HM TREASURY

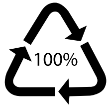
Review of the UK's regulatory framework for covered bonds

April 2011

HM TREASURY

Review of the UK's regulatory framework for covered bonds

April 2011



Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

© Crown copyright 2011

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit http://www.nationalarchives.gov.uk/doc/open-government-licence/ or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or e-mail: psi@nationalarchives.gsi.gov.uk.

ISBN 978-1-84532-862-7
PU1159

Contents

		Page
Chapter 1	Introduction	3
Chapter 2	The current regime	7
Chapter 3	The review	23
Chapter 4	Related regulatory issues	39
Chapter 5	Impact Assessment	43
Annex A	Draft amending regulations	61
Annex B	Draft FSA Sourcebook amendments	69
Annex C	FSA Compatibility Statement	79
Annex D	How to respond to the consultation	81

1 Introduction

1.1 The financial crisis exposed significant weaknesses in many banks' funding models. An over-reliance on short-term funding that required constant re-financing left many institutions too vulnerable to market disruptions. Banks are now moving to a base of longer-term, more stable funding, which will make them better able to withstand market disruptions and maintain a stable supply of lending to support the economy.

1.2 Covered bonds can play an important role in this transition. Covered bonds are a category of secured bonds issued by banks and building societies and typically backed by mortgages or public sector loans. Box 1.A sets out more detail on their key features. Covered bonds can provide long-term, stable funding from a diverse investor base. Covered bond markets have demonstrated their relative resilience even in distressed market conditions and, following the crisis, have grown to make up for some of the loss of other sources of funding.

1.3 The Government and the Financial Services Authority (FSA) are committed to supporting the development of a strong covered bond market in the UK. This will help banks and building societies make best use of covered bond funding alongside other sources of funding such as unsecured funding or securitisations to develop a diversified, resilient funding model. This will support lending to the real economy, and improve financial stability.

1.4 Regulation has a very important role to play in the covered bond market. Most covered bond markets across the world are underpinned by dedicated legislation. This typically sets out criteria for the assets that can back a covered bond, a process for managing investors' recourse to those assets if the issuer of the covered bond fails, and a system of regulatory oversight.

1.5 The first UK covered bonds were issued in 2003, without the benefit of dedicated legislation. To support further development of the UK covered bond market and help UK covered bonds compete on a level playing field with other jurisdictions, a legislative framework for UK covered bonds was introduced in 2008, known as the Regulated Covered Bonds Regulations 2008.

1.6 The Regulations have been a success and have facilitated rapid growth in the UK covered bond market. There are now ten registered issuers of regulated covered bonds, and the sterling equivalent value of outstanding covered bonds issued under the regulated framework has exceeded £100 billion. See 2.53 for further information on the UK regulated covered bond market, and Chart 2.B for a list of current registered issuers of regulated covered bonds.

1.7 The UK market is continuing to develop and become increasingly sophisticated:

- a key development in the market in 2010-11 has been growing demand for sterling-denominated covered bonds. The Government and the FSA welcome this development, and note that sterling-denominated bonds issued in 2011 have been strongly oversubscribed;

- since the regime was introduced, five issuers have successfully applied to the FSA for permission to issue N-Bonds[1], a category of covered bonds that are privately placed with certain German investors; and
- UK covered bond issuers have successfully issued bonds in the emerging covered bond market in the USA, while features of the UK framework have been adopted in other jurisdictions.

Box 1.A: What is a covered bond?

Covered bonds are a type of secured bond that is usually backed by mortgages or public sector loans. In the UK, the assets backing the bond are transferred to a separate legal entity (a 'Special Purpose Vehicle' or SPV[2]) and form collateral for the bonds.

The asset pool of a covered bond is dynamic and so, for example, mortgages which are refinanced or which fall into arrears can be replaced with new mortgages of similar credit quality and characteristics, for as long as the issuer of the bond remains solvent.

An important feature of covered bonds, which clearly distinguishes them from securitisations, is that investors have dual recourse, both to the issuer and to the underlying pool of assets:

- under normal circumstances, covered bonds are an obligation of the issuer, so investors can expect that the issuer will make interest and principal payments on the agreed dates;
- in the event that the issuer of the covered bond defaults on its obligations to covered bond holders or becomes insolvent, the asset pool becomes static and the SPV takes responsibility for administering the asset pool to continue to make payments to bondholders on the agreed dates; and
- if there are insufficient assets in the asset pool to meet obligations to covered bond holders, they become unsecured creditors of the failed issuer for the residual amount.

1.8 When the UK regulated framework for covered bonds was introduced in 2008, it was intended that a routine review take place within a year of its implementation, to evaluate its effectiveness. The financial crisis caused widespread disruption in all financial markets, which made it difficult to assess the performance of the UK framework. The review was therefore postponed.

1.9 During 2010, covered bond markets regained their stability and UK firms issued a significant volume of new regulated covered bonds. With conditions continuing to improve in 2011, further regulated covered bonds have been issued in public markets in the early part of this year and were favourably received by investors. In light of these developments, the Government and the FSA have decided that now is an appropriate time to conduct a review of the UK's regulated covered bond regime.

[1] Namensschuldverschreibungen.

[2] Referred to as the 'owner' in the Regulations and FSA Sourcebook.

1.10 The review has been informed by feedback from a wide range of market participants, including issuers, investors, rating agencies and analysts. This feedback has been positive, with many participants commenting that the UK regime is strong and has supported the development and growth of the UK covered bond market. No major weaknesses have been raised by market participants.

1.11 Instead, the feedback has suggested that a number of small changes to the UK regime could help highlight its key strengths and increase its comparability with other countries' regimes without imposing significant costs on issuers. Both issuers and investors have indicated these changes could increase the appeal of UK regulated covered bonds as an investment.

Wider regulatory issues affecting covered bonds

1.12 In addition to developments in covered bond markets themselves, the ongoing development of new international standards of financial regulation may have broader consequences that affect covered bonds. These matters are not within the formal scope of this review, but will be of interest to covered bond market participants.

1.13 One such area is bank liquidity regulation, which is designed to ensure financial institutions hold sufficient liquid assets that they can weather short-term disruptions in financial markets. The UK is actively engaged in the ongoing international negotiations about liquidity regulation, which include consideration of how covered bonds could be incorporated into the make-up of the liquid asset buffers that banks will be required to hold. The FSA will consider carefully how best to adopt the agreed international framework for liquidity regulation, once this has been finalised, into the regulation already in place in the UK. See 4.11 for further information.

1.14 Another area is the development of resolution powers, which are designed to allow the authorities to deal with a failing financial institution in a way that minimises disruption to the economy and costs to taxpayers. International discussions on these powers are ongoing, and the UK is engaging actively with its international partners. A key issue of current discussion is the scope of proposed 'bail-in' powers, which would allow the authorities to impose losses on the creditors of a failing financial institution. The UK believes that in the exercise of any bail-in powers, secured creditors' rights to collateral should not be over-ridden. See 4.1 for further information on how this applies to covered bonds.

Summary of the review

1.15 The aim of this review is to ensure the Regulations continue to support the UK covered bond market. The Government and the FSA believe the Regulations should help UK issuers compete on a level playing field with issuers from other jurisdictions. This involves enhancing the quality and reputation of the UK regulated covered bond market, maintaining high standards, and emphasising best practice.

1.16 The Government and FSA are also committed to promoting investor understanding of the UK's regulated covered bond regime. Chapter 2 of this review is a guide to the UK regime that will help investors identify its key features and strengths. It explains both the UK's covered bond legislation and the associated FSA supervision of regulated covered bonds.

1.17 The review also considers a number of small changes to the UK's regulated covered bond regime. Informed by the feedback from investors, the Government and FSA are proposing a collection of measures which will build on and emphasise existing best practice in the UK market. These measures aim to increase the visibility of regulation, make it easier to understand the strengths of the UK regime, and facilitate comparability between the UK and other jurisdictions by creating a more prescriptive regulatory framework.

1.18 The proposed measures will highlight the relative appeal of UK regulated covered bonds to investors choosing between different covered bond markets. Many issuers and investors have indicated their support for these measures, and many are already features of existing covered bond markets in other jurisdictions. The measures include:

- creating an option in legislation for an issuer to formally designate a regulated covered bond programme as backed by only a single asset type and liquid assets;
- excluding securitisations as eligible assets for regulated covered bond asset pools;
- requiring issuers to meet a fixed minimum level of overcollateralisation in regulated covered bond programmes, to facilitate comparison with the legal minima in other jurisdictions;
- creating a formal role for an 'asset pool monitor' to provide independent, external scrutiny of an issuer's regulated covered bond programme;
- introducing consistent standards of investor reporting across all UK regulated covered bond programmes, including loan-level data; and
- updating and consolidating the regulatory reporting that the FSA requires when issuers apply to register with the FSA and on an ongoing basis.

1.19 Chapter 3 of the review considers and explains these proposals in detail, and seeks feedback from market participants on them and on the regulated covered bond framework more generally. It also seeks views on the appropriate timeframe for implementing these proposals.

1.20 Chapter 4 discusses a number of related areas of regulation that are not in the formal scope of this consultation, but may affect the covered bond markets. This includes bank liquidity regulation and the ongoing development of resolution powers that allow the authorities to intervene in failing financial institutions.

1.21 Chapter 5 is an Impact Assessment of the proposed changes. It estimates that the proposals could benefit issuers by around £2m a year, while the administrative costs involved in the changes would be around £0.4m a year. The Government and the FSA would welcome comments on the Impact Assessment.

1.22 Annex A sets out the draft amending regulations to implement the proposed changes, and Annex B sets out corresponding amendments to the FSA Sourcebook. Annex C explains how the proposed changes align with the FSA's statutory objectives under the regulated covered bond regime.

1.23 Annex D explains how to respond to the consultation. The Government and the FSA will consider these responses, and then announce what changes they intend to make to the framework as a result. Legislation will then be laid before Parliament and the FSA will amend its Sourcebook accordingly.

2 The current regime

2.1 This Chapter is intended as an overview of the current UK regulated covered bond regime. It provides a high-level outline of:

- the legal underpinnings of UK regulated covered bonds;
- the FSA's supervision of regulated covered bond programmes;
- recent performance of the UK regulated covered bond market; and
- the industry forums for UK regulated covered bonds.

2.2 Box 2.A provides a summary of the key features of the UK regime. These are discussed in detail in the rest of this Chapter.

2.3 The UK's regulatory regime for covered bonds allows UK regulated covered bonds to take advantage of favourable treatment in European legislation, which increases their attractiveness to investors. This treatment recognises that the legislative requirements placed on regulated covered bonds and the regulatory supervision of regulated covered bond programmes makes them a safer investment than other asset classes. The favourable treatment includes:

- Increased investment limits: the Undertakings for Collective Investment in Transferable Securities Directives (UCITS) are a set of European Union Directives that allow collective investment schemes to operate throughout the EU on the basis of a single authorisation from one member state. UCITS schemes and non-UCITS retail schemes can hold up to 25% of their assets in regulated covered bonds issued by a single issuer, compared to only 5% in other bonds from a single issuer[1]. Similarly, firms subject to the FSA's regulations concerning insurance companies can invest up to 40% of their assets in regulated covered bonds, but only 5% in unregulated covered bonds[2]; and

- Preferential prudential risk weighting: credit institutions subject to the Capital Requirements Directive must hold capital to cover possible losses on their assets based on the riskiness of those assets. Investments in regulated covered bonds benefit from up to 60% lower risk weights than other corporate bonds[3]. Insurance companies are also subject to prudential regulation, which the European Commission is revising through the draft Solvency 2 Directive. The current proposals assign 'AAA' rated regulated covered bonds a spread risk factor of 0.6% compared with 0.9% for 'AAA' rated corporate bonds.

[1] Article 22(4) of the 85/611/EEC UCITS Directive. See http://ec.europa.eu/internal_market/investment/legal_texts/instruments_en.htm.

[2] INSPRU 2.1.22R (3)(b). See http://fsahandbook.info/FSA/html/handbook/INSPRU/2/1.

[3] Paragraph 71 of Annex VI of the 2006/48/EC CRD Directive. See http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

Box 2.A: Ten key features of the UK's regulated covered bond regime

1. The regime is based on dedicated legislation, the Regulated Covered Bonds Regulations 2008.
2. The Regulations provide for the full segregation of covered bond asset pools from the issuer in a separate legal entity (a 'Special Purpose Vehicle' or SPV) on which bond holders have a priority claim if the issuer becomes insolvent.
3. Only deposit-taking institutions with their headquarters in the UK can become regulated covered bond issuers, and the SPV holding the asset pool must also be based in the UK.
4. Only eligible property as defined in legislation can be used as collateral in regulated covered bond asset pools.
5. Regulated covered bond issuers and regulated covered bonds are supervised by the UK's financial regulator, the FSA. Issuers must seek approval from the FSA before making changes to their programme that the FSA judges to be material.
6. The Regulations require the assets backing a regulated covered bond programmes to be maintained in a way that ensures 'there will be a low risk of default in the timely payment' of the bonds.
7. Issuers are subject to an extensive initial registration process and regular stress-testing of their regulated covered bond programmes by the FSA, independently of issuer's own stress testing and any rating agency scrutiny.
8. Overcollateralisation requirements are set by the FSA's robust stress testing. These are determined on a post-insolvency basis and based on the risk profile of each individual programme.
9. The FSA has a wide range of enforcement powers to ensure issuers comply with the Regulations, including the power to issue directions, for example to add assets into the asset pool, which are enforceable by the courts.
10. On the insolvency of a regulated covered bond issuer, the FSA continues to supervise the SPV holding the asset pool, and does so in line with the FSA's legal duty to have regard to the need to preserve investor confidence in the regulated covered bond market.

The UK's regulated covered bond legislation

2.4 The UK's covered bond legislation is set out in the Regulated Covered Bonds Regulations 2008 (the Regulations)[4]. The key features of the legislation are as follows.

Regulatory supervisor of covered bond programmes

2.5 The FSA is the designated supervisor of UK regulated covered bonds. The FSA assesses all applications by financial institutions for admission to the Register of issuers of regulated covered bonds, and assesses applications to register individual bonds or programmes[5]. Only deposit-taking institutions with their registered office in the UK can register as regulated covered bond issuers.

2.6 Once programmes are registered, the FSA monitors the level and quality of assets in the programmes and the issuers' compliance with their obligations under the Regulations on an ongoing basis. As supervisor of the regulated covered bond regime, the FSA has a duty under the Regulations to have regard to the need to preserve investor confidence in the regulated covered bond market[6]. Where issuers propose making changes to their regulated covered bond programmes, the issuer must notify the FSA and seek approval from the FSA if the FSA deems the proposed changes to be material[7].

2.7 The FSA is also responsible for giving guidance in relation to the operation of the Regulations. This guidance can be found in the FSA's Sourcebook[8], and covers the following areas:

- applications for registration, including requirements on the quality of the asset pool;
- ongoing requirements for issuers to provide the FSA with information relating to the asset pool and the regulated covered bonds issued under a programme, and to certify compliance with the regulated covered bond regime's requirements;
- use of external auditors, accountants and lawyers to verify compliance with the regulated covered bond regime's requirements; and
- the FSA's enforcement powers under the regulated covered bond regime and its policy on giving decision and warning notices to issuers in cases of non-compliance.

2.8 In addition to monitoring compliance with the Regulations, the FSA conducts regular stress testing of regulated covered bond programmes. The FSA also receives prior notification of any proposed new issuance, allowing it to intervene ahead of new issuance if there are any concerns about the resulting levels of overcollateralisation. More detail on the FSA's supervisory practices is set out below. See 2.25.

2.9 Supervision and oversight of UK regulated covered bonds under the Regulations will continue following the proposed restructuring of the UK's regulatory architecture for financial services. Under the proposed split of the FSA into the new PRA (Prudential Regulation Authority) and FCA (Financial Conduct Authority), the supervision of the UK's regulated covered bond market would be transferred to the FCA.

[4] S.I. 2008/346, http://www.legislation.gov.uk/uksi/2008/346/contents/made.

[5] Regulations 8 to 14.

[6] Regulation 6.

[7] Regulation 20.

[8] http://fsahandbook.info/FSA/html/handbook/RCB.

