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Russian Securitization

An overview of risks and structural mitigants for investors and originators

James Walters

Dresdner Kleinwort

A member of Allianz

Introduction

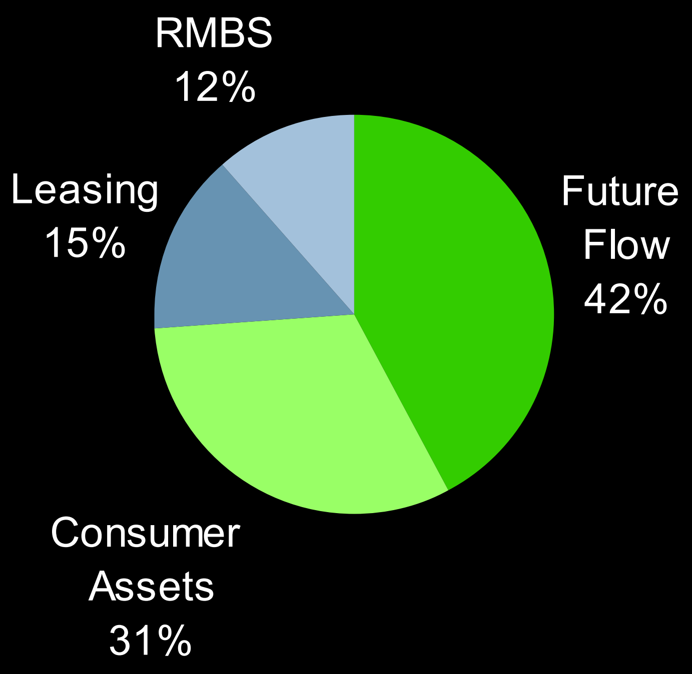
- Emerging market securitizations often encounter similar legal hurdles and structural challenges

- This presentation aims to:
  - Recap the types of deals completed in Russia in 2006
  - Review the primary risks of Russian securitization
  - Review the structural approaches to risk mitigation

- Due to the transaction-specific nature of many risks, this is intended as an overview of the most common risks

Securitization in Russia in 2006

In 2006, US$3.3bn of international ABS was issued from Russia



- Future flow transactions:
  - Alfa DPR Finance Company
  - MDM DPR Finance Company
- Existing asset transactions:
  - Taganka Car Loan Finance (MDM)
  - Russian Car Loans No.1 (RSB)
  - Russian Consumer Finance No.1 (RSB)
  - Russian Mortgage Backed Securities 2006-1 (VTB)
  - CityMortgage MBS Finance (CityMortgage Bank)
  - Gazprombank RMBS Series 2006-1 (GPB)
  - Red Arrow International Leasing

Securitization in Russia to date

- Reflecting issuance in 2006, we group deals into 2 categories:

    - **Future flow transactions** (such as Alfa DPR Finance Co)
    - **Existing asset transactions** (such as MDM’s Taganka Car Loan Finance)

- Before we discuss the risks and mitigants, we briefly overview these two deal types

Future flow securitization

Future flows of assets

Non-contractual future cashflows

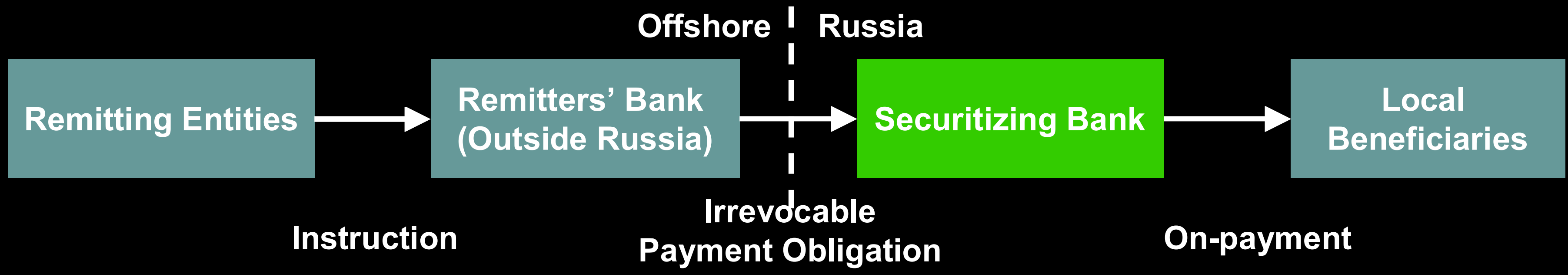
- Credit card settlements
- Ticket sales
- Correspondent banking SWIFT remittances – called diversified payment rights (DPRs)

