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UK Asset-backed Securities Guarantee Scheme

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UK Asset-backed Securities Guarantee Scheme

June Rhee¹

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Abstract

The key structures of housing finance in the UK in the years leading up to the global financial crisis of 2007-09 consisted of retail deposits, secondary market funding and wholesale interbank lending. Although retail deposits were the major funder of UK mortgages, secondary market funding, which included covered bonds and residential mortgage-backed securities (RMBS), accounted for 31% of UK mortgage lending in 2006. In 2007, the collapse of the U.S. subprime mortgage market triggered a financial shock, and the shock quickly traveled beyond national borders. Regardless of differences in the UK mortgage market, investors' concern over the prospects of the U.S. housing market influenced their perception of UK mortgage-backed assets. And with the UK RMBS market substantially reliant on overseas investors, their concern contributed to a downturn in the UK market.

In a November 2008 report on mortgage finance by Sir James Crosby, it was argued that “[w]ithout intervention, the market in mortgage-backed securities won't return any time soon ...” and that “the inability to refinance existing mortgage-backed funding and the continuing pressures in wholesale funding markets ... [were] really hitting the banks' capacity to make new loans ...”. In response to this report, HM Treasury announced a £50 billion guarantee scheme for asset-backed securities (the Scheme) on January 19, 2009 and launched this Scheme on April 22, 2009.

The Scheme, in which HM Treasury provided a guarantee for eligible newly issued RMBS, represented an extension of the 2008 Credit Guarantee Scheme for unsecured debt issuance by UK incorporated banks and building societies. The Scheme aimed to support residential mortgage lending in the UK economy. The Scheme closed on December 31, 2009 without having been used.

Keywords: United Kingdom, asset-backed securities, ABS, residential mortgage-backed securities, RMBS, securitization, guarantee

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UK 2009 Asset-backed Securities Guarantee Scheme

At a Glance

In 2007, the collapse of the US subprime mortgage market triggered a financial shock, and the shock quickly traveled beyond national borders. US investors' concern over the prospects of the US housing market influenced their perception of UK mortgage-backed assets. And with the UK RMBS market substantially reliant on overseas investors, the U.S. investors' concern contributed to a downturn in the UK market. A November 2008 report on mortgage finance by Sir James Crosby (Crosby Report) stated that there was a "disappearance of a substantial section of the previous investor base" in mortgage-backed securities, draining liquidity from the RMBS market. Net lending secured on residential property totaled £37.4 billion during January – September 2008, compared to £84.7 billion during January – September 2007. The Crosby Report concluded that an "intervention which addresses the 'closure' of mortgage-backed funding markets will bring about increased competition and improve the availability of mortgage finance to homeowners and would be homeowners" and "such intervention should ensure that a cyclical correction in the housing market does not turn into something much more serious with all that would ultimately imply for the wider economy".

In response to the Crosby Report, HM Treasury announced on January 19, 2009 that the £50 billion Asset-backed Securities Guarantee Scheme (Scheme) would be launched on April 22, 2009. The Scheme, under which HM Treasury provided a guarantee for eligible newly issued RMBS in exchange for a fee, represented an extension of the 2008 Credit Guarantee Scheme for unsecured debt issuance by UK incorporated banks and building societies. Under the Scheme, the maximum term of a guarantee was either up to 3 years or up to 5 years, and the participating institution's group could not have more than one third of the total guaranteed eligible RMBS with a 5-year term.

Guarantees were originally to be provided only to eligible RMBS issued within 6 months of the commencement of the Scheme, but HM Treasury subsequently extended the period up to December 31, 2009. The Scheme expired on December 31, 2009 having never been used.

Summary Evaluation

As noted, the Scheme was never used. Some commentators have criticized the effectiveness of the Scheme due to alleged design flaws.