Eligible assets

2.10 The Regulations limit the assets that are eligible for inclusion in regulated covered bond asset pools[9]. The standards for eligible assets are derived from those set out in European legislation, in the Capital Requirements Directive. This allows exposures to loans secured on residential property up to a loan-to-value ratio (LTV) of 80% and loans secured on commercial property up to an LTV of 60%. Loans with higher LTVs can also be included, but their balances will only be counted up to these LTV limits. It also allows exposures to public sector loans, and to loans secured on ships.

2.11 In the UK covered bond legislation, the category of public sector loans has been extended to include loans to housing associations in the private sector where those loans are ultimately secured on residential property. Housing associations are closely regulated social enterprises with a long history of no defaults, and whose tenants usually receive contributions towards their rent from the state. Eligible public sector loans also include loans connected to public-private partnerships where the cashflows for the loans are backed by public sector bodies.

Quality of covered bond programmes

2.12 The Regulations set out an explicit requirement that the asset pool of a regulated covered bond must be 'of sufficient quality to give investors confidence that in the event of the failure of the issuer there will a low risk of default in the timely payment'[10] of the obligations to bond holders.

2.13 Issuers must manage the asset pool with this objective in mind, and follow directions provided by the FSA. The Regulations require that the FSA's guidance must include information on the factors it will take into account in assessing issuers' compliance with the Regulations, such as[11]:

- fluctuations in the value of assets and the income from assets;
- fluctuations in the value of interest and exchange rates;
- geographical concentration and diversification of assets in the asset pool;
- the risk of loss if a person fails to perform its obligations, or fails to perform them in a timely manner; and
- counterparty credit risk, in particular, in relation to any interest rate, currency or other hedging instruments relating to the asset pool.

2.14 Further details of the FSA's approach to assessing how issuers have taken account of these factors are discussed below. See 2.33.

Structure of UK regulated covered bonds

2.15 Figure 2.A illustrates the simplified typical structure of a UK regulated covered bond.

2.16 Regulated covered bonds are issued by credit institutions that have successfully registered with the FSA as a regulated issuer. The issuer is responsible for the payment of interest and principal on the bonds.

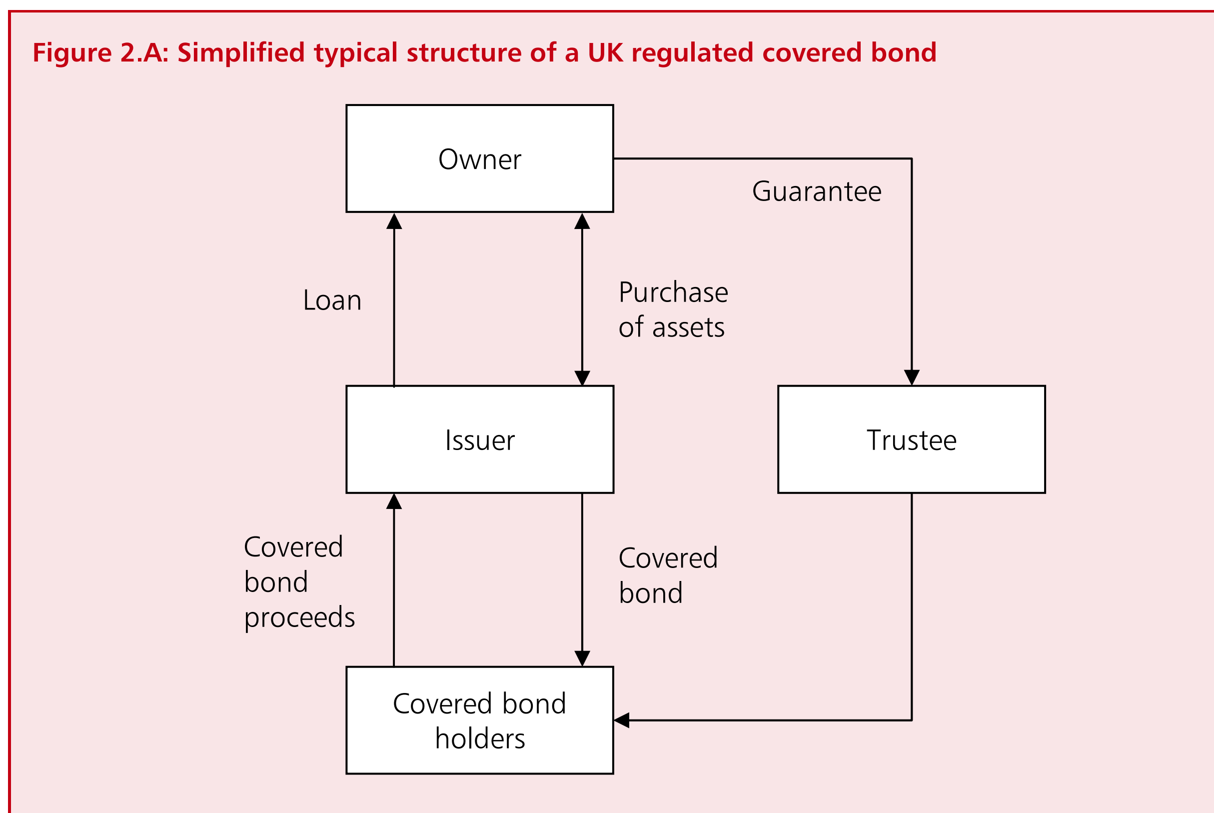
[9] Regulation 2.
[10] Regulation 17(2)(d).
[11] Regulation 42(3).

2.17 Under the Regulations, an issuer must set up a Special Purpose Vehicle (SPV), which is typically a limited liability partnership (LLP). The Regulations refer to the SPV as the 'owner' of the asset pool.

2.18 The Regulations require the issuer to use the proceeds from issuing a regulated covered bond to make a loan to the owner. The owner must then use this loan to purchase a portfolio of eligible assets from the issuer[12]. The issuer may also make contributions to support any additional overcollateralisation.

2.19 The owner must grant a guarantee (which is typically via a trustee) to use the asset pool to pay the issuers' obligations to regulated covered bond holders in the event of the failure of the issuer[13]. The following section describes the provisions of the Regulations that would apply in this scenario.

Figure 2.A: Simplified typical structure of a UK regulated covered bond



Insolvency treatment of regulated covered bond programmes

2.20 Regulated covered bonds are, in the first instance, an obligation of the issuer.

2.21 Regulated covered bonds are also ultimately secured against the asset pool held by the owner via a guarantee, as described above. Issuers are required to maintain and administer the asset pool in such a way that there is timely payment of claims attaching to the bond and provide the FSA with information on steps taken to achieve this.

2.22 Following an event of default or the insolvency of the issuer, the obligations to investors under the programme continue. The owner is subject to supervision by the FSA, and must

[12] Regulations 16 and 22.

[13] Regulation 4.

comply with the Regulations that require it to administer the asset pool to provide for timely payment of claims attaching to the bond.

2.23 The Regulations provide that holders of regulated covered bonds shall have a priority claim on the asset pool ahead of other creditors, subject to the priority of the expenses of the winding-up in a compulsory liquidation[14]. They will also remain unsecured creditors of the failed issuer, which will give them the opportunity to recover any residual loss after realisation of the asset pool in line with other creditors. Investors therefore benefit from 'dual recourse' – to both the issuer of the regulated covered bond and to the underlying pool of assets.

2.24 Any material change to a regulated covered bond programme must be approved by the FSA[15]. Such changes would include any change of ownership of the owner. The FSA would consider an application for a change of the owner in line with its duties as the regulator, including its duty to have regard to preserving investor confidence in regulated covered bonds.

The FSA's supervision of UK regulated covered bond programmes

2.25 The FSA is responsible for the initial registration and ongoing supervision of regulated covered bond programmes.

Registration

2.26 When an institution first applies for registration as an issuer of regulated covered bonds, the FSA conducts a rigorous two stage review of the issuer and their proposed programme.

2.27 This review is independent of any other analysis, such as credit rating agency analysis, and assesses at least the following:

- oversight and governance framework;
- asset quality;
- ability to make timely payment; and
- legal compliance, including an independent review of the legal documentation submitted as part of the application.

2.28 The total application process is split into two stages. Firstly, prospective issuers are required to submit a detailed application form and supporting legal documentation. This includes the proposed structure and governance of the regulated covered bond programme, underwriting policies, information relating to the asset pool, proposed issuance plans, management information relating to the assets, and six stressed scenarios devised by the issuer. These must reflect their view of the key risks to the programme and the proposed issuance plans.

2.29 The FSA reviews this information, including the legal documentation, against the criteria set out in the Regulations and Sourcebook and in line with its duty to have regard to the quality and integrity of the UK regulated covered bond sector and investor confidence in it. It also conducts its own stress testing of the asset pool against the scenarios provided by the issuer, and separately against the criteria set out in the Regulations and Sourcebook using its own stress testing model.

2.30 This is followed by an on-site visit to the issuer's premises by the FSA's regulated covered bonds supervision team, the FSA's prudential risk specialists, and the FSA team that supervises

[14] Regulation 27.
[15] Regulations 20, 25.

the issuer's overall operations. The FSA reviews the creditworthiness of the regulated covered bond programme, and investigates the wider governance and compliance arrangements.

2.31 The FSA may then request further information or mandate further actions to improve the programme, until it is satisfied that the programme meets all the registration criteria. Applications may be refused if the FSA judges that the prospective issuer fails to meet the required standards, or could compromise the quality of the UK's regulated covered bond regime.

2.32 The Sourcebook requires that information submitted in applications to join the register is verified by a senior manager. The FSA requires these individuals to take ongoing responsibility for ensuring compliance with the requirements set out in the Regulations and Sourcebook. They are expected to sign an annual attestation of compliance with the Regulations, and this attestation is published on the FSA website[16].

Ongoing FSA supervision and stress testing

2.33 Once an issuer is admitted to the Register of regulated issuers, they must provide information to the FSA on the composition of the asset pool on a regular basis. The FSA continues to monitor and analyse the impact of changes to the programme through regular modelling of each programme's ability to meet its obligations under a range of stressed scenarios.

2.34 The FSA tests the programmes against a number of stressed scenarios of increasing severity. These stress tests are developed based on input from the FSA's specialist risk teams and primary market data available to the FSA, for example concerning mortgage arrears. Some of the key factors considered in the FSA stress testing are listed in Box 2.C.

2.35 The stress testing is tailored to each programme to reflect the risk profile and characteristics of the underlying assets. Stress testing of regulated programmes is undertaken on a quarterly basis, or when a new series or tranche of regulated covered bonds is issued from a programme. The FSA also conducts additional stress testing as required, for example whenever an issuer proposes material changes to a regulated programme, when material volumes of assets are transferred out of the asset pool, and in response to any wider market stresses, such as a sudden or significant currency depreciation.

2.36 The FSA's stress testing leads to a total overcollateralisation requirement for each individual programme. This will take account of the structural features of particular programmes. For example, the liquidity risk assigned to a 'hard bullet' covered bond, which must be paid on the day of maturity, is greater than the risk attached to a 'soft bullet' bond, as soft bullet bonds have a built-in extension period on maturity that allows extra time for issuers to raise the funds to make payments to covered bond investors. Issuers are therefore required by the FSA to hold relatively more overcollateralisation for hard bullet bonds, to account for this greater degree of liquidity risk.

2.37 The FSA's stress testing is independent. It does not rely on analysis undertaken by other parties such as stress testing carried out by issuers, credit rating agency analysis, or contractual stress tests built into the legal documentation of individual covered bond programmes.

2.38 The FSA's modelling is based on robust assumptions. In particular, the FSA's stress testing is carried out on a post-insolvency basis. This means that the level of assets in the asset pool has been stress tested by the FSA to a low probability of default on timely payment of claims to bond holders without relying on support from the issuer.

[16] http://www.fsa.gov.uk/pages/Register/rcb_register/index.shtml

Box 2.B: Key factors taken into account in FSA stress testing

- Default risk: the risk that assets in the asset pool do not perform as expected, for example if payments on loans in the asset pool are made late or not at all.
- Pre-payment risk: the risk that assets in the asset pool may be refinanced faster or slower than expected, requiring issuers to add in further assets to maintain the value of the asset pool or sell assets to maintain the cashflows required to make payments on the covered bonds.
- Currency risk: the risk that currency exchange rates may move adversely, which would affect the value of the assets in the asset pool (denominated in sterling) relative to the outstanding bonds (which may be denominated in another currency).
- Interest rate risk: the risk that interest rates may move adversely, so the interest payments received from assets in the asset pool are less than the interest payments due to covered bond holders.
- Counterparty risk: the impact of material changes to hedging arrangements with other financial institutions designed to protect against the risks outlined above.
- Liquidity risk: the risk that assets in the asset pool, although of sufficient value to meet obligations to bond holders, cannot immediately be sold to raise cash, which would increase the risk that covered bond investors may not be paid in a timely fashion.

2.39 While it is important for investors to undertake their own analysis, the stress testing conducted by the FSA is a key strength of the UK regime that supports investor confidence in the quality of UK regulated covered bonds. The high overcollateralisation requirements resulting from the FSA's stress testing give investors greater certainty of timely payment and lower probability of loss in the event of the issuer becoming insolvent.

2.40 Where appropriate, the FSA can direct issuers to provide further information on the asset pool or any other aspect of its programme. For example, the FSA may impose additional reporting requirements on issuers if the composition of a particular asset pool means additional information is required to appraise the risk of the programme.

2.41 The FSA also conducts an annual onsite review of each issuer's ongoing management of their programme, including systems and controls, governance arrangements, and compliance and internal audit work relating to the programme.

2.42 The Regulations provide that the FSA can exercise its powers under sections 165 and 166 of the Financial Services and Markets Act 2000 in relation to any person to whom the Regulations apply[17]. These powers allow the FSA to direct individual issuers to provide information or documents, or appoint a skilled person to provide a report on any area connected with the exercise of any of the FSA's responsibilities in relation to regulated covered bonds.

[17] Regulation 46, and paragraphs 3 and 4 of the Schedule to the Regulations.

2.43 Issuers must seek the FSA's permission before making any changes to their programmes that the FSA judges to be material. In deciding whether to give permission, the FSA evaluates the impact of the proposal on the programme, including the issuer's ability to pass the FSA's stress testing scenarios after the change, the impact on existing regulated covered bond investors, and the consequences for the overall quality of the UK regulated regime. The obligation to seek FSA approval is independent of any requirement in the contractual terms of each programme to seek a bondholder vote for approval of material changes.

2.44 In addition to the FSA's stress testing of regulated covered bond programmes, the FSA's general liquidity policy requires firms to hold liquid assets of appropriate quality and quantity to minimise the risk that they are unable to meet liabilities when they fall due. These requirements apply to all current registered issuers of regulated covered bonds. Detailed requirements are set out in the FSA Handbook[18].

Enforcement

2.45 The FSA has a robust and flexible set of enforcement powers in relation to regulated covered bonds[19]. These include powers to issue directions, de-register issuers, or fine persons for any breach of the requirements placed on regulated covered bond programmes, either explicitly in the Regulations or by the FSA under those Regulations. These powers are explained below.

2.46 Firstly, the FSA's power of direction allows it to direct an issuer or owner to take steps to comply with the Regulations or the requirements imposed by the FSA if an issuer or owner has failed, or is likely to fail, to do so. For example, if the FSA considers the level of overcollateralisation in the asset pool is too low, and that this makes it likely that the issuer could breach the obligation to make timely payment on their covered bonds, the FSA could direct the issuer or owner to transfer more eligible assets into the asset pool.

2.47 Typically, a decision notice would be published when enforcement action is taken against an issuer or owner. This is decided on a case-by-case basis in line with the provisions of section 391 of the Financial Services and Markets Act 2000.

2.48 Secondly, the FSA can impose financial penalties if an issuer, owner or other person has contravened a requirement imposed on it by or under the Regulations.

2.49 Thirdly, the FSA can remove an issuer from the Register if it is failing, or has failed, to comply with any requirement imposed on it by or under the Regulations. The FSA will consider representations made by issuers before serving a final decision notice, and issuers may appeal a decision to de-register at a tribunal. If an issuer is removed from the register, they will no longer be able to issue regulated covered bonds, but the standards and criteria for safeguarding the quality of the asset pool backing existing bonds still continue to apply.

