STRUCTURE OF THE BORROWING MECHANISM FOR THE SPTF

The borrowing will be structured in the form of long term loans with an escrow arrangement and a security creation for lender comfort. A credit enhancement mechanism is also proposed to be a part of the structure so as to improve the overall strength of the product, both in terms of yield on investment as well as credit risk. The proposal envisages the creation of a Special Purpose Fund, under the aegis of the Tea Board, who will contribute the initial capital of the fund. The following section details the structure of the proposed fund along with administration of the fund, the credit disbursement process, the credit monitoring process and the proposed credit enhancement methodology.

1. Nature of the Fund:

The Special Purpose Tea Fund will be a fund set up under the aegis of the Tea Board and will be funded as follows :

A] Capital from Tea Board and Central Government

B] Borrowings from Banks

C] Subsidies payable to the Tea planters

2. Borrowings by the SPTF

Mode of Borrowings:

The SPTF will borrow funds from Indian banks and financial institutions through lines of credit.

Potential Lenders:

Commercial banks who already have exposures on tea along with other banks who would like to lend to the tea industry as part of their mandatory exposure to the agricultural sector. L.I.C and NABARD could also participate in the program as co-financiers.

Borrowing Limits :

As explained earlier, borrowings by the SPTF should not exceed 50% of the total cost of the re-plantation program, proposed to be part-funded by borrowings. Banks would be approached to sanction lines of credit for the next 2 years requirements as banks cannot commit funds for periods exceeding 2 years.

Draw down would be commensurate with the SPTF's lending program to avoid negative returns on borrowed funds. The proposed borrowing in FY'07 is Rs 127 Cr going up to Rs 286 Cr in FY '08 and Rs 444 Cr in FY'09 and peaking at Rs 1349 Cr in FY'18.

Interest :

The rate at which the lines of credit would be availed would be 1% above the prevailing **G-SEC rates** at the commencement of the financial year in which the draw down is made. The current benchmark rate for 10 year G-sec is around 7.50%

Repayment Terms :

To coincide with the on- lending terms

Tenure :

13 years with a moratorium of 5 years.

Repayments :

In 8 equal instalments starting from the 6^{th} year from draw down.

3. Lending by the SPTF

Funds borrowed by the SPTF will be on- lent to individual borrowers.

Amount Of Loan :

Individual loan requirements would be assessed by physical verification of the field assets and the financial position of the borrower. The eligible amount of loan for replanting would not exceed 50% of the unit cost as approved by

NABARD from time to time for the particular location, the remaining amount being funded by borrower's margin and subsidy.

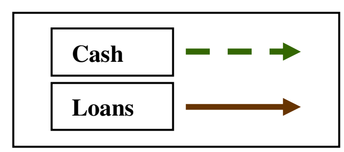
Interest :

