

29th November 2011

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Dear Jay,

Risk retention – follow-up from meeting with AFME and members on 2nd November

Thank you very much for meeting with AFME and our members Nationwide Building Society, Deutsche Bank and Allen & Overy LLP on 2nd November. We very much appreciated you taking the time to see us to discuss further some of the issues raised in our letter to you and the other agencies dated 19th July 2011. This letter is to follow up on the points on which you requested further clarification.

AFME very much appreciates the help and advice of its counsel Allen & Overy for their help in preparing this letter.

Issues of clarification

I believe the issues on which you requested further clarification from us were as follows:

- Necessary amendments to the draft provisions regarding the proposed seller's interest holding option to permit the use of such option in the context of typical UK mortgage master trusts;
- Calculation and measurement of the required retained interest under the European risk retention provisions; and
- Use of standby letters of credit to satisfy the first loss tranche holding option under the European risk retention provisions.

Each of these points is addressed below.

We would be happy to set up a call to discuss any further questions you may have. Once again, thank you for meeting with us.

Proposed seller's interest holding option and UK mortgage master trusts

The Proposed Rule provides for a seller's interest retention holding option but limits the availability of this option to revolving asset master trusts. As a result, revolving *pool* master trusts involving *non-revolving assets* – such as UK mortgage master trusts – would not be able to use the seller's interest holding option. Taking into account the principles behind the retention requirements (i.e. alignment of interests), the justification for this difference in treatment (based on the nature of the underlying assets) is not clear to us.

As discussed in our meeting, given the potential difficulty of making other retention holding options work in an efficient manner in a UK mortgage master trust context and the fact that the EU retention regime does not similarly restrict the availability of the seller's interest holding option to revolving asset transactions, the

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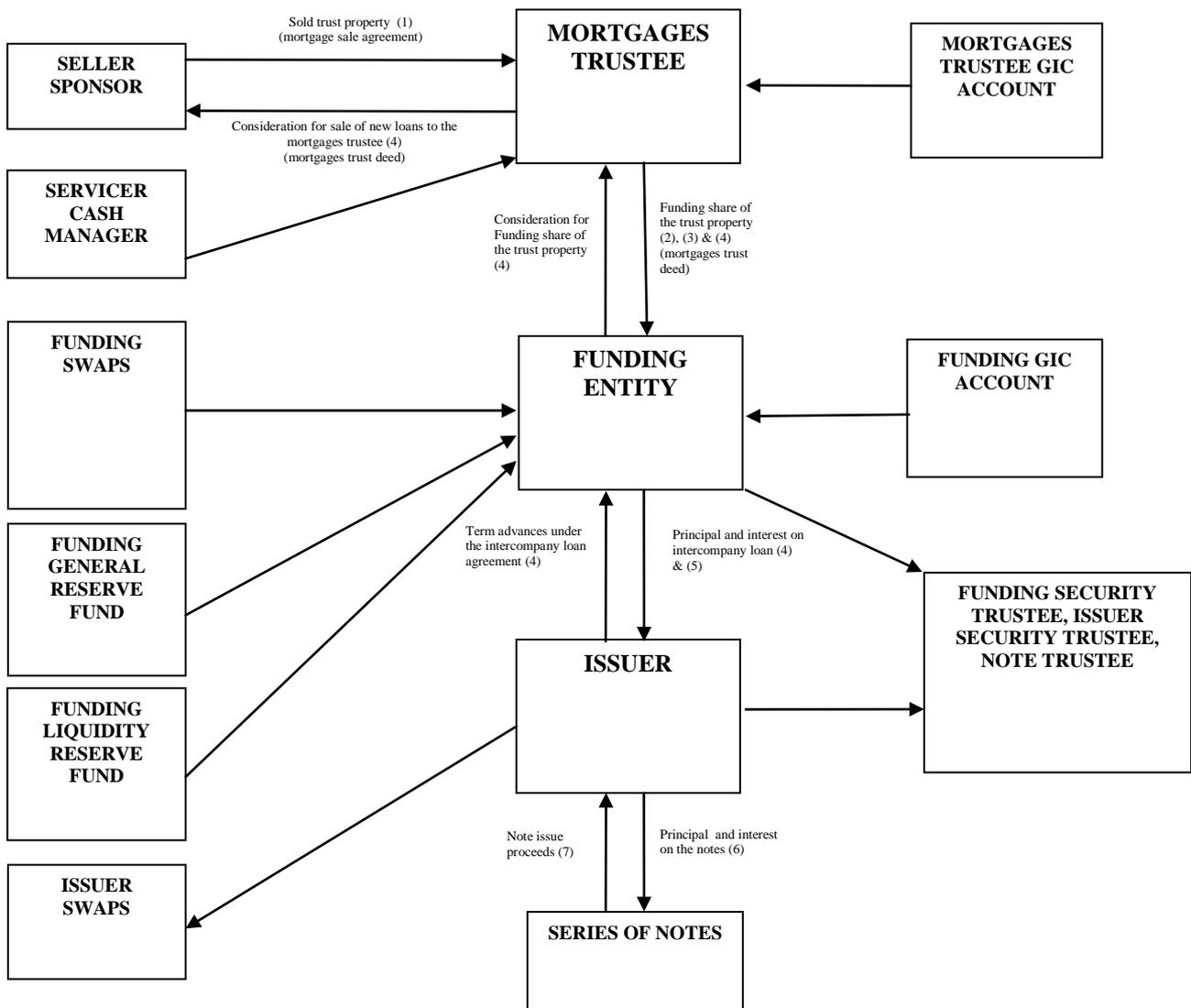
proposed limitation contemplated by the Proposed Rule is likely to operate in a disproportionately restrictive manner for certain EU market participants and in particular for UK RMBS originators and issuers.

