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Briefing note January 2014

RMBS in the UK: Recent Developments in an Evolving and Resilient Market

2013 saw modest activity in the UK residential mortgage backed securitisation space, but an absence of prime issuance created an opportunity for non-conforming and more bespoke trades. As 2014 kicks off, Clifford Chance considers the prospects for the year ahead, in light of structural challenges and ongoing regulatory change.

The last year saw modest new issue volumes for UK RMBS, whether on a standalone basis or through master trust structures. Across Europe the story was of weak activity levels, with the Association of Financial Markets in Europe revealing that in the first nine months of the year, UK RMBS issuance stood at €7,261mn as compared to €39,504mn for the whole of 2012.

The Bank of England's Funding for Lending Scheme (FLS) provided an alternative source of funding for lenders, but decreased volumes could also be attributed to greater diversification by financial institutions between wholesale and retail funding, volatility in the secondary market, the recovery of the senior unsecured market, and the general decrease in funding needs of some lenders – taking into account the high levels of issuance in 2012. Many lenders had sufficient liquidity not to need to access the RMBS market, and were focussed more on raising regulatory capital than financing their mortgage book.

The decrease in supply of UK prime RMBS, and tightening in pricing, created an opportunity for non-conforming transactions, near-prime deals, and those involving buy-to-let mortgages. Though non-conforming securitised portfolios have largely related to mortgages originated pre-crisis, a combination of substantial credit enhancement for the most senior class of notes, low arrears and defaults, attractive spreads and, in some cases, overcollaterisation has proved a compelling investment proposition for investors searching for yield. In comparison to the experience in the USA, non-performing mortgages had performed relatively well in the UK through the crisis and investor confidence in the asset class remained intact.

These transactions have also provided an efficient refinancing mechanism for non-conforming and near-prime portfolios acquired by fund buyers, non-bank lenders and some bank lenders. A general trend was the accessing of the RMBS market by non-bank lenders and we see that continuing in 2014, though the extent to which the market remains accessible to such lenders may in some part be driven by the level to which established issuers of prime RMBS return to the market this year, particularly following the changes made to restrict the application of the FLS in respect of household lending. We currently expect prime RMBS to pick up more in the second half of 2014, rather than earlier in the year.

Structural developments

With issuers taking more input from investors ahead of the formal launch of transactions, we have seen a number of changes to the way RMBS deals are being structured. Last year, particularly in the non-conforming sector, we saw deals that included features we have broadly termed "extension risk mitigants", designed to allay investor fears that transactions may not be called and redeemed by the issuer on the stated call option date.

One of these mechanics involves the inclusion of a residual certificateholder call option, giving an option to purchase the beneficial, and in some cases, legal title to the securitised portfolio from a specific date, by deed poll, in favour of either the holders of the residual certificates or, in some cases, the holder of the most subordinated class of notes.

Exercise of such an option is made subject to certain conditions, including the level of the purchase price, designed to ensure that the issuer has sufficient funds to redeem the notes at par and pay all priority items required in the transaction waterfall.

We have also recently seen the re-emergence of the "turbo feature", under which available interest in the interest priority of payments is diverted following the call option date, to pay down principal on the rated classes of notes, prior to the payment of interest on the subordinated notes. Some transactions have gone further

than this, including a "turbo" before the call option date, with interest being diverted to pay down principal on the senior rated notes immediately after the payment of interest on the subordinated notes, but before payment of deferred consideration.

Last year also saw dialogue increasing between arrangers, issuers and investors as to the type and level of post-closing transaction modifications that are hardwired into the documentation and in respect of which trustee approval is made "automatic" and therefore much quicker. As a result of such dialogue, we have seen a number of transactions move away from the inclusion of a wide range of hardwired permissible modifications (e.g. to facilitate changes to ratings criteria), with this right generally being restricted to accommodate changes required by certain specific regulatory matters, such as EMIR. However, when some of the larger programmatic issuers return to the market, the trend to restrict the ambit of "deemed consent" language may be reversed.

We see investors increasingly expressing the view that they wish, in general, to be involved in the modification process and have the ability to vote, where the trustee does not feel able to approve a modification without noteholder consent. Balanced against this is the need for sponsors and issuers to be able to make efficient and timely changes to transactions in certain situations. In seeking to achieve such balance, some transactions that closed last year have included "negative consent" language, which permits the passing of certain resolutions by the negative consent of noteholders in the absence of more than a specified percentage of noteholders objecting to the particular resolution.

Finally, we predict that the role and duties of third party service providers, in particular the role of back-up servicers, back-up servicer facilitators and back-up cash managers, and the provisions regarding their activation in case of default by the servicer or cash manager, will remain an important structuring issue, including for some issuers returning to the prime market. With rating agencies focused on this point, transactions face a fine balancing act in addressing the requirements of the rating agencies whilst also taking into account the commercial discussions that occur when structuring transactions with respect to the responsibility of third parties.