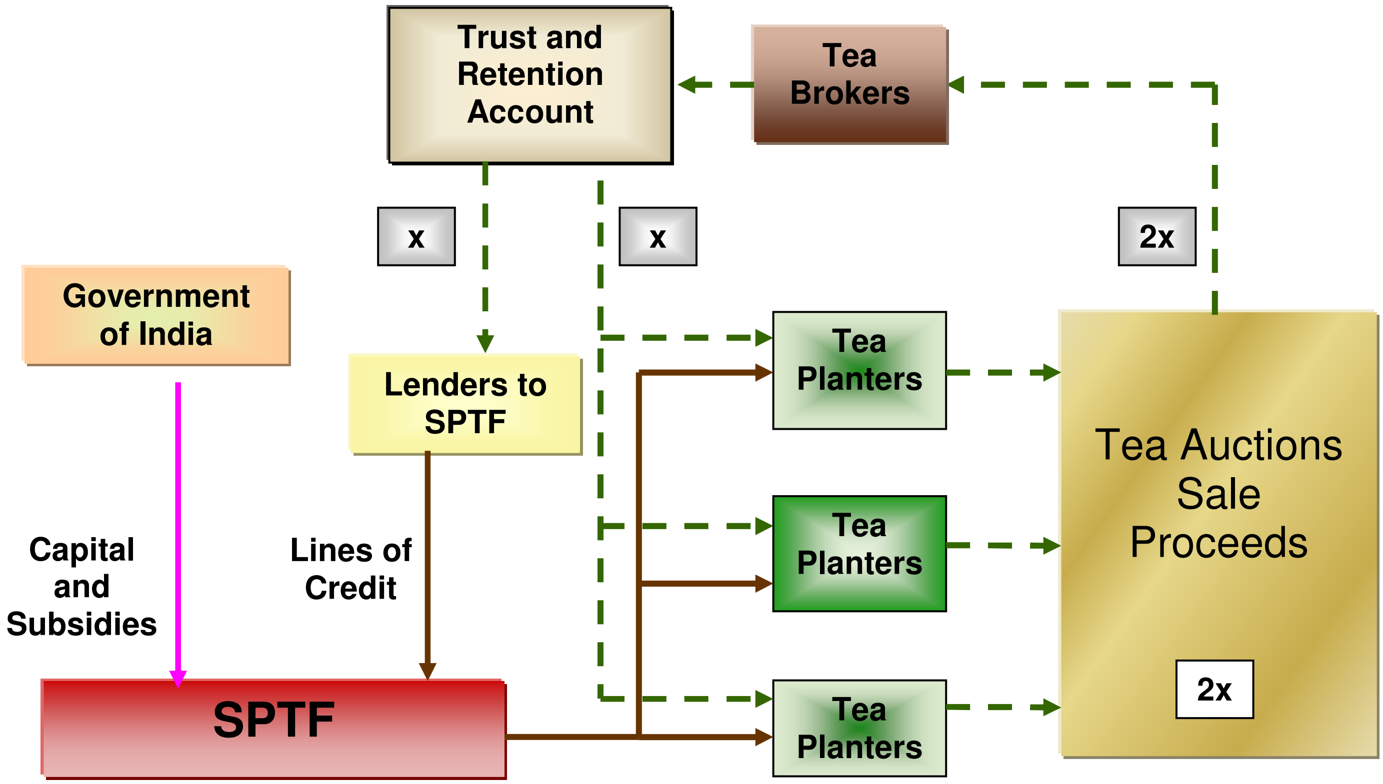
0.5% over the prevailing borrowing rate of the SPTF.

Repayment Terms:

8 equal instalments starting from the 6th year of sanction, with a principal repayment moratorium of 5 years.

<u>Structure of the Proposed Transaction</u>





The Structure of the transaction envisages the setting up of a Special Purpose Tea Fund under the aegis of the Tea Board, with capital contribution from Government and subsidies being routed through the SPTF. Participating lenders will lend funds to the SPTF, which will then on-lend these funds to the individual planters. The borrowers from the fund would have to commit to route sales equivalent to 200% of their annual debt servicing requirements through the tea auctions. The sale proceeds would be routed by their brokers direct into a Trust and Retention Account for repayment to the lenders to the fund. The remaining amount would be remitted to the borrowers.

