MARKET NOTICE - EXPANDING ELIGIBLE COLLATERAL IN THE DISCOUNT WINDOW FACILITY

1. This Market Notice provides details on the Bank's requirements for accepting portfolios of loans as collateral in the Discount Window Facility (DWF). These detailed criteria have been developed following feedback on the consultation paper[1] issued by the Bank on 17 March 2010, and build on the high level proposals published by the Bank in its Market Notice[2] of 19 July 2010.

Overview

2. The Bank will begin accepting loan portfolios as eligible collateral in the DWF from April 2011, and intends to process applications from interested participants from January 2011.

3. There will be a two part eligibility approval process. The first will be an assessment of a participant's lending and funding policies, procedures and controls, including a legal review of the participant's capacity to transfer loan collateral to the Bank. The second will be a detailed review of the individual portfolios of loans proposed to be delivered as collateral in the DWF. DWF participants will be required to complete both stages when seeking to provide loan portfolios as collateral for the first time. For subsequent loan portfolios of the same type, it is envisaged that a participant will be required to complete only the second part of this process. Participants may proceed with both parts in parallel.

Participant Eligibility Approval Process

Review of a participant's lending policies, procedures and controls

4. The Bank will require the participant to provide information on its lending policies, procedures and controls. Specifically, the Bank will require the following information and documents to be submitted to the Bank for review:

- Full details of underwriting/lending policies and procedures in place at the time of origination for each loan asset class to be submitted to the Bank.
- Details of the relevant lending products offered, the participant's marketing strategy and the distribution of its lending products (for instance, by branch network, authorised intermediaries and/or telephone sales).

[1] Available at: http://www.bankofengland.co.uk/markets/money/publications/condocmar10.pdf
[2] Available at: http://www.bankofengland.co.uk/markets/marketnotice100719.pdf

- Copies of all necessary licences obtained by the participant to carry on its relevant lending business.

- Details of any legislative or regulatory action or change, planned or discussed, that might materially impact on the participant's relevant lending business.

- Internal management information showing detailed arrears data (by origination brand or business line), where applicable.

- Details of the policies and procedures for enforcement of loan arrears, restructurings, and defaults/foreclosures.

- Details of the relevant arrears capitalisation policies and associated controls together with the relevant management information on volumes and values of capitalised arrears.

- Descriptions of relevant loan credit rating and IT systems in use, including an outline of the key process controls (e.g. what prevents the system from assigning an individual loan to more than one asset portfolio).

- Details of the process and controls surrounding the reporting of the relevant loan portfolio data on a monthly basis. The participant will need to describe how compliance with the Bank's eligibility criteria will be achieved on an ongoing basis.

- Copies of all internal audit reports issued in the last five years (or 2 internal audit cycles) covering the relevant loan asset classes that the participant seeks to submit to the Bank. Additionally the participant will need to declare that the reports provided represent a complete and accurate list of relevant internal audit reports. The Bank reserves the right to request an independent, third party review if the internal audit reports are deemed to be of poor quality, or do not cover all the areas which the Bank considers relevant. Costs of a third party review would be borne by the participant. Internal audit reports should focus (at a minimum) on systems, processes and controls relating to a participant's underwriting, loan origination, securitisation (if relevant), portfolio monitoring and risk management. Where available, the Bank would expect to review the internal audit reports relating to each loan asset type to be considered for the DWF.

5. The Bank's review will, among other things, look to confirm that the policies, procedures and controls in place around lending are consistent with those of a reasonable, prudent lender, as determined by the Bank. It will also assess the participant's adherence to those lending policies and procedures.

<u>Legal review of a Participant's capacity to transfer loan collateral to the Bank</u>

6. Participants may have restrictions on disposing of assets to a third party, or encumbering assets based on their own existing funding documentation with third parties

(e.g. as a result of having granted a negative pledge). Participants would need to review any funding documentation for contractual provisions that would limit their ability to pre-position and transfer their loan portfolios as collateral. The participant will be required to represent and warrant to the Bank in the Annex to the Terms and Conditions for SMF Transactions that there are no restrictions on its provision of the loans as collateral and that funding and other documentation is not violated. In addition, for the purposes of transferring a portfolio of loans as collateral, the participant will be required to instruct counsel to provide a legal opinion confirming that the portfolio is freely assignable to the Bank in accordance with the terms of the participant's loan documentation (or that the participant is otherwise able to declare a trust over the portfolio in favour of the Bank).