Regulatory change

As a general point, whilst the announcement last year of the inclusion of certain RMBS in the definition of "High Quality Liquid Assets" under Basel III's Liquidity Coverage Ratio was welcomed, the Basel Committee's proposed changes to the Basel securitisation framework remain a key point of concern, particularly when compared with the regulatory treatment applied to covered bonds.

There is still a feeling in the market that the uneven playing field between RMBS and covered bonds needs to be addressed by European lawmakers, particularly as regards the risk weighting applied to each product.

Elsewhere, the Capital Requirements Regulation has taken effect from the beginning of this year, and though it has generally caused less concern in the RMBS world than, for example, the CLO market, given the steps already taken by the RMBS market to adapt to Article 122a of the Capital Requirements Directive (now Article 405 of the CRR) (in particular, the methods of retention and expectations regarding the provision of information to investors), there is an element of uncertainty regarding any approach to risk retention in transactions structured post-January 2014 that does not clearly fall within the provisions of the CRR.

Issuers returning to the market this year should also be aware of Chapter III, Section 5 of the AIFM Regulation, the provisions of which introduce investor due diligence requirements in respect of alternative investment fund managers who are required to be authorised under the AIFMD. These investor due diligence requirements include restrictions on investing unless risk retention requirements are met by those putting together the deal.

Towards the end of 2013 we saw AIFMs beginning to grapple with these new requirements in a number of ways, including requesting additional confirmations within prospectus disclosure with regard to underwriting policies for the granting of credit to borrowers, the administration of the portfolio and approaches to credit risk mitigation.

Another impending regulatory change is Solvency II, which will impact the ways in which insurance companies hold interests in mortgage pools.

The UK landscape

Mortgage Market Review

The majority of the new rules resulting from the FCA's mortgage market review in the UK are due to come into effect on 26 April 2014. Key changes include a requirement for lenders to undertake affordability assessments at origination, including verifying income in all cases, and stress tests to ensure mortgages remain affordable when interest rates increase. For interest-only mortgages, lenders must check that borrowers have a credible plan to repay the capital at the end of the loan. There

are also changes to disclosure requirements.

The FCA has started to track firms' progress towards implementation of the mortgage market review from the second quarter of 2013, and when selecting portfolios, sellers should be aware that mortgages entered into on or after 26 April 2014 must comply.

Also in April 2014, the FCA is to take over from the Office of Fair Trading responsibility for regulating lenders subject to the Consumer Credit Act. Consideration is currently being given to the question of whether issuers will need to apply for a CCA licence after April, and to the impact of this regulatory change on UK RMBS more generally.

Transparency

Clear disclosure and transparency remains a key issue and amendments were announced in October 2013 to the Prime Collateralised Securities eligibility criteria in respect of UK RMBS, based in some part on the feedback of regular issuers. Certain sections of the existing criteria have been consolidated and are now contained in a simpler format, and this should make the application process more straightforward for issuers.

Help to Buy

October 2013 saw the launch of the mortgage guarantee element of the Help to Buy Scheme, whereby qualifying buyers will need to raise 5% of the property value, while the UK government will provide a guarantee for a further 15%. Issuers wishing to securitise portfolios including loans that benefit from the guarantee will need to structure deals such that any amounts received pursuant to the guarantee can be passed on to the transaction.

Under the scheme rules, a lender can assign a loan covered by the guarantee to a body corporate in the course of securitisation or the issuance of covered bonds, but in such circumstances the loan must continue to be serviced by the original lender and any loss suffered by the buyer following the assignment will be deemed to be a loss suffered by the seller, such that the seller will be entitled to make a claim and receive payment in respect thereof.

As such, in order to transfer the economic benefit of the guarantee, any transaction with Help to Buy Loans in the portfolio may need to consider contractual mechanisms such as an undertaking that the seller will make a claim and turn over the proceeds to the buyer.

Whether such high LTV loans will be included with traditional UK prime portfolios in the same transaction, or whether it may be more appropriate from a structuring and marketing perspective to go to market with a transaction solely consisting of these loans, needs further consideration.

Conclusions

A functioning RMBS market is a key component of the UK housing market and it is important that a number of issuers remained active in 2013, printing deals in order to remain engaged with their key ABS investor base.

The Bank of England announced in November 2013, that the FLS is to be refocused early this year to support business lending, rather than household lending. Indeed, the gradual withdrawal of central bank support combined with the predicted increase in mortgage lending this year and the need for some issues to refinance existing transactions, may mean increased levels of prime RMBS this year. Notwithstanding this, we expect larger issuers will weigh up a number of other factors when considering a return to the market, such as overall funding needs, the all-in cost of doing in RMBS and the impact of the current regulatory landscape.

In the meantime, the funding opportunity provided by the RMBS market to non-bank lenders and smaller bank and building society lenders will remain an attractive proposition. As such, we expect activity to continue in 2014, particularly in the non-conforming, near-prime and buy-to-let sectors with timing considerations in some part being driven by the extent to which bigger players begin returning to the market.

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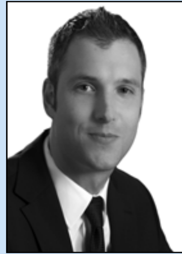

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