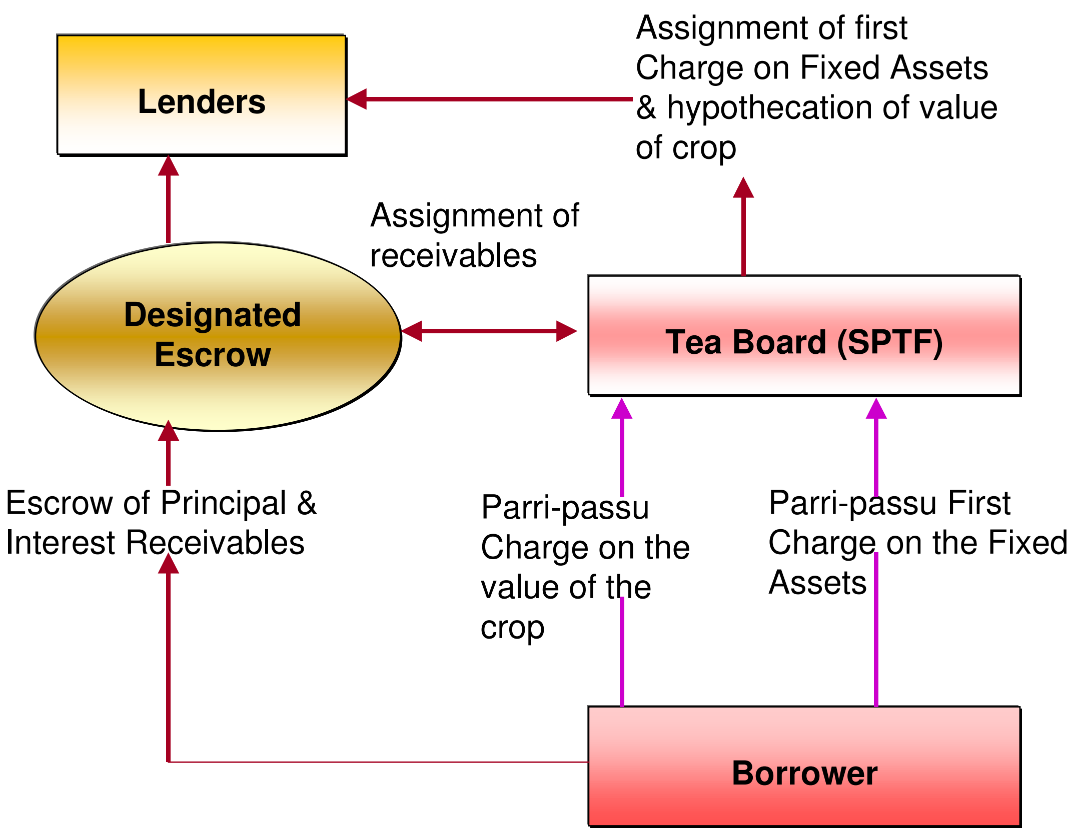
The capital subsidies received from the Government of India will be passed on to the borrowers through the SPTF. In case, planters do not want to avail of loans, subsidy entitlements can be disbursed directly to them by the Board.

Viability Of The SPTF

The viability of the SPTF will depend upon the viability of the individual on-lending schemes. As examined in the Section headed ' Viability Of The Schemes', **aggregate lending to individual borrowers, should not exceed 50% of the total costs, if this scheme is to be viable**. Therefore, the aggregate borrowings of the SPTF will have to be restricted to 50% of the gross requirement of the scheme. Earnings from the capital contribution of 12% of outstanding borrowings would be sufficient to offset a 7% default rate in principal and interest payments.

For the purpose of establishing the viability of the fund, it has been assumed that 30% will come in by way of Government subsidy and 20% will come in by way of Promoters' contribution. Therefore, the aggregate funding required from the participating banks will be to the extent of 50% of the gross requirement. The individual borrowers will have to compulsorily sell part of their produce(equivalent to 200% of the annual debt servicing requirements) through the Tea Auctions so as to establish an escrow mechanism. The sale proceeds would be routed by the brokers directly into a T& R account. This arrangement would ensure the overall viability of the SPTF.

Security Creation



Under the proposed structure of the fund, the lenders will be lending to the Tea Board, which will then on-lend to the individual tea planters. Therefore, the Tea Board will be the direct lending entity. The security creation for the Tea Board will be a first charge on the fixed assets, hypothecation of the crop and future receivables, parri-passu with the existing lenders. However, since the ultimate lending agencies are the banks who will be taking an exposure on the Tea Board, the Tea Board will have to assign these charges to the lenders.

