



International Swaps and Derivatives Association, Inc.

### **Disclosure Annex for Asset-Backed Security Derivative Transactions**

This Annex supplements and should be read in conjunction with the General Disclosure Statement. NOTHING IN THIS ANNEX AMENDS OR SUPERSEDES THE EXPRESS TERMS OF ANY TRANSACTION BETWEEN YOU AND US OR ANY RELATED GOVERNING DOCUMENTATION. Accordingly, descriptions in this Annex of the operation of ABS Derivative Transactions (as defined below) and the consequences of various events are in all cases subject to the actual terms of an ABS Derivative Transaction executed between you and us and its governing documentation (whether or not such qualification is expressly stated).

As used in this Annex, the term “**ABS Derivative Transaction**” refers to Transactions in which the Underliers are asset-backed securities (“**ABS**”). An ABS is a security that entitles the holder to receive payments that depend on the cash flow from a discrete pool of assets. The terms of an ABS Derivative Transaction may incorporate standard definitions published by industry bodies, annexes and supplements thereto, master confirmations and other market standard terms, which may in turn be amended or customized pursuant to the terms of the ABS Derivative Transaction and its governing documentation. Before entering into an ABS Derivative Transaction, you should obtain and review carefully any such materials incorporated by reference as their content could materially affect your rights and obligations under the ABS Derivative Transaction, its value and its appropriateness for your particular objectives.

One common type of ABS Derivative Transaction is a credit default swap (“**CDS**”) on an ABS or an index of ABSs. CDSs referencing ABSs will typically incorporate the definitions and provisions of the 2003 ISDA Credit Derivatives Definitions (the “**Credit Derivatives Definitions**”) published by the International Swaps and Derivatives Association, Inc. (“**ISDA**”), or any updated form of Credit Derivatives Definitions published by ISDA. However, unlike many other kinds of CDSs, CDSs referencing ABSs will typically exclude a supplement to the 2003 ISDA Credit Derivatives Definitions that provides for certain determinations to be made by Credit Derivatives Determinations Committees and for auction settlement. Therefore, for CDSs referencing ABSs, unlike many other kinds of CDSs, important determinations will typically be made by the calculation agent (which may be us) or by the party entitled to a relevant payment, rather than an industry body. Because a CDS on an ABS or an index of ABSs is a credit transaction, you should review the Disclosure Annex for Credit Derivative Transactions in connection with consideration of any such CDS.

Another common type of ABS Derivative Transaction is a total return swap (“**TRS**”) on an ABS or an index of ABSs. TRSs referencing ABSs will typically incorporate the definitions and provisions of the 2006 ISDA Definitions published by ISDA, or any updated form of those definitions published by ISDA.

#### **Pay-as-you-go CDS**

“Pay-as-you-go” credit default swaps (“**PAUG CDS**”) are a type of CDS developed for reference obligations that are ABSs. PAUG CDS may reference a single ABS or a portfolio of ABSs, sometimes in the form of a published index. ABSs may have complex structural features whereby the timing and amount of payments due to holders of a specific class of ABS are affected by the priority of payments among various classes of securities and the operation of coverage ratio, collateralization, and other structural tests. You should review carefully the governing documents of the reference obligation(s) of a PAUG CDS. The effectiveness of a PAUG CDS as a hedge of a particular ABS will depend on the extent to which the terms of the PAUG CDS reflect the structural features of the ABS and provide for possible contingencies that may affect the security.

PAUG CDS define a class of events related to the reference obligation and issuer as “floating amount events.” Certain PAUG CDS may also define a second class of events as “credit events.” Certain types of events may be both “floating amount events” and “credit events” under certain PAUG CDS, and certain PAUG CDS may allow for multiple settlement events to occur for a single reference obligation. If so specified under a PAUG CDS, the occurrence of a “credit event” may give rise to conditions to settlement and settlement obligations similar to those described in the Disclosure Annex for Credit Derivative Transactions under “Settlement Methods – Physical settlement.” However, under other PAUG CDS, the mechanism for payments and settlement may differ significantly from that for other CDS transactions. Credit events under a PAUG CDS may include events not defined under the Credit Derivatives Definitions, such as the principal and interest payment shortfalls and writedowns that could constitute a floating amount event (as described below), as well as a ratings downgrade of the reference obligation below a specified ratings threshold.

