EUROPEAN COMMISSION

Brussels, 27.10.2009
C(2009)8309 final

COMP Operations

Subject: **State Aid N 550/2009 – UK**
Prolongation of the Asset Backed Securities guarantee Scheme

Sir,

I. PROCEDURE

(1) On 8 October 2009 the UK notified a request related to the prolongation of its asset-backed securities scheme. Prenotification contacts had taken place from 12 August 2009 onward.

(2) The original measure was notified on 17 April 2009 and approved by the Commission on 21 April 2009[1]. The scheme subsequently entered into force on 22 April 2009.

II. DESCRIPTION

The original measure

(3) The scheme is aimed at supporting new lending to homeowners and promoting more robust and sustainable capital markets in the longer-term by establishing a long-term investor base in mortgage-backed securities. The final goal is restarting securitization in the UK.

Eligible institutions

(4) Eligibility conditions regarding participating institutions are aligned with those of the Credit Guarantee Scheme (hereinafter the "CGS"). The institutions eligible

[1] State Aid N 232/2009 "Asset Backed Securities Scheme", OJ C 147, 27.06.2009, p. 3.

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are thus UK incorporated banks (including UK subsidiaries of foreign institutions) that have a substantial business in the UK and building societies. A UK incorporated bank has a "substantial business" for this purpose if it is eligible to sign up for the Bank of England's Standing Facilities in accordance with its Framework for the Bank of England's Operations in the Sterling Money Markets (i.e., with eligible liabilities above £500 million). However, any other UK incorporated bank (including a UK subsidiary of a foreign institution) may apply to take part in the notified scheme. The guarantee will be provided by Her Majesty Treasury (hereinafter "HMT") in relation to eligible instruments issued by a special purpose vehicle sponsored by eligible bank or building society.

Eligible securities

(5) Only AAA rated residential mortgage-backed securities (RMBS) would be eligible under the scheme. The bonds must be AAA rated by at least two credit rating agencies at the time of issuance and independently of the applicable UK government's guarantee.

(6) The Guarantee may be applied to stand-alone (i.e., one-off) issuances or to instruments issued off newly established or existing programmes (including existing master trusts), in each case approved by HMT at its sole discretion, such discretion to be applied in a consistent manner with reference to transparent and non-discriminatory criteria. The UK authorities commit not to allow master trusts with multiple sellers outside the same banking group into the Scheme.

(7) The guarantee shall apply to instruments as they are issued and is thus restricted to issuances posterior to the entry into force of the scheme. However, the Guarantee may apply to RMBS collateralised by mortgage loans that have already been transferred into existing master trusts.

(8) In addition, the mortgages supporting the bonds shall conform to a number of supplementary conditions : a) to have been originated after 1 January 2008; b) to have at the level of the pool an average loan-to-value of 75 % on a weighted basis and for any included single mortgage a loan-to-value of less than 90 % ; c) be secured by a valid first ranking mortgage, or standard security (in Scotland) located in the United Kingdom ; d) not to be a self-certified mortgage.

(9) The collateral pool will be subject to external audit. There will be regular (monthly) reporting in line with industry best practice at both the level of the collateral pool and individual loan. Banks and building societies accessing the scheme have to follow international standards and best practice on underwriting, disclosure, reporting and valuation.

(10) Eligible institutions are not granted access to the guarantee for acquired RMBS backed by mortgages that they originated.

(11) As in the CGS[2], eligible instruments may be denominated in sterling, euro, US dollar, yen, Australian dollar, Canadian dollar, Swiss franc and any other currencies as may be determined by HMT.

Types of guarantees

(12) The Guarantee comprises an option between a credit guarantee and a liquidity guarantee. These guarantees are alternative and not cumulative.

(13) The first type of guarantee (hereinafter the "Credit Guarantee") is an unconditional and irrevocable guarantee of the timely payment of all amounts of contractually due payments of principal and interest from the relevant issuer in respect of the eligible instruments for the duration of the Credit Guarantee (up to 5 years, see section III.4 hereunder). The terms and conditions of the instruments have to contain the details of the obligations of the issuer to the holders of the instruments, including obligations to pay principal and interest. The Credit Guarantee will only apply to payments of principal and interest that are contractually due during the lifeline of the guarantee. Therefore, if the issuer fails to make contractually due payments of principal or interest during the guarantee period, the government will be under an obligation under the Credit Guarantee to make those contractually due payments of principal or interest.

(14) The Credit Guarantee only applies to payments of principal and interest that are contractually due during the guarantee period. The Credit Guarantee does not apply to failures to make payments of interest and principal which are contractually due after the guarantee period.

(15) In case the issuer fails to make contractually due payments of principal or interest during the guarantee period, recourse of investors against the issuer will be limited to the assets, even if there is a legal default. Consequently, following a legal default on contractually due sums, the recoveries by investors may still be limited. The obligations which are contractually due will be specifically identified in the transaction documentation including in the certificate to be issued by HM Treasury evidencing the issue of the Guarantee of the bonds in question.