2.50 The standards also continue to apply to the owner of the asset pool (the SPV) if the original issuer becomes insolvent[20]. The FSA can, where appropriate, take action against the owner, for example, by directing the owner to sell assets within a suitable time-frame to maintain sufficient liquidity to meet payments to bondholders.

2.51 Finally, the Regulations expand the offence of misleading the regulator in section 398 of the Financial Services and Markets Act 2000 to apply to the regulated covered bond regime[21]. It is a criminal offence for any person to knowingly or recklessly provide the FSA with false information in relation to any requirements imposed by or under the Regulations.

[18] http://fsahandbook.info/FSA/html/handbook/BIPRU/12.

[19] Regulations 30 to 37.

[20] Regulation 24.

[21] Regulation 38.

2.52 Further detail on the FSA's enforcement powers can be found in the FSA's Enforcement Guide[22].

The UK covered bond market

2.53 This section sets out some key facts and figures about the UK regulated covered bond market.

2.54 Regulated covered bond issuance has been growing steadily since bank credit markets re-opened in late 2009. There are now ten registered issuers of regulated covered bonds and over £100bn of UK regulated covered bonds outstanding in sterling equivalent terms. Issuance in the first quarter of 2011 was almost £10bn and made up almost 8% of overall issuance in the European covered bond market. See Charts 2.A, 2.B and 2.C.

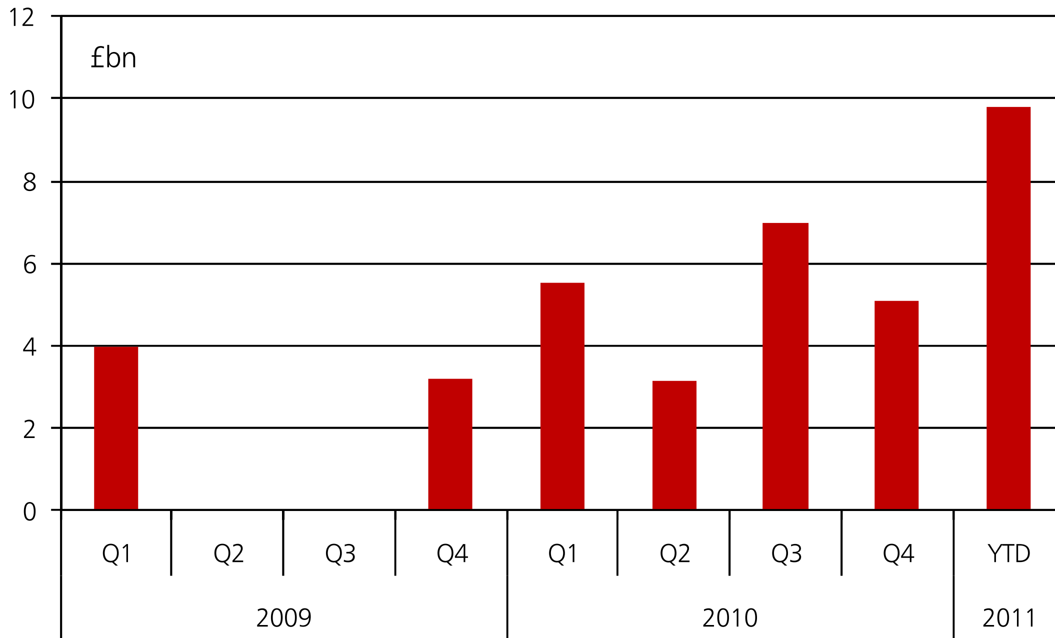
2.55 UK regulated covered bonds are issued mainly in euros and sterling. A large proportion of outstanding sterling issuance relates to bonds placed with the Bank of England during the financial crisis, but there is now a growing market for sterling bonds placed with end investors, with £3bn issued so far in 2011. There has also been issuance in a range of other currencies, including Swiss francs, Norwegian krones, Danish krones and US dollars. See Chart 2.D.

2.56 The largest group of investors in UK regulated covered bonds are asset managers, pension funds and insurance companies, which may be attracted by the favourable regulatory treatment of regulated covered bonds. As a result, issuers have been able to extend the duration of their funding, and this is reflected in the long term maturity profile of UK regulated covered bonds. See Charts 2.E and 2.F.

2.57 UK regulated covered bonds are sold to investors from a range of European countries. Germany, Austria, Scandinavia, France and the UK provide the majority of investors. The German and Austrian markets, in particular, are an important source of stable investors such as pension funds and asset managers, due to the long history and favourable regulatory treatment of covered bonds in these jurisdictions. These investors' demand for UK regulated covered bonds as well as domestic ones is evidence of their confidence in UK regulated covered bonds as a product. Regulated covered bonds have also been sold into the Spanish, Italian, and Benelux markets. See Chart 2.G.

[22] See paragraphs 19.86 – 19.89, http://fsahandbook.info/FSA/extra/5511.pdf.

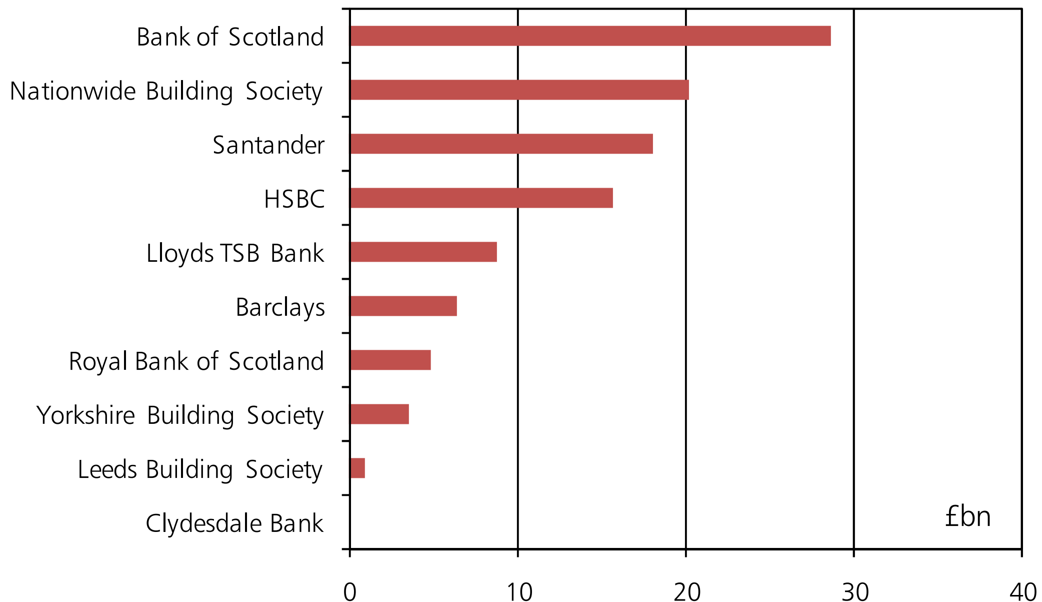
Chart 2.A: UK regulated covered bond issuance since 2009



Source: FSA.

Note: Sterling equivalent amounts as at 18 March 2011.

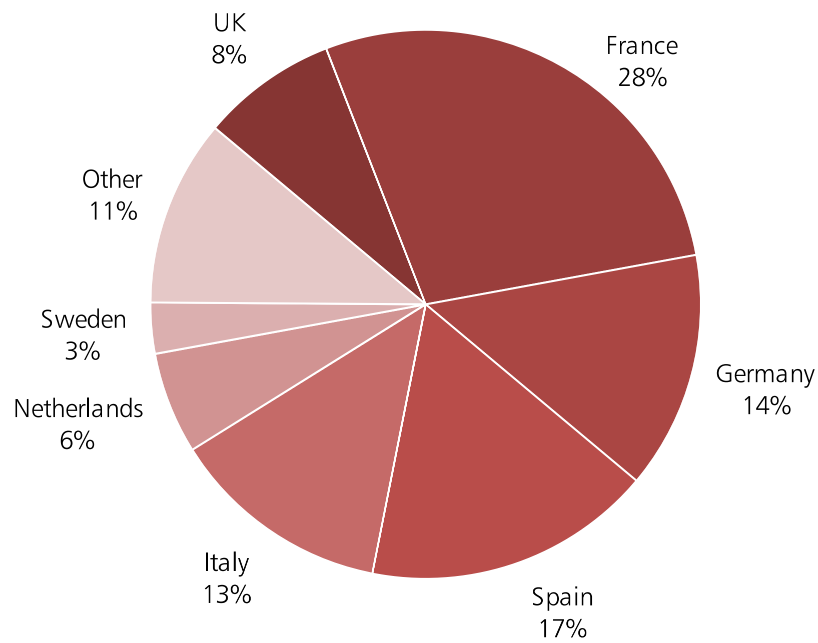
Chart 2.B: UK regulated covered bond issuers and balances outstanding



Source: FSA.

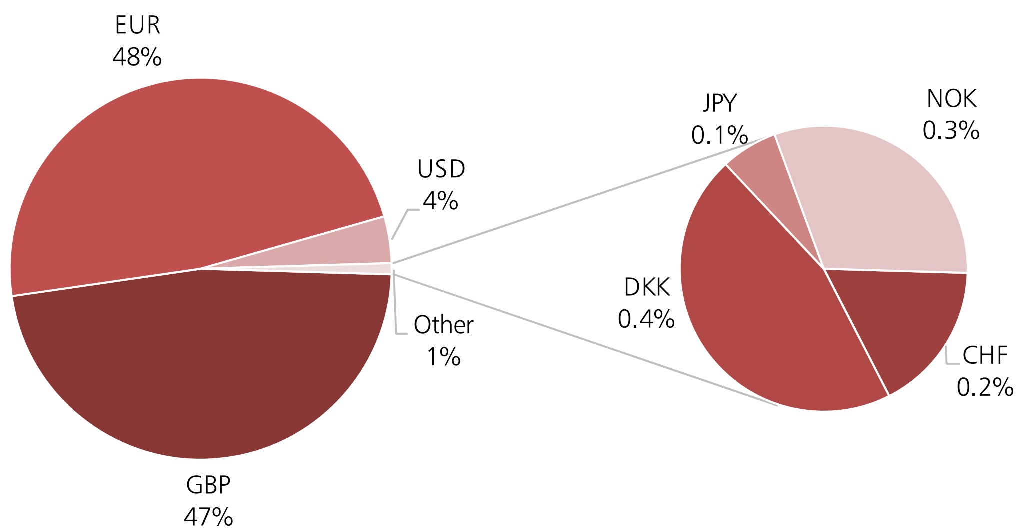
Note: Sterling equivalent amounts as at 18 March 2011. Clydesdale Bank is the most recent entrant to the register of regulated covered bond issuers and has not yet issued any regulated covered bonds.

Chart 2.C: Issuance of European benchmark covered bonds by country, 2011YTD



Source: Barclays Capital.

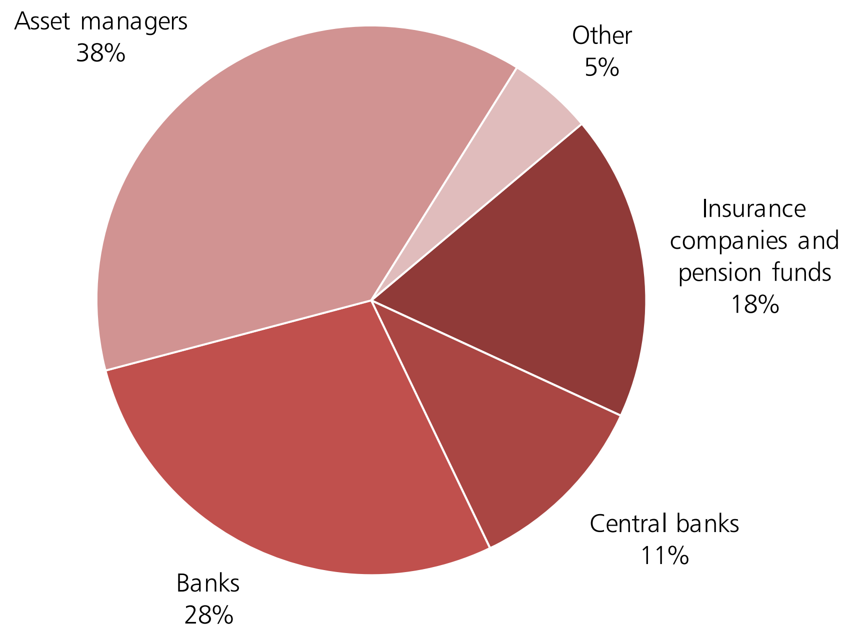
Chart 2.D: Outstanding UK covered bonds by currency



Source: FSA.

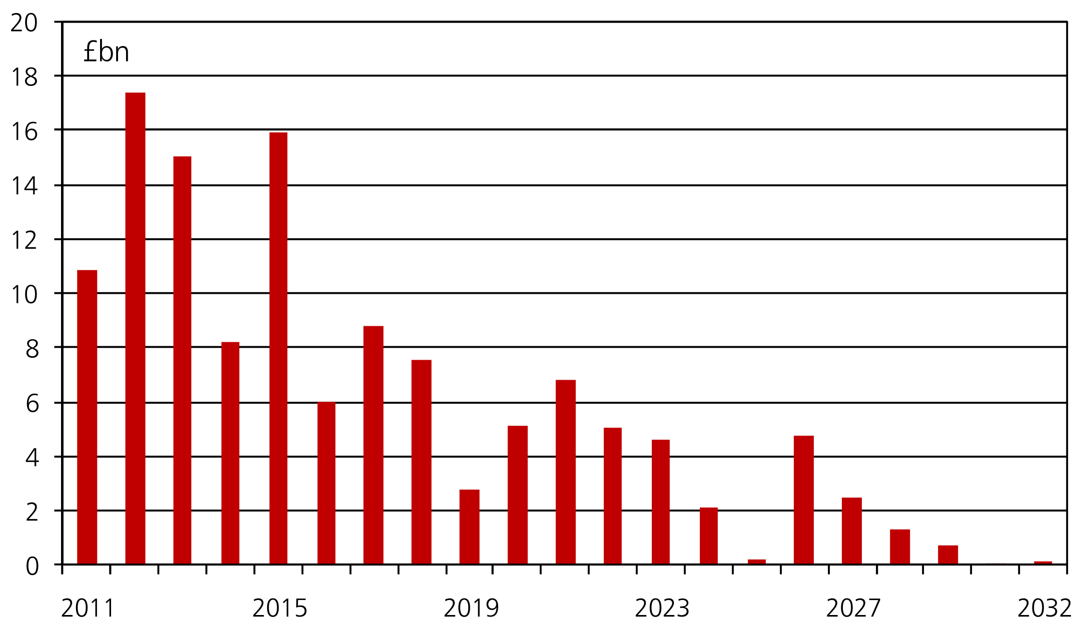
Note: Sterling equivalent amounts as at 18 March 2011. A large proportion of sterling issuance relates to bonds placed with the Bank of England. See 2.55.

Chart 2.E: Investors in UK regulated covered bonds by type, 2011YTD



Source: Barclays Capital.

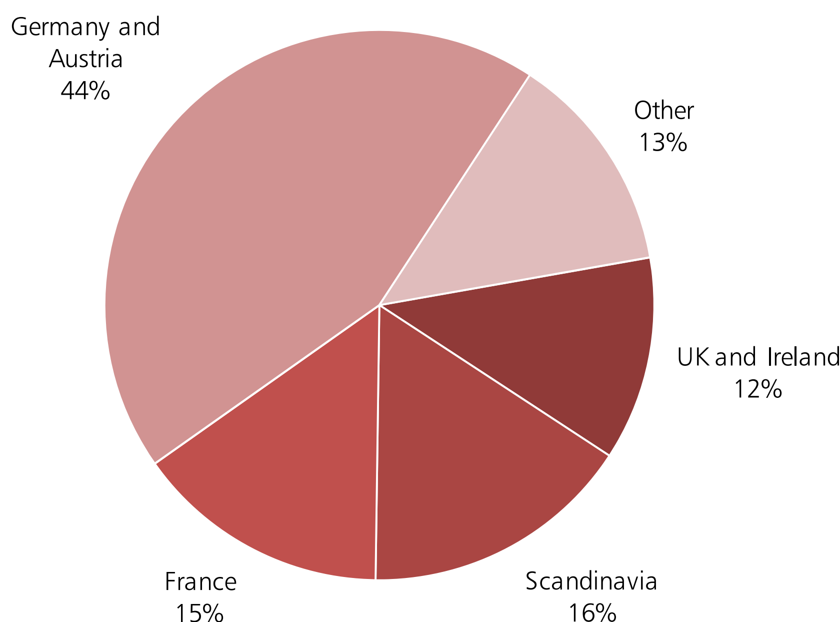
Chart 2.F: Maturity profile of UK regulated covered bonds



Source: FSA.