The lenders will also have additional security through an escrow of the interest and principal repayments made by the individual borrowers to the Tea Board, which will be routed directly into a Trust Retention Account.

<u>Documentation required for creation of security in favour of the Lenders</u>

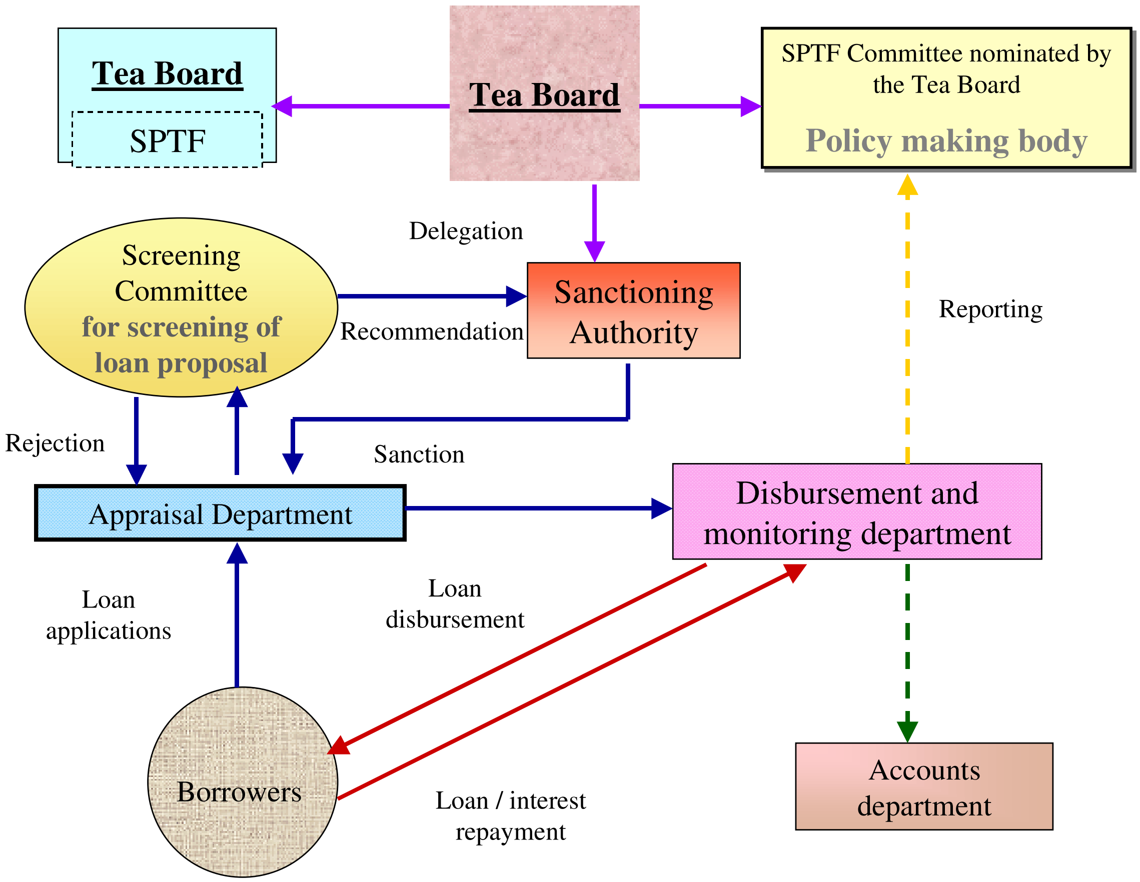
(a) Trust & Retention Account Agreement

A Trust & Retention Account (TRA) will have to be set up to ensure escrowing of the receivables to a separate account. This agreement will be between the Tea Board, the lenders to the Board and the coordinating bank (which will hold the TRA) and the Tea Brokers.

(b) Hypothecation of Future receivables to the lenders

(c) Assignment of Pari-passu charge on fixed assets and current assets in favour of the lenders.