The occurrence of a floating amount event may require the protection seller to pay certain “floating amounts” to the protection buyer determined by reference to certain principal payment shortfalls, writedown amounts with respect to principal, and interest payment shortfalls. The terms of a PAUG CDS may include as an additional floating amount event an “implied writedown” with respect to principal, an event which the calculation agent may determine has occurred if there is a deficiency in the current value of the assets available to make payments both on the reference obligation and all liabilities senior and pari passu to it.

The terms of a PAUG CDS may specify that interest shortfall payments are subject to a cap, which may be fixed or variable. For example, a fixed cap may be set at a level equal to the periodic protection premium owed by protection buyer to protection seller. If the PAUG CDS does not contain a cap on interest shortfall payments, the protection seller is exposed to the full amount of expected interest payments on the reference obligation and thus a greater degree of variability in the amount of the interest shortfall payments it may be required to make. Parties should note that interest shortfall amounts under a PAUG CDS may be determined by reference to an “expected interest amount”, a quantity that is to be calculated without taking into account certain caps and other provisions found in the governing documents for the reference obligation that would limit, defer, extinguish or reduce the interest payments due.

Upon the occurrence of an event that is both a “floating amount event” and a “credit event”, under certain PAUG CDS, the terms of the PAUG CDS may allow the protection buyer to elect which of the two settlement mechanisms described above, or to specify that a combination of the

two mechanisms, will apply. The terms of the PAUG CDS may specify that the protection buyer is obligated to reimburse all or part of certain payments to the protection seller if the related writedown or shortfall amounts are ultimately paid to holders of the reference obligation or if the reference obligation is written up or, if applicable, the calculation of the implied writedown shows that the overall deficiency in assets has decreased. A reimbursement payment may be required in circumstances in which the protection seller did not pay, and the protection buyer did not receive, the amounts being reimbursed. The protection seller under a PAUG CDS has credit exposure to the protection buyer in respect of such reimbursement amounts. The duration of this reimbursement obligation, as specified in the terms of the PAUG CDS, may differ from the period over which a holder of the reference obligation would be entitled to receive the corresponding reimbursement payments, and may continue for a period of one year or more beyond the termination of the protection provided to the protection buyer by the PAUG CDS. In order to trigger a reimbursement requirement, notice must be given to the protection buyer by the calculation agent or the protection seller within a specified time period.

Determination of the floating amounts and reimbursement amounts in relation to floating amount events, as well as satisfaction of the conditions to settlement in relation to certain credit events, may depend solely on the relevant servicer reports for the reference obligation being available and containing adequate information to enable the required calculations to be made. We can offer you no assurance that such reports will be available and contain adequate information. In particular, access to servicer reports may be limited if such reports are confidential and neither counterparty holds the related reference obligation. If a servicer report corrects information provided in a previous report and such corrections impact calculations made under a PAUG CDS, the terms of the PAUG CDS may provide for retroactive adjustments to be made (without accrued interest on the adjusted payments, unless otherwise specified in the terms of the PAUG CDS).

The amount of credit protection purchased or sold under a PAUG CDS on a specific ABS may be greater or less than the actual outstanding principal balance of such ABS, and in such instances the actual payment shortfalls, writedowns and reimbursements may be scaled up or down, as applicable, by a multiplier or “applicable percentage” in order to calculate the corresponding floating amounts and reimbursement amounts due under the PAUG CDS. In addition, the terms of the PAUG CDS may provide that floating amounts are only due and payable by the protection seller to the extent that the aggregate of all floating amounts calculated under the PAUG CDS exceeds a certain threshold, and that floating amounts cease to be due and payable by the protection seller when the aggregate of all floating amounts calculated exceeds a second, higher threshold.

Some PAUG CDS may include provisions granting voting or other control rights from the protection buyer to the protection seller; however, such agreement between the parties to the PAUG CDS is not binding on the issuer or trustee for the related ABS and may be subject to conditions and requirements. See the Disclosure Annex for Credit Derivative Transactions under the heading “A protection seller will not have the rights of a holder of a debt obligation (e.g., voting, participation in restructuring)”.