Note: Sterling equivalent amounts as at 18 March 2011.

Chart 2.G: Investors in UK regulated covered bonds by country, 2011YTD



Source: Barclays Capital.

Industry forums for the UK regulated covered bond market

The UK Regulated Covered Bond Council (RCBC)

2.58 The Regulated Covered Bond Council (RCBC) is an independent organisation that acts as the industry body for UK issuers of regulated covered bonds. Membership of the RCBC is open to all issuers of regulated covered bonds and, as of March 2011, all ten regulated issuers are members.

2.59 The objectives of the RCBC are:

- to promote UK regulated covered bonds at the UK and international level;
- to collect, produce and disseminate information and analysis relevant to UK regulated covered bonds;
- to promote best practice and common standards in investor reporting, modelling asset capability and other areas relating to regulated covered bonds; and
- to campaign for RCBC interests with other industry members, national or international industry bodies, and regulators.

2.60 The RCBC also works with investors to promote greater understanding of the quality, features and standards of UK regulated covered bonds. It does this by facilitating dialogue between issuers, investors and other market participants about developments in the UK regulated covered bond market, and acting as a central source of information about the common features of UK regulated covered bonds.

2.61 The RCBC is an independent organisation and has no formal connections to regulators. The RCBC is governed by a Steering Committee of representatives drawn from among its membership. The Steering Committee meets regularly, usually monthly. The Steering Committee

elects a Chairperson from among its members and an Executive Director is responsible for the administration of the Council.

2.62 The RCBC is developing its website, www.ukrcbc.org, which will have links to information about all of the regulated covered bond issuers in the UK and information about upcoming events.

UK Covered Bond Forum (UKCBF)

2.63 The FSA already maintains close contact with the covered bond market as a result of its ongoing supervision of regulated covered bond programmes. To build on this regular market contact, the FSA will establish a UK Covered Bond Forum (UKCBF) chaired by the FSA. This will be used to promote industry-wide awareness of new and emerging issues. It will also give relevant market participants, including investors and other parties, the opportunity to maintain a regular dialogue with the FSA on these issues. This will be used to inform the FSA's supervisory approach and any future policy initiatives.

2.64 Under the FSA’s current plans the Forum will convene at least twice a year with ad hoc meetings when appropriate. The FSA intends to have all facets of the market fully represented at these forums.

3 The review

3.1 This Chapter sets out a number of possible changes to the UK's regulated covered bond regime. These changes are designed to increase comparability between the UK's and other regimes, and increase disclosure and transparency to the market. The Government and the FSA would welcome market participants' views on these changes and on the UK's regulated covered bond regime more generally. Specific questions for consultation are summarised at the end of this Chapter.

3.2 The proposed changes are informed by analysis of the UK regime and informal feedback from a range of market participants. This feedback has been very positive, with many participants commenting that the UK regime is strong and has supported the growth and development of the UK covered bond market. The Government and the FSA are keen to build on these successes.

3.3 No major weaknesses in the UK regime have been identified, and so this review is not proposing any major changes to the core approach of the Regulations. A number of market participants, however, have commented that they believe the UK regime could do more to bring out the high underlying quality of UK regulated covered bonds. The UK regime is largely principles-based in that it sets out general duties for issuers and the FSA, rather than specific, prescriptive rules. These general principles have led to UK regulated covered bonds maintaining high standards, driven by robust FSA supervision. A more prescriptive framework, however, may make it easier for investors to understand and compare the key features of the UK regime.

3.4 Creating specific statutory requirements to capture the existing high standards could help emphasise the quality of UK regulated covered bonds. The Government and the FSA are therefore proposing a collection of measures which will increase the visibility of the regulation and provide greater clarity for investors. The changes are:

- segregating asset types – creating an option in legislation for an issuer to formally designate a regulated covered bond programme as backed by only a single asset type and liquid assets. All UK issuers currently only use residential mortgages in their programmes, but the range of eligible assets in the Regulations is much broader. This option will allow issuers who use only a single asset type to give greater clarity to their investors. See 3.11;

- asset eligibility – excluding securitisations as eligible assets for regulated covered bond asset pools. No issuers make use of the current flexibility to include securitisations, and its removal will emphasise the important distinctions between covered bonds and securitisations, and give greater clarity to investors. See 3.20;

- fixed minimum overcollateralisation – requiring issuers to maintain a fixed minimum level of overcollateralisation in regulated covered bond programmes. The FSA's robust stress-testing regime will continue to require issuers to maintain levels of overcollateralisation considerably above the minimum, but a fixed floor will give clarity to investors and aid comparison between the UK and other regimes. See 3.29;

- asset pool monitor – creating a formal role of 'asset pool monitor' to provide independent, external scrutiny of an issuer's regulated covered bond programme. This codifies the existing UK practice of audits and will provide added reassurance about the high standards of UK regulated covered bonds. See 3.38;
- investor reporting – introducing consistent standards of investor reporting across all UK regulated covered bond programmes, including the provision of loan-level data. This will increase transparency for investors and highlight the quality of underlying assets, while the use of common standards will make it easier for investors to compare different programmes. See 3.44; and
- regulatory reporting – updating and consolidating the regulatory reporting that the FSA requires when issuers apply to register with the FSA and on an ongoing basis. This information is used to assess issuers' applications and as part of the regular stress-testing the FSA conducts on regulated covered bond programmes. See 3.51.

3.5 Many of these changes are already features of covered bond regulation in other European covered bond markets. Table 3.A illustrates that many of the measures above have been adopted in the French, German, Irish, and Spanish markets.

Table 3.A: Prevalence of proposed measures in European covered bond markets

	France[a]	Germany	Ireland	Spain[b]
Segregating asset types	No	Yes	Yes	Yes
Excluding securitisations	No	Yes	Yes	Yes
Fixed minimum overcollateralisation	Yes	Yes	Yes	Yes
Asset pool monitor	Yes	Yes	Yes	No

Source: Bank of America Merrill Lynch, Royal Bank of Scotland.
[a] Obligations Foncières [b] Cédulas Hypotecarias

3.6 The Government and the FSA propose that the changes above should come into force at the end of 2012, and believe this would allow issuers sufficient time to implement the changes. The Government and the FSA would welcome views on this timeline. See 3.66.

3.7 An Impact Assessment of the changes assessing their costs and benefits is included in Chapter 5. The Government and FSA would welcome views on whether the Impact Assessment accurately captures the costs and benefits. See 3.63.

3.8 The FSA also intends to change the fees charged to issuers under the regime. See 3.61.

3.9 In addition, when the regulated covered bond framework was introduced in 2008, the Government and the FSA committed to reconsider two issues at a later date:

- whether the UK regime should allow regulated covered bond issuance without the transfer of assets to a separate legal vehicle (i.e. the 'integrated model'). See 3.54; and
- whether the UK regime should allow firms not registered in the UK to issue UK regulated covered bonds. See 3.58.

The Government and the FSA have reconsidered these two areas and are not proposing any changes.

3.10 All the issues above are discussed in detail in the remainder of this Chapter.

Segregating asset types

3.11 The Regulations allow a variety of property assets to be included in regulated covered bond asset pools. This mirrors the approach taken in the European Banking Consolidation Directive (see 2.10) and gives flexibility to issuers.

3.12 All current UK regulated covered bond programmes, however, are backed exclusively by UK residential mortgages. The Government and the FSA are aware that many market participants, including some smaller issuers such as building societies, regard regulated covered bonds as primarily a residential mortgage product. Many issuers formalise this practice by committing to using a narrow range of assets in the legal documentation that governs their regulated covered bond programmes.

3.13 The Government and the FSA do not believe it would be appropriate to prohibit running regulated covered bond programmes that include a variety of different asset types. The ability to create programmes backed by a variety of asset types may in the future match the needs of a number of issuers and investors.

3.14 However, the dynamic nature of regulated covered bond programmes means that the assets in an asset pool are replenished over time. A number of market participants have suggested that, if regulated covered bonds currently backed by residential mortgages came to be backed by other asset types, they would be a very different product due to the different risk characteristics of these assets. For some investors, this perceived risk of a change of asset type could reduce the attractiveness of regulated covered bonds.

3.15 In practice, this risk should be low, because many UK issuers commit to using only a single type of asset in the contracts governing their programme. However, the central role of regulation in the covered bond markets means that some investors may attach less value to these contracts than to the requirements of the Regulations. This may be particularly pertinent because the statutory segregation of asset classes is a feature of covered bond legislation in a number of other jurisdictions[1].

3.16 To make the UK regime more comparable with these jurisdictions, the Government proposes to amend the Regulations to require issuers to designate their regulated covered bond programmes as 'single asset type' or 'mixed asset type'. To implement this proposal, Annex A includes draft Regulations which would have the following effect[2]:

- issuers will be required to designate their programmes as 'mixed asset type' or 'single asset type' when they apply for registration;
- mixed asset type programmes will be able to contain the full range of assets as set out in 2.10, in line with the existing approach of the Regulations;
- single asset type programmes will be able to contain eligible property from just one of the classes below and liquid assets, consisting of cash and government securities as defined in the FSA Sourcebook[3]. The class of property used must remain the same for the lifetime of the programme. The classes are based on the three key classes of assets used in most covered bonds in Europe:
  - residential mortgages, as defined in the Banking Consolidation Directive (BCD);
  - commercial mortgages, as defined in the BCD; or

[1] For example, Germany, Ireland, and Spain. See Table 3.A.

[2] See Regulations 2(3), 2(4), 2(12), 2(13), and consequential changes in Regulations 2(5) to 2(8).

[3] See 2.3.20 in Annex B.

- public sector loans, as defined in the BCD and also including loans to UK private sector housing associations and public-private partnerships[4].

- existing programmes using only a single asset type can be designated by the issuer as 'single asset type' before the coming into force of this new approach. Any existing programme not designated as a single asset type programme will be registered as a mixed asset type programme; and

- designations of 'single' or 'mixed' programmes will be fixed, as the certainty that running a single asset class programme is meant to provide to investors would be undermined if designations could be changed.

3.17 This proposal would combine flexibility for those issuers who may wish to vary asset types, with greater certainty for investors in programmes that use only a single asset type. It does not impose any additional costs on issuers, since they will be free to choose whether to designate their programmes as 'single asset type' or retain the flexibility of the current approach by designating their programmes as 'mixed'.

3.18 Designating a programme as 'single asset type' may theoretically constrain an issuer's ability to top up the programme with additional assets. This constraint could arise if the availability of the assets of the relevant single type decreases, for example in times of stress or if an issuer changes their underlying business model. This constraint is very unlikely to be felt, however, in the case of single asset type programmes of residential mortgages, for which all issuers are likely to have a large stock of eligible assets available.

3.19 For some issuers and some asset types, however, there may be a risk that the issuer will not always have sufficient assets of a single type available. The FSA already assesses prospective issuers' ability to originate eligible assets when an issuer applies for registration. If an issuer applied to register a single asset type programme and there was a concern about the issuer's ability to continue to originate eligible assets on an ongoing basis, the FSA could reject the application, or impose additional criteria, such as requiring the issuer to maintain a higher level of overcollateralisation in the programme.

Do you agree the UK regime should give issuers the option to formally designate their programmes as backed by a single type of asset, and that the draft legislation achieves this?

Asset eligibility – securitisations and non-property assets

3.20 Securitisation is a financial technique for packaging up portfolios of assets into more readily tradeable bonds. The Government and the FSA believe that securitisation can be an important source of funding for banks and non-bank lenders. The Treasury, the Bank of England, and the FSA are actively engaging with the UK securitisation industry to support recovery in the securitisation market by developing more consistent standards for UK securitisations.

3.21 The Banking Consolidation Directive allows the inclusion of securitisations of residential or commercial mortgages in covered bond asset pools, subject to certain conditions and limits. This provides flexibility for issuers who may hold eligible assets in securitised form.

3.22 The inclusion of securitisations in regulated covered bond asset pools can lead, however, to a blurring of the boundaries between regulated covered bonds and securitisations. The Government and the FSA are aware that some investors would like to see securitisations excluded as eligible assets in regulated covered bond asset pools.

[4] See 2.11 for further detail about these asset types.

3.23 The Regulations currently only allow securitisations to be included in asset pools of UK regulated covered bonds if the securitisations are originated by the same issuer as the regulated covered bond and hold a 'AAA' credit rating. This means the circumstances in which an issuer may include securitisations in a UK regulated covered bond asset pool are already very limited. In practice, no UK regulated covered bond programme currently contains securitisations.

3.24 The Government and the FSA believe it is important to continue to carefully distinguish between securitisations and regulated covered bonds. The importance of making this distinction may grow as a result of the Basel Committee's proposals on bank liquidity regulation, which propose allowing banks to hold covered bonds but not securitisations as part of a second tier of liquid assets. See 4.11.

3.25 In light of these issues, the Government proposes to amend the Regulations to exclude securitisations from the definition of eligible property for UK regulated covered bonds. The draft Regulations set out in Annex A will achieve this[5].

3.26 In contrast to some investors' concerns about the inclusion of securitisations, the Government and the FSA are also aware that it has been suggested that the list of assets eligible for inclusion in regulated covered bonds could be expanded. This would allow the potential development of new products, for example unsecured consumer loan covered bonds. This could, however, dilute the identity of regulated covered bonds, and many investors have said they would be unlikely to buy covered bonds backed by such assets.

3.27 European law does not allow the inclusion of unsecured consumer loans or other non-property assets in covered bonds. This means covered bonds backed by these new asset types would not benefit from favourable treatment under European regulation. In addition, the risk attached to loans which are not secured on any underlying assets is greater than the risk attached to loans backed by assets, such as mortgages. This means issuers would have to maintain higher levels of overcollateralisation in their covered bond programmes, which could render them uneconomic.

3.28 In light of these concerns, the Government and the FSA are not currently minded to expand the list of eligible assets, but would welcome views on this issue from market participants.

Do you agree that securitisations should be excluded as eligible property in UK regulated covered bonds, and that the draft legislation achieves this?

Do you agree that the list of assets eligible for inclusion in UK regulated covered bonds should not be expanded?

Fixed minimum overcollateralisation requirement

3.29 Overcollateralisation is the degree to which the total principal balances outstanding on the assets in a covered bond asset pool exceed the total principal amounts outstanding on the covered bonds. Overcollateralisation provides protection to investors by ensuring the asset pool can suffer a certain threshold of losses but still be able to secure repayment of the bonds if the issuer fails.

3.30 A number of European covered bond regimes set out in legislation a fixed minimum level of overcollateralisation that issuers must maintain in their covered bond programmes. Many also impose an interest coverage requirement, which requires that the interest due on the assets in the asset pool must match the interest due on the covered bonds. Table 3.A illustrates a

[5] See Regulation 2(3).

selection of legislative fixed overcollateralisation requirements in other countries, whether the country also imposes an interest coverage requirement, and whether these are defined in nominal or net present value terms.

3.31 Actual overcollateralisation levels in all covered bond markets are in practice driven by rating agency requirements, investor preferences, issuers' operational decisions, and regulatory requirements. Overcollateralisation in jurisdictions which have a fixed minimum will tend to be significantly above the typical minimum levels in Table 3.B.

3.32 In the UK, there is no fixed minimum requirement, but overcollateralisation levels are well above the typical levels in Table 3.B. One factor in determining the level of overcollateralisation is the FSA's robust stress testing. This takes into account the individual characteristics of each regulated covered bond programme and is a key strength of the UK regime that supports investor confidence in UK regulated covered bonds. See 2.33.