<u>Mechanism of Credit Administration & Management</u>



The Tea Board currently lends out funds to the Indian Tea industry. The capital subsidy available to the borrowers is also routed through the Tea Board. The Tea Board has an existing credit approval and implementation monitoring process. This arrangement may be strengthened and utilised to approve and sanction loans by the SPTF to the individual borrowers.

In order to avail a loan from the SPTF, each prospective borrower will need to apply to the SPTF with his proposed rejuvenation/replantation program. The proposal screening committee nominated by the Board will screen the applications after initial processing by the appraisal department.

The screening committee will evaluate the merits of the case and recommend sanction of the loan on terms which are in line with the policies of the Fund. Sanctions will be made by the competent authority nominated by the Board. Disbursement of the loan will be made by the Tea Board to the borrowers' account.

Recovery Process

As a part of the loan agreement, the borrower will agree to route a pre-specified proportion of his entire production through specified tea auctions through specified brokers. In terms of the Escrow Agreement between the Tea Brokers, the Borrower and the SPTF, the proceeds of the sales through the auctions will be directly routed by the Tea Brokers to the Trust and Retention account.

The calculation of this pre-specified amount will be done in the following manner. At the beginning of each lending period, the total debt servicing requirement for the ensuing period is calculated. This will comprise both the principal repayment and the interest payable. Since sales in the Tea industry typically take place in the months of July to September, the collections with respect to receivables from the borrowers will be made predominantly during this period only. **The planters will be required to route their produce through the auctions to the extent of 200% of the total debt servicing requirement calculated for a particular year**. The routing of 200% of the total requirement is being suggested to take care of any defaults that might take place in the principal repayments or the interest collections in any period during the year. Once the amount in the T & R account is sufficient to cover the debt servicing obligations of the planters, the remaining auction proceeds will be released directly to the planters. This mechanism of recovery ensures low defaults and a secure recovery process for the participating banks, for whom, it would be difficult to recover dues in the normal set of circumstances. To that extent, this instrument becomes a secure structured lending instrument, wherein, the interests of both the borrowers and the lenders are protected to a satisfactory degree.

This process of credit recovery is also logistically simple. This is so because the escrow of receivables from the individual borrowers is already in place in the case of certain borrowers. Under the structure the brokers make payments against auction sales directly to the borrowers' Bank to meet the debt service obligations of the borrower. This structure is proposed to be replicated on a larger scale under the SPTF.

However, in the case of a borrower where an escrow arrangement is already in place with the existing bankers of the borrower and he wishes to avail funds from the SPTF, a suitable pari passu charge on the escrow account can be structured.

By capturing the revenue stream of the borrower upto the extent of 200% of his repayment commitments, the SPTF ensures a low default ratio. Nevertheless, to account for performance risks, a default ratio of 10% has been assumed in our model.

Default Mitigation Measures

1. During the early stages of the program since only the interest has to be serviced, the likelihood of defaults is minimal. Nevertheless, as a measure of caution, loans would be disbursed to individual borrowers in phases, to the maximum extent of 2.5% of his total re-plantation requirements, under the entire program in any year. Any defaulter would be barred from availing further loans or subsidies.
2. The Tea Act provides the Board with numerous powers, including the authority to stipulate the minimum quantity of tea to be sold through public auctions, the authority to cancel the manufacturing license of the borrower etc. The Tea Board will issue appropriate orders to borrowers to route sales equivalent to 200% of the debt servicing requirements through the Tea Auctions. Other punitive powers may be exercised to ensure repayments from willful defaulters.
3. Borrowers would be required to deposit an amount equivalent to one quarter's interest payment and one quarter's repayment installment in advance, which would be adjusted against the last installment due. The funds so collected would be invested to build up a default reserve fund. The detailed workings are given in table A.