We respectfully request that the seller's interest holding option should be made expressly available in the context of both revolving asset and non-revolving asset master trust transactions, with sufficient flexibility built into the relevant provisions and corresponding definitions to address the issues outlined below.

Given the very specific features of UK mortgage master trusts, and their importance in the analysis, we set out first a description of a typical structure and then go on to explain the amendments required to the proposals.

Background

By way of background, set out below is a structure diagram for a typical UK mortgage master trust, along with a summary of the various steps involved in such transactions. (The numbers noted in the diagram below correspond to the numbers of the various points included in the summary.)



- (1) The originator/seller (the **Seller**) will sell residential mortgage loans and their related security to the a special purpose vehicle which acts as the mortgages trustee (the **Mortgages Trustee**). From time to time the Seller may, subject to satisfaction of certain conditions, sell further loans and their related security to the Mortgages Trustee.
- (2) The Mortgages Trustee holds the loans and other property on trust for the benefit of the Seller and a special purpose funding entity (the **Funding Entity**) pursuant to a mortgages trust deed. Each of the Seller and the Funding Entity has a joint and undivided interest in the trust property, but its entitlement to the proceeds from such property is in proportion to its respective share.
- (3) The Mortgages Trustee allocates income receipts and losses on the loans to the Funding Entity and the Seller based on their (fluctuating) percentage share in the trust property. The Mortgages Trustee allocates principal receipts on the loans between the Funding Entity and the Seller in amounts depending on whether the Funding Entity is required to pay amounts on the intercompany loan on the next Funding payment date or accumulating cash to repay a "bullet" term advance or a term advance which has scheduled amortisation instalments, as the case may be.
- (4) The special purpose issuing entity (the **Issuer**) will make term advances available to the Funding Entity pursuant to the intercompany loan agreement from the proceeds of each series of notes. The Funding Entity will use the proceeds of term advances received from the Issuer under the intercompany loan to either: (a) make an initial contribution to the Mortgages Trustee to acquire a share of the trust property¹ (the Mortgages Trustee will use the proceeds of the initial contribution to pay the Seller part of the consideration for loans (together with their related security) sold to the Mortgages Trustee) or make a further contribution to the Mortgages Trustee to acquire part of the Seller's share of the trust property; (b) fund or replenish a reserve fund; and/or (c) repay one or more of the existing term advances then outstanding.
- (5) The Funding Entity will use a portion of the amounts received from its share in the trust property to meet its obligations to pay interest, principal and certain fees due to the Issuer under the intercompany loan agreement and to replenish any relevant reserve funds as well as paying certain fees and expenses. The Funding Entity's obligations to the Issuer under the intercompany loan agreement will be secured under the Funding deed of charge by, among other things, the Funding Entity's share of the trust property.
- (6) The Issuer's obligations to pay principal and interest on the notes will be funded primarily from the payments of principal and interest received by it from the Funding Entity under the intercompany loan agreement. The Issuer's primary asset will be its rights under the intercompany loan agreement. Neither the Issuer nor the noteholders will have any direct interest in the trust property, although the Issuer will have a shared security interest under the Funding deed of charge in the Funding Entity's share of the trust property.
- (7) Subject to satisfying certain issuance tests, the Issuer will issue notes in separate series and classes (or sub-classes) from time to time. The Issuer may issue notes of any class on any date provided there is sufficient credit enhancement on that date, either in the form of lower-ranking classes of notes or other forms of credit enhancement. The Issuer's obligations under, among other things, the notes will be secured under the Issuer deed of charge by, among other things, the Issuer's rights under the intercompany loan agreement.

¹ This may vary in practice between deals but the basic principles remain the same.

General principles

Under UK mortgage master trust structures, it is the case that the Seller's interest is aligned with the interests of investors. This is demonstrated by certain general principles embedded within the transaction structure. In particular, we note that, such structures provide for (i) the allocation of credit losses on the securitised assets between the Seller and the Funding Entity on a *pro rata* and *pari passu* basis, (ii) the allocation of revenue/interest receipts between the Seller and the Funding Entity on a *pro rata* and *pari passu* basis and (iii) the allocation of principal receipts to the Funding Entity *in priority* to the Seller's interest at all times prior to the occurrence of an "asset trigger event" when such entity requires funds to meet its payments obligations, for example, if the Funding Entity needs cash in order to pay amounts on the intercompany loan on the next due date or if the Funding Entity needs to accumulate cash to repay a bullet term advance or a term advance which has scheduled amortisation instalments.

In keeping with this, we note that, in UK mortgage master trust transactions, the Seller's interest will not at any time be prioritised over amounts paid to the Funding Entity (which in turn may be used to make payments to investors in the notes). Neither are cashflows and losses applied in a manner which would result in a disproportionate reduction of the Seller's interest when compared to the position held by the Funding Entity (and in turn held by investors).

We believe that this demonstrates that the typical structure of the Seller's interest in a UK mortgage master trust is aligned with the interests of investors.

Analysis of required amendments to proposals

Various amendments would be necessary in order to make the current provisions under the Proposed Rule work for UK mortgage master trusts. The key issues and required adjustments are summarised below. We note that it would not be feasible to restructure existing UK master trusts to satisfy the Proposed Rule as currently drafted with respect to the seller's interest holding option.

- *Revolving assets versus revolving pool of non-revolving assets:* as a starting point, the current restriction on the availability of the seller's interest holding option to revolving asset master trust transactions would need to be amended to make it clear that the option could also be used in the context of master trust arrangements involving a revolving pool of non-revolving assets. This would require the amendment or removal of the general requirement conditions set out in Section 7(a)(1) and (2) and amendment to any corresponding definitions (e.g. to the "revolving asset master trust" definition).
- *Direct holding by an issuing entity:* the proposals set out in Section 7 and the corresponding definitions are framed such that the securitised assets would be required to be held directly by an "issuing entity". For example, the holding option requires the retained interest to be "not less than five percent of the unpaid principal balance of *all of the assets owned or held by the issuing entity*" and the "seller's interest" definition includes similar references and turns on the retained interest being comprised of an ABS interest issued by an issuing entity. Unlike U.S. master trust transactions which typically involve the direct issuance of asset-backed securities by the trust which holds the securitised assets, in UK mortgage master trusts the transferred assets are held by a trustee (the Mortgages Trustee) on trust for the benefit of the Seller and the Funding Entity. It does not appear that this trustee entity would fall within the definition of "issuing entity" for the purposes of the proposals. As such, amendments would be required to the proposals to reflect UK structures where reference is made to the interest being an ABS interest issued by the issuing entity and/or to the assets being held by the issuing entity. For example, amendments would be required to Section 7(a), the seller's interest definition and (to the extent it is referred to) the "securitised assets" definition.
- *Pari passu requirement:* the proposed definition of seller's interest also requires the retained interest to be an ABS interest that "is *pari passu* with all other ABS interests issued by the issuing

entity with respect to the allocation of all payments and losses prior to an early amortisation event (as defined in the transaction documents)". We assume that the reference to "payments" in this context is intended to mean collections received in respect of the underlying assets. This requirement would, technically, not be satisfied in the context of UK mortgage master trusts, given the use of an interposed Funding Entity in the structures. A similar point may apply in the context of UK *credit card* master trusts, which also use an intermediate Funding Entity which receives a beneficial interest in the trust and issues loan notes (which are in turn purchased by a separate issuing entity) but typically does not itself issue securities directly to capital market investors. In the context of these credit card structures, it would also be helpful if it was confirmed that the Funding Entity (which issues the loan notes) would not be regarded as a separate issuing entity for the purposes of the Proposed Rule (to ensure that such structures are not viewed as a re-securitisation arrangement etc).

- *Other difficulties with the pari passu requirement for UK mortgage master trusts:* it may be difficult to satisfy the *pari passu* requirement described above in the context of UK mortgage master trusts for other reasons in the context of principal payments, although such payments are made in a manner which is consistent with the principles behind the risk retention requirement. As noted above, distributions of principal receipts will be made to the Funding Entity *in priority* (in respect of time) to amounts paid to the Seller if the Funding Entity has a repayment requirement or a requirement to accumulate cash and provided that an "asset trigger event" has not occurred. If an asset trigger event occurs, then all principal receipts will be allocated and paid *pari passu* and *pro rata* to the Funding Entity and the Seller according to their respective trust shares. At no time will the Seller's interest be prioritised over amounts paid to the Funding Entity (which in turn may be used to make payments to investors in the notes). Moreover, cashflows and losses are not applied in a manner which would result in a disproportionate reduction of the Seller's interest when compared to the position held by the Funding Entity (and in turn held by investors). In keeping with the principles referred to in the Proposed Rule, the Seller's interest in UK mortgage master trusts is a direct, shared interest in the trust assets and, as such, exposes the Seller to the credit risk of such assets.
- *Adjustments for fluctuations and measurement of interest:* lastly, we note that the Seller's interest in UK mortgage master trusts is adjusted over time in a manner which corresponds to fluctuations in the trust assets (although a reduction in the Seller's interest in the trust property to below a minimum amount and percentage will result in an asset trigger event occurring). To be clear, it would be helpful if the proposals were adjusted to make it clear that the Seller's interest may be measured over time based on the then current position with respect to trust assets and liabilities. As is, the provisions may be interpreted to require measurement of the Seller's interest on the closing date and thereafter to be maintained at that level which is calculated on the basis of the trust as at that closing date.

Measurement of the retained interest

As discussed in our meeting, the retention holding options under the EU regime refer to retention of not less than five percent of "the nominal value of the securitised exposures" (other than the vertical slice holding option, which refers to five percent of the nominal value of each of the tranches sold or transferred to investors).²

² The on-balance sheet/representative sample holding option actually refers to the "nominal amount" of the securitised exposures but CEBS guidelines indicate that this "distinction is not considered to be intentional, and need not be considered when measuring the retained interest" (see paragraph 34).

The guidelines published by the Committee of EU Banking Supervisors (**CEBS**, now the EU Banking Authority) on 31 December 2010³ provide guidance on the calculation and measurement of the retained interest. In particular, the guidelines note that:

- Nominal value of the securitised exposures/assets "refers to the gross exposure value (i.e. gross of impairments and value adjustments, not net of these)" (see paragraph 33);
- Calculation of the retention requirement is "independent of the acquisition price of the exposures to be securitised". By way of example, the guidelines indicate that "acquiring assets at a discount to nominal value does not itself impact calculation of the retention requirement" (see footnote 8 to paragraph 43);
- The interest should be measured when the exposures are first securitised, rather than when the assets were first created (see paragraph 43);
- Dynamic re-measurement and re-adjustment of the retained percentages throughout the life of the transaction is not necessarily required, although where a securitisation involves an underlying asset pool that may fluctuate over time (meaning that the nominal value of the exposures may increase or decrease over time), the retained net economic interest would typically be expected to increase or decrease proportionately (see paragraph 43);
- The relevant provisions refer to a nominal exposure, and not a notional exposure and "therefore securitisation positions which have no principal component (for example, an excess spread tranche) do not qualify as part of the retention requirement" (see paragraph 35).

Certain holding options referred to in the Proposed Rule provide for calculation of the required retained interest on the basis of the "par value" of all of the ABS interests in the issuing entity issued as part of the securitisation transaction (horizontal) or the "par value" or fair value of each class of ABS interests (vertical). The term "par value" is not defined in the Proposed Rule, although we understand that this term may have been intended to mean "market value". As described above, the EU risk retention regime does not provide for the measurement and calculation of the required retained interest on the basis of market value and instead uses the face amount or principal amount of the securitised assets.

Any significant differences between the calculation and measurement requirements for the retained interest as between the EU and U.S. regimes may make it difficult for market participants to comply on an efficient basis with both regimes.

Use of standby letters of credit to satisfy the first loss tranche holding option

As also discussed in our meeting, the CEBS guidelines refer to various forms which may be used to satisfy the first loss holding option (see paragraphs 54 onwards), on their own or via combinations.

Amongst other things, the guidelines indicate that letters of credit or similar forms of credit support may be a permissible form of first loss tranche retention provided that the following requirements are met (see paragraph 57):

- It covers the credit risk of the exposures/assets, and not just other non-credit related risks;
- It covers at least 5% of the credit risk of such exposures, and it has assumed a first-loss position with respect to the securitisation;

³ See: <http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf>.

- It covers such credit risk for as long as the originator, sponsor or original lender has to meet the retention requirement by means of it for the relevant securitisation positions;
- It is provided by the sponsor, originator or original lender (and not by any other entity); and
- The credit institution investing in, or otherwise assuming exposure to, the securitisation has sufficient access to appropriate documentation to enable it to verify the conditions referred to above.

The above guidance is not expressly stated to be restricted in application to ABCP conduits. That said, the CEBS guidelines do include an example of an arrangement that may satisfy the guidance and such example refers to a standby letter of credit provided as programme-wide credit enhancement to an ABCP conduit by the conduit sponsor.

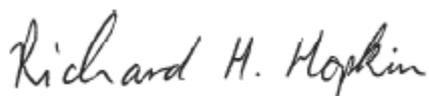
While many conduit arrangements are regarded as "existing securitisations" under the EU regime and, as such, effectively grandfathered until after the end of 2014, it is expected that the guidance set out above will provide essential flexibility for retention in the context of conduits which provide funding for EU originated assets when the EU regime provisions apply to such arrangements.

As noted in our July response, the retention holding option designed for ABCP conduits under the Proposed Rule would not work in practice for most ABCP conduits which provide funding for EU originated assets due to the restrictive conditions applied. It would be extremely difficult for European market participants to comply with the U.S. retention requirements in an ABCP conduit context unless a holding option similar to the standby letter of credit option outlined above is made available for use in such context.

Your consideration of the issues we highlighted in our meeting is appreciated.

We would be happy to set up a conference call to discuss the matters referred to above if that would be helpful.

Yours sincerely,



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