Table 3.B: Fixed minimum overcollateralisation requirements in other jurisdictions

Country	Overcollateralisation requirement	Interest coverage requirement	Definition
Austria	2%	Yes	Nominal
Denmark	n/a	Yes	Net present value
Finland	2%	Yes	Net present value
France[a]	2%	Yes	Nominal
Germany	2%	Yes	Net present value
Ireland	3%	Yes	Nominal
Portugal	5%	Yes	Nominal
Spain[b]	25%	No	Nominal
Sweden	n/a	Yes	Net present value

Source: Bank of America Merrill Lynch

[a] Obligations Foncières [b] Cédulas Hypotecarias

3.33 The Government and the FSA believe it is important to promote consistency and comparability between different covered bond regimes, and so propose to introduce a fixed minimum level of overcollateralisation and an interest coverage requirement in the UK regulated covered bond regime.

3.34 The Government and FSA envisage setting the minimum level in a way that promotes comparability with the existing minima in other jurisdictions. This means it would be well below the current levels of overcollateralisation in the UK and would therefore have no material impact on issuers. Asset pools would continue to maintain a higher level of overcollateralisation driven in part by the FSA's stress testing, but the minimum would set a clear floor for comparison.

3.35 To ensure the minimum level of overcollateralisation fulfils the objective of providing a clear, readily intelligible benchmark for investors, the proposed definition is based simply on principal payments outstanding in relation to the regulated covered bonds relative to the total principal amounts outstanding in relation to assets in the asset pool. The level of overcollateralisation is also to be calculated after taking into account the benefits of any hedging through currency and interest rate swaps, to avoid introducing the additional complication of interest rate and currency volatility into the calculation.

3.36 To implement this, the draft Regulations in Annex A make the following provisions[6]:

- the principal balances outstanding on the assets in a regulated covered bond asset pool must exceed the principal balances outstanding on the associated covered bonds by at least a fixed percentage, after taking into account the effect of hedging arrangements such as currency swaps; and
- the interest payments generated by the assets in a regulated covered bond asset pool must exceed the interest payable on the associated covered bonds by at least a fixed percentage, after taking into account the effect of any hedging arrangements such as interest rate swaps.

3.37 A key decision if the UK introduces a minimum level of overcollateralisation will be the calibration of the fixed level. The Government and the FSA believe it would be positive for the European covered bond market if there were common, robust standards on issues such as this. In the absence of an agreed standard, the Government and the FSA would be interested in respondents' views on how best to set the minimum level in order to promote comparability between the UK and other regimes.

Do you agree the UK should introduce a fixed minimum level of overcollateralisation and an interest coverage requirement for regulated covered bonds, and that the draft legislation achieves this?

At what level should the minimum overcollateralisation requirement be set?

Asset Pool Monitor

3.38 UK regulated covered bond programmes are subject to a high degree of scrutiny not only by the FSA but also by independent third parties. When an issuer applies for registration, for example, the FSA requires independent legal and accounting opinions that the issuer has made suitable arrangements for the management of the regulated covered bond programme.

3.39 In some jurisdictions, the role of an independent auditor or monitor of covered bond programmes is formalised in legislation[7]. This has the benefit of giving investors greater clarity about the independent monitoring arrangements for different programmes, and assigning clear powers and responsibilities to the monitor.

3.40 The Government and the FSA believe it would be positive to bring the UK into line with other jurisdictions, by introducing a regulatory requirement for regulated covered bond programmes to be subject to independent scrutiny by a formal Asset Pool Monitor. This would provide an extra layer of reassurance for investors and also help improve the comparability of the UK's regime with that of other countries, without imposing any major changes on issuers' current arrangements.

3.41 The draft Regulations at Annex A make the following provisions[8]:

- regulated covered bond issuers must appoint an Asset Pool Monitor for each asset pool;
- the Asset Pool Monitor must be eligible to act as an independent auditor, and has the power to inspect all relevant records and information held by the issuer;

[6] See Regulations 2(9) and 2(13).
[7] For example, France, Germany and Ireland. See Table 3.A.
[8] See Regulations 2(10) and 2(14).

- the Asset Pool Monitor must conduct a biannual inspection of the issuer's compliance with the issuer's duties as set out in the Regulations, which must have regard to whether the asset pool meets the necessary requirements and the accuracy of the records kept by the issuer in relation to the asset pool;
- the Asset Pool Monitor must write an annual report which is delivered to the FSA and gives his view on these matters. The FSA will provide guidance on the contents of the Asset Pool Monitor's report, which may be required to address specific areas for individual issuers; and
- if, in the course of his duties, the Asset Pool Monitor finds that an issuer is failing to comply with the issuer's duties, he must report this to the FSA as soon as possible.

3.42 These responsibilities and powers set out in the amended Regulations would be complemented by more detailed guidance in the FSA's Sourcebook on the FSA's interpretation of the Asset Pool Monitor's statutory duties. Annex B includes draft changes to the Sourcebook which set out that:

- issuers must supply the asset pool monitor's report to the FSA in line with their annual attestation of compliance with the Regulations and Sourcebook requirements;
- the report must address the level of overcollateralisation in the asset pool with regard to the requirements set out in Regulation 17, in particular that the asset pool is capable of covering claims attached to the regulated covered bonds;
- the report must seek confirmation that appropriate due diligence procedures have been undertaken to check the record of the assets is accurate, that it corresponds to supporting information, and that the information provided to the FSA is correct; and
- in performing their duties the Asset Pool Monitor must consider a representative statistical sample of the assets in the asset pool.

3.43 This more formal approach for independent monitors of regulated covered bond programmes may lead to an increase in costs for issuers. As set out in the Impact Assessment in Chapter 5, however, it is expected that these costs will be limited, since the Asset Pool Monitor largely formalises existing market practices. Any additional costs will be accompanied by benefits in the form of greater clarity for investors about the quality of UK regulated covered bonds.

Do you agree that the UK should introduce an independent Asset Pool Monitor for regulated covered bond programmes, with the powers and responsibilities described above, and that the draft legislation and Sourcebook changes achieve this?

Investor reporting

3.44 The financial crisis underlined the importance of clear, timely and accurate disclosure of information about financial markets and institutions. Disclosure drives market discipline, by enabling a more informed appraisal of prices and risks. It also promotes stability, by reducing uncertainty in times of crisis.

3.45 A key part of the FSA's duties in supervising regulated covered bonds is to have regard to 'the need to preserve investor confidence in, and the desirability of maintaining the good reputation of, the regulated covered bonds sector in the United Kingdom.' While investors and issuers can draw comfort from the high quality of covered bonds issued under the UK framework, it is also essential that investors conduct their own due diligence and analysis. Feedback provided to the FSA and the Government suggests that some groups of investors,

particularly in the US, strongly value the ability to undertake this kind of analysis. The provision of data to facilitate this analysis would help UK issuers better access these markets.

3.46 An ability to undertake clear and comprehensive analysis of covered bonds and the asset pools backing them also reduces the links between the perceived resilience of the issuer and investors' assessment of its covered bonds. Reduced reliance on the issuer benefits not only investors, who will have a greater understanding of the quality of a covered bond, but also issuers themselves. This is because in a well-informed market, covered bonds with high quality underlying assets will benefit from more favourable valuations, which may be especially important for a number of UK issuers who do not themselves benefit from high credit ratings but have high quality asset pools.

3.47 Detailed investor reporting, including loan-level data, will therefore bring benefits to the UK market. The Government and the FSA think it is appropriate for this information to be made widely available in a consistent format, and for this to be a requirement of the UK regulated covered bond regime. This will help to emphasise the high quality of assets in regulated covered bond programmes to the market, and will facilitate appropriate due diligence by investors.

3.48 The FSA already requires quarterly loan-level data and copies of key transaction documents as inputs into its stress testing of regulated covered bond programmes. Quarterly loan-level disclosure is also made available to credit rating agencies, and is a requirement for covered bonds used in the Bank of England's operations with which most issuers have indicated they already plan to comply[9]. This means the introduction of standardised reporting should not impose major new burdens on issuers, and will to a large extent involve the wider dissemination of information that issuers already prepare.

3.49 The draft amending Regulations in Annex A would give the FSA the power to require publication of information in relation to regulated covered bonds[10]. The corresponding draft changes to the Sourcebook in Annex B set out that the FSA will in the first instance use this power to require issuers to place the following information on a secure, subscription only website:

- key transaction documents;
- a link to the latest programme prospectus;
- a revised and updated notification form on the characteristics of the asset pool, known as RCB3 Annex 2D; and
- quarterly loan-level information on the asset pool.

3.50 The Government and the FSA believe it would be helpful for other jurisdictions to adopt similar standards of disclosure, to drive consistency across the covered bond market. Universal, consistent reporting standards will promote a more informed, transparent market, and reduce costs for investors.

Do you agree that the UK should introduce a mandatory loan-level disclosure requirement for regulated covered bonds, and that the draft legislation and Sourcebook changes achieve this?

Regulatory reporting to the FSA and other Sourcebook requirements

3.51 A key requirement of the UK's regulated covered bond regime is that issuers must provide the FSA with regular, comprehensive information about their regulated covered bond

[9] See http://www.bankofengland.co.uk/markets/money/dwf/.

[10] See Regulation 2(11).

programmes. After the initial introduction of the UK regime in 2008, the FSA has placed additional requirements on issuers in relation to the information they must provide to the FSA on an ongoing basis. This has reflected ongoing changes to regulated covered bond programmes and developments in the FSA's stress-testing methodology. The FSA believes that the incremental costs of these requirements for issuers have been marginal.

3.52 The FSA is proposing to update and consolidate these requirements as part of this review. A summary of the proposed consolidated requirements is set out in Table 3.C. The associated forms are set out in Annex E[11].

3.53 The FSA is also proposing a number of minor changes to the FSA Sourcebook outside of the changes proposed as part of this review. These are summarised in Box 3.A and included in Annex B.

Do you have any views on the FSA's updated notification requirements and proposed changes to the Sourcebook?

[11] This Annex is available separately on the Treasury website at www.hm-treasury.gov.uk.

Table 3.C: Summary of proposed notification requirements in the FSA Sourcebook

Notification form	Notification requirement
Annex 1D (application form)	• Prospective issuers must complete a detailed application form with details of the proposed programmes, supporting assets, and governance structure.
Annex 2D (asset notification form)	• An issuer must submit information relating to the asset pool each month using this form. If the issuer or the owner proposes to add or remove assets in the asset pool in a way that will change the level of over collateralisation by 5% or more, it must notify the FSA prior to the proposed transfer, giving details of the size and composition of the transfer.
Annex 3D (liability structure form)	• An issuer must submit information relating to the covered bonds issued under the programme each month and on the date of any issuance using this form.
Annex 4D (indicative terms form)	• An issuer must submit information relating to prospective issuances at least three business days before the date of issuance using this form.
Annex 5D (issuance form)	• An issuer must submit information on covered bond issuance on the date of issuance using this form, when the issuer must also provide final terms of the covered bonds and signed copies of swap documents.
Annex 6D (cancellation form)	• An issuer must notify the FSA if it proposes to cancel a covered bond or programme at least three business days before the cancellation will take effect. The issuer must submit information on the cancellation on the date of cancellation using this form.
Annex 7D (loan-level disclosure)	• An issuer must submit loan-level data within one month of the end of each quarter using this form. • The issuer must publish this data, and the transaction documents (excluding legal opinions) relating to the covered bond or programme, on a subscription only, secure, password-protected website. This website must contain a link to the latest published prospectus relating to the relevant covered bond or programme. • If the issuer is in insolvency, the owner must publish this information.

Box 3.A: Further changes to the FSA Sourcebook

- The FSA will not treat an application to register as a regulated covered bond issuer as having been received until it receives the registration fee and all relevant documentation requested by the FSA prior to the FSA's on-site review of the application. This reflects the need for the FSA to have all the relevant documentation in order to conduct the desk based review of the application and asses if the application can be progressed to the on-site assessment.
- The issuer must ensure that a director or a senior manager of the issuer verifies the application by confirming on the FSA's form that the issuer has obtained the appropriate third party advice or reports as required by RCB 2.3.16 D.
- Where possible, the director or senior manager who signs the annual confirmation should be the same director or senior manager who has verified the application for registration under RCB 2.2.6D. If the director or senior manager is different to the director or senior manager who verified the application for registration, the issuer should notify the FSA before sending the confirmation to the FSA.
- This reflects current practice and the FSA's expectation of the level of ongoing senior management engagement with regulated covered bond programmes.
- 'Off-set' has been added as a specific example of areas of credit risk the FSA may consider when assessing an application. This reflects aspects of the FSA's stress testing which have evolved since the regime was introduced in 2008 to match the asset profile of the regulated covered bond programmes.
- Guidance on appropriate due diligence procedures for the accountancy report have been extended to include an analysis of a representative statistical sample of the assets in the asset pool, to standardise market practice on regulated covered bonds.

Integrated model

3.54 The Regulations require that the assets constituting the asset pool of a regulated covered bond are transferred to a special purpose vehicle (SPV) that is separate from the issuer of the bonds (see 2.20). When the UK first considered the introduction of the Regulations, the Government consulted on also allowing the issuance of regulated covered bonds where the assets in the asset pool could be retained on the issuer's balance sheet, and segregated by specific legislation. This is sometimes known as the 'integrated model'.

3.55 The Government and the FSA are aware that a number of other jurisdictions use the integrated model, which can bring some operational advantages for issuers. However, where the SPV model provides clear legal certainty that the asset pool has been segregated from the issuer, the integrated model relies on the creation of new insolvency procedures that need to be specified in legislation. Respondents to the 2008 consultation on the initial design of the UK covered bond legislation were concerned that the nature of UK insolvency law would make it difficult to give sufficient certainty about the segregation of assets in the integrated model, and so the Government decided to limit regulated covered bonds to the SPV model. A commitment was made, however, to reconsider this decision in this review.

3.56 The Government and the FSA believe the SPV model has served the UK market well and is easy for investors to understand. They are also aware that a number of other jurisdictions use a similar model[12]. The use of an SPV or integrated model does not appear to be a material factor in investors' assessments of covered bonds. For example, market participants have commented that French covered bonds based on the SPV model and the integrated model respectively trade at very similar spreads. A detailed analysis of covered bond spreads in different jurisdictions by the Bank of International Settlements did not find a strong correlation between spreads and whether or not the covered bond legislation was based on an integrated or an SPV model[13].

3.57 This evidence suggests the transitional costs of introducing an integrated model and the consequent market disruption may well exceed the benefits of any change. After careful consideration, the Government and the FSA are not minded to introduce an integrated model, but would welcome views on this decision.

Do you agree that the UK should not introduce an 'integrated model' for regulated covered bonds?

Eligible issuers

3.58 The 2008 consultation on the Regulated Covered Bonds Regulations considered whether UK branches of European Economic Area (EEA) issuers, as well as firms registered in the UK, should be eligible to register to issue regulated covered bonds. The Government decided at the time to limit the regime to UK issuers only, but committed to reconsider this position in this review.

3.59 The basis of the decision taken in 2008 was that the arrangements for cross-border supervision and co-operation were not sufficient to allow the FSA to subject EEA issuers to the same level of scrutiny, or have recourse to the same enforcement action, as with UK-based issuers admitted to the Register. This would undermine the FSA's ability to have regard to the integrity of the regime consistently across all issuers.

3.60 The Government and the FSA believe the basis for the decision in 2008 remains sound, and so are minded to retain the current limitation to UK-based issuers.

Do you agree that the UK covered bond regime should be limited to issuance by firms registered in the UK?

FSA fees

3.61 The FSA currently charges £25,000 to assess applications by issuers for registration, and £20,000 per year thereafter to cover the cost of supervising regulated issuers. These costs have not been revised since 2008 and are substantially below the actual cost of supervising the regime.

3.62 The FSA will set out increases in its fee structure in a subsequent consultation paper later in 2011. The FSA intends to charge registration and supervision fees that are proportionate to the costs incurred, and are based on the size and complexity of issuers' operations. For example, the FSA will propose a fee for assessing material changes to regulated programmes which will reflect the cost of evaluating these changes.

[12] For example, the covered bond laws in Italy and the Netherlands are also based on a model where an SPV acts as a guarantor. Source: Bank of America Merrill Lynch.

[13] *The covered bond market, BIS Quarterly Review*, September 2007. http://www.bis.org/publ/qtrpdf/r_qt0709f.pdf.

Impact assessment

3.63 Chapter 5 contains an Impact Assessment that considers the costs and benefits of the proposed changes to the UK's regulated covered bond framework. It estimates costs to issuers of around £0.4m a year, and benefits of around £25m a year.