Credit Enhancement Mechanism

The credit enhancement proposed under the structure will incorporate the following elements :

- The planters availing loans from the SPTF, will have to compulsorily sell a part of their entire produce through the tea auctions to cover 200% of their loan servicing requirements.
- The borrowers would also have to take crop insurance cover for the replanted areas to safeguard against crop failure.

The cash flows available to the lenders will therefore comprise the following :

- Principal repayment amounts
- Interest payments
- Charge on auction proceeds to the extent of scheduled cash flows to the lenders in case of default or shortfall in the scheduled collections.
- Insurance claims

Cash Flow Structuring for the Proposed Securitisation of Future Receivables
(Refer Table A, Table B & Table C)

While assessing the economic feasibility of the fund, we have considered a model that covers a 15 year programme with the following assumptions.

1. Total requirement of the program in each year is as per the detailed plan drawn up by the Tea Board.
2. Capital infusion is at stages so as to maintain a capital adequacy of 12%
3. Loans availed from banks is to the extent of 50% of the aggregate re-plantation program
4. One quarter's interest and repayment installments are to be collected in advance.

5. Zero tax has been assumed both for borrowing and for lending as Tea Board is exempted from payment of Tax on any income accruing or arising to it.

The other assumptions underlying the financial model are as follows :

Assumptions	
Interest Rate charged by Tea Board to Borrowers (0.5% above borrowing rate)	9.00%*
Interest rate charged by Investing Banks to Tea Board (1% above applicable 10 year G-sec rate currently around 7.50%)	8.50%*
Margin to Tea Board for payment of administration expenses and Bank charges	0.50%
Repayment of Loan to commence from Year	6
Number of equal annual installments for repayment	8
Default Rate (in repayments)	7.00%
Default Rate (in interest payments)	7.00%
Govt. Subsidy	30.00%
Capital Subsidy to be paid to borrower on Year	2 – 4
Borrowers' Contribution	20.00%

*The rate of borrowing and lending will vary according to the sources of borrowing by the SPTF. The rate of refinancing by NABARD is 6.75% and the current G.Sec rates is 7.5% Therefore, the average rate of borrowing interest would be around 8.50%.

The cash flows to the SPTF will comprise of the following:

(a) Receivables of subsidies from the Government of India

(b) Receivables from the interest payments made by the borrowers.

(c) Receivables from the principal repayments made by the borrowers.

(d) Interest income earned on capital and surpluses after meeting defaults

The cash flow structure for the fund is given in :

Table A : Cash Flow Model for the proposed structured Lending Mechanism

Table B : Cash flow management by the Fund

Table C : Assumptions for calculations

The model assures a comfortable cover for a default rate of 7% in principal and interest repayments, yielding a net surplus of Rs. 203.64 crores at the end of the program.

Residual Fund Deployment

Residual funds being generated out of the transaction (depending on the actual collections being greater than the projected collections) may be re-deployed by the Tea Board in deserving units at concessional rates. This will provide a fillip to the small tea planters who otherwise would not have any access to bank credit.

Possible Option of Takeout Financing

A possible option for the banks to exit the project at the end of 10 years may be structured in by means of a takeout finance mechanism. In such a scenario, the National Bank for Agriculture and Rural Development (NABARD) may be involved in refinancing the loans at favourable rates. This option may be exercised in case the participating banks are uncomfortable with an exposure greater than 10 years.

Risk Mitigation Options

The risks as envisaged for the lenders are as follows:

(a) Credit Default: Default rates as high as 7% have already been considered and even with such high rates of default the rate of return on the transaction is favourable. Moreover, the participating banks will not be taking a direct exposure on the individual borrowers, but on Tea Board, which is an entity owned by the Govt. of India.

(b) Commingling Risk: The lenders run a risk that the cash flows from debt servicing coming from the individual borrowers through the auctions, will be mingled with the cash flows of the Tea Board : this is commingling risk. However, under the proposed structure, the debt service receivables will be directly escrowed in the T&R Account for the benefit of the lenders.