Summary of Key Terms

Purpose: To support residential mortgage lending in the UK economy

Announcement Date January 19, 2009

Operational Date April 22, 2009

Date of First Guaranteed Loan Issuance N/A

Issuance Window Expiration Date Originally October 22, 2009; extended until December 31, 2009

Program Size £50 billion

Usage No usage

Outcomes N/A

Notable Features Specialized lenders excluded despite their importance to relevant market; terms less attractive than already existing program

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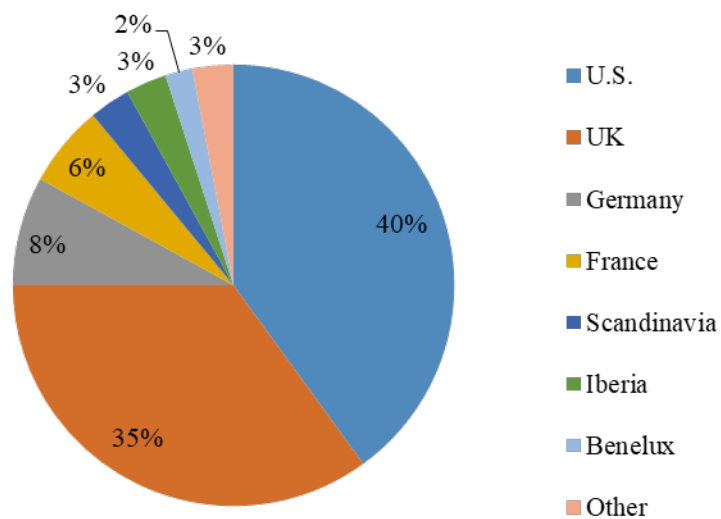
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I. Overview

Background

The key structures of housing finance in the UK in the years leading up to the global financial crisis of 2007-09 consisted of retail deposits, secondary market funding and wholesale interbank lending. Although retail deposits were the major funder of UK mortgages, secondary market funding, which included covered bonds and residential mortgage-backed securities (RMBS), accounted for 31% of UK mortgage lending in 2006. (Housing Finance Review 2008) Investors in the UK RMBS market were heavily from the U.S., as seen in Figure 1.

Figure 1: Investors in UK RMBS, by country



Source: Mortgage Finance: Interim Analysis, July 2008.

In 2007, the collapse of the U.S. subprime mortgage market triggered a financial shock, and the shock quickly traveled beyond national borders. Compared to the U.S., the UK was reported to have fewer defaulting mortgage borrowers. Moreover, it was estimated that in the U.S. up to a quarter of all mortgage loans were subprime or near-prime, whereas in the UK market this percentage was much smaller. Additionally, most U.S. subprime lending was at heavily discounted initial rates, and was “non-recourse lending” incentivizing the mortgage borrowers to walk away from their debt once the equity in the property had been extinguished. (Crosby Final 2008)

Regardless of such differences in the UK mortgage market, U.S. investors' concern over the prospects of the U.S. housing market influenced their perception of UK mortgage-backed assets. And with the UK RMBS market substantially reliant on overseas investors, the U.S. investors' concern contributed to a downturn in the UK market. A November 2008 report on mortgage finance by Sir James Crosby (Crosby Report) stated that there was a "disappearance of a substantial section of the previous investor base" in mortgage-backed securities, draining liquidity from the RMBS market. Net lending secured on residential property totaled £37.4 billion during January – September 2008, compared to £84.7 billion during January – September 2007. (Crosby Final 2008)

The Crosby Report also argued that "[w]ithout intervention, the market in mortgage-backed securities won't return any time soon ..." and that "the inability to refinance existing mortgage-backed funding and the continuing pressures in wholesale funding markets ... [were] really hitting the banks' capacity to make new loans ...". The Crosby Report concluded that an "intervention which addresses the 'closure' of mortgage-backed funding markets will bring about increased competition and improve the availability of mortgage finance to homeowners and would be homeowners" and "such intervention should ensure that a cyclical correction in the housing market does not turn into something much more serious with all that would ultimately imply for the wider economy". In response to the Crosby Report, HM Treasury announced on January 19, 2009 that the £50 billion Asset-backed Securities Guarantee Scheme (Scheme) would be launched on April 22, 2009. (HMT Statement 2009).

Program Description

The Scheme, under which HM Treasury provided a guarantee for eligible newly issued RMBS, represented an extension of the 2008 Credit Guarantee Scheme for unsecured debt issuance by UK incorporated banks and building societies. (Market Notice 2009)

The Scheme aimed to support residential mortgage lending in the UK economy. It intended to (i) improve banks' and building societies' access to wholesale funding markets, (ii) help support lending to credit worthy borrowers, (iii) promote robust and sustainable markets over the long term, and (iv) protect the taxpayer by HM Treasury guaranteeing mortgage-backed securities backed by UK residential properties. (Market Notice 2009)

Institutions eligible to participate in the Credit Guarantee Scheme were also eligible to participate in this Scheme, and were required to use the pro forma application form available on the UK Debt Management Office website. (Market Notice 2009) The institution would submit a request for participation to HM Treasury. HM Treasury, in its discretion, issued an ABS Scheme Institution Certificate confirming the participation. The participating institution then would apply for an ABS Transaction Confirmation for its proposed ABS transaction. Again, it was under HM Treasury's discretion to confirm such application. (Rule 2009)

Eligible institutions included 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 had Tier 1 capital in an amount deemed appropriate by HM Treasury. Only

one entity within a corporate group was allowed to participate in the Scheme, but issuances under the Scheme were allowed to be made either by the participating institution or by its sponsored affiliated entities (Issuer). (Market Notice 2009)

There were two types of guarantee available under the Scheme. The first type was the credit guarantee, which ensured the timely payment of all amounts of interest and principal payable in respect of the eligible RMBS. The second type was the liquidity guarantee, which ensured that if an issuer failed to honor its obligation to purchase the eligible RMBS following an exercise of a put or call option under the terms of the eligible RMBS, then HM Treasury would purchase such RMBS from the holder. An eligible RMBS under the Scheme could only benefit from either a credit guarantee or a liquidity guarantee. (Market Notice 2009)

Eligible RMBS under the Scheme were to be (i) issued under stand-alone transactions or under established or newly established master trusts, which have been approved by HM Treasury at its sole discretion; (ii) denominated in a single currency; (iii) 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 (iv) listed on the regulated market of the London, Irish or Luxembourg Stock Exchanges. (Market Notice 2009)

Furthermore, any mortgages contained in the underlying mortgage pool of the eligible RMBS were required to meet certain requirements. Some of these requirements included that (i) each mortgage loan must have been made on or after January 1, 2008; (ii) each mortgage loan must have been secured by a valid first ranking mortgage, or the equivalent in Scotland, over a residential property located in the United Kingdom; (iii) 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; (iv) the weighted average LTV ratio of all the mortgage loans in the underlying pool must not have exceeded 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 (v) each mortgagor must not have had an adverse credit history. (Market Notice 2009)

Guarantees were originally to be provided only to eligible RMBS issued within 6 months of the commencement of the Scheme, but HM Treasury subsequently extended the period up to December 31, 2009. The maximum term of a guarantee was either up to 3 years or up to 5 years, and the participating institution's group could not have more than one third of the total guaranteed eligible RMBS with a 5-year term. (Market Notice 2009)

Issuers under the Scheme were required to provide periodic reports, at least quarterly, to the RMBS investors and HM Treasury. The disclosure in these periodic reports was to be in line with international best practice such as the "RMBS Issuer Principles for Transparency and Disclosure, Version 1" published by the European Securitisation Forum in February 2009. (Market Notice 2009)

Under the Scheme, HM Treasury was entitled to be indemnified for the amounts paid under the guarantee from the participating institution or the Issuer. Moreover, it could, under its discretion, require indemnification from any member of the corporate group to which the Issuer belonged. (Rule 2009) In addition, to participate in the Scheme, the participating institution had to pay a fee to HM Treasury in an amount equal to 25 basis points over its

median 5-year CDS spread during the period from July 2, 2007 to July 1, 2008, as determined by HM Treasury, and HM Treasury could charge an incremental fee in respect of guarantees of non-sterling denominated eligible RMBS. (Market Notice 2009).

Outcomes

There was no further extension of the issuance window for the Scheme and it expired on December 31, 2009. A report by the National Audit Office on December 15, 2010 states that the Scheme was not used.

II. Key Design Decisions

- 1. The British government introduced the Scheme as an extension of the Credit Guarantee Scheme adopted in October 2008.**
- 2. The Scheme was established pursuant to the authority of the Chancellor of the Exchequer to issue guarantees of debt.**
- 3. In accordance with State aid rules, the Scheme required European Commission approval to be implemented.**
- 4. The Debt Management Office, an executive agency of HM Treasury, administered the Guarantee Scheme.**
- 5. The size of the program was established at £50 billion.**
- 6. Institutions eligible for the Credit Guarantee Scheme were also eligible for this Scheme.**

Institutions eligible to participate in the Credit Guarantee Scheme were also eligible to participate in this Scheme, and were required to use the pro forma application form available on the UK Debt Management Office website. When the British government introduced the Credit Guarantee Scheme as part of the October 8, 2008 package of stabilization measures, it made eight major institutions² automatically eligible for participation “in recognition of their commitment to strengthen their aggregate capital position” by a collective £25 billion in Tier 1 capital pursuant to the Bank Recapitalisation Fund that was also part of the package. Other UK deposit-takers (including UK-incorporated subsidiaries of foreign institutions) and building societies could apply to be eligible, with eligibility contingent on a determination by HM Treasury that the applicant possessed sufficient Tier 1 capital. Applicants would also have their roles in the UK banking system and overall economy evaluated.

² Abbey National, Barclays, HBOS, HSBC Bank, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland and Standard Chartered.

The list of eligible institutions in the Scheme was narrower (limited to deposit takers and building societies) than recommended by the Crosby Report, which included not only banks and building societies but also specialist lenders. (Crosby Final 2008; Rules 2009)

Only one entity within a corporate group was allowed to participate in the Scheme, but issuances of RMBS under the Scheme could be made either by the participating institution or by its sponsored affiliated entities. (Market Notice 2009)

7. The securities eligible for guarantee under the Scheme were certain RMBS backed by residential mortgages over property in the UK.

When the Scheme was first announced, eligible securities to be guaranteed under the Scheme were RMBS, but the UK government also stated that HM Treasury would keep the scope of the Scheme “under review”. However, there was no extension of the Scheme beyond RMBS. (Market Notice 2009)

Eligible RMBS under the Scheme were required to be:

- issued under a master trust existing at April 22, 2009, the aggregate principal amount of the proposed issue of Eligible Securities not exceeding the Capped Amount³;
- denominated in a single currency of Sterling, Euro, US Dollars, Australian Dollars, Canadian Dollars, Swiss Francs, Yen or such other currency as approved by HM Treasury;
- 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
- admitted to the official list of the relevant competent authority or stock exchange (as the case may be) and admitted to trading on the regulated market of the London, Dublin or Luxembourg stock exchanges.

(Rule 2009)

Furthermore, any mortgages contained in the underlying mortgage pool of the eligible RMBS were required to meet additional requirements:

- each mortgage loan must have been originated on or after January 1, 2008;
- each mortgage loan must have been secured by a valid first-ranking mortgage, or (in Scotland) standard security, over a residential property located in the United Kingdom;
- the current balance of each mortgage loan could not exceed £500,000;

³ “Capped Amount” means the aggregate principal amount of eligible securities which could be issued if they were backed exclusively by the Proposed Pool in a stand-alone transaction; “Proposed Pool” means the pool of eligible mortgages which is proposed to be sold by the eligible institution to the master trust to back the proposed issue of eligible securities.

- LTV ratio of each mortgage at origination could not exceed 90% of the lower of the purchase price or the then most recent valuation of the mortgaged property;
- the weighted average LTV ratio of all the mortgage loans in the underlying pool could not 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;
- at least one full payment in respect of each mortgage loan must have been made;
- no amount of principal or interest in respect of each mortgage loan can have been in arrears at any time prior to the date of sale referred to above; and
- each borrower of each mortgage loan:
 - must have been a natural person;
 - must have satisfied the lending criteria that would be applied by a reasonable and prudent mortgage lender;
 - must not have been a “self-certified” borrower (but this does not refer to “fast-track” credit underwriting procedures); and
 - must not have had an adverse credit history. (Rule 2009)

8. There were two types of guarantees – credit guarantees and liquidity guarantees – available under the Scheme, and each issuance could only benefit from one type.

There were two types of guarantee available under the Scheme. The first type was the credit guarantee, which ensured the timely payment of all amounts of interest and principal payable in respect of the eligible RMBS. The second type was the liquidity guarantee, which ensured that if an issuer failed to honor its obligation to purchase the eligible RMBS following an exercise of a put or call option under the terms of the eligible RMBS, then HM Treasury purchased such RMBS from the holder. An eligible RMBS under the Scheme could only benefit from either a credit guarantee or a liquidity guarantee. (Market Notice 2009)

9. RMBS with maturities up to three years (or five years in special circumstances) could be issued under the Scheme.

A participating institution’s group could not have more than one third of the total guaranteed eligible RMBS with a 5-year term. The government does not appear to have established minimum maturity requirements for eligible debt.

10. Only RMBS issued in sterling, euros, US dollars, Japanese yen, Australian dollars, Canadian dollars, Swiss francs were eligible.

Additional currencies could be made eligible via a determination by HM Treasury.

11. There do not appear to have been caps on an individual institution’s participation in the Scheme.

12. The fee for issuing RMBS pursuant to the Scheme varied based on the soundness of the issuing bank.

To participate in the Scheme, the participating institution had to pay a fee to HM Treasury in an amount equal to 25 basis points over its median 5-year CDS spread during the period from July 2, 2007 to July 1, 2008, as determined by HM Treasury, and HM Treasury could charge an incremental fee in respect of guarantees of non-sterling denominated eligible RMBS. (Market Notice 2009).

13. Issuers of RMBS guaranteed by the Scheme were required to produce periodic reports to its investors and HM Treasury.

The disclosure in these periodic reports was to be in line with international best practice such as the “RMBS Issuer Principles for Transparency and Disclosure, Version 1” published by the European Securitisation Forum in February 2009. (Market Notice 2009).

14. The deadline for issuance under the Scheme was initially October 22, 2009 but was later extended to December 31, 2009.

Guarantees were originally to be provided to eligible RMBS issued within 6 months from the start of the Scheme, subject to any extension at the discretion of HM Treasury. HM Treasury subsequently extended the issuance window of the Scheme up to December 31, 2009. (EU 2009, Market Notice October 2009).

III. Evaluation

There do not appear to be any significant reports or studies analyzing the outcomes of the Scheme. However, a published report by the Communities and Local Government Committee (CLGC) contains a statement by John Heron of the Intermediary Mortgage Lenders Association criticizing the effectiveness of the Scheme in restarting mortgage lending. CLGC is a select committee of the House of Commons in the Parliament of the UK. Heron argues that the Scheme did not work from a mortgage lender’s standpoint because:

- it could only be accessed by banks and building societies, which meant more specialist lenders – the lenders that typically support the private rental sector and have customers in greater financial difficulty – did not have access;
- it only covered AAA-rated securities; and
- the guarantee was only for three or five years’ term and if a lender borrowed with a guarantee from the Scheme, it could be required to repay that money in three or five years’ time, which is not satisfactory for long-term funding of mortgages that may be 20 or 25 years. (CLGC 2009)

Rob Thomas, a senior policy advisor at the Council of Mortgage Lenders, and Kevin Ingram, a partner at Clifford Chance, have questioned the effectiveness of the Scheme as it was only made available to deposit takers against the advice of the Crosby Report. Moreover, both Thomas and Ingram point out that these deposit takers already had access to the Credit Guarantee Scheme whose terms were more attractive than the Scheme's. (Thomas 2010; Ingram 2009).

Ingram also criticized a certain design aspect of the Scheme, comparing it to TALF in the U.S. Both are aimed at restarting the securitization market by tempting investors to participate in the market, However, whereas TALF provided the investors of eligible asset-backed securities resources to pay for their investments, the Scheme only focused on the guarantee side of the investments and the investors would still have to raise the funds to invest in the securitization market when such funding was hard to obtain in the first place. (Ingram 2009).

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- [Market Notice: Extension of Entry Window for the Government's Asset-backed Securities Guarantee Scheme](#), October 28, 2009
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- [The Government's Deed of Guarantee](#), April 22, 2009
- [The Rules of the Scheme and Pro Forma Application Forms](#), April 22, 2009
- Thomas, Rob. [The Role of Mortgage Securitisation in the Financial Crisis and how to Restore the Market's Health](#), Housing Finance International (Online), Autumn 2010

V. Key Program Documents

Summary of Program

- [The Rules of the Scheme](#), April 22, 2009, *rules set forth on how the guarantee provided under the Scheme works*
- [Market Notice: Extension of Entry Window for the Government's Asset-backed Securities Guarantee Scheme](#), October 28, 2009, *HMT announcement extending the period of the Scheme.*
- [Market Notice: Outline of the UK Government's 2009 Asset-backed Securities Guarantee Scheme](#), UK Debt Management Office, April 22, 2009, *HMT document outlining the terms of the Scheme*

Implementation Documents

- [Form of ABS Scheme Institution Certificate](#), *HMT document certifying that the named institution is a registered participant in the Scheme.*
- [Form of Application for ABS Transaction Confirmation](#), *a form submitted to apply for participation in the Scheme.*
- [Form of Application for ABS Eligibility Certificate](#), *a form applying for certification of the ABS to be guaranteed under the Scheme.*
- [Form of ABS Transaction Confirmation](#), *HMT providing confirmation that the named ABS transaction is guaranteed under the Scheme.*
- [Form of ABS Eligibility Certificate](#), *HMT certifying that the named securities are guaranteed under the Scheme.*
- [Form of Closing Certificate](#), *issuer of the eligible securities certifying that the transaction and issued securities comply with the rules set forth by HMT.*
- [Form of Eligible ABS Institution Counter-Indemnity in respect of \[the Guaranteed Credit Liabilities\]\[the Guaranteed Liquidity Liabilities\]](#), *form provided to HMT by issuer setting forth terms for indemnifying the amount paid out under the guarantee.*

- *Form Fee Letter, UK Debt Management Office's letter providing the amount of the fee for participating in the Scheme.*
- [Form of Offering Document Disclosure](#), *disclosure form to be attached to the offering circular of the issued securities stating that the issued securities were guaranteed by the Scheme.*
- [Relevant Guarantor Transaction Legal Opinions](#), *a legal opinion confirming certain items of the documentation under the Scheme.*
- *Form of Demand, form to be used by appropriate party to demand payments under the guarantee from HMT.*

Press Releases/Announcements

- [Statement on financial intervention to support lending in the economy, HM Treasury, January 19, 2009](#)

Reports/Assessments

- [Ingram, K. If securitization is Dead, why do so many government schemes use it? Capital Markets Law Journal, October 2009](#)
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- [Communities and Local Government Committee Eighth Report, Housing and the Credit Crunch: Follow-up, July 7, 2009, a report by Communities and Local Government containing a statement criticizing the effectiveness of the Scheme.](#)