3.64 The Impact Assessment also considers the impact of the changes on small businesses. No impact on small businesses is expected, since the minimum size of issuance of covered bonds in the market is normally in the tens of millions of pounds, beyond the scale achievable by a small business. In addition, the Regulations only apply to firms that wish to register with the FSA as issuers of regulated covered bonds. Smaller firms can exempt themselves from the Regulations by not registering with the FSA as regulated covered bond issuers. A number of firms have already issued unregulated covered bonds, and there is no legislative or regulatory barrier to them continuing to do so.

3.65 The Government and the FSA would welcome views on whether the Impact Assessment accurately captures the costs and benefits of the changes.

Does the Impact Assessment of the proposed changes accurately capture their costs and benefits?

Timeline for implementation

3.66 The Government and the FSA are mindful of the fact that issuers will need time to implement the proposed changes to the Regulations in their individual regulated covered bond programmes. Following this consultation and in light of the responses received, the Government and the FSA intend to set out later in 2011 a final set of changes that will be taken forward. The Government and the FSA envisage that the proposed changes would come into force at the end of 2012.

3.67 This should allow sufficient time for issuers to make the necessary changes. If issuers are able to make the changes sooner, there may be benefits for the UK market in implementing the regulatory changes earlier. The Government and the FSA would welcome views on the proposed timeline.

Are you content with the proposed timeline for implementing any changes to the regime by the end of 2012?

Summary of consultation questions

3.68 The following table summarises the specific questions asked in this consultation, on which respondents' views would be particularly appreciated. Question 14 also invites respondents to give any general views on other aspects of the UK's covered bonds regime.

3.69 Annex D explains how to respond to the consultation.

No.	Question	Paragraph Reference
1	Do you agree the UK regime should give issuers the option to formally designate their programmes as backed by a single type of asset, and that the draft legislation achieves this?	3.11
2	Do you agree that securitisations should be excluded as eligible property in UK regulated covered bonds, and that the draft legislation achieves this?	3.20
3	Do you agree that the list of assets eligible for inclusion in UK regulated covered bonds should not be expanded?	3.26
4	Do you agree the UK should introduce a fixed minimum level of overcollateralisation and an interest coverage requirement for regulated covered bonds, and that the draft legislation achieves this?	3.29
5	At what level should the minimum overcollateralisation requirement be set?	3.37
6	Do you agree that the UK should introduce an independent Asset Pool Monitor for regulated covered bond programmes, with the powers and responsibilities described above, and that the draft legislation and Sourcebook changes achieve this?	3.38
7	Do you agree that the UK should introduce a mandatory disclosure requirement for regulated covered bonds, in line with the Bank of England requirements, and that the draft legislation and Sourcebook changes achieve this?	3.44
8	Do you have any views on the FSA's updated notification requirements and proposed changes to the Sourcebook?	3.51
9	Do you agree that the UK should not introduce an 'integrated model' for regulated covered bonds?	3.54
10	Do you agree that the UK covered bond regime should be limited to issuance by firms registered in the UK?	3.58
11	Does the Impact Assessment of the proposed changes accurately capture their costs and benefits?	3.63
12	Are you content with the proposed timeline for implementing any changes to the regime by the end of 2012?	3.66
13	Do you have any suggestions on any other aspects of the UK's covered bond regime not covered in the questions above that you think the Government and the FSA should consider as part of this review?	N/A

4 Related regulatory issues

Bank resolution policy

4.1 The financial crisis threatened the viability of a number of large financial institutions, and required very significant interventions by taxpayers and central banks to prevent the failure of major institutions in cases where this would have had severe economic consequences.

4.2 New standards of bank regulation, such as higher capital and liquidity requirements, are designed to reduce the risk of major institutions failing in this way. Recovery and resolution plans and formal resolution powers, such as powers to transfer assets or put institutions into temporary public ownership, have also increased the range of tools available to the authorities to avoid major disruption from the failure of a large financial institution.

4.3 In addition to these existing tools, there are also ongoing international discussions about the development of a concept of 'bail-in'[1]. This would give the authorities the power to impose losses on the uninsured creditors of a failing financial institution as part of a resolution process. The adoption of a bail-in tool would reduce the need for taxpayer support for failing financial institutions. The UK is actively engaged in the international debate about these issues. Negotiations about bail-in are at an early stage, and no detailed proposals have been developed on the operation of such potential such powers.

4.4 A key issue of current discussion is on the scope of any bail-in powers. The authorities recognise that this is an important issue for many investors in banks. If a bail-in power were introduced into the UK's Special Resolution Regime (SRR) for failing banks, the power would be subject to the same creditor safeguards that apply more generally within the SRR, including the safeguard that protects covered bond holders. In addition, the UK believes that, in the exercise of any bail-in powers, secured creditors' rights to collateral should not be over-ridden, and that the claims of covered bond holders in relation to the asset pool of a covered bond, including under a guarantee which forms part of the covered bond arrangement[2], should not be affected. This would mean that only a secured creditor's residual unsecured claims after realisation of collateral or recoveries under a guarantee would be subject to bail-in. As international negotiations about bail-in powers progress, the authorities should consider carefully the mechanisms by which creditors could call upon any guarantee forming part of a covered bond arrangement in respect of the original unsecured claims.

Asset encumbrance

4.5 Asset encumbrance occurs when a firm's assets are tied to a particular transaction. This means that if the firm fails, these assets are not available to meet the claims of unsecured creditors, such as depositors. Where depositors are protected by the Financial Services Compensation Scheme, this can increase the cost to the taxpayer of a firm's failure.

[1] See the recent European Commission consultation on crisis management, http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm.

[2] See 2.15 for a description for how the guarantees in UK covered bond programmes operate.

4.6 The FSA's policy towards asset encumbrance considers the benefits of firms' ability to access secured funding, and the impact of asset encumbrance on unsecured creditors, including depositors. The FSA monitors cover bond issuance and other significant forms of asset encumbrance on a case-by-case basis[3]. This assessment considers the volume of encumbered assets as a proportion of the firm's total assets, and the level of over-collateralisation within the asset pool. Firms with high levels of encumbrance may be required to hold additional capital. The supervisory outcome may include an additional Pillar II capital charge, a cap on covered bond issuance, or a limit on the term of issuance.

4.7 The FSA's Prudential Policy Division is conducting a review in 2011 to further develop the FSA's asset encumbrance policy.

Set-off

4.8 In the context of a covered bond programme, set-off risk arises when individuals hold both a loan and a deposit with the same financial institution. These individuals may try to set their deposit off against the loan if the financial institution fails and they cannot recover their deposit. This can reduce the value of the loan, and hence affect its value as collateral in a covered bond asset pool.

4.9 The impact of set-off risk in the UK is substantially reduced by the Financial Services Compensation Scheme (FSCS). The FSCS provides a guarantee for depositors of a failed financial institution. On 31 December 2010, the maximum amount that each depositor can claim in aggregate from each authorised deposit-taking institution under the guarantee was increased from £50,000 to £85,000. In addition, the basis of the guarantee was changed to apply to the gross balance of deposits, rather than the net amount after taking into account any borrowings the depositor has with the failed institution, for example a mortgage.

4.10 Overall, this means depositors can claim the gross balance of their deposit with a failed deposit-taking institution up to £85,000 from the FSCS. If the depositor has deposits in excess of £85,000 and outstanding debts with the same institution, then the remaining value of the deposits may be set off against the debt owed. Just 1% of depositors in the UK have a gross balance above £85,000[4], and not all depositors with such high balances will have a debt with the same institution. These changes therefore significantly reduce the impact of set-off risk attached to covered bond asset pools.

Bank liquidity regulation

4.11 The financial crisis exposed failings in many banks' funding models, including that banks did not hold sufficient liquid assets to allow them to raise funds during market disruptions. Considerable work has been undertaken both in the UK and internationally to develop appropriate, effective and robust liquidity regulation to address this. This includes the development of quantitative standards for 'liquid asset buffers' that financial institutions must hold.

4.12 Work is ongoing internationally to define the types of liquid assets that would be eligible for liquid asset buffers, in the context of the standards recently agreed by the Basel Committee on Banking Supervision. This includes consideration of how covered bonds can be incorporated into the make-up of liquid asset buffers. Liquidity regulation will be implemented in Europe through the Capital Requirements Directive.

[3] See Director, Prudential Policy Division, Letter to Firms October 2008, http://www.fsa.gov.uk/pubs/international/cov_bond.pdf.

[4] See p. 51 of http://www.fsa.gov.uk/pubs/cp/cp10_22.pdf.

4.13 The UK is actively engaged in this process, and the FSA will consider carefully how best to adopt the international framework, once this has been finalised, into the regulation already in place in the UK. Further information on the FSA's current liquidity standards is set out in the FSA Handbook[5].

[5] http://fsahandbook.info/FSA/html/handbook/BIPRU/12.

5 Impact Assessment

Title: **Regulated covered bonds review** **Lead department or agency:** HM Treasury **Other departments or agencies:** Financial Services Authority	**Impact Assessment (IA)**
	IA No:
	Date: 05/04/2011
	Stage: Consultation
	Source of intervention: Domestic
	Type of measure: Secondary legislation
	Contact for enquiries: coveredbondreview@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

Covered bonds are a category of bond backed by pools of assets, such as mortgages, that can provide stable funding for banks and building societies. European regulation favours investment in covered bonds subject to domestic regulation. Investors value this regulation, and prefer stringently regulated bonds as these provide the greatest certainty of paying out as expected.

The UK already has covered bond regulation to allow UK issuers of covered bonds to meet the European regulatory requirements. The Government and the FSA have identified a number of small improvements to the regulation to bring it closer into line with the regulation in other European countries. This will increase the appeal of UK regulated covered bonds to investors and so improve issuers' access to funding.

What are the policy objectives and the intended effects?

The objective is to support UK issuers' access to stable funding from covered bonds. In particular:

- the UK's regulation should allow UK covered bonds to meet the relevant European regulatory standards;

- the regulation should promote investor confidence in UK covered bonds, by making clear the quality of UK regulated covered bonds and the strengths of the regulatory approach; and

- financial institutions' use of covered bonds should be consistent with financial stability.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

There are no viable alternatives to regulation, since European law favours regulated covered bonds. The absence of regulation would reduce confidence in the UK market. These proposals are about improving existing regulation to make sure it meets its policy objectives.

The Government and the FSA propose to build on the general principles set out in the existing Regulations by introducing more prescriptive rules and codifying best practice in the market, to match the approach taken in some other countries and address certain investor concerns.

The proposed changes cover: the types of assets eligible for covered bonds; the maintenance of covered bond asset pools; and the arrangements for independent scrutiny of covered bonds.

Doing nothing will not address the issues raised by investors and help increase UK financial institutions' access to covered bond funding. The preferred option is therefore to proceed with the changes.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 12/2017

What is the basis for this review? Duty to review. **If applicable, set sunset clause date:** Month/Year

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Yes

Minister's sign-off

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date: 5 April 2011

Summary: Analysis and Evidence — Policy Option 1

Description: Proceed with all proposed changes.

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: £40m	**High:** £445m	**Best Estimate: £220m**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	1	Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	**£0.8m**		**£0.4m**	**£4.6m**

Description and scale of key monetised costs by 'main affected groups'

FSA: extra administrative costs of supervising covered bond issuers. £20,000 per year.

Covered bond issuers: administrative costs of complying with Regulations. £0.8m transitional, then £0.4m per year.

Other key non-monetised costs by 'main affected groups'

N/A

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	£0	1	£5m	**£45m**
High	£0		£55m	**£450m**
Best Estimate	**£0**		**£25m**	**£225m**

Description and scale of key monetised benefits by 'main affected groups'

Covered bond issuers: lower spreads on covered bonds. £25m average per year.

Other key non-monetised benefits by 'main affected groups'

Wider society: more stable funding for banks and building societies, leading to less risk of financial disruption; fewer opportunities for regulatory arbitrage

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Financial markets have displayed high volatility since the financial crisis. Any further disruption could affect the pricing of covered bonds and issuers' use of them.

Future changes to bank regulation could affect the relative appeal of covered bonds to issuers and investors.

Note: Benefits rounded to nearest £5m, costs rounded to nearest £0.1m.

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: £0.5m	**Benefits:** £27.0m	**Net:** £26.5m saving	Yes	OUT

Enforcement, Implementation and Wider Impacts

<table>
<tr><td colspan="3">What is the geographic coverage of the policy/option?</td><td colspan="3">United Kingdom</td></tr>
<tr><td colspan="3">From what date will the policy be implemented?</td><td colspan="3">31/01/2012</td></tr>
<tr><td colspan="3">Which organisation(s) will enforce the policy?</td><td colspan="3">FSA</td></tr>
<tr><td colspan="3">What is the annual change in enforcement cost (£m)?</td><td colspan="3">£20,000</td></tr>
<tr><td colspan="3">Does enforcement comply with Hampton principles?</td><td colspan="3">Yes</td></tr>
<tr><td colspan="3">Does implementation go beyond minimum EU requirements?</td><td colspan="3">Yes</td></tr>
<tr><td colspan="3">What is the CO_2 equivalent change in greenhouse gas emissions?
(Million tonnes CO_2 equivalent)</td><td colspan="2">Traded:
N/A</td><td>Non-traded:
N/A</td></tr>
<tr><td colspan="3">Does the proposal have an impact on competition?</td><td colspan="3">No</td></tr>
<tr><td colspan="3">What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?</td><td colspan="2">Costs:
0</td><td>Benefits:
0</td></tr>
<tr><td>Distribution of annual cost (%) by organisation size
(excl. Transition) (Constant Price)</td><td>Micro
0</td><td>< 20
0</td><td>Small
0</td><td>Medium
0</td><td>Large
100%</td></tr>
<tr><td>Are any of these organisations exempt[1]?</td><td>N/A</td><td>N/A</td><td>N/A</td><td>N/A</td><td>N/A</td></tr>
</table>

Specific Impact Tests: Checklist

Does the policy have an impact on…?	**Impact**	**Page ref within IA**
Statutory equality duties	No	59
Economic impacts		
Competition	No	59
Small firms	No	59
Environmental impacts		
Greenhouse gas assessment	No	N/A
Wider environmental issues	No	N/A
Social impacts		
Health and well-being	No	N/A
Human rights	No	59
Justice system	No	59
Rural proofing	No	N/A
Sustainable development	No	N/A

[1] The Regulations only apply to firms that wish to register as regulated covered bond issuers with the FSA. There is no barrier to firms exempting themselves from the Regulations by not registering as such and issuing unregulated covered bonds instead. See the Small Firms Impact Test.

Evidence Base – Notes

References

No.	Legislation or publication
1	Review of the UK's regulatory framework for covered bonds [consultation document] [link]
2	Regulated Covered Bonds (Amendment) Regulations 2011 [draft changes to regulations] [link]
3	Regulated Covered Bonds Regulations 2008 [existing legislation] http://www.legislation.gov.uk/uksi/2008/346/contents/made

Annual profile of monetised costs and benefits - (£m) constant prices

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	Y_9
Transition costs	£0.8m	£0	£0	£0	£0	£0	£0	£0	£0	£0
Annual recurring cost	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m
Total annual costs	£1.2m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m	£0.4m
Transition benefits	£0	£0	£0	£0	£0	£0	£0	£0	£0	£0
Annual recurring benefits	£5m	£10m	£15m	£20m	£25m	£30m	£35m	£40m	£45m	£50m
Total annual benefits	£5m	£10m	£15m	£20m	£25m	£30m	£35m	£40m	£45m	£50m

Evidence Base

Background

Covered bonds are a category of secured bond backed by a pool of assets. The assets provide security for investors in covered bonds in case the issuer of the bonds fails. Covered bonds are issued by financial institutions to raise funding. There are over £100bn of covered bonds outstanding in the UK, issued by all the major banks and a number of building societies. In the first few months of 2011, issuance of covered bonds represented about 15% of the longer-term public issuance of funding by UK banks[2].

The financial crisis revealed that many banks were over-reliant on unstable, short-term funding. This over-reliance made banks very vulnerable to market disruptions. During the financial crisis in 2008, many institutions began to struggle to refinance their short-term obligations. As a result, governments and central banks across the world eventually had to step in to provide emergency funding and additional capital to prevent the failure of large, systemically important financial institutions. The ensuing disruption to the economy has imposed very large costs on UK society.