(16) The second type of guarantee (hereinafter the "Liquidity Guarantee") is designed to address the consequences of the mismatch between the duration of the guarantee and the maturities of the RMBS securities which are much longer (typically more than thirty years). The liquidity guarantte enables to cover the purchase of the RMBS instruments by the issuer or originating bank or building society at a date prior to the final legal maturity of the bonds, even if such a purchase occurred within the guarantee period.

(17) The Liquidity Guarantee is a conditional but irrevocable guarantee of the obligation of the originating bank or building society, or issuer, to purchase the

[2] See State Aid N 650/2008 " UK Modifications to the Financial Support Measures to the Banking Industry in the UK" OJ C54, 7.3.2009, p.3

eligible instruments on a specified date or dates, as agreed with HMT prior to the issue of the eligible instrument, prior to the final legal maturity of the instrument.

(18) A liquidity guarantee will only be issued in respect of an eligible instrument where the originating bank or building society, or issuer, has an obligation to purchase the instrument on a specified date or dates (e.g., because the investor has a put option, or there is a mandatory call) but not later than 5 years after the issuance date. The Liquidity Guarantee only applies to the obligation to purchase the instruments on these specific dates.

(19) The two conditions to be fulfilled before the Liquidity Guarantee can be called are: (i) that on the specified date or dates the originating bank or building society, or issuer, has defaulted on its obligation to purchase the eligible instrument; and (ii) that the holder of the eligible instrument transfers ownership of the eligible instrument to HMT against payment under the Liquidity Guarantee. Once the Liquidity Guarantee has been called, HMT will purchase the eligible instruments at the relevant purchase price, as explained above.

(20) HMT will have recourse both to the originator of the assets, as well as the secured asset pool in the event of the issuer's failure to discharge any obligations to the bondholder.

Recourse to the State

(21) Prior to issuing the guarantee, the UK authorities require the originating bank or building society to sign a counter-indemnity. Under that counter-indemnity, the originating bank or building society will be under a legal obligation to reimburse the UK authorities for payments made by the UK authorities under the Guarantees and its losses arising from the operation of the guarantee.

(22) The UK authorities benefit from double recourse: firstly, recourse to the originating banks and, in the case of a guarantee on RMBS issued by a master trust, any entity within the banking group (including entities registered outside the UK); secondly, they acquire the rights of bondholders which are collateralised with the pool of mortgages.

(23) In order to ensure that banks using master trusts do not obtain an advantage over banks doing stand alone issuances by virtue of being able to securitize mortgage loans that do not conform to the additional eligibility criteria, the HMT intends that banks using existing master trusts will be required to demonstrate that they will place into those structures the same volume of new mortgage loans as they would have to place into a hypothetical non-master trust structure to achieve the equivalent volume of guaranteed bond issuance.

(24) The aggregate principal amount of the proposed issue of Eligible Securities must not exceed the Capped Amount in which (i) "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 ; (ii) "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 ; (iii) "eligible mortgages" means mortgage loans which satisfy the conforming criteria specified.

(25) The Rules of the ABS Scheme require that any credit enhancements are fully utilised as if the UK Government Guarantee had not been issued. In other words, the terms will not permit the Issuer, or other relevant parties, to act in such a way that these credit enhancements are not utilised to the full extent of their availability.

Term of the guarantees

(26) The decision of 21 April 2009 provides that the guarantees have maturities of up to three years, with the possibility of up to a third of the total guaranteed debt being granted guarantees up to five years.

Budget and allocation

(27) The maximum overall amount of guarantees to be granted within the scheme shall not exceed £ 50 billion.

(28) […][*]

(29) […]

Fee

(30) Irrespective of the nature of the guarantee, its price shall be consistent with the remuneration applicable to the CGS. The fee payable to HMT on any guaranteed issues is 100% of the participating institution's median five-year Credit Default Swap (CDS) spread registered between 2 July 2007 and 1 July 2008[3], as determined by the HMT. Thanks to this, a measure of the institution-specific risk has been taken into account. A fixed component should be added, in line with the CGS fee structure. However, this add-on has to take into account the collateralised nature of the guarantee. Thus, the add-on fee is 25bp instead of 50bp.

[*] Confidential information.

[3] The period covered for the CDS spread is different than that proposed in ECB guidance (Jan 2007 end Aug 2008) which has been used as a reference by the Commission. However, the UK authorities informed the Commission that by having a shorter period diminishing the influence of "pre-crisis" situation, the spread in the UK scheme is most of the time higher than it would have been according to ECB guidance.

Report on the operation of the scheme

(31) The UK commited to present a report to the Commission every 6 months on the operation of the scheme.

(32) The scheme was launched on 22 April 2009.[4] Market feedback received by the UK authorities on the scheme has been positive. As yet, however, no guarantees have been issued under the scheme.

(33) According to the UK authorities, banks have not used the ABS Scheme because of unforeseen technical issues with the design of the scheme, and are not expected to be able to use the scheme as long as these issues remain.

The notified measure

(34) The UK government is seeking an extention of the scheme until 31 December 2009 as well as a modification of the scheme's characteristics regarding one aspect.

Extension of ABS Scheme to 31 December 2009

(35) The original scheme was approved by the Commission for 6 months. The UK seeks to extend the scheme to 31 December 2009 to allow banks a sufficient period of time to issue guaranteed RMBS under the amended scheme rules.

Duration of the guarantees

(36) The UK authorities report that it would assist issuance if issuers were able to issue 5 year guaranteed RMBS. This is because the cost of raising guaranteed RMBS issuance is relatively flat across the maturity profile of the securities, whereas the cost of raising 5 year unsecured funding is greater than the cost of raising 3 year unsecured funding.

(37) The existing scheme rules allow for up to one-third of the guaranteed debt actually issued to have a 5 year length. This implies that banks are required to issue guaranteed securities guaranteed up to 3 years before (or at least simultaneously with) any 5 year issuance. However, under other guarantee schemes approved by the Commission, a third of the overall budget may be used for guarantees having a duration between 3 and 5 years.

(38) In order to facilitate take-up of the scheme alongside the CGS and deliver on the scheme's objective to restore securitisation markets, the UK government intends to modify the ABS Scheme to allow banks to issue up to one-third of the total size of the scheme (i.e £16.67 billion) at 5 year length, with the rest of the budget reserved for guarantees up to 3 years. To ensure that the scheme remains accessible to all banks, the UK government intends to cap the guarantees available to a single institution to one third of the overall budget. Further, the one-third cap will apply to issuance of 5-year debt by an institution (in other words,

[4] http://www.dmo.gov.uk/index.aspx?page=CGS/ABS_about

the amount of 5-year debt a single institution can issue will be one-ninth of the overall budget).

III. Position of the UK

(39) The UK government submits that the notified modifications to the ABS Scheme (insofar as they may contain aid) remain compatible with the common market pursuant to Article 87(3)(b) of the EC Treaty as aid to remedy the continuing serious disturbance in the economy of the United Kingdom.

(40) With the exception of a single issuance in September by Lloyds Banking Group plc of £4bn of RMBS, the UK Government states that the RMBS securitisation markets remain closed for public issuance and the purpose of the Scheme is to help reopen those markets. The modified scheme strikes the correct balance between maximising the impact of the ABS Scheme on financial and wider economic stability while ensuring that market-based (i.e. non-State guaranteed) RMBS issuance is not crowded-out now or when better market conditions return and are consistent with the principles established in the Commission's Communication of 13 October 2008 and decisions taken in accordance with those communications.

IV. Assessment

Existence of state aid

(41) As set out in Article 87(1) of the EC Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market, save as otherwise provided.

(42) For the reasons indicated in its decisions in the above-mentioned cases N 232/2009, the Commission considers that the Scheme constitutes State aid. The notified prolongation and modifications do not affect that conclusion. The Scheme, with the notified changes, remains State aid within the meaning of Article 87(1) of the EC Treaty.

Compatibility of the Scheme

(43) For reasons indicated in the original decision[5] the Commission found the Scheme to be compatible with the common market under Article 87(3)(b) of the EC Treaty, as it meets the relevant criteria of appropriateness, necessity and proportionality.

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[5] N 232/2009, mentioned above.

(44) Given that the notification does not change to the substance of the Scheme, it is only necessary to assess whether the finding of compatibility holds true also of in view of the extension of the Schemes' validity and the amended limit to the term of the guarantees.

(45) The Commission acknowledges that the global financial crisis is still ongoing and takes note that the functioning of the UK financial system still remains seriously affected and continues to have an adverse impact on the real economy, given the importance of securitization for financing the UK residential housing market and the importance of the latter in UK's economy. The Commission thus judges that perturbations affecting the RMBS securitization markets are causing a serious disturbance to the UK economy and that the Scheme is necessary to remedy this. As markets are unlikely to have returned to normal before the end of the year, the Commission considers that the contemplated prolongation until 31 December 2009 is appropriate and necessary to remedy this situation.

(46) Furthermore, the Commission notes that the extension is limited in time to two and half months and thus limits effectively potential distortion of competition. Any further extension will require the Commission's approval and will have to be based on a review of the developments in financial markets and the Scheme' effectiveness. This change is therefore proportionate to the purpose of the Scheme.

(47) The amendment set out in paragraph 37 provides enough safeguards to consider that the scheme does not favour any particular institutions and is in line with other decisions adopted by the Commission.

(48) The Commission consequently finds that the notified changes to the Schemes are compatible with the common market under Article 87(3)(b) of the EC Treaty.

V. CONCLUSION

The Commission finds that the Scheme constitutes State aid within the meaning of Article 87(1) of the EC Treaty.

Since the Scheme satisfies the conditions for aid under Article 87(3)(b) of the EC Treaty, it is compatible with the common market. The Commission has accordingly decided not to raise any objections to the prolongation of the Scheme until 31 December 2009 and the aforementioned amendment of the limit to the use of the guarantees per maturity.

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Your request specifying the relevant information should be sent by registered letter or fax to:

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Yours faithfully,
For the Commission

Neelie Kroes
Member of the Commission