Loan Portfolio Eligibility Approval Process

Eligibility criteria

7. Individual loans should meet the following eligibility criteria.

   i) The loan must be a residential mortgage, consumer loan (excluding credit cards), commercial real estate loan or corporate loan to a non-bank (including small and medium-sized enterprises);

   ii) The borrower must be domiciled in the United Kingdom with, in the case of a corporate, its centre of main interest in the UK. The Bank will consider other jurisdictions subject to the participant providing legal opinions satisfactory to the Bank confirming that the transfer of loans will be enforceable in all the relevant jurisdictions;

   iii) The loan must be denominated in sterling, euro, US dollars, Australian dollars, Canadian dollars, Swedish krona or Swiss francs;

   iv) No borrower should currently be in default under any loan (including payment default or arrears). In order to minimise operational complexity for participants, the Bank will not require the removal of loans in arrears from loan portfolios that have previously been delivered to the Bank, but will assign these loans no value;

   v) The loan and, where applicable, the security must be governed by the laws of England and Wales, Scotland or Northern Ireland;

   vi) The loan must be fully drawn, senior and for a fixed term;

   vii) The residual loan maturity must be between three months and forty years;

   viii) The underlying loan documentation must not include restrictions on the disclosure of communications, financial and/or other information to the Bank, subject to appropriate confidentiality undertakings;

ix) The loan must have been originated by the participant (or where applicable, third party lender) in accordance with the participant's (or where applicable, third party lender's) standard lending criteria.

x) In the event that the participant's documentation lists the owner of a loan asset as being a legal entity other than the participant, evidence, such as a formal legal opinion from internal counsel, that at the time of the transaction the participant was the legal and beneficial owner of the loan asset will be required.

8. Additionally, the loan must have a low expected probability of default, as determined by the Bank, and evidenced by a participant's internally or externally assigned rating, or as otherwise agreed with the Bank. The valuation of any loan portfolio will in part depend on the level of portfolio diversification. The Bank may apply both maximum borrower concentration limits and maximum industry concentration limits as relevant.

9. The Bank reserves the right to reject any loan portfolio or individual loan offered or provided as collateral, for any reason, at any time.

10. The following types of loans will not be eligible:

- Loans to banks, building societies, bank holding companies, and companies within banking groups;
- Loans under partially drawn term loan facilities, where the lender of record may be legally required to provide further advances, or where part of the term loan is made available by letter of credit/bank guarantee;
- Term loan facilities where the Bank's eligibility criteria are met only as a result of any letters of credit/bank guarantees;
- Loans under a revolving credit facility (including credit cards);
- Loans where a subordinated creditor has material control over the exercise of the rights of the senior lender(s), or where the rights of the senior lender(s) are subject to onerous restrictions;
- Subordinated debt (including second ranking loans);
- Leveraged loans.

11. As described below due diligence, including a legal review and portfolio audit, will be required to ensure these requirements are met.

Loan Portfolio Audit

12. In order to pre-position loan portfolios in the Discount Window Facility, participants will be required to undertake a loan portfolio audit. The aim of the loan portfolio audit is to verify the existence, ownership and quality of the loans. The audit will be conducted by an independent third party - selected by the participant (but agreed upon with the Bank) - and based on a random sampling approach (typically at a 95% confidence level). Costs of the audit will be borne by the participant. The Bank may request a different level of confidence on a case by case basis.

- The Bank reserves the right to require such audits to be updated. For loan portfolios with a relatively high rate of change of composition the Bank may require the participant to provide updated portfolio audits on an annual basis. For other portfolios the Bank may require updates on a less frequent basis. The loan portfolio audit will comprise of 1) data validation and analysis, 2) detailed due diligence tests or "Agreed Upon Procedures" and, in certain circumstances, 3) a loan portfolio valuation.

- *Data validation and analysis*

  Independent third party service providers will be asked to analyse data supplied by the participants to confirm compliance with basic eligibility requirements for the relevant loan type. Any loans not meeting the eligibility criteria will be reported.

- *Due diligence tests - Agreed Upon Procedures*

  The agreed upon procedures (AUPs) will be based broadly on those used in securitisations of equivalent assets. Participants will be required to divide each loan portfolio into a number of discrete, homogenous portfolios of assets reflecting key characteristics of the loans such as: 1) the dates over which they were originated, 2) the brands under which they were issued, 3) the systems on which they were recorded, 4) the lending criteria for the loans. For each homogenous portfolio within the loan portfolio, participants are required to complete a set of AUP tests (available upon request).

- *Loan Portfolio Valuation*

  In certain circumstances, the Bank may request a participant to obtain key default prediction information from the third party service provider conducting the loan portfolio audit. The Bank will specifically be interested in the assumptions for probability of default, loss given default and exposure at default at the portfolio level.

Loan Portfolio Legal Review

13. Participants will be required to appoint external legal counsel to review samples of loan files to confirm, among other things, that there are no variations from the standard loan document or other matters which would undermine the loans effectiveness as collateral for the Bank and compliance with the eligibility criteria. Any costs would be borne by the participant. Key criteria for assessment are:

- The location, jurisdiction and governing law of the assets;
- That the assets are valid, binding and enforceable against the underlying borrower;
- That the documentation for the asset does not prevent the mechanism by which the asset is delivered as collateral being effective, or impose conditions for the delivery mechanism to be effective, such as the need to advise or obtain the approval of the borrower;
- Compliance with consumer credit requirements;
- That the loan was originated in the ordinary course of business and has not been terminated, redeemed or cancelled; and
- That the participant has an effective charge over the property used to secure the loan.

14. The Bank will risk-manage the existence of set-off rights through its haircuts; participants may therefore wish to remove these rights in new loan agreements, to the extent they are permitted to do so.

Pre-Positioning and Drawing against a Loan Portfolio

15. A participant must pre-position loan portfolios with the Bank before requesting a drawing against them. Pre-positioning cannot be undertaken until the eligibility approval process has been completed, and the Bank has made a decision to deem the portfolio eligible.

16. Pre-positioning involves the participant:

- submitting a list of the loans in the loan portfolio in the form required by the Bank;
- submitting an original signed power of attorney (a standard will be available on the Bank's website from January 2011) which gives the Bank the ability, amongst other things, to exercise all of the participant's rights in respect of the loans;

- submitting a legal opinion (a standard will be available on the Bank's website from January 2011) in form and substance satisfactory to the Bank that the transfer is enforceable; and

- submitting such other documentation as the Bank may require.

17. Pre-positioned portfolios of loans must be transferred to the Bank by one of the following mechanisms: equitable assignment, declaration of trust, or a grant of security (first fixed charge). The form of transfer will be determined by the Bank, but may vary between loan portfolios depending on the type of underlying loans. Transfer occurs automatically upon drawdown, at which point participants will be bound by one or more annexes to the Terms and Conditions for the Sterling Monetary Framework (SMF), which supplement and amend the SMF Terms for particular types of loan. The forms of annex will be made available on the Bank's website from January 2011. Where loans are to be the subject of a declaration of trust, the participant will also be required to enter into a trust deed. Legal title will not be transferred either on pre-positioning or when an advance is made, except in the case of a participant default. The permissible forms of transfer may be amended in due course.

18. Loans in the pre-positioned pool are still owned by the participant and can be used as the participant wishes prior to drawing against the portfolio as DWF collateral, at which point they would be transferred to the Bank using the agreed transfer mechanism.

Ongoing reporting requirements

19. Information is required on a regular basis to enable ongoing monitoring and valuation of the loan portfolio once pre-positioned. Where applicable, the information requirements will be consistent with the Bank's ABS loan-level reporting requirements. Templates for asset classes covered by the ABS transparency arrangements will be available on the Bank's website at http://www.bankofengland.co.uk/markets/money/eligiblecollateral.htm; other loan type data templates are available upon request. Data will need to be provided on a monthly basis. The Bank would require weekly reporting of nominal loan balances. Initially, to minimise operational complexity, the Bank will allow monthly reporting of nominal loan balances, but will take into account the frequency of reporting in its haircuts calculations.

<u>Drawdown process</u>

20. Once the participant's loan portfolio is approved as eligible collateral, and pre-positioned in the DWF, the process for entering into a DWF transaction takes the same form

as a drawing against pre-positioned securities. The transaction notice must specify which of the pre-positioned loan portfolios is to be transferred to the Bank on the drawdown date.

21. Transfer of the beneficial interest in or declaration of trust over the loans will take place on the drawdown date, once the Bank has approved the drawing.

22. Except following a participant default, the Bank would not normally expect to physically receive the cash flows generated by loan portfolios during the drawn period, nor would it normally require the participant to establish segregated accounts for the collection of these payments prior to any enforcement of its beneficial interest in the loans.

23. It is possible to draw against a combination of loans and securities.

24. Loans will be classed as Level D collateral for the purpose of calculating the fee payable on DWF drawings.

Termination

25. On termination of a transaction, the Bank will reassign to the participant the beneficial interest in the loans. If the participant wishes to re-pre-position the loans, it can do so provided the loans continue to satisfy the eligibility criteria.

Additional Information

Loan haircuts and valuations

26. The Bank will apply haircuts to loan portfolios. The process of analysing different types of loan assets will be in line with the methodology applied to securities backed by equivalent assets and will be dependent on the credit quality of the loan portfolios. Where available, the loan portfolios will be valued taking into account prevailing market prices.

Costs

27. Any costs incurred by the participant or any external advisers, including those of the Bank's professional advisers, in connection with this process will be borne by the participant.

Bank of England
30 November 2010