S&P Global Ratings

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Presale:

Tolkien Funding Sukuk No. 1 PLC

This presale report is based on information as of Jan. 29, 2018. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings.

Class	Prelim rating*	Class size (%)§	Available credit support (%)†	Profit rate	Step-up profit rate	Step-up date	Legal final maturity
Certificates	AAA (sf)	83.33	18.33	Three-month sterling LIBOR plus a margin	Three-month sterling LIBOR plus a margin	April 20, 2021	July 20, 2052

*The rating on the certificates is preliminary as of Jan. 29, 2018, and subject to change at any time. We expect to assign the final credit rating on the closing date subject to a satisfactory review of the transaction documents and legal opinion. Our rating on the certificates addresses timely receipt of profit and ultimate repayment of principal. §Class size is expressed as a percentage of the performing collateral balance at closing. †This is the initial credit support comprising overcollateralization and cash reserve.

Transaction Participants	
Issuer	Tolkien Funding Sukuk No. 1 PLC
Originator, seller, and servicer	Al Rayan Bank PLC
Arranger	Al Rayan Bank PLC
Lead managers	Al Rayan Bank PLC and Standard Chartered Bank
Back-up servicer	Homeloan Management Ltd.
Security trustee and delegate	U.S. Bank Trustees Ltd.
Cash manager, transaction account provider, agent bank, and principal paying agent	Elavon Financial Services DAC (U.K. Branch)
Corporate services provider	Law Debenture Corporate Services Ltd.

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Supporting Ratings

Institution/role	Ratings
Elavon Financial Services DAC (U.K. Branch) as transaction account provider*	AA-/Stable/A-1+

*Rating derived from the rating on the parent entity.

Transaction Key Features*

Closing date	February 2018
Collateral	Home purchase plans structured as Sharia-compliant diminishing musharaka with Ijara, originated by Al Rayan Bank to its retail customers in the U.K.
Principal outstanding of the pool (mil. £)§	300.0
Country of origination	England and Wales
Concentration	South East and London: 55.9%
Property occupancy	Owner-occupied: 100%
Weighted-average indexed current FTV ratio (%)†	59.60
Weighted-average indexed original FTV ratio (%)†	69.16
Average HPP size balance (£)†	180,482
Weighted-average seasoning (months)†	22
Arrears > one month (%)†	0.00
Redemption profile	Repayment 100%
Cash reserve (%)	Static at 2.0% of closing balance of the certificates (see explanation in relevant section below)
Property charge priority	First-ranking

*Data is based on a provisional pool as of Jan. 19, 2018. §Expected performing collateral balance at closing. †Calculations are according to our methodology. FTV--Finance-to-value. HPP--Home purchase plan.

Transaction Summary

S&P Global Ratings has assigned its preliminary 'AAA (sf)' credit rating to the certificates that Tolkien Funding Sukuk No. 1 PLC (Tolkien No. 1; the issuer) will issue.

Our preliminary rating addresses the timely and full payment of profit on the certificates, and ultimate repayment of principal by the final maturity date falling in July 2052.

Tolkien No. 1 is the first securitization originated by Al Rayan Bank PLC (Al Rayan Bank). It securitizes a static pool of home purchase plans (HPPs) originated by Al Rayan Bank to its retail clients in England and Wales. An HPP is a Sharia-compliant form of financing an individual customer for the acquisition of residential property, having a similar, although not identical, economic effect to a conventional mortgage loan. Each HPP contract is governed by English law and is also compliant with Sharia law (for more details on HPPs, see 'Notable Features' below).

On the issue date, Tolkien No. 1 will issue the certificates, acquire the portfolio assets (the eligible pool of HPPs) from Al Rayan Bank, and declare a trust over the portfolio assets for the benefit of the certificateholders. As security for the payments under the certificates, Tolkien No. 1 will enter into the deed of charge with the security trustee, creating security for the certificateholders and other secured creditors. All payments due under the certificates will therefore be secured by cash collections from HPPs distributed in accordance with the contractual payment priority, and will not be guaranteed by any third party. Credit risk of the closing portfolio of HPPs, which is a rather small and untested product in the U.K. residential finance market, is the main risk factor in this transaction.

Al Rayan Bank, which we do not rate, will service the portfolio of HPPs. The back-up servicer, Homeloan Management Ltd. (HML), will be appointed from closing to become a successor servicer if the original servicer is terminated. HML has an above average servicer ranking from S&P Global Ratings, and has gained practical experience in servicing HPP contracts (see "Servicer Evaluation: Computershare Loan Services (HML)," published on Oct. 5, 2017). Given a limited range of potential successor servicers of HPPs, which is a burgeoning and niche product in the U.K., we consider the availability of an experienced back-up servicer an important mitigating factor for the operational risk in this transaction. As to the commingling risk arising from an unrated servicer, we stressed it in our cash flow model.

The transaction will be exposed to the counterparty risk of Elavon Financial Services DAC (U.K. Branch), acting as a transaction account provider. Given that the U.K. branch is not rated, we equalize its rating with that of the parent entity, Elavon Financial Services DAC (AA-/Stable/A-1+), according to our criteria (see "Methodology Applied To Bank Branch-Supported Transactions," published on Oct. 14, 2013). The draft transaction documents contain adequate replacement provisions to support a preliminary 'AAA (sf)' rating on the certificates in line with our counterparty criteria (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013).

The credit enhancement available to the certificates will comprise overcollateralization, cash reserve and excess spread. The overcollateralization will arise from a positive difference between the performing collateral balance and the certificates' balance at closing, to be recorded as a deferred purchase price and repaid as a junior item in the pre-enforcement principal payment priority. Taking into account our credit and cash flow stresses and the transaction's payment structure, we consider the available credit enhancement for the certificates to be commensurate with the preliminary 'AAA (sf)' rating that we have assigned.

Notable Features

This is the first transaction backed by a pool of HPPs that we have rated.

HPP contracts

HPPs are structured as Sharia-compliant diminishing musharaka. In its broad sense, musharaka is a co-ownership contract where each party provides capital toward the financing of a project or a venture. The eligible HPPs backing this transaction have been provided for the acquisition of freehold or leasehold residential properties in England or Wales. At HPP origination, the customer finances no less than 20% of the appraised property value, and the rest of the acquisition cost is financed by Al Rayan Bank. As long as one party (a customer) makes payments to another to increase its participation in the property, the share of another party (the originator) is diminishing, therefore from the originator's standpoint, the product is called HPP, which is based on diminishing musharaka and Ijara.

Each HPP contract between Al Rayan Bank and a customer consists of four agreements:

- A diminishing co-ownership agreement (musharaka), by which the customer agrees to buy Al Rayan Bank's initial share in the financed property, and to make scheduled monthly acquisition payments resulting in increasing customer share in that property. Once the customer repays the entire finance balance, the property ownership is passed to the customer. Prior to that, the legal title in the property remains with Al Rayan Bank.

- A lease agreement, by which Al Rayan Bank leases the property to the customer, enabling the customer to reside in that property. Monthly rental payments under the lease agreement and monthly acquisition payments under diminishing co-ownership agreement comprise a single monthly payment, which is what the customer pays to Al Rayan Bank. When compared with payments under a conventional mortgage, acquisition payments are analogous to the principal component, and rent payments are analogous to the interest component.
- A service agency agreement, by which Al Rayan Bank appoints a customer as a service agent during the lease term for the property maintenance and other charges in relation to the property, payable at the customer's expense.
- A legal charge, by which the customer charges all its interests in the diminishing co-ownership agreement and the lease agreement to Al Rayan Bank through a separate first fixed charge, as a security for all payments due under the HPP contract.

Each agreement constituting an HPP contact is governed by English law. All four agreements contain a uniform set of representations and undertakings by the customer, and a single set of events of default. A customer's failure to comply with any representation or any payment obligation (be it a rent payment, an acquisition payment, or a property maintenance charge) gives Al Rayan Bank the right to terminate all four agreements in their entirety and sell the underlying property.

HPP transfer to the issuer

At the sale date, Al Rayan Bank will transfer to the issuer all of its rights, titles, interests, and benefits under the HPPs, including the right to receive all remaining payments due by the customers, benefits in insurance contracts in relation to the underlying properties, and beneficial title in the residential properties backing HPP contracts. The legal title to the HPPs and the underlying properties will be retained by Al Rayan Bank on trust for the issuer unless any of the perfection events are triggered.

Compared to conventional U.K. residential mortgage-backed securities (RMBS), in this transaction the issuer will become the beneficial titleholder in the underlying residential properties from the sale date. In our analysis, we relied on the tax opinion confirming that stamp duty land tax should not be applicable to the issuer. In all other respects, the tax analysis is similar to a typical U.K. RMBS. We have therefore not applied any specific tax-related stresses in our cash flow model.

The issuer holding the beneficial title in the underlying properties has not negatively affected our comfort on the assets' true sale, or our analysis of the issuer's bankruptcy remoteness in accordance with our legal criteria (see "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017).

Enforcement of HPP contracts

Based on the transaction legal opinion, the enforcement process on HPP contracts is fairly similar to the enforcement of a conventional residential mortgage in the U.K. In both cases, a court decision is required before selling the underlying property with vacant possession: in case of a conventional mortgage, to allow the bank possession of the mortgaged property and appoint a receiver, while in case of HPPs, to terminate the lease agreement. The grounds for terminating the lease have been set out in the prevailing housing law of the U.K., and include two outstanding missed monthly rent payments, among other requirements.

As of the portfolio cut-off date, Al Rayan Bank has not experienced any defaults on the HPPs, and therefore has not sought court enforcement of the HPP agreement. Nevertheless, the bank has developed internal procedures to handle the enforcement stage, with the use of its own staff and external legal support, if required.

In our analysis, we applied the same assumptions to foreclosure costs and recovery period to the pool of HPPs as for conventional U.K. mortgages, in accordance with our residential loan criteria (see "Methodology And Assumptions: Assessing Pools of European Residential Loans," published on Aug. 4, 2017). While we recognize the untested nature of HPP agreements in the U.K. court practice, we believe that a well-developed legal framework for residential loans would support the servicer through the enforcement process.

Strengths, Concerns, And Mitigating Factors

Strengths

- Al Rayan Bank has a proven record of prudent underwriting procedures, which has kept the actual level of arrears and defaults in the eligible book of HPPs at a very low level over the past 10 years. Since mid-2014 to date, the peak of total arrears was recorded in March 2015 at 1.43%.
- The provisional pool of HPPs has strong characteristics, including no buy-to-let products, no second charges, no customers with county court judgements (CCJs) or bankruptcy records, and no self-certified customers. The weighted-average original finance-to value (OFTV) ratio is 69.2%. The HPP agreements do not allow further advances or redraws on overpayments.
- The transaction has a sequential payout structure and a static reserve. Therefore, the available credit enhancement to the certificates can build up during the transaction's life, enabling it to withstand performance shocks. If a shortfall in revenue collections occurs, principal receipts and the cash reserve can be used to meet timely payment of profit on the certificates.

Concerns and mitigating factors

- HPP is a burgeoning and niche product in the U.K. residential finance market. We assess severity risk (the potential impact of disruption in Al Rayan Bank's servicing to the transaction's cash flows) as moderate, and portability risk (the risk of inability to replace Al Rayan Bank as a servicer) as high in line with our operational risk criteria (see "Global Framework For Assessing Operational Risk In Structured Finance Transactions," published on Oct. 9, 2014). We assess the disruption risk (likelihood of a material disruption in Al Rayan Bank's servicing) as low. Therefore, based on our operational risk criteria, the maximum potential rating on the certificates is 'AA', absent the additional support provided by the back-up servicer. The appointment of HML as an experienced back-up servicer from closing adds two notches to the operational risk cap (up to 'AAA') in our analysis.
- Al Rayan Bank has a limited default history and has not sought enforcement of HPPs in court. Nevertheless, the bank is operationally ready to handle enforcements, and will rely on the U.K.'s well-developed legal framework for residential loans.
- The underlying pool is highly unseasoned, with the weighted-average seasoning of 22 months. Only 3.8% of the HPPs in the provisional portfolio receive a seasoning benefit, in accordance with our European residential loans criteria. In addition, to reflect an elevated credit risk stemming from the fast and ongoing portfolio growth, we projected an increase in the level of arrears to 4.55% based on the maximum historical level recorded in our U.K. prime RMBS index since 2010, after the 2008-2009 recessionary period. This increased our weighted-average foreclosure frequency (WAFF) assumptions.
- The issuer, as the beneficial titleholder in the properties, may be liable for property maintenance charges if the

customer fails to cover them, leading to an increase in loss severity for the issuer at the end of the recovery process. These expenses would apply only to the leasehold flats in the provisional portfolio. We stressed for these potential charges in our credit analysis.

- The transaction does not hedge the risk arising from the mismatch between the rental rate on HPPs and the profit rate on the certificates. In addition, HPPs in the pool may be subject to a revision in the contractual rental rate at the customers' demand before the step-up date falling in April 2021. We have applied few stress scenarios for pool yield in our cash flow model.
- The transaction will be exposed to a deposit set-off risk, as Al Rayan Bank as the seller is a deposit taking institution. To address this risk, we modelled a set-off loss in our cash flow model.
- There is a commingling risk related to Al Rayan Bank performing as an unrated servicer and collection account bank in this transaction. We stress it as one month of credit loss in our cash flow analysis.

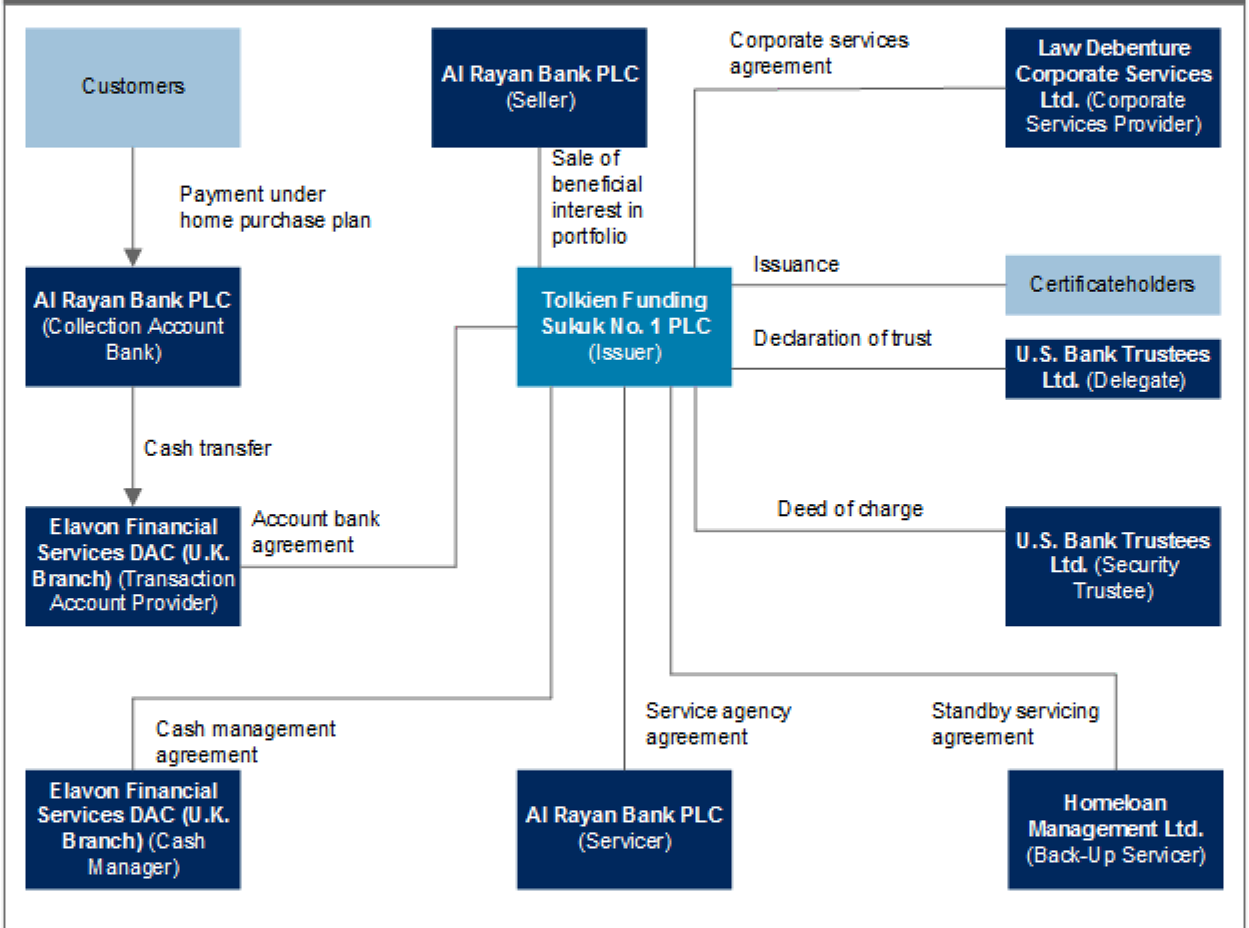
Transaction Structure

At closing, Tolkien No. 1 will issue £250 million of the certificates and use the proceeds to establish a £5 million cash reserve, and invest £245 million to purchase a portfolio of HPPs worth £300 million in outstanding principal balance. Al Rayan Bank will cover the initial costs of issuance.

The certificates will represent an undivided beneficial ownership interest in the closing portfolio of HPPs held on trust for the certificateholders in agreement with a declaration of trust between the issuer and U.S. Bank Trustees Ltd. as delegate. As a security for all payments due under the certificates, the issuer will grant security over all of its assets in favor of U.S. Bank Trustees as the security trustee (see chart 1).

Chart 1

Transaction Structure



Originator and servicer overview

Al Rayan Bank is a leading Sharia compliant retail bank in the U.K. Sharia-compliant home finance products are a nascent and small segment in the U.K. residential mortgage market, representing only 3% of the total outstanding amount.

Founded in 2004, Al Rayan Bank had a limited scope of operations until 2014, when it started to grow rapidly following a change in controlling shareholder and a capital injection. HPPs remain one of Al Rayan Bank's core products, and the bank aims to further expand this type of financing activities. Underwriting is centralized and is mainly based on affordability tests and customer data verification.

Customer payments are collected through direct debit from bank accounts. Missed payments are handled by the dedicated servicing team in accordance with the arrears management policy.

Al Rayan Bank has a limited arrears history. It recorded no arrears since the beginning of its operations in 2004 until

2012, including over the recessionary period of 2008-2009. Starting from 2012, the bank faced few cases of arrears each year, and all of them have been cleared prior to entering the enforcement stage. Therefore, up until now the bank has had no practical experience in enforcing HPPs. Al Rayan Bank is nevertheless operationally ready to handle enforcements in the future.

We have conducted an onsite review and update calls of Al Rayan Bank's origination and servicing processes as an integral part of our rating analysis. We are satisfied that Al Rayan Bank is capable of performing its functions in this transaction.

Terms And Conditions Of The Certificates

Profit on the certificates

Tolkien No. 1 will pay quarterly profit on the certificates on the 20th day of January, April, July, and October of each year, beginning in July 2018. The profit rate will be equal to three-month sterling LIBOR plus a margin. Following the step-up date (April 2021), the certificates will pay a step-up margin above three-month sterling LIBOR, which we have considered in our analysis.

Mandatory redemption

The certificates will be fully repaid by July 2052, which is the final dissolution date. The issuer will apply available principal receipts to redeem the certificates on each quarterly payment date, subject to the principal priority of payments.

Optional redemption

The issuer may redeem all of the certificates at their outstanding principal balance and accrued profit in the following events:

- In case of an amendment or a change in the tax law, leading to taxes being withheld on the payments under the certificates; or
- On the step-up date or any payment date thereafter following the repurchase of the underlying HPP portfolio by Al Rayan Bank.

In line with the terms and conditions of the certificates, our preliminary rating addresses timely payment of profit and ultimate repayment of principal on the certificates by the legal final maturity. We deem optional redemption events ratings remote because the certificates are to be repaid at outstanding principal and accrued profit in these scenarios.

Collateral Description

As of the cut-off date on Jan. 19, 2018 the provisional HPP pool of £301,428,226.24 comprised 1,672 HPPs secured against properties in England and Wales. The majority of the HPP contracts were originated in 2016 and 2017.

Table 1

Transaction Key Features	
Portfolio data	
Deal name	Tolkien Funding Sukuk No. 1 PLC
Closing Date	Feb. 9, 2018
Originator	Al Rayan Bank PLC
Country of origination	U.K.
Original balance	£335,372,612.00
Current balance	£301,428,226.24
Property occupancy	100% owner-occupied
Geographich concentration	South East Inc. London (55.81%)
Weighted-average current FTV	59.60%
Weighted-average original fTV	69.16%
Weaighted-average seasoning	2 years
Avgerage time to maturity	24 years
Redemption profile	100% repayment
Income verified/self certified	0% self-certified
CCJ/IVA/bankruptcy	0%/0%
Employment status	16% self-employed
Specific features	
Rental rate	
Floating rate	3.22%
Fixed rate	2.74%
Weighted-average rental rate	3.17%
Weighted-average rental rate margin	2.67%
Arrears	
30-60	0.00%
60-90	0.00%
90+	0.00%

FTV--Finance-to-value. CCJ--County court judgement. IVA--Individual voluntary arrangements.

Main features of the provisional pool include the following (see table 1):

- None of the customers in the provisional portfolio were subject to CCJs or individual voluntary arrangements, or were subject to bankruptcy proceedings.
- No customers are self-certified.
- The provisional pool comprises approximately 45.3% of HPPs to first-time buyers, which, when unseasoned, are more likely to exhibit a higher historical default probability than otherwise similar contracts.
- The weighted average seasoning is 2 years. As only 3.8% of the provisional pool is more than five years seasoned, we have applied an adjustment to our foreclosure frequency expectation, in line with our European residential loans criteria.
- All HPPs in the provisional pool are repayment type contracts.
- All properties in the provisional pool are owner occupied, and subject to first lien.
- The largest geographical concentration is in South East including London, which represents 55.9% of the total

provisional pool. Given that it exceeds the concentration limit set by our European residential loans criteria, we have applied an adjustment to our foreclosure frequency expectation.

- There is a relatively high amount of jumbo valuations in the pool, representing 40.7% of the total, most of them in South East including London, as well as in North West and West Midlands. We have factored these jumbo valuations in our loss severity expectation.

Chart 2

Seasoning Distribution

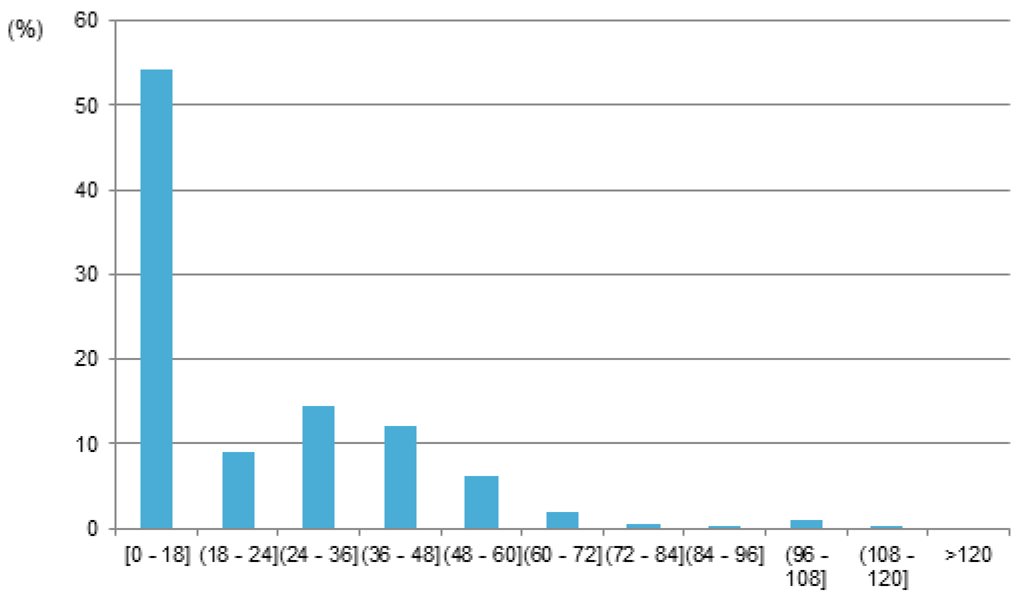
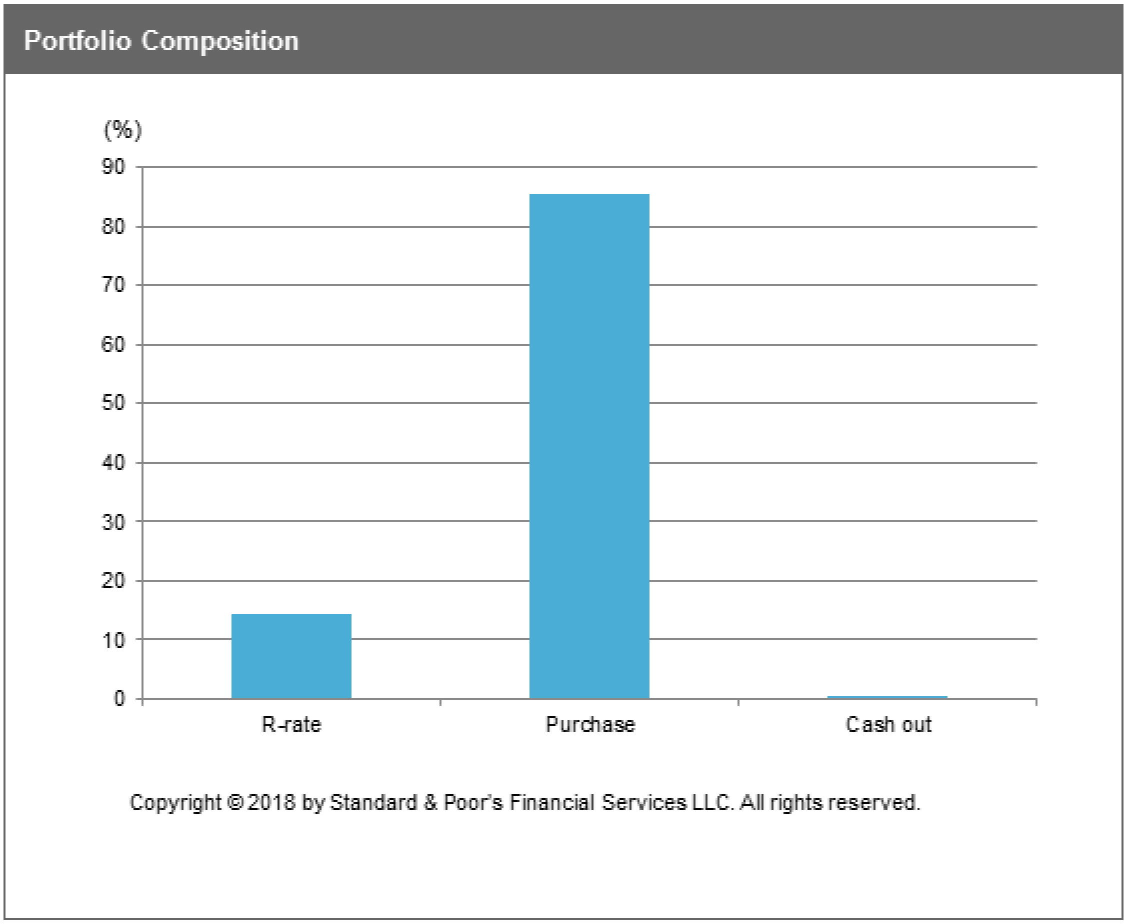