New banking regulation currently being developed is designed to make banks less vulnerable to short-term market disruptions, by forcing them to raise more longer-term funding. Such funding does not need constant refinancing, and so will make banks better able to weather periods where short-term funding is less available.

Covered bonds can be one source of longer-term, more stable funding. Covered bonds last on average for around five years, and are often bought by stable investors such as pension and insurance funds that are less affected by short-term market disruptions. They proved more resilient in the financial crisis and recovered more rapidly than some other sources of funding.

European regulation under the UCITS and Capital Requirements Directives favours investment in covered bonds that are subject to dedicated domestic regulatory scrutiny, by imposing lower capital requirements and higher investment limits on investors making investments in regulated bonds than other bonds. This has naturally led the investor base for covered bonds to focus largely on regulated covered bonds, and the nature of the regulation backing covered bonds has become a key component of the product.

High quality domestic regulation is therefore a necessary condition of ensuring that UK issuers have favourable access to the widest possible covered bond investor base. Without a high quality of regulation, UK covered bond issuers would not be able to compete on a level playing field in the EU market.

As a result, the Government introduced the Regulated Covered Bond Regulations 2008 to help UK financial institutions access covered bond funding. These Regulations provide a regulatory framework for UK covered bonds that enforces minimum standards in line with the minima in European covered bond regulation. The Regulations follow a broad, principles-based approach, which sets out high-level standards that covered bonds must meet, rather than detailed, prescriptive rules.

The Regulations have been broadly successful. Ten covered bond issuers have registered as regulated issuers, including all the major UK banks and a number of larger building societies. Issuance of covered bonds has grown rapidly since the financial crisis.

Policy objectives

Covered bonds can provide a stable source of long-term funding for financial institutions, which can make banks and building societies more resilient to financial disruptions. It is therefore important to ensure UK financial institutions have suitable access to the covered bond markets and can compete on a level playing field with European competitors in raising covered bond funding.

The introduction of the Regulations in 2008 and the ongoing regulatory approach have therefore been driven by three objectives:

[2] Source: Dealogic.

- the UK's regulation should allow UK covered bonds to meet the relevant European regulatory standards;
- the regulation should promote investor confidence in UK covered bonds, by making clear the quality of UK covered bonds and the strengths of the regulatory approach; and
- financial institutions' use of covered bonds should be consistent with financial stability.

Problem under consideration

Market feedback from post-implementation review

During December 2010, the Treasury and the FSA met with a range of covered bond market participants to assess the effectiveness of the Regulations as part of a post-implementation review. Most participants believed the UK covered bond market meets high standards. This is partly as a result of positive practices among issuers that are driven by the high-level duties and principles set out in the Regulations.

However, covered bond regulation in some other European jurisdictions takes a more direct, prescriptive approach and imposes detailed, specific rules on covered bond issuers rather than general principles. This goes far beyond the minimum requirements of EU legislation. A more prescriptive approach is particularly evident in Germany and France, which are among the most established European covered bond markets.

Numerous market participants said they believed UK covered bonds would appeal more to investors if the Regulations took a more prescriptive approach in line with these other jurisdictions. Some investors used to investing in covered bonds subject to prescriptive rules did not believe that high-level principles could reliably deliver equivalent quality standards. This means they regarded UK covered bonds as a less attractive product.

Exceeding the minimum requirements of EU legislation is often regarded as unnecessary ‘gold-plating’. In this case, however, so many EU Member States have exceeded the minimum requirements, and investors say they attach so much value to regulation, that not exceeding the minimum requirements may be putting the UK at a significant competitive disadvantage.

In effect, the absence of ‘gold-plating’ could be more costly for the UK than its presence. Any costs that issuers might save from less regulation could be more than offset by having to pay higher interest rates on their covered bonds to investors, or having less access to covered bond funding. This reduces UK financial institutions access to stable, long-term funding or leads to a higher cost of funding for UK banks, which may be passed on as a higher cost of credit for consumers and businesses. Such an outcome would constitute a regulatory failure.

The following two sections discuss the evidence for this in detail.

Qualitative evidence of a problem with the regulations

It is important to consider why some investors may regard the lack of a prescriptive regulatory approach as problematic even if the market meets high standards through non-prescriptive arrangements. One could argue, for example, that if investors prefer prescriptive rules, issuers could meet this demand by making detailed commitments in the individual contracts governing their covered bonds. On this argument, there would be no need for regulation to address investor demand for prescriptive rules.

This argument misses an important distinction between contractual commitments and statutory requirements. With a regulated product whose issuers face statutory requirements, investors can rely on the regulator to ensure the issuer complies with these requirements. With contractual commitments, an investor’s recourse against an issuer who fails to comply with their commitments is to pursue the issuer through the courts to enforce the contract.

Pursuing a breach of contract through the courts can involve delays, legal fees, and uncertainty about outcomes for an investor. Regulatory enforcement requires far less individual investor engagement and, given the regulator’s considerable powers, tends to involve less uncertainty as to whether enforcement will be successful.

In general, statutory requirements therefore involve less uncertainty and are more readily enforceable than contractual commitments. Where an investor can choose between a covered bond subject to certain statutory requirements and an otherwise identical product subject to equivalent contractual commitments, it would be rational to prefer the additional certainty and enforceability in the product that is subject to statutory requirements.

The above theoretical distinction applies to all business arrangements. However, market feedback from investors suggests the distinction between contractual commitments and statutory requirements is particularly pertinent to the covered bond market. This is for two reasons.

Firstly, investors face a broad choice of covered bonds from different countries and will compare the approach in the UK Regulations with the covered bond regulations in other jurisdictions. Many other jurisdictions, including the long-established covered bond markets in Germany and France, take a more prescriptive approach than the UK.

Secondly, covered bonds are typically low-yielding products, and so it is not cost-effective for most investors in them to conduct detailed analysis on the contractual structure of individual bonds. Instead, investors may assess covered bonds with reference to the general standards prevailing in the covered bond market of a particular country, by reference to the country's covered bond regulation. The lack of prescriptive rules in the UK Regulations may therefore negatively affect investors' assessments of the UK market.

Quantitative evidence of a problem with the regulations

The importance of regulation as a factor in investors' perceptions of UK covered bonds can be expressed in terms of the impact it has on the price of covered bonds. Other things being equal, one would expect investors who are concerned about the lower level of prescription in UK covered bonds to demand a higher return when they buy the bonds. This would be reflected in the spread[3] on UK covered bonds being higher relative to the relevant 'risk-free' interest rate than with covered bonds from countries with more prescriptive regulatory regimes.

In March 2011, the spread on UK covered bonds relative to risk-free rates was around 150bps. The spread on German covered bonds, which are based on a more prescriptive regulatory framework, was around 20bps. The spread on French covered bonds was also around 20bps[4]. This means investors demand over 100bps extra return on UK covered bonds relative to those from France and Germany.

Many factors come into the choice between covered bonds from different jurisdictions, and in practice there is never a choice between identical bonds that differ only in terms of being subject to statutory or contractual rules. When choosing between different bonds, investors' perceptions of the strength of the underlying housing market in a particular jurisdiction, the strength of covered bond issuers, the track record and history of covered bonds in that jurisdiction, and the extent of state support for covered bonds may be a more material factor than the nature of the covered bond regulation.

However, analysis by the Bank of International Settlements (BIS) of the spreads on covered bonds from different jurisdictions found that, after controlling for several such factors, there was a residual difference between spreads in different jurisdictions that could be due to perceptions of the regulatory regime[5]. While the BIS analysis was inconclusive on the precise impact of the regulatory regime, it is at least possible that the less prescriptive UK regulation of covered bonds is a factor in the much higher spreads on UK covered bonds. The investor feedback from the post-implementation review described above certainly supports this view.

Economic consequences of regulatory failure

The spread on a covered bond reflects a transfer of risks and rewards between agents in a financial market. Lower spreads would reduce costs for covered bond issuers at the expense of reducing returns for covered bond investors. There is therefore no immediate connection between higher spreads on covered bonds and an economic cost to UK society. In this case, however, there is an argument that higher spreads do represent a welfare loss, to the extent that they arise from a regulatory failure.

As explained above, many market participants have stated that they believe the underlying quality of UK covered bonds is high in comparison to international peers. To the extent that this is true, those investors who regard UK covered bonds as being of lower quality and so demand higher spreads may be doing so partly on the basis of the regulatory framework – due to the greater uncertainty and lower enforceability that arises from the need for investors to rely on contractual commitments or market practice rather than statutory requirements.

[3]The spread on a bond is an indication of how much investors demand to be paid to buy the bond. In detail, the 'price' of a bond is the price for which it can be bought and sold in the market. The return an investor derives from buying a bond is determined by the interest payable on the bond relative to the price the investor has to pay. This is known as the 'yield'. Differences in yields between different bonds are known as 'spreads'. Spreads are typically expressed in 'basis points' or 'bps', which each represent 0.01%.

[4] Source: JP Morgan. Rounded average secondary market spread vs asset swap curve for covered bonds with maturities of 5 years or more, March 2011.

[5] *The covered bond market - BIS Quarterly Review*, part 4, September 2007, http://www.bis.org/publ/qtrpdf/r_qt0709f.pdf.

Using more prescriptive regulation to reduce this uncertainty and increase enforceability could reduce spreads for issuers by removing uncertainty for investors. Issuers would benefit to the extent that spreads are lower without them having to make any major changes to their covered bond programmes. The net effect on investors is zero – since the pricing of covered bonds is determined in a competitive market, the cost to the investor of accepting a lower spread on the covered bond will be equal to the benefit of the greater certainty the investor derives from the more prescriptive rules. Overall, there is therefore a gain to society. The extent of that gain will depend on how lower costs for issuers contribute to overall social welfare. The extent of the gain is discussed further in the section on Benefits below.

Summary

In conclusion, these arguments suggest that there may be scope to make changes to the Regulations that could produce a welfare gain for the UK. The general direction of these changes would be to introduce more prescriptive requirements into the Regulations, in excess of the minimum EU standards and in line with the practice in competing jurisdictions.

Policy options

In discussions with market participants, the Treasury and the FSA investigated which specific issues underlie the general market perception that the UK regulatory framework may not be sufficiently prescriptive compared to international peers. Through this process, the Government and FSA have identified a set of areas, discussed below, where issuer and investor feedback has suggested that regulatory change will improve outcomes in the UK covered bond market.

Excluding securitisations as eligible assets

The Regulations set out which assets are eligible for inclusion in covered bond asset pools. They currently allow securitisations of residential and commercial mortgages to be included in covered bond asset pools, as well as 'raw' mortgages. This is in line with the relevant provisions of the European Banking Consolidation Directive. However, many other jurisdictions take a stricter approach than the Directive and do not allow securitisations to be included[6].

The rationale for excluding securitisations is that the complex structure of securitisations can make it more difficult to analyse the likely performance of a covered bond. However, since covered bonds are typically low-yielding products, it is not cost-effective for most investors in them to conduct the detailed analysis needed to fully understand this additional complexity. Instead, investors may choose to uniformly mark down their assessment of a covered bond that contains, or could contain, securitisations.

No UK regulated covered bond programmes currently contain securitisations, and no issuer has ever applied to the FSA to use them. Despite this, market feedback suggests that investors look to the Regulations that allow securitisations to be included and adjust their assessment of UK covered bonds accordingly. This constitutes a failure in the Regulations – issuers are unable to credibly communicate their intentions and the nature of their product to investors.

This means that aligning the Regulations with the practice in other countries by removing the option to include securitisations in covered bond asset pools will remove uncertainty for investors and improve perceptions of the quality of UK covered bonds, while imposing no costs on issuers.

The Government and FSA have considered whether adding additional conditions in the Regulations relating to the inclusion of securitisations could address the problems above without excluding securitisations completely. Such conditions would need to ensure securitisations were only included if they were sufficiently simple to be readily understood by non-specialist investors and not complicate the assessment of the quality of a covered bond. Given the intrinsic complexity of securitisation, this is not a realistic option.

Beyond reducing uncertainty for investors, there are benefits to broader financial stability from excluding securitisations. While there is a favourable regulatory treatment for covered bonds under the UCITS and Capital Requirements directives, the treatment of securitisations is much less favourable. If securitisations could be included in covered bond asset pools, this would represent an opening for regulatory arbitrage – market participants could evade the tighter regulatory requirements placed on securitisations by repackaging them into covered bonds. Since the tighter regulatory requirements have been introduced to correct failures that contributed to the financial crisis, evasion of these requirements could substantially increase risk in the financial system.

Single asset type pools

The Regulations currently allow a range of asset types to be included in a covered bond asset pool, including residential mortgages, commercial mortgages, and public sector loans. The risk characteristics of these assets types are very different. Since the assets in a covered bond programme need to be replenished over time, some investors have remarked that with broad eligibility criteria they are concerned that over time the mix of assets in a covered bond programme could change from less risky to more risky assets. These investors will factor this risk into their assessment of the quality of a covered bond, which could raise the spread on the bond.

[6] For example, Germany, Ireland, and Spain.

Some other jurisdictions make it a requirement in their regulation that issuers maintain asset pools with only a single type of asset in them[7]. In these countries, different asset types must be placed in separate pools. In comparison with such jurisdictions, some investors have said that in the UK there are insufficient protections against a change of asset quality, even in cases where an issuer states they will not change the type of assets over time.

No UK covered bond issuer currently includes or has expressed an interest in including any assets other than residential mortgages in their programme. The risk of a change in asset types perceived by investors therefore represents a regulatory failure, since the Regulations appear to be preventing issuers from credibly communicating their intention not to change asset types to investors.

The Government proposes to address this by introducing an option in the Regulations for issuers to formally declare their covered bond programme as a 'single asset type' programme. Such programmes would only be allowed to include assets of a single type. Issuers would still be able to retain the current flexibility in the Regulations to mix and change asset types by declaring their programme as a 'mixed asset type' programme.

This proposal will impose no change and hence no costs on issuers who wish to continue with their current, potentially more flexible arrangements. Issuers who choose to declare their programmes as single asset type would only do so if they believed this would be benefit them by removing uncertainty for their investors. Overall, this proposal is therefore expected to lead to a net benefit for issuers

The Government and the FSA considered removing the option for mixing asset types altogether, which would bring the UK fully into line with some other jurisdictions. The Government and the FSA have rejected this option because it is unnecessary to go this far to address the problem identified. Mixing asset types may in future meet the needs of some issuers and investors, so removing this option from the Regulations may unnecessarily constrain the potential for innovation and growth in the covered bond market.

Investor reporting

One contributor to the financial crisis was a lack of transparency about the characteristics of financial products and financial institutions' exposures to them. This lack of transparency led to a mispricing of risk, especially an under-pricing of risk in the run-up to the crisis.

UK covered bonds benefit from high levels of transparency, such as detailed reporting about the quality of covered bond asset pools and disclosure of legal documentation. This transparency, however, is not driven by any feature of the Regulations and is instead a result of market practice. The lack of regulation in this area means the format of disclosure is not consistent across all issuers, increasing the barriers to comparing and evaluating the relevant data for investors. A lack of regulation also means investors may not have as much confidence in the quality of this disclosure or recognise it as a key feature of UK covered bonds as if the disclosure was enforced by regulatory requirements

The Government proposes to amend the Regulations to give the FSA the power to direct publication of information. The FSA will use this to ensure consistent reporting and disclosure for UK covered bonds, in line with guidance provided by the FSA. This will reduce the costs for investors of using the information issuers provide and increase its reliability. A better informed market will benefit from more efficient pricing, which will benefit issuers with high quality covered bonds.

To minimise costs to issuers, the FSA is building on existing forms and processes in developing the proposed reporting standards. The proposed standards are similar to the information issuers already provide to the FSA and to credit rating agencies, and to new standards developed by the Bank of England with which almost all issuers have indicated that they are already planning to comply. Overall, this means the proposal is likely to impose only minimal additional administrative costs on most issuers. The scale of costs is discussed below.