### **ABS Derivative Transactions Referencing Mortgage-Backed Securities**

A mortgage-backed security (“**MBS**”) is a security that entitles the holder to receive payments that depend on the cash flow from a discrete pool of residential or commercial mortgage loans. A MBS is typically issued by a trust or other special purpose entity (collectively, “**SPE**”) that holds the underlying mortgage loans. A single SPE may issue multiple classes (or tranches) of MBSs, each having a different priority with respect to defaults and/or prepayments of principal on the mortgage loans held by the SPE. A holder of a MBS may be entitled to a fixed rate of interest, or may be entitled only to an amount based on actual cash flows realized on the underlying mortgage loans during a given period (subject to the rules that allocate such cash flow among the various tranches). Even if a given MBS pays a fixed rate of interest, the SPE issuer will pay such fixed amount only if it has sufficient available funds, which will generally depend on the cash flows on the underlying mortgage loans.

A holder of a MBS is subject to a number of risks, including:

- the risk of default on the underlying mortgage loans;
- the risk that the underlying mortgage loans will be prepaid when general interest rates are low, forcing the holder to reinvest in a lower interest rate environment; and
- the risk that general interest rates will rise, leaving the holder with an entitlement to below-market interest rates on the MBS that will have a longer duration due to the lack of prepayments.

Generally, the impact of default on the underlying mortgage loans is greater the more junior the MBS tranche. A party to an ABS Derivative Transaction who has a long position with respect to underlying MBSs (such as the protection seller in a CDS referencing MBS) will also be subject to these risks.

The SPE issuing a MBS may be created by a private entity, by a government-sponsored enterprise (“**GSE**”) such as the Federal National Mortgage Association (“**Fannie Mae**”) or the Federal Home Loan Mortgage Corporation (“**Freddie Mac**”) or by a governmental agency such as the Government National Mortgage Association (“**Ginnie Mae**”). We refer to any such MBS as an “**agency MBS**”. The cash flows on certain MBSs may be guaranteed by a GSE or by Ginnie Mae. It is important to understand that any guarantee by a GSE is subject to the credit risk of the GSE and is not backed by the full faith and credit of the United States Government.

There are many different types of MBS. You should carefully review and understand the characteristics of the MBSs underlying any Credit Transaction you may enter into, including:

- whether the underlying mortgage loans are residential or commercial;
- if the underlying mortgage loans are residential, the credit profile of the underlying borrowers, the debt-to income ratio of the borrowers and the loan-to-value ratio of the mortgages and whether the underlying mortgage loans are first lien or junior lien;
- whether the underlying mortgage loans are fixed rate or adjustable rate and whether they are fully amortizing, interest only or permit the capitalization of interest;

- the rules governing the priority and other characteristics of the specific MBS tranche;
- whether the MBS is guaranteed by a GSE or governmental agency;
- the degree of concentration of the underlying mortgage loans in terms of salient characteristics;
- the current delinquency rate on the underlying mortgage loans; and
- if any credit support is provided for the MBS in the form of a third-party guarantee, insurance or otherwise, any limitations on the coverage of that credit support and the creditworthiness of the applicable credit support provider.

It is important to understand these characteristics of a MBS because they may have a significant effect on the likelihood that there will be losses on the MBS, which may affect the Transaction Economics.

We or our affiliates may act as sponsor, originator, servicer, underwriter, trustee, swap provider or in other capacities with respect to one or more MBSs that underlie any Credit Transaction we enter into with you. We and our affiliates will have no obligation to take your interests into account in acting in such capacities, and actions we or our affiliates may take and fees we may receive in such capacities may adversely affect the Transaction Economics.

#### *CDS on MBS Index*

The parties to a CDS on a MBS index typically have rights and obligations as though they had entered into separate CDSs in respect of each MBS underlying the index, except that the parties may not be permitted to transfer or terminate the index CDS except as a whole (if they are otherwise entitled to do so). The portion of the total notional amount of the CDS that is attributable to each underlying MBS will depend on the rules of the index and may or may not be equal for all underlying MBSs. A CDS on a MBS index will generally involve the risks described under “Index CDS – General risks” in the Disclosure Annex for Credit Derivative Transactions.

MBS indices may be differentiated based on whether the mortgage loans underlying the underlying MBSs are residential or commercial, among other characteristics. You should carefully review and understand the characteristics of the MBSs underlying any Credit Transaction you may enter into. MBS indices comprising MBS tranches with lower priority generally have lower credit ratings and a greater risk of losses. However, it is important to understand that a high credit rating is no guarantee that there will not be losses, and the credit rating given upon issuance of a MBS may be downgraded over the term of the MBS. In real estate market downturns, even MBSs that are highly rated at issuance may experience significant losses.

The terms of a CDS on a MBS index may follow a different market convention depending on the characteristics of the underlying MBSs, including with respect to: (i) whether the underlying MBSs can experience implied writedowns; (ii) whether expected interest (as described above

under “Pay-as-you-go CDS”) gives effect to a “weighted average coupon” or “weighted average rate” cap with respect to the underlying MBSs; and (iii) whether there is a cap on interest shortfall amounts. If a correction payment is required as a result of a correction being made to information on which a calculation or determination under the CDS was made, CDSs on MBS indices typically provide that the correction payment will be owed by the person who is the applicable counterparty at the time of the correction, even if that person was not the applicable counterparty at the time of the original payment.

#### *TRS on MBS Index*

A TRS on a MBS index is an ABS Derivative Transaction that typically transfers the return on a specified underlying MBS index from one party to the other in exchange for a financing payment. The financing payment will typically be paid at a specified rate (which may be a floating benchmark rate, such as a LIBOR rate, that is reset periodically) by the party that has “long” exposure to the underlying MBS index (the “long party”) to the party that has “short” exposure to the underlying MBS index (the “short party”). In exchange for the financing payment, if the return on the underlying MBS index is positive, the long party will receive a payment from the short party based on that return. However, if the return on the underlying MBS index is negative, the long party will owe a payment to the short party based on that negative return, in addition to the financing payment.

The return on an underlying MBS index will depend on whether the index represents only the interest component, only the principal component or both the interest and principal components of the underlying MBSs.

- If a MBS index represents only the interest component of the underlying MBSs, the return on the MBS index over a specified period will typically consist of the fixed rate of interest payable on the underlying MBSs plus any change (which may be positive or negative) in the “mark-to-market” value of the interest component of the underlying MBSs over that period. If the mark-to-market value of the interest component increases, or if it decreases by less than the interest payment, the return on the underlying MBS index will be positive and the short party will owe a payment to the long party based on that return. However, if the mark-to-market value of the interest component decreases by more than the interest payment, the return on the underlying MBS index will be negative and the long party will owe a payment to the short party based on that negative return, in addition to the financing payment.
- If a MBS index represents only the principal component of the underlying MBSs, the return on the MBS index over a specified period will typically consist of any payments of principal on the underlying MBSs over that period, as reflected in an “index factor” calculated by the index publisher, plus any change (which may be positive or negative) in the mark-to-market value of the principal component of the underlying MBSs. If the mark-to-market value of the principal component increases, or if it decreases by less than the principal payment reflected by the change in the index factor, the return on the underlying MBS index will be positive and the short party will owe a payment to the long party. However, if the mark-to-market value of the principal component decreases by more than the change in the index factor, the return on the underlying MBS index will

be negative and the long party will owe a payment to the short party based on that negative return, in addition to the financing payment.

- If a MBS index represents the interest and principal components of the underlying MBSs, the return on the MBS index will reflect a combination of the two preceding bullets.

The mark-to-market value of the applicable component(s) may be determined based on the price of the MBS index as published by the index publisher, which may be determined based on a poll of dealers. Each dealer's submission in response to the poll will not represent an actual bid or offer for the applicable component(s). Dealers may not be required to employ any particular methodology in calculating values of the applicable component(s) for purposes of the poll, and the poll results may be significantly influenced by the different methodologies dealers choose to employ. We may be one of the dealers polled by the index publisher and, if so, our actions could affect the published price. In taking any such actions, we have no obligation to consider your interests as our counterparty. Our actions could affect the index and could adversely affect your Transaction Economics.

The value of a TRS on a MBS index will be affected significantly by the speed of prepayments on the underlying MBSs. In general, increased prepayments:

- will reduce the value, from the perspective of the long party, of a TRS on a MBS index representing only the interest component of underlying MBSs;
- will reduce the value, from the perspective of the short party, of a TRS on a MBS index representing only the principal component of underlying MBSs; and
- may increase or decrease the value of a TRS on a MBS index representing both the interest and principal components of underlying MBSs, depending on the circumstances.

Prepayments may occur for a variety of reasons, including because mortgagors refinance their mortgages to take advantage of lower rates or, in the case of certain agency MBSs, because defaults occur that require a federal agency to repurchase mortgages from the underlying pool. The speed of prepayments is affected by such factors as general interest rates, general economic conditions, lending capacity and homeowner turnover rates.

In some cases, your objective in entering into a TRS on a MBS index may be to hedge or offset other exposure you may have. There can be no assurance that payments under the TRS on a MBS index will match such other exposure. See "No assurance that you will achieve your hedging or other objectives" in the Disclosure Annex for Credit Derivative Transactions.

Please refer to "Total Return Swap" in the Disclosure Annex for Credit Derivative Transactions, which describes considerations that are generally relevant for a TRS on a MBS index. The words "total return" indicate that the TRS passes through the return on the applicable MBS index, but do not indicate that there is any reinvestment of coupon or prepayments.

### *Markit MBS Indices*

Markit Group Limited (together with its affiliates, “**Markit**”) publishes a number of MBS indices, including the following CDS indices:

- ABX, a family of subprime residential MBS indices;
- PrimeX, a family of prime residential MBS indices excluding agency MBSs; and
- CMBX, a family of commercial MBS indices;

and the following TRS indices:

- MBX, a family of residential agency MBS indices;
- IOS, a family of indices referencing the interest component of residential agency MBSs;
- PO, a family of indices referencing the principal component of residential agency MBSs; and
- TRX II, a family of commercial MBS indices.

Important information about ABS Derivative Transactions linked to a Markit-published index may be found on Markit’s website at [www.markit.com](http://www.markit.com). The information on Markit’s website includes the standard terms supplement for the applicable ABS Derivative Transaction, the most recent and archived annexes of reference obligations for the applicable index and the rules of the applicable index. If any ABS Derivative Transaction is cleared through a clearinghouse, the rules, by-laws and procedures of the clearinghouse will govern the cleared ABS Derivative Transaction and define its terms, which may differ from those contained on Markit’s website. See Section II.B. – “You should review carefully each Transaction’s particular structure, including terms incorporated by reference” – of the General Disclosure Statement.

### **Balance Guaranteed Swaps**

A balance guaranteed swap is a derivative instrument in which the notional amount amortizes in part or in its entirety based upon the realized amortization of either a reference pool of assets or a tranche or securitized interest backed by a pool of assets. The uncertainty in the amortization schedule distinguishes balance guaranteed swaps from other amortizing swaps. The other terms of a balance guaranteed swap may or may not be linked to the reference pool, tranche or securitized interest to which the amortization of the notional amount is linked. The value of a balance guaranteed swap will depend on the factors that are relevant to those other terms, as well as on the realized and expected amortization of the underlying reference pool, tranche or securitized interest and the volatility of the amortization rate. The amortization rate and its volatility may be subject to significant uncertainty and will be affected by factors such as prepayments and defaults on the underlying assets. Because the amortization rate may be subject to significant uncertainty, valuation of a balance guaranteed swap may be difficult and require significant discretionary determinations to be made. When we calculate the value of a balance guaranteed swap for any purpose, including in the event of early termination of a balance guaranteed swap, our interests will be adverse to yours. See IV.A.6 – “Conflicts of Interest and

Material Incentives – Our financial market activities may adversely impact Transactions – Act as calculation agent, valuation agent, collateral agent, or determining party” – of the General Disclosure Statement. If a balance guaranteed swap is linked to a tranche or securitized interest, the balance guaranteed swap may contain specific terms relating to matters such as the priority of payments from the underlying pool of assets, which may have a significant effect on the amortization rate.