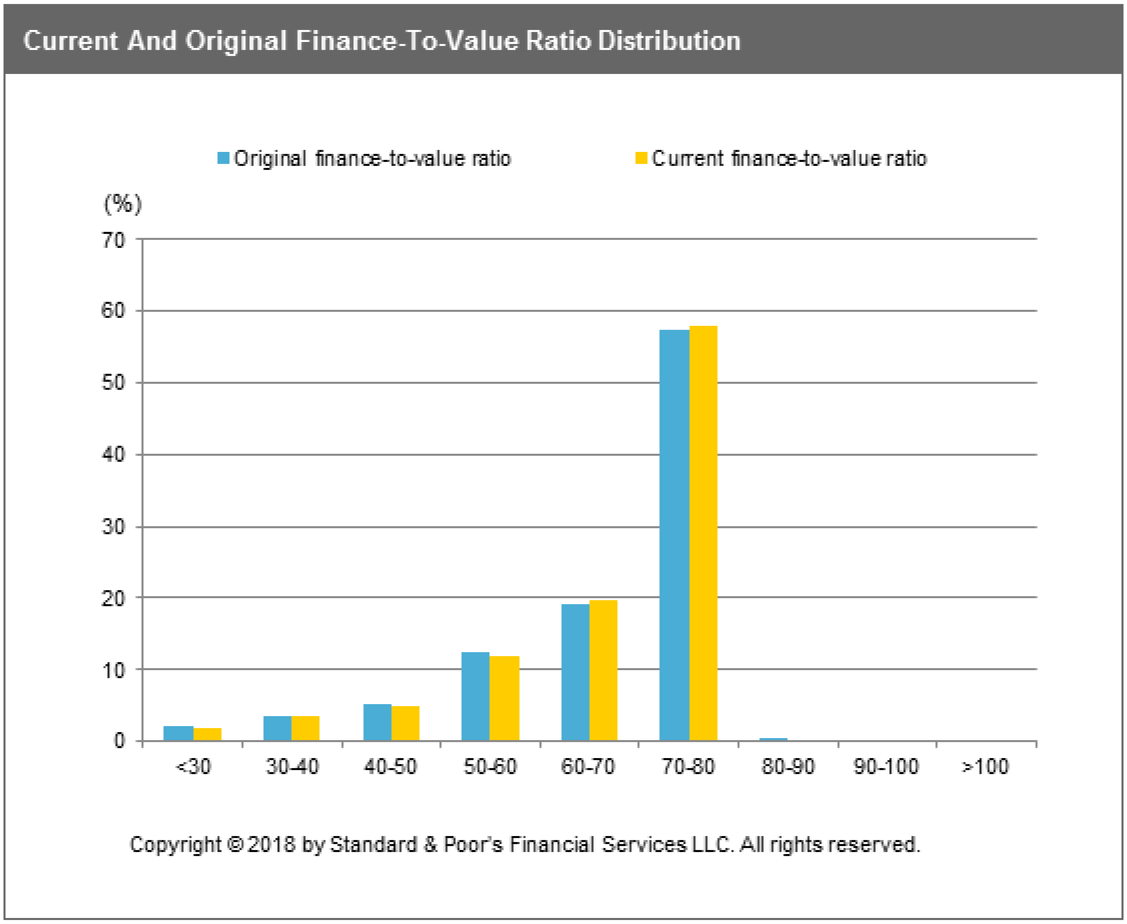
Chart 3



The provisional collateral pool's weighted-average OFTV ratio is 69.16%--calculated using our European residential loans criteria. We consider that customers with minimal equity in their property are less likely to be able to refinance, and are more likely to default on their obligations, than customers with HPPs that have lower OFTV ratios.