Contracts giving rise to future cashflows

- Export receivables (oil and gas, goods, commodities)

Future flow securitization: diversified payment rights

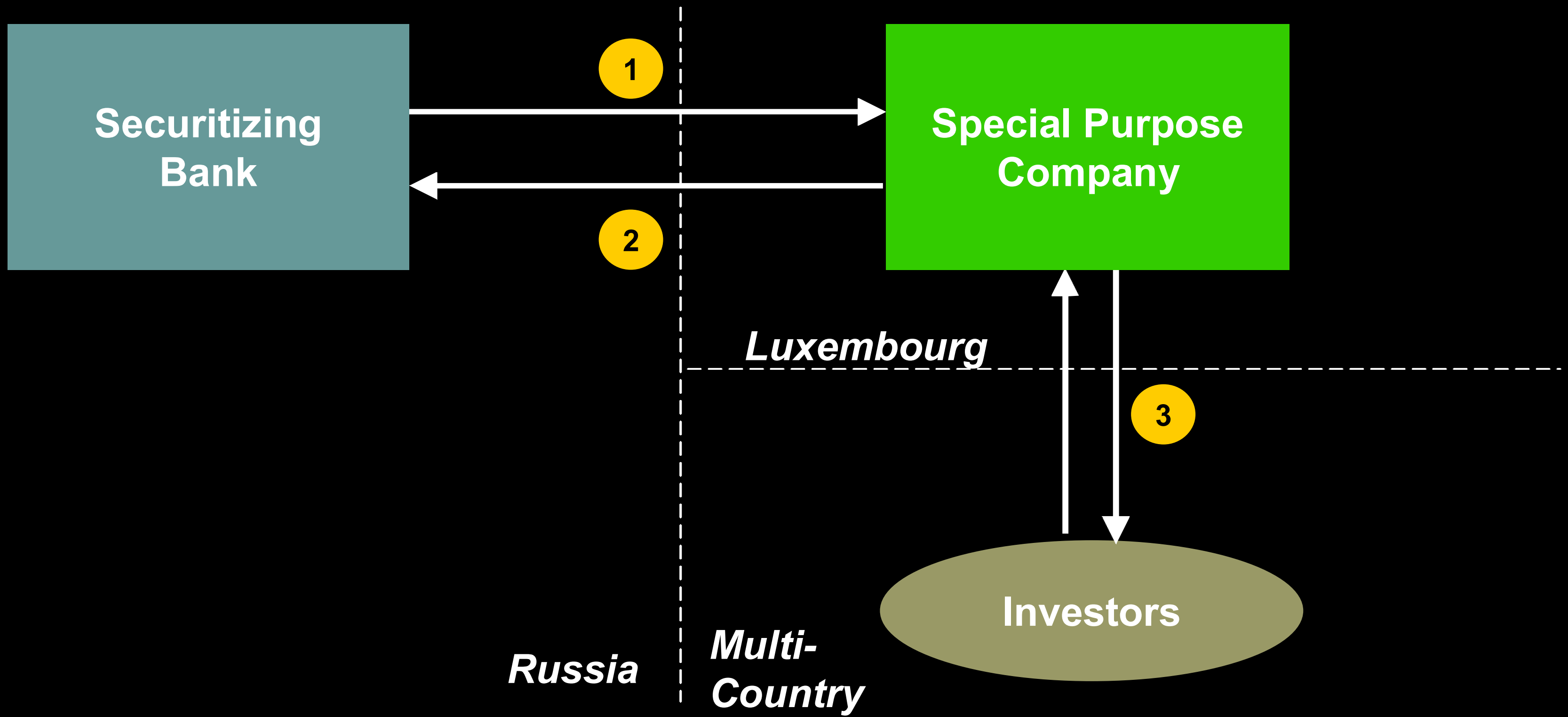
- DPRs are the rights (but none of the obligations) of a bank to hard-currency-denominated Payment Orders received by the bank
- “Payment Orders”
  - Instruct the bank to make a payment to another beneficiary
  - Predominantly consist of MT102s/103s/202s payment messages sent via SWIFT
- In a DPR securitization, the rights to Payment Orders are sold or pledged to an SPC



- Future flows included in a DPR securitization may include payments relating to:
  - Cash against goods transactions (export payments)
  - Loans to, and deposits from, corporate customers
  - Foreign direct investment
  - Other commercial payments
  - Worker remittances

DPR transaction structure

Pledge of Diversified Payments Rights & Secured Loan



The deal involves:

1. A pledge by the securitizing bank of all its rights to the DPRs to an SPC
2. A loan to the securitizing bank by the SPC, secured by the pledge over the DPRs
3. An issuance of Notes by the SPC to investors to finance the secured loan

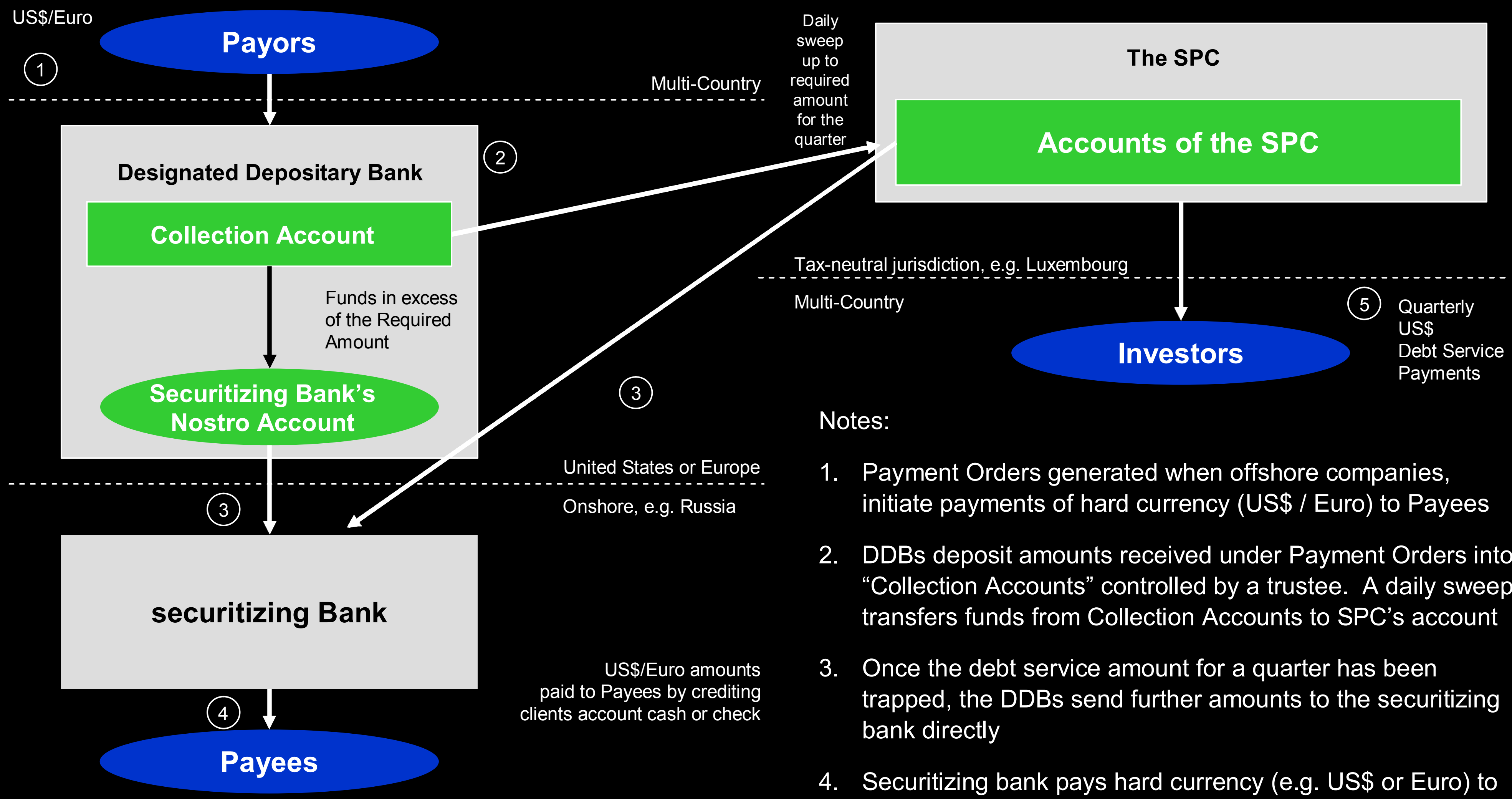
DPR transaction structure

The role of the correspondent banks

- DPRs are paid by payors into accounts at the securitizing bank's offshore correspondent banks
- Certain correspondent banks sign "Account Agreements" ceding control over these accounts to a trustee acting on behalf of the securitization SPC
- For example, Russia's Alfa Bank has signed Account Agreements with four of its top correspondent banks, representing 89.96% of the DPRs received by Alfa-Bank in 2005:

Correspondent Bank	Ratings	2005 DPR Flows	
JPMorgan Chase Bank, New York	Aa3 / A+ / A+ (pos)	9,750,625,436	69.14%
Deutsche Bank Trust Co. Americas, New York	Aa3 / AA- / AA-	1,718,057,446	12.18%
HSBC Bank USA, New York	Aa2 (pos)/ A+ (pos) / AA-	643,582,162	4.56%
Bank of New York, New York	Aa3 / A+ / AA-	574,021,537	4.07%
Total – Designated Depositary Banks		**12,686,286,581**	**89.96%**
Others		1,416,516,850	10.04%
Collections		14,102,803,431	100.0%

DPR transaction cashflows

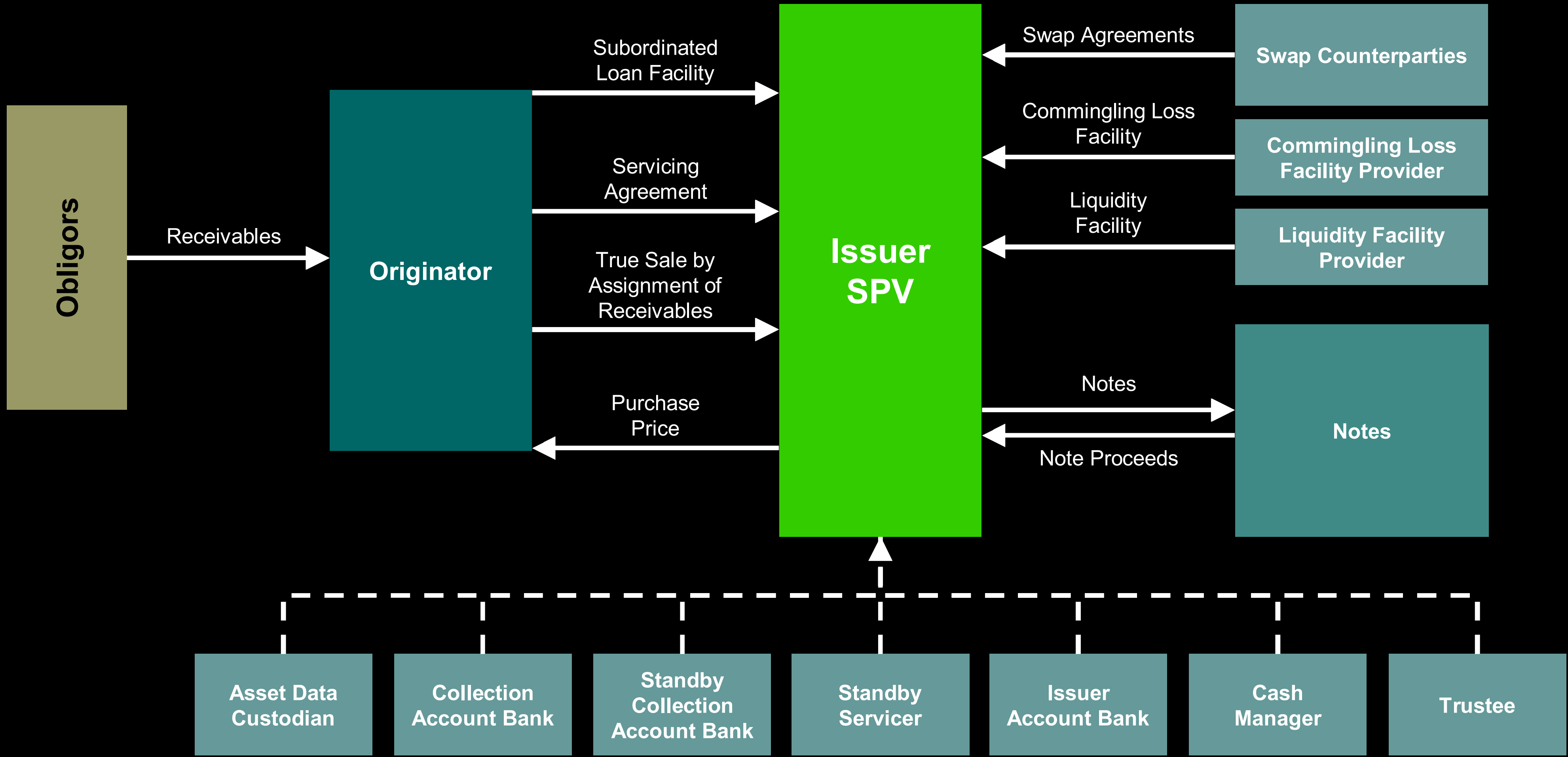


Notes:

1. Payment Orders generated when offshore companies, initiate payments of hard currency (US$ / Euro) to Payees
2. DDBs deposit amounts received under Payment Orders into "Collection Accounts" controlled by a trustee. A daily sweep transfers funds from Collection Accounts to SPC's account
3. Once the debt service amount for a quarter has been trapped, the DDBs send further amounts to the securitizing bank directly
4. Securitizing bank pays hard currency (e.g. US$ or Euro) to the Payees, as applicable
5. Funds in the SPC's accounts are used to meet debt service payments

Existing asset securitization structure

Existing asset structures are simpler, but the risks are more numerous



Risks & Mitigants

Dresdner Kleinwort

Key risks in future flow & existing asset securitization

Jurisdictional/Macro

- Economic instability
- Banking crisis
- Sovereign interference/redirection
- Transfer and convertibility
- Limited historical data

Legal

- Uncertainty of true sale/pledge
- Collection account security
- Enforcement & recovery of defaulted assets
- Commingling
- Set-off
- Commercial/data protection & bank secrecy

Counterparty/Credit

- Credit quality of counterparties
- Servicing interruption/substitution
- Insolvency of originator/servicer

Market

- Currency and basis risk
- Limited secondary market for assets
- Limited secondary market for notes

Macro risk: Economic instability

Future Flow	Existing Assets

- Economy expected to continue the recent strong economic and financial growth

Future Flow

- Devaluation of the RUR would result in Russian exports becoming more cost competitive thereby facilitating/stabilising exports during times of economic difficulty
- Trade related financings are often exempt from sovereign reschedulings
- High debt service coverage tests and decline in flows test (compared to future flow transactions in other jurisdictions) trigger early amortization resulting in quick repayment of Notes
- Tight rating downgrade trigger resulting in early amortization (20% of flows go to repayment of Notes)

Existing Assets

- RUR devaluation may mean increased defaults on non-RUR portfolios
- Rating agencies apply higher stresses to non-RUR assets – so higher credit enhancement
- Indexation of RUR salaries to hard currency
- Transfer of servicing in rating downgrade

Macro risk: Banking crisis

Future Flow	Existing Assets
▶ Originators typically of strategic/systemic importance – expected to receive shareholder/government support ▶ Early amortization likely to be triggered	▶ Liquidity facility to cover 9 months of interest interruption due to banking crisis

Macro risk: Sovereign interference/redirection

Future Flow

- The DPR payment transfers are created electronically offshore
- DDBs take instructions from the Trustee
- Russian sovereign has no jurisdiction over offshore DDBs
- In an early amortization event, significant cash flow is still released to the Originator
- Interference is an event of default requiring full repayment – incentivises the Russian government not to interfere with an important source of foreign currency

Existing Assets

- Russian government is supportive of securitization:
  - Law on Mortgage-Backed Securities – to foster development of the Russian mortgage market
  - Subsequent working group to develop the law further

Macro risk: Transfer and convertibility

Future Flow	Existing Assets
▶ No T&C risk as all flows are in hard currency arising and trapped offshore	▶ T&C risk remote at rating levels assigned to most Russian securitizations ▶ Moody's and S&P consider T&C risk remote up to a rating level of A2 and A- respectively ▶ Use of PRI can pierce T&C rating ceiling

Macro risk: Limited historical data

- Young and rapidly growing market
- Historical data may not be representative of future performance

Future Flow	Existing Assets
Level of historic data is similar to other jurisdictions	Conservative assumptions and stresses applied by Rating Agencies resulting in healthy levels of subordination and credit enhancement High interest rates on underlying assets results in significant excess spread Potential to benchmark against similar portfolios in other markets

Counterparty risk: Credit quality

- Counterparty ratings are often below the sovereign rating – unlike some other EM jurisdictions

Future Flow

- Higher debt service coverage ratios (e.g. 17x) compared to transactions from other jurisdictions (e.g. c. 6-8x)
- Rating downgrade triggering early amortization (triggers increase in scheduled amortization payment in transactions from other jurisdictions

Existing Assets

- Tight/automatic triggers to:
  - Notify borrowers of assignment (perfection, set-off, commingling)
  - Activate standby servicing
- Hot standby arrangements
- Selection of experienced servicers from limited pool

Counterparty risk: Servicing interruption/servicer substitution

Future Flow	Existing Assets
▶ Not applicable	▶ Hot standby servicer arrangements in place on closing with experienced originator of assets ▶ Standby servicer receives servicer reports and loan-by-loan data on a regular basis ▶ Expenses contingency fund to cover any expenses associated with the transfer of servicing ▶ Commingling loss facility/reserve ▶ Detailed analysis of timing/procedure for notification and payment redirection

Counterparty risk: Insolvency of originator or servicer

Future Flow

- DPR generation will cease
- High DSCR tests and ratings downgrade triggers cause early amortization well before originator/servicer insolvency

Existing Assets

- Insolvency and rating downgrade (likely to occur well before insolvency) both trigger:
  - notification of sale
  - payment redirection
  - transfer to hot standby servicer

Legal risk: Uncertainty of true sale/pledge

- Russian law unclear and untested
- Lack of independence of the judicial system
- Difficulty enforcing court decisions
- Unpredictability of the legal system

Future Flow	Existing Assets
DPRs pledged under foreign law	Documents governed by foreign law
Russian legal opinion that pledge is valid and enforceable	Russian legal opinion that true sale is valid and enforceable in Russia
Cashflows trapped in offshore accounts controlled by trustee	Qualifications to true sale opinion limit delinkage from originator rating
Therefore challenges to pledge heard and enforced outside Russia	Strength of opinion caps ratings at A-/A3 for short-term notes
	Trustee with Russian presence facilitates enforcement of security

Legal risk: Collection account security

- Security over accounts located in Russia is unlikely to be valid and enforceable under Russian law

Future Flow	Existing Assets
Not applicable – all accounts are located offshore	Daily sweeps to secured offshore issuer accounts Commingling loss facility/reserve

Legal risk: Enforcement and recovery of defaulted assets

- Russian court procedures, timing and costs are unpredictable
- Limited case law/practice

Future Flow	Existing Assets
Not applicable	Recovery experience to date primarily from out-of-court procedures (phone calls, SMS messages, letters, meetings with customer) Rating agencies give minimal benefit to recoveries Detailed due diligence on collections processes Detailed analysis on enforceability in legal opinion

Legal risk: Commingling

- Collections commingled with originator's assets
- Commingled funds lost in originator insolvency until borrowers notified to redirect payment

Future Flow	Existing Assets
- DPR generation will cease in originator insolvency - High DSCR tests and ratings downgrade triggers cause early amortization well before insolvency	- Commingling loss facility/reserve - Daily cash sweep of collection accounts held with originator to offshore issuer accounts

Legal risk: Set-off

- Risk of set-off of borrowers' payment obligation against deposits with originator

Future Flow	Existing Assets
Not applicable	Set-off reserve Accept linkage to originator – set-off exposure addressed by credit enhancement Borrower notification triggers

Legal risk: Commercial/data protection & bank secrecy

- Uncertainty around interaction between bank secrecy/personal data protection rules and originator's right to assign its assets
- Underlying loan agreements often contain confidentiality provisions

Future Flow	Existing Assets
Not applicable	Disclosure relating to sold assets should not breach rules – but uncertainty remains Use of data custodian limits disclosure of commercially sensitive data

Market risk: Currency and basis risk

- Currency swap market illiquid, expensive and limited in term

Future Flow	Existing Assets
▶ Limited currency risk as underlying DPR flows denominated in hard currency ▶ Basis risk mitigated through very high coverage levels	▶ Three hedging solutions seen in the market: ▶ Fully balance guaranteed swap (MDM and RSB auto loan deals) ▶ Rolling spot and NDFs (RSB and HCFB consumer loan deals) ▶ Investors take currency risk (Red Arrow leasing deal)

Market risk: Limited secondary market for assets

- Post enforcement, the limited secondary market for loan portfolios in Russia may mean investors having to wait for scheduled repayment

Future Flow	Existing Assets
Not applicable	Nascent secondary market developing

Market risk: Limited secondary market for notes

Future Flow	Existing Assets

- Liquidity likely to develop as market matures:
  - Recent transactions have met with a broad range of demand from investors – likely to foster more liquidity
  - Active commitment by arranging banks to make a market in Russian securitizations – fosters liquidity and is valued by investors

Conclusion

- Given the activity and potential of the Russian ABS market, it is an opportune time for investors to seriously consider this asset class:
  - Russia is one of the largest and fastest growing emerging market economies with strong economic fundamentals and ample reserves
  - Fast growing consumer finance market – significant growth expected in the volume of Russian ABS transactions
  - Rating agencies currently taking a conservative approach to potential risks in this new jurisdiction – resulting in robust structures and significant credit enhancement
- As the market matures, market participants should grow more comfortable:
  - Legal risks – more case law/practice increases certainty of true sale and enforcement
  - Data – more complete historical data available for analysis
- **The stability of Russia and the robust risk mitigation and security offered by ABS structures offers investors sufficient comfort to participate in Russian ABS and benefit from the relative value of this growing market**

Thank you