it may need to guarantee the Yield Supplement Facility provider.

- This NHB guaranty will be drawn if the Yield Supplement Facility provider is not reimbursed fully and immediately by the HFC for drawings made from Yield Supplement Facility.

- The Trustee will make a draw on the Yield Supplement Facility if, during any month, the weighted average yield of the Loan Pool is lower than the Base Rate.

- The calculation of the weighted average yield will take into account the price received by the HFC for the Loan Pool. For example, if the sales price was below the aggregate unpaid principal balance of the Loan Pool, the weighted average yield would be higher than the WAC of the Loan Pool.

PREPAYMENTS

- A prepayment is defined as a receipt of principal (from borrowers) ahead of schedule.
- Prepayments can be caused by full or partial payoffs and the realization of credit losses.
- Excess Prepayments are defined as prepayments on the Loan Pool in excess of prepayments received according to the prepayment assumption underlying the Projected Loan Amortization Schedule (see under "Purchase Price").
- Excess Prepayments will not be passed through to MBS investors when received.
- Instead, Excess Prepayments will be held in a bank deposit until they are needed to repay principal on Class A MBS according to Class A Contractual Amortization Schedule.
- Excess Prepayments, when on deposit in a bank, will earn a rate equal to Class A MBS coupon.

COLLECTION AND ALLOCATION OF CASH

- Each month, cash collected by the Servicer from the Loan Pool ("Collections") - from installments or any other sources - will be transferred to the Trustee.

- The Trustee will make payments in accordance with a pre-specified formula.

- The formula will be largely negotiated between the rating agencies, NHB (as guarantor for Class A MBS), Class A MBS investors, and the HFCs.

- The formula will generally require the Trustee to make the following payments (in order of priority) each month out of the Collections:

1. Servicing Fee of the Successor Servicer (if the HFC is no longer the Servicer) and certain other nominal administrative fees of the Issuer and the Trustee;

2. Interest payment on Class A MBS and the Liquidity Facility (if the Liquidity Facility has been drawn);

COLLECTION AND ALLOCATION OF CASH (*continued*)

3. Principal payments on Class A MBS and the Liquidity Facility (if the Liquidity Facility has been drawn) based on Class A Contractual Amortization Schedule;
4. Servicing Fee to the HFC as the Servicer;
5. Excess Prepayments deposited in an Eligible Bank;
6. Reimbursement to NHB for any outstanding draws on the NHB Guaranty; and
7. Interest and principal payments on Class B MBS.

GENERAL PRINCIPLES OF CASH ALLOCATION

- Although the exact formula governing the allocation of cash will be negotiated among the parties mentioned earlier, such formula will generally provide for the following.

- If Collections are not sufficient to pay Servicing Fee and interest and principal on Class A MBS, and if such shortfall is caused by a temporary increase in arrears or delinquency (rather than realized credit losses), then the Trustee will make a draw on the "Liquidity Facility."

- If Collections are not sufficient to pay Servicing Fee and interest and principal on Class A MBS, and if such shortfall is caused by realized credit losses, then the Trustee will make a draw on the NHB Guaranty. If the NHB Guaranty is drawn, then NHB will have the right to demand full and immediate reimbursement from the HFC (subject to a reimbursement cap equal to the unpaid principal balance of Class B MBS).

- Failure by the HFC to reimburse NHB will <u>not</u> result in an event of default under Class A MBS. As long as NHB has not been fully reimbursed by the HFC, future payments on Class B MBS will be withheld from the HFC and, instead, will be paid to NHB until NHB has been fully reimbursed. Any unreimbursed draw made under NHB Guaranty will bear an interest rate of ___ percent per year.

- If the NHB Guaranty has not been drawn and cash is available after making payments of Servicing Fee and interest and principal on Class A MBS, then such excess cash will be used to make interest and principal payments under Class B MBS, subject to the following restriction.

GENERAL PRINCIPLES OF CASH ALLOCATION (*continued*)

- Excess cash attributable to Excess Prepayments will not be paid on Class B MBS but, instead, will be deposited in an Eligible Bank, until they are needed to make principal payment on Class A MBS according to Class A Contractual Amortization Schedule.

- An Eligible Bank is a bank rated in the highest categories. To the extent the rate earned on the deposit is below Class A MBS coupon, the resulting shortfall in interest income will be covered by NHB under the NHB Guaranty.

- NHB, in turn, will be reimbursed for any such shortfall by the HFC. Alternatively, Excess Prepayments could be invested with NHB at a rate equal to Class A MBS coupon, and NHB, in turn, could deposit an equal amount with the HFC, earning the same rate of interest.

CREATING LIQUIDITY FOR MBS

- In order to create liquidity for Class A MBS, the following regulatory treatment will be highly desirable:

  - Class A MBS, by virtue of being fully guaranteed by NHB, should be accorded a 20 percent risk-weighting for bank investors, and

  - Listed MBS meeting a certain rating threshold (for example "AA" or "AAA"), with or without an NHB Guaranty, should be regarded as an eligible security for investments by insurance companies, pension funds, provident funds, and mutual funds.

- NHB could also consider providing a guaranty in favor of "eligible banks" providing temporary liquidity to "eligible dealers" to make a two-way market in Class A MBS.

- Finally, NHB could consider acting as a depository for Class A MBS in order to make it easier and cheaper to transfer ownership between the buyers and sellers of Class A MBS.