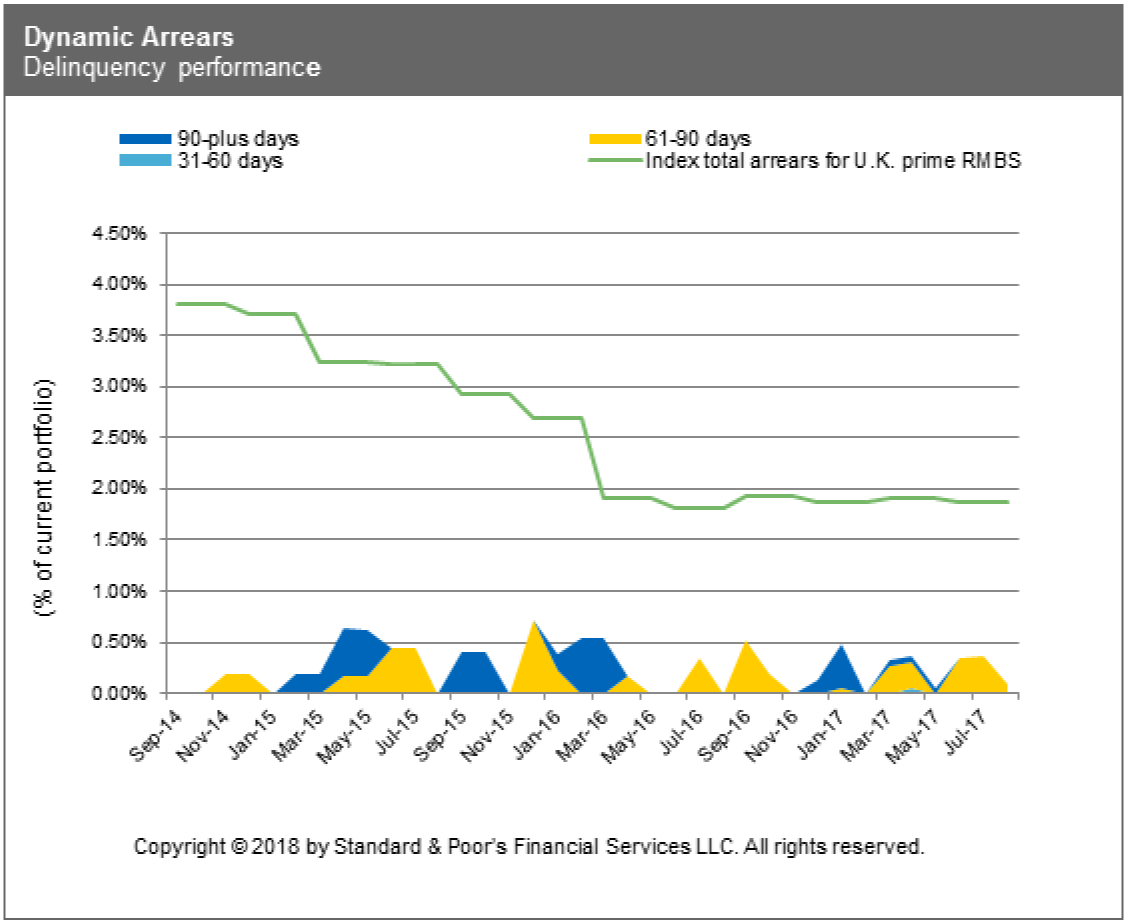
At the same time, HPPs with current indexed high FTV ratios are likely to incur greater loss severities if the customer defaults. The weighted-average indexed current FTV ratio is 59.60%. Of the pool, 0.82% exhibits a current indexed FTV ratio between 80% and 100%.

Chart 4



Of the provisional portfolio, no HPPs are 30+ days past due arrears. The historical level of arears in the eligible pool of HPPs has been very low (see chart 5).

Chart 5



In our loss severity calculations, we applied repossession market-value decline (RMVD) assumptions in accordance with our European residential loans criteria, based on the degree of over- or under-valuation for each specific region of the U.K. (see table 2).

Table 2

Repossession Market Value Declines At The 'AAA', 'AA', 'A', 'BBB' And 'BB' Rating Levels

Region	AAA (%)	AA (%)	A (%)	BBB (%)	BB (%)	% of the pool
East Anglia	63.01	57.51	48.62	42.88	38.47	2.36
East Midlands	58.48	53.65	45.43	40.25	36.30	7.06
North	48.49	45.16	38.39	34.45	31.53	1.41
Northwest England	52.09	48.22	40.93	36.54	33.25	10.90
Northern Ireland	45.70	42.74	36.34	32.72	30.05	0.00
Scotland	44.37	41.43	35.05	31.44	28.78	0.00
Southeast including London	75.00	69.07	58.18	50.76	44.96	55.94
Southwest England	64.12	58.45	49.40	43.52	39.00	2.96
Wales	52.36	48.45	41.12	36.70	33.38	1.33
West Midlands	55.48	51.10	43.32	38.51	34.87	11.56
Yorkshire and Humberside	48.54	45.20	38.42	34.48	31.55	6.47

Table 2

Repossession Market Value Declines At The 'AAA', 'AA', 'A', 'BBB' And 'BB' Rating Levels (cont.)						
Region	**AAA (%)**	**AA (%)**	**A (%)**	**BBB (%)**	**BB (%)**	**% of the pool**
Weighted-average market value decline	66.09	60.88	51.41	45.18	40.36	

Repurchase of HPPs

The seller will repurchase the affected HPPs if:

- The servicer identifies an HPP that breached the seller's asset warranties on or prior to the sale date, which could have a material adverse effect on the value of the underlying HPP portfolio;
- The seller provides a further advance to a customer;
- The servicer extends the payment terms on any HPP, other than under the recovery or forbearance processes;
- At any time following the step-up date on the certificates (April 2021), the seller changes the original rental rate of an HPP, such as switching the rent rate, extending a fixed-rate period, or extending a discount period; or
- At any time after closing, as a result of switching the original rental rate of the HPPs, the weight of fixed-to-floating rental rate HPPs exceeds 80% of the total current pool balance.

Credit Structure

A combination of overcollateralization, the case reserve, and excess spread provides credit enhancement for the certificates (see table 3).

Table 3

Final Pool WAFF And WALS				
Rating level	**Base FF for an archetypical pool in U.K. (%)**	**WAFF (%)**	**WALS (%)**	**Expected losses (%)**
AAA	12.00	26.40	49.73	13.13
AA	8.00	18.52	40.80	7.56
A	6.00	14.32	26.07	3.73
BBB	4.00	10.20	17.64	1.80
BB	2.00	6.24	12.24	0.76

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loss severity.

Cash collection arrangements and the transaction account

Customers make monthly payments into a collection account held with Al Rayan Bank in its own name. It will take up to two business days for the servicer to reconcile collections and transfer them to the transaction account held in the issuer's name. The transaction documents will establish a declaration of trust over any amounts in the collection that relate to HPPs purchased by the issuer. We do not rate Al Rayan Bank as a collection account bank or any of its roles in this transaction.

Tolkien No. 1 will open the transaction account in the U.K. branch of Elavon Financial Services. The transaction account will contain five ledgers: the revenue ledger, the principal ledger, the reserve ledger, the principal deficiency ledger, and the trustee profit ledger. Given that we do not rate the U.K. branch, we equalize its rating with that of the parent entity, Elavon Financial Services DAC (AA-/Stable/A-1+), according to our criteria (see "Methodology Applied To Bank Branch-Supported Transactions," published on Oct. 14, 2013).

The draft transaction documents contain adequate replacement provisions on the transaction account bank to support a 'AAA (sf)' preliminary rating on the certificates, in line with our counterparty criteria. Namely, the documents provide that the issuer must take remedial actions, including the replacement of the transaction account provider by a suitably rated financial institution if, at any time, we lower our long-term issuer credit rating on the account bank below 'A/A-1' (or 'A-1+' if no short-term rating is assigned).

In our view, the transaction is exposed to commingling risk arising from the unrated servicer. Given that the collection account bank is not rated, and considering equal distribution of cash collections within a month and one month being sufficient to notify the customers, we sized commingling risk as one month of credit loss in our cash flow model. Commingled amounts include revenue and principal collections and prepayments at a 10% constant prepayment rate (CPR). Our CPR assumption for commingling stress considers limited refinancing options available to HPP customers in the U.K., due to a relatively small number of HPP originators.

Cash reserve

At closing, the proceeds of the sale of the certificates will fund a cash reserve in the amount of £5 million, or 2% of the certificates' balance. The required reserve amount will not amortize. On any payment date, the cash reserve can be used to cover a shortfall in revenue collections to cover senior items of the revenue priority of payments, including senior fees, profit on the certificates, and topping up of the debit balance in the principal deficiency ledger (PDL). On the payment date when the certificates are fully repaid, the outstanding amount of the reserve will be added to the revenue collections and repaid via the revenue priority of payment.

Revenue priority of payments

The revenue collections will comprise the revenue collections on HPPs over the preceding three-month collection period and the amount of cash reserve needed to cover any revenue shortfall on the forthcoming payment date, less any payments received from the customers in error and not previously returned from the collection account.

The revenue priority of payments will be as follows:

- Fees payable to the security trustee and the delegate;
- Remuneration of the cash manager, the agents, the account bank, the corporate services provider, and the standby servicer;
- Trustee profit;
- Servicer fees and Sharia compliance fees;
- Profit on the certificates;
- Amounts to be credit to the PDL until the debit balance is reduced to zero;
- Replenishment of the reserve ledger up to the required amount; and
- Residual revenue to the seller.

Principal priority of payments

The available principal funds will include the principal collections on HPPs over the preceding three-month collection period, and the reduction in the PDL debit balance on the following payment date following the application of the revenue priority of payment.

The pre-enforcement principal priority of payment will be as follows:

- If not paid from the available revenue funds, pari passu and pro-rata, profit on the certificates and fees payable to the security trustee and the delegate;
- If not paid from the available revenue funds, pari passu and pro-rata, remuneration of the cash manager, the agents, the account bank, the corporate services provider, and the standby servicer;
- Redemption of the certificates;
- If not paid from the available revenue funds, servicer fees and Sharia compliance fees; and
- Deferred purchase price payable to the seller.

Principal collections can be used to cover deficiencies in revenue collections only under condition that they were not covered from the available revenue funds, which include the use of the cash reserve.

Principal deficiency ledger

Amounts will be recorded on the PDL if the portfolio suffers any losses or if the transaction uses principal collections as available revenue receipts.

HPP rental rate

About 21.1% of the provisional pool are floating rental rate HPPs linked to the Bank of England base rate (BBR), 23.0% are floating rental rate HPPs linked to BBR with an initial period of a discounted margin, and the remaining 55.9% are HPPs with the current fixed rental rate convertible into floating rate (BBR plus a margin) at a certain future date. The profit on the certificates is linked to a three-month LIBOR. The transaction structure does not have any hedge in place against the risk of negative carry. We have therefore stressed some additional scenarios in our cash flow model to test the transaction's sensitivity to the assets yield.

The transaction allows Al Rayan Bank to modify the original rental rate on HPPs until the step-up date on the certificates, falling in April 2021. Permitted variations include the extension of the initial fixed or discounted rate period, or the conversion of floating rental rate HPPs into either fixed-to-floating or discounted margin products. The only limit on permitted variations before the step-up date is the seller's obligation to repurchase fixed-to-floating rental rate HPPs, which would result in the share of fixed-to-floating rental rate products exceeding 80% of the current pool balance.

To address the risk that up to 80% of the pool may switch to fixed-to-floating rental rate products, and the remaining 20% may be comprised of discounted margin products before April 2021, we tested this scenario in our cash-flow model.

If Al Rayan Bank is replaced as servicer, the issuer will instruct the stand-by servicer to not offer a contractual floating rental rate but rather a minimum margin of 2.7% over a BBR. We have run a cash flow scenario assuming the entire portfolio will switch to that minimum rental rate.

Set-off risk

The transaction is exposed to a deposit set-off risk as Al Rayan Bank is a deposit-taking financial institution. We stressed a set-off loss in our cash flow model, applicable at closing in the amount of £900,000, based on the historical level of deposits maintained by the customers in excess of the maximum amount covered under the Financial Services Compensation Scheme - currently at £85,000.

Credit And Cash Flow Analysis

We stress the transaction's cash flows to test the credit and liquidity support that the assets and cash reserve provide.

We apply these stresses to the cash flows at a 'AAA' rating level commensurate with the preliminary rating on the certificates. In our 'AAA' stress, all certificates must pay full and timely profit, and full principal by the legal maturity date.

Default and recovery amounts

We have applied the European residential loans criteria in our assessment of the WAFF and the weighted-average loss severity (WALS) for this portfolio. As a starting point in our analysis, we have used the archetypical U.K. residential loan pool assuming benign starting conditions. We have then applied the adjustment factors to each HPP to reflect its characteristics, in accordance with the criteria, to derive its foreclosure frequency, as well as the loss amount upon the property's subsequent sale (the loss severity, expressed as a percentage of the outstanding principal). For the entire pool, we have then determined the WAFF and WALS as summarized in table 3.

Default timings

At each rating level, the WAFF specifies the total balance of HPPs we assume to default over the transaction's life. We model these defaults to occur over a three-year recession. Further, we test the effect of the timing of this recession on the ability to repay the liabilities by starting the recessionary period at closing and year three.

We applied the WAFF to the principal balance outstanding at closing. We model defaults to occur periodically, in amounts calculated as a percentage of the WAFF. The timing of defaults follows two paths, referred to as "front-loaded" and "back-loaded" (according to table 4 in our European residential loans criteria).

Recovery timings

We assume that the issuer regains any recoveries 18 months after a payment default, in line with our standard assumption for owner-occupied properties in the U.K. The value of recoveries at each rating level is 100%, minus the WALS for that rating level (see table 4).

Table 4

Summary Of Cash Flow Assumptions	
	Certificates
Scenario	AAA
Credit enhancement available (%)	18.33
Expected losses at each rating scenario	13.13
Recoveries (%)	50.27
Recovery lag (months.)	18.00
CPR high (%)	30.00
CPR low (%)	4.00
CPR during recession (%)	3.00
PDL definition	Loss
Actual fees (£)	200
Servicing fee (%)	0.50

Table 4

Summary Of Cash Flow Assumptions (cont.)

	Certificates
Other fees (one-off fee)	357.01
Weighted-average margin (%)	2.67
Weighted-average margin after compression (%)	2.29

CPR--Constant prepayment rate. PLD--Principal deficiency ledger.

We base the WALS that we use in our cash flow model on losses in the finance balance, including foreclosure costs. We do not give credit to the recovery of any rental rate accrued on HPPs during the foreclosure period.

Delinquencies

We model the liquidity stress that results from short-term delinquencies (those HPPs that cease to pay for a period of time, but then recover and become current with respect to both rental rate and finance balance). To simulate the effect of delinquencies, we model a proportion of scheduled collections equal to one-third of the WAFF to be delayed. We apply this in each of the first 18 months of the recession, and model full recovery of these delinquencies to occur 36 months after they arise. Therefore, if the total scheduled collateral collections expected to be received is £1 million and the WAFF is 30% in month five of the recession, £100,000 (one-third of the WAFF) is delayed until month 41.

Profit and prepayment rates

We model four different profit rate scenarios on the certificates — up, down, up-down, and down-up.

We model three prepayment scenarios at all rating levels—high, low, and forecast. For this transaction, we modeled the forecast constant payment rate as 3.4%. During the recessionary period, we model the prepayment rate at 3.0%, before gradually reverting to a high prepayment rate under both scenarios. At the 'AA' level and above, we model an additional low prepayment scenario, which also reverts to a low prepayment rate after the recession period.

In combination, the default timings, recession timings, profit rates, and prepayment rates described above give rise to 60 different scenarios at a 'AAA' rating level (see table 5). The preliminary rating we assign means that the certificates have all paid timely profit and ultimate principal under each of the scenarios at the assigned rating level.

Table 4

Transaction Stress Scenarios

Rating level	Total number of scenarios	Prepayment rate	Recession start	Profit rate	Default timing
'AAA'	60	High, expected, and low	Closing and year 3	Up, down, up-down, down-up, forward for standard run	Front-loaded and back-loaded
'AA-' and below	40	High and low	Closing and year 3	Up, down, up-down, down-up, forward for standard run	Front-loaded and back-loaded

Scenario Analysis

Various factors could lead us to lower our rating on the certificates, such as increasing foreclosure rates in the underlying pool, house price declines, and changes in the pool composition. We have analyzed the effect of increased delinquencies by testing the sensitivity of the rating to two different levels of movements.

Increasing levels of delinquencies will likely cause more stress to a transaction, and would likely contribute to a downgrade of the rated certificates.

In our analysis, our assumptions for increased delinquencies are specific to a transaction, although these levels may be similar (or the same) across different transactions. The levels do not reflect any views as to whether these deteriorations will materialize in the future. However, our analysis already incorporates additional adjustments to the pool's default probability by projecting buckets of expected arrears.

Even under these scenarios, structural features in securitizations may mitigate these deteriorations in performance.

Further delinquencies of 16%

In the first scenario, in addition to the rating-dependent stress assumptions, we apply a further 16% increase in nonperforming HPPs. These are split equally between the one-month and three-month buckets. In the second scenario, we apply an increase of 16%, but all the HPPs are deemed to have missed three monthly payments. The default probability we assign to an HPP increases in tandem with the monthly payments missed. As a consequence, assuming that all HPPs have missed three monthly payments, the increase in the WAFF would be greater in the second scenario.

Tables 6 and 7 summarize the results of assuming increasing levels of delinquencies.

Table 6

Scenario Analysis

Assuming An Additional 8% Of Arrears, Split Equally Between One Monthly Payment And Three Monthly Payments Missed

Ratings	WAFF (%)	WALS (%)	CC (%)
AAA (sf)	31.40	49.73	15.61
AA (sf)	22.52	40.80	9.19
A (sf)	17.12	26.07	4.46
BBB (sf)	12.80	17.64	2.26
BB (sf)	8.44	12.24	1.03

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loss severity. CC--Credit coverage.

Table 7

Scenario Analysis

Assuming An Additional 8% Of Arrears, Split Equally Between One Monthly Payment And Three Monthly Payments Missed

Ratings	WAFF (%)	WALS (%)	CC (%)
AAA (sf)	34.40	49.73	17.11
AA (sf)	24.52	40.80	10.00
A (sf)	18.32	26.07	4.78
BBB (sf)	14.20	17.64	2.50
BB (sf)	9.44	12.24	1.15

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loss severity.

Under our scenario analysis, the rating on the certificates in the transaction is in line with our expectations in terms of the maximum potential deterioration for a 'AAA' rating level for one- and three-year horizons under moderate stress conditions, which are 'AA' and 'BBB', respectively (see "Methodology: Credit Stability Criteria," published on May 3, 2010).

We based our analysis above on a simplified assumption, i.e., that the increase in arrears materialized immediately on the day after closing. In reality, these are likely to occur over a period of time. Therefore, other factors, such as seasoning or repayments of some HPPs, could partially mitigate the effect of deteriorating performance of other HPPs.

Surveillance

We will maintain surveillance on the transaction until the certificates are fully repaid. To do this, we will analyze regular servicer reports detailing the performance of the underlying collateral, monitor supporting ratings, and make regular contact with the servicer to ensure that it maintains minimum servicing standards and that any material changes in the servicer's operations are communicated and assessed.

The key performance indicators in the surveillance of this transaction are:

- Increases in credit enhancement for the certificates;
- Total and 90-day delinquencies;
- Cumulative realized losses;
- FTV ratios;
- Constant prepayment rates; and
- Increases in the seasoning of the collateral pool.

Related Criteria

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Related Research

- EMEA Sector Roundup: Trends And Emerging Risks December 2017, Dec. 5, 2017
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- U.K. RMBS Index Report Q3 2017, Nov. 22, 2017
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