Fixed minimum overcollateralisation

Overcollateralisation is the degree to which the balances outstanding on the assets in a covered bond asset pool exceed the balances outstanding on the bonds. It provides protection to investors by ensuring

[7] For example, Germany, Ireland and Spain.

the asset pool can suffer a certain threshold of losses but still be able to secure repayment of the bonds if the issuer fails, and is a key factor in determining the quality of a covered bond.

Overcollateralisation levels in all covered bond markets are driven by rating agency requirements, investor preferences, issuers' operational decisions, and regulatory requirements. In the UK, the regulatory component of overcollateralisation levels is determined by FSA stress testing. This assess the performance of the covered bond programme against a range of possible adverse scenarios, to determine how much overcollateralisation is needed to ensure the programme can continue to meet is liabilities under these stresses.

Some other jurisdictions take a different approach and impose a statutory fixed minimum level of overcollateralisation that issuers must meet[8]. In practice, overcollateralisation in these countries is, like in the UK, far higher than the typical fixed minimum levels used, and is driven by rating agency requirements and investor preferences. A fixed minimum level is, however, more transparent and readily understood by investors than a variable level. It also provides a floor to the possible levels of overcollateralisation on which investors can rely. Some investors have commented that the absence of a minimum in the UK introduces a degree of uncertainty and makes the UK regime harder to compare with other jurisdictions.

The Government therefore proposes to introduce a requirement in the Regulations that issuers must maintain a fixed minimum level of overcollateralisation in covered bond asset pools. The Government and the FSA envisage setting the fixed level in line with the fixed minima in other jurisdictions, which would be well below the current levels of overcollateralisation in the UK. This means the new requirement will have no material impact on issuers, but will bring benefits through reducing investor uncertainty.

Asset Pool Monitor

UK covered bonds benefit from a high degree of external scrutiny, including an annual external audit of the programme. As with numerous other features of positive UK market practice, however, the external audit is not currently a statutory requirement in the Regulations and so, for the reasons described above, not all investors are aware that it takes place and they do not give issuers full credit for the added confidence that external scrutiny of programmes should bring.

Some other jurisdictions include a formal requirement in their regulation for an 'asset pool monitor' or related role, which performs a similar function to an external auditor[9]. The lack of such a requirement in the UK Regulations, despite market practice that would meet this requirement, may be putting UK issuers at a disadvantage compared with competitors from other jurisdictions.

The Government proposes to address this by adding a requirement to the Regulations for issuers to appoint a formal Asset Pool Monitor, with a remit that is very similar to that of existing auditors. This will make the presence of external scrutiny of UK covered bond programmes more apparent to investors without imposing major changes on issuers.

However, formalising the role of auditors could increase costs for issuers. Auditors currently conduct their annual reviews on the basis of contracts with issuers. The cost of a review is currently around £30,000[10]. Some issuers have said auditors may regard conducting a review in line with a statutory requirement as increasing their potential liability in case of error compared with one conducted under contract, and so could try to increase their fees. The effect of such an increase is discussed below.

[8] For example, Germany, France, Ireland and Spain.

[9] For example, France, Germany and Ireland.

[10] Source: FSA, based on information from issuers.

Overall costs and benefits

Benefits

The key direct benefits from these proposals are in the form of removing uncertainty among investors about the quality of UK covered bonds, especially when comparing UK covered bonds with covered bonds from other jurisdictions. As set out above, a reduction in uncertainty may manifest itself in the form of lowering the spreads on UK covered bonds. For the reasons given above, this represents an overall welfare gain by reducing costs for issuers without any net welfare impact on investors.

Lower costs for issuers could lead to higher profits, or be passed on to firms and individuals in the form of a lower cost of credit for those who borrow from issuers. The overall impact of a lower cost of credit on society is very hard to quantify. It could lead, for example, to the financing of a greater number of productive investment opportunities, which could boost economic output by an amount greater than the immediate monetary reduction in credit costs. However, due to the difficulty of estimating such effects and the very small scale of any possible reduction in the overall cost of credit for the economy, this Impact Assessment assesses only the immediate monetary gains to issuers from a reduction in spreads.

The Bank of International Settlements analysis of covered bond spreads discussed above found that the unexplained residual component in spread differences that could be attributable to perceptions of the regulatory regime was +/- 8ps, at a time in 2005/6 when the difference in spreads between different jurisdictions was around 20bps. This means the residual accounted for the majority of the difference in spreads. Spread differences across products in all financial markets have increased substantially since the financial crisis. As discussed above, the difference between UK covered bond spreads and those of key European competitors is now over 100bps. A conservative estimate of the reduction in spreads due to the measures proposed could therefore be 5bps, which represents a reduction of only 5% in the current difference between UK and other countries' covered bond spreads.

The outstanding volume of UK covered bonds is around £100bn. If the collective impact of the measures above was to reduce the spread on UK covered bonds by 5bps, in the steady state this would represent a saving to UK issuers of £50m annually (£100bn x 0.05%). In practice these savings will build up slowly over time, as existing bonds on fixed interest rates are refinanced. The average maturity of UK covered bonds is around five years. As a conservative assumption, if a tenth of bonds are refinanced every year (compared to average maturities of five years), and there is no net growth in the overall volume of outstanding covered bonds (despite the recent increase in issuance), this represents an NPV benefit of £220m (rounded) to UK issuers over the next ten years. This is the discounted sum of £5m in the first year (£100bn x (1/10) x 0.05%), £10m in the second year (£100bn x (2/10) x 0.05%) and so on, for 10 years.

A reduction of 5bps in spreads is the central assumption. The table below illustrates the potential benefits from a lower reduction in spreads (1bps) and a higher reduction in spreads (10bps).

Summary of benefits from possible spread reductions	
Spread reduction	**NPV benefit (10 years)**
1bps	£50m
5bps – central assumption	£220m
10bps	£450m

The measures above will also reduce systemic risk in the financial system, through encouraging issuers to make use of longer-term, more stable funding through covered bonds, eliminating opportunities for regulatory arbitrage, and improving the functioning of markets through greater transparency. These benefits are difficult to quantify, but given the very large costs that the financial crisis has imposed on society, these are noted as important non-monetised benefits from the proposals.

Costs of the proposals

The costs to issuers of the individual measures have been discussed above in the context of each measure, and are in most cases negligible. The FSA sent a survey to all existing issuers to inform the estimates of these costs. Out of the 10 issuers, 4 responded.

Transitional costs

The key transitional costs of the proposals will be in the form of administrative costs for issuers in implementing the changes, for example as a result of changing legal documentation or amending IT systems.

Most issuers' estimates of the incremental costs were zero, since the changes involved were minor, could be integrated in an existing programme of routine changes, or (in the case of IT systems) are already taking place to meet existing requirements such as those set out by the Bank of England. The only area where major transitional costs were reported was in relation to one large issuer that indicated they did not already intend to comply with the Bank of England reporting requirements. The median transitional cost given by issuers for compliance with the Bank's existing requirements was £290,000.

Overall, the impact assessment assumes a transitional cost of £10,000 per issuer for each proposal, to represent the cost of legal advice to make changes to documentation. It also assumes a £290,000 transitional cost for the one issuer not already planning to comply with the Bank's reporting requirements.

Ongoing costs

Ongoing costs may arise from complying with the new investor reporting requirements and from any increase in the cost of external audits by the Asset Pool Monitor. The proposals to exclude securitisations, to allow single asset class pools, and to impose a minimum level of overcollateralisation do not impose any ongoing costs on issuers, since they do not mandate any change in existing or intended practice.

In relation to investor reporting, since the requirements will be based on existing forms and processes, issuers expected that at most a small amount of additional staff time would be required, of the order of a few hours a month. To be conservative, this impact assessment assumes a cost of £10,000 of staff time per issuer per year. To reflect the fact that one issuer has said they are not already planning to comply with the Bank of England's requirements, the Impact Assessment adds additional annual costs of £30,000, reflecting the median annual cost of meeting the Bank's requirements given by issuers.

In relation to the Asset Pool Monitor, issuers have said auditors may increase their fees to reflect the additional costs of undertaking a statutory rather than contractual duty. To be conservative, this impact assessment assumes a doubling of reported existing costs from £30,000 to £60,000 per year.

The costs are summarised below. They have been scaled to the current population of 10 issuers.

Summary of costs to issuers		
Proposal	**Transitional costs**	**Ongoing annual costs**
Excluding securitisations	£0.1m	£0
Single asset class pools	£0.1m	£0
Minimum overcollateralisation	£0.1m	£0
Investor reporting	£0.4m	£0.1m
Cover pool monitor	£0.1m	£0.3m
Total	**£0.8m**	**£0.4m**
NPV cost (10 years)	**£4.4m**	

No administrative costs for investors are expected, since the Regulations do not place any direct requirements on them.

There may be costs to the FSA from additional staff time in monitoring issuers' compliance with the new requirements. The FSA estimates these costs will be equivalent to at most one fifth of a full-time

equivalent staff member. Taking into account all the costs associated with employing staff, the FSA estimates this represents a cost of £20,000 annually, or £0.2m on an NPV basis.

Risks and assumptions

A key risk to the assessment of the benefits from these proposals is the potential for disruption to financial markets. Disruption may lead to a change in investors' or issuers' appetite for issuing or buying covered bonds, which could lead to a change in the size of the covered bond market or the nature of the covered bonds issued.

There is less uncertainty in the assessment of costs, since these are largely administrative and so less sensitive to broader changes in financial markets. The assessment of costs has been informed by a survey of issuers, in which they may have made simplifying assumptions. Unexpected changes in the costs of IT systems or in legal fees, for example, could affect these assumptions.

A third risk affecting both the costs and benefits arises from the ongoing development of financial regulation in Europe and internationally in the wake of the financial crisis. Were there to be major changes to the regulatory approach to covered bonds, the nature of these changes could affect the costs and benefits of these proposals.

Specific impact tests

Equality

The proposals relate solely to financial instruments traded between financial institutions in wholesale markets. They are not expected to have any impact on equality.

Competition

The proposals are not expected to have an impact on competition. While the increase in costs to issuers of covered bonds may in theory raise barriers to entry in the market for issuing covered bonds, the additional costs involved are immaterial in comparison to the already high costs of developing the necessary IT systems and legal arrangements to issue covered bonds.

Small firms

No impact on small firms is expected, for two reasons.

Firstly, the minimum size of issuance of covered bonds in the market is in the hundreds of millions of pounds, given investors' preference for large issues that provide greater liquidity. Such a scale of issuance is very unlikely to be achievable for a small firm, and no small firms currently issue covered bonds.

Secondly, only firms that apply to the FSA to become regulated issuers of covered bonds are subject to the Regulations. This means that should a firm decide they wish to issue covered bonds but want to exempt themselves from the burden of regulation, they can readily do so by not registering with the FSA as an issuer of regulated covered bonds. A number of firms have issued unregulated covered bonds, and there is no barrier to them continuing to do so.

Justice

No justice impact is expected. The proposals do not involve the creation of any new offences. The only proposal where there is a potential for offences to be committed is the proposal to introduce an Asset Pool Monitor. In line with existing provisions of the Regulations, which bring the provision of information about covered bonds to the FSA into the scope of the existing offence of 'misleading the Authority' in section 398 of the Financial Services and Markets Act 2000, the draft Regulations treat the provision of information to the Asset Pool Monitor as information provided to the FSA. It is not expected this will lead to any material increase in offences under section 398.

Human rights

The proposals relate solely to financial instruments traded between financial institutions in wholesale markets. They are not expected to interfere with human rights.

Annex 1: Post Implementation Review (PIR) Plan

Basis of the review: A duty for the Treasury to review the Regulations by the end of 2017 is set out in the draft Regulations.
Review objective: To assess whether the Regulations continue to meet their policy objectives, as described above, and whether those objectives remain appropriate.
Review approach and rationale: The review is expected to follow the same approach as this current review, which has been informed by detailed feedback from market participants.
Baseline: The baseline position is the current UK market for covered bonds in 2011. Broader developments in financial markets and future regulatory changes could affect this baseline, and so these will need to be taken into account in the review.
Success criteria: Success criteria include positive market feedback about the quality of UK covered bonds and their regulation compared to the standards in other jurisdictions. This may be accompanied by a reduction in covered bond spreads in the UK compared to those in other countries. Success criteria also include positive feedback from issuers on their ability to access covered bond funding.
Monitoring information arrangements: The FSA supervises all UK regulated covered bond programmes, and collects data and conducts analysis on an ongoing basis.
Reasons for not planning a review: N/A

A Draft amending regulations

2011 No.

FINANCIAL SERVICES AND MARKETS

The Regulated Covered Bonds (Amendment) Regulations 2011

Made - - - -	***
Laid before Parliament	***
Coming into force - -	***

The Treasury are a government department designated for the purposes of section 2(2) of the European Communities Act 1972([a]) in relation to—

(a) credit and financial institutions and the taking of deposits or other repayable funds from the public([b]); and

(b) measures relating to securities and rights in securities([c]).

The Treasury, in exercise of the powers conferred by section 2(2) of that Act, make the following Regulations:

Citation and commencement

1. These Regulations may be cited as the Regulated Covered Bond (Amendment) Regulations 2011, and come into force on [ ].

Amendment of the Regulated Covered Bond Regulations 2008

2.—(1) The Regulated Covered Bonds Regulations 2008([d]) are amended as follows.

(2) In regulation 1—

(a) in paragraph (2), insert in the relevant places—

““government stock” means stock or bonds of any of the descriptions included in Part 1 of Schedule 11 to the Finance Act 1942([e]);”

““liquid assets” means—

(a) government stock or treasury bills issued by Her Majesty’s Government in the United Kingdom and other specified government securities;

(b) deposits in sterling or another specified currency in an account held in the name of the owner with the issuer or with a specified credit institution,

and “specified” for the purposes of this definition means specified by the Authority in guidance issued under regulation 42;”

““mixed asset class bond” means a mixed asset class regulated covered bond included in Part 1 of the register of regulated covered bonds;”

(a) 1972 c.68; section 2(2), and Schedule 2 to the 1972 Act were amended by section 27 of the Legislative and Regulatory Reform Act 2006 (c.51); and by section 3 of, and the Schedule to, the European Union (Amendment) Act 2008 (c. 7).
(b) S.I. 2001/3495, amended by 2008/1714; 2010/22; 2010/671.
(c) S.I. 2000/3057.
(d) S.I. 2008/346.
(e) 1942 c.21. Part 1 of Schedule 11 was amended by the Finance Act 1963 (c.25), Schedule 14, Part 7; the National Loans Act 1968 (c.13); Schedule 6, Part 2), the Statute Law (Repeals) Act 1986 (c. 12), Schedule 1, Part 2; and the Finance Act 1989 (c.26), Schedule 17, Part 14).

““reference rate” means a rate used to set the interest rates charged to borrowers in relation to a loan included in the asset pool;”

““the relevant date” is [the date on which the Regulated Covered Bonds (Amendment) Regulations 2011 come into force];”

““single asset class bond” means a single asset class regulated covered bond included in Part 2 of the register of regulated covered bonds;”

““total principal amounts outstanding” means—

(a) in relation to loans, the sum of the original amounts advanced on the loan and any further advances, less any repayments of principal made on the loan;

(b) in relation to other assets, the total amount of principal which remains due to be repaid in relation to the asset.”.

(3) In regulation 2—

(a) in paragraph (1)—

(i) for the first line, substitute “In these Regulations, “eligible property” in relation to a mixed asset class bond or programme means any interest in—”;

(ii) for sub-paragraph (a), substitute—

“(a) subject to paragraph (1B), eligible assets specified in and compliant with the requirements contained in paragraph 68 of Annex VI of the banking consolidation directive;”;

(iii) after sub-paragraph (e), insert—

“(f) other liquid assets.”.

(b) after paragraph (1), insert—

“(1A) In these Regulations, “eligible property” in relation to a single asset class bond or programme means, subject to paragraph (1B), any interest in eligible assets specified in and compliant with the requirements of one (and only one) of the following classes—

(a) class 1 (public sector assets): eligible assets referred to in subparagraph (a) or (b) of paragraph 68 of Annex VI of the banking consolidation directive, assets referred to in sub-paragraph (b), (c), (d) or (e) of paragraph (1) above and other liquid assets;

(b) class 2 (residential mortgage assets): eligible assets referred to in sub-paragraph (d) of paragraph 68 of Annex VI of the banking consolidation directive, and liquid assets;

(c) class 3 (commercial mortgage assets): eