News Bulletin

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UK Government's 2009 Asset-Backed Securities Guarantee Scheme

In his November 2008 report into the state of UK mortgage finance, Sir James Crosby concluded that, without intervention, UK mortgage lenders would need to survive with little or no access to wholesale asset-backed funding until the end of 2010, yet during the same period would need to meet redemption obligations on such securities of £160 billion. The UK Government's proposed solution is the 2009 Asset-Backed Securities Guarantee Scheme (the "Scheme"), which was originally announced on 19 January 2009, as part of the raft of measures introduced to support the UK financial system [1], and which became operational on 22 April 2009[2], following approval of the Scheme under the EU State Aid rules.

Purposes of the Scheme

The Scheme aims to support residential mortgage lending in the UK economy by the UK Treasury ("HMT") guaranteeing mortgage-backed securities secured on UK residential properties and therefore enabling banks and building societies to access wholesale funding markets more easily. The Scheme stands side-by-side with the 2008 Credit Guarantee Scheme [3](the "Credit Guarantee Scheme") for unsecured debt issuance by UK incorporated banks and building societies.

Access to the Scheme

The criteria for eligibility to participate in the Scheme are the same criteria that apply to the Credit Guarantee Scheme. Eligible institutions are UK incorporated banks (including UK subsidiaries of foreign banks) which have a substantial business in the UK, and UK building societies, in each case so long as they have Tier 1 capital in an amount deemed appropriate by HMT. Only one entity within a corporate group will be allowed to participate in the Scheme. ("participating institution") although issuances under the Scheme can be made either by the participating institution or by its sponsored affiliated entities ("Issuers").

Guarantees

There are two types of guarantee available in relation to eligible instruments.

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[1] For more details, see our client alert dated 4th February 2009, http://www.mofo.com/news/updates/files/090204UKGovernmentsBankingSupportMeasures.pdf
[2] Scheme Market Notice dated 22nd April 2009, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/2009-04-22ABSMarketNotice.pdf&page=
Scheme Guarantee, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/2009-04-22ABSDeed.pdf&page=
Scheme Rules, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/2009-04-22ABSRules.pdf&page=
[3] Credit Guarantee Scheme Market Notice dated 13th October 2008, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/mktnotice08.pdf&page
Credit Guarantee Scheme Rules, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/cgsrules.pdf&page=

The first type of Guarantee (the "Credit Guarantee") ensures the timely payment of all amounts of interest and principal payable in respect of the eligible instruments.

The second type of Guarantee (the "Liquidity Guarantee") ensures that if an Issuer fails to honour its obligations to purchase the eligible instruments following an exercise of a put or call option under the terms of the eligible instruments, then HMT will purchase such eligible instruments from the holder at the relevant price. The relevant price will be the principal amount outstanding of the eligible instruments on the due date, adjusted to include accrued but unpaid interest but reduced to reflect any principal losses on the loan portfolio allocable to the eligible instruments, as recorded on a ledger required to be kept for this purpose[4].

There are a few notable limitations placed on the availability of the Guarantees, as follows:

- an eligible instrument can benefit from a Credit Guarantee or a Liquidity Guarantee but not both;
- Guarantees will be provided only in respect of eligible instruments issued within 6 months of the commencement of the Scheme, unless the period is extended at HMT's discretion; and
- the maximum term of a Guarantee will be either up to 3 years or up to 5 years and no more than one third of the total guaranteed eligible instruments of the participating institution's group may have the up-to-5-year term.

Eligible instruments

To qualify under the Scheme, instruments must fulfil the following criteria:

- be issued under stand-alone transactions or under established or newly established master trusts, which have been approved by HM Treasury at its sole discretion;
- be denominated in a single currency, such as Sterling, Euro, US Dollars, Yen, or other major specified currencies or such other currency as approved by the HM Treasury;
- be rated "AAA" (or the equivalent) at the time of issue by at least two international credit rating agencies, disregarding the availability of the applicable Guarantee; and
- be listed on the regulated market of the London, Irish or Luxembourg Stock Exchanges.

Furthermore, any mortgages contained in the underlying mortgage pool must meet additional requirements, including:

- each mortgage loan must be made on or after 1 January 2008;
- each mortgage loan must be secured by a valid first ranking mortgage, or the equivalent in Scotland, over a residential property located in the United Kingdom;
- the loan-to-value ("LTV") ratio of each mortgage at origination must not have exceeded 90% of the lower of the purchase price or the then most recent valuation of the mortgaged property;
- immediately after the date of sale of the mortgage loan into the relevant mortgage pool, the weighted average LTV ratio of all the mortgage loans in the underlying pool must not, by reference to the mortgage loans at their respective origination, exceed 75% of the lower of the respective purchase prices of the mortgaged properties or the most recent valuations as at the time of origination; and

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[4] It is interesting to note that, in respect of the Liquidity Guarantee, the holders of the eligible instruments are therefore still exposed to losses on the loan portfolio, which would seem to raise questions about the usefulness of this type of guarantee. This is especially so, since the guarantee fee payable is still calculated on the full (i.e. unadjusted) principal amount of the eligible instruments.

- each mortgagor must not have an adverse credit history and cannot be "self-certified".

Information disclosure

Issuers will be required to produce periodic reports, at least quarterly, to investors and HMT in line with international best practices such as those outlined in the "RMBS Issuer Principles for Transparency and Disclosure, Version 1" which was published by the European Securitisation Forum in February 2009.[5]

HMT Recourse

Under the Scheme's provisions, HMT is entitled to be indemnified, whether by the participating institution or the Issuer of the eligible instruments, for amounts paid under a Guarantee, and HMT will have a claim against the Issuer and the asset pool that will give it the same priority as the holders of the eligible instruments had.

Fee

The guarantee fee payable to HMT will be equal to 25 basis points over the participating institution's median 5-year CDS spread during the period from 2 July 2007 to 1 July 2008, as determined by HMT. The fee will be applied to the principal amount outstanding of the guaranteed eligible instruments and be payable on the interest payment dates of the eligible instruments until the earlier of the expiry of the term of the Guarantee and the redemption date (or call or put date in respect of a Liquidity Guarantee) of the eligible instruments. The fee is payable in Sterling and HMT may also charge an incremental fee in respect of Guarantees of non-Sterling denominated eligible instruments to reflect its hedging/foreign exchange costs.

The Solution?

Undoubtedly the Scheme is a step in the right direction when it comes to reviving the mortgage-backed securities market for UK mortgage lenders, but there remain doubts as to how high the take-up rate will be for the Scheme.

The maximum guaranteed tenors for the eligible instruments are relatively short for the RMBS markets and, despite the Scheme being limited to AAA-rated instruments, the guarantee fee payable to HMT is only 25 basis points lower than the equivalent guarantee fee payable under the Credit Guarantee Scheme, which does not tie up any of the institution's loan assets.

Initial reactions, therefore, are that the Scheme may not add a great deal to the Credit Guarantee Scheme, and given that to make the first issuance under the Scheme requires 3 successive sets of application forms and supporting documents, and that final approval of the issuance always remains at HMT's sole discretion, the Scheme will not be winning many friends for its user-friendliness or its certainty of outcome.

[5] http://www.europeansecuritisation.com/Advocacy/Market_Standards/ESF%20RMBS%20Issuer%20Principles%20for%20Transparency%20and%20Disclosure%20Dec08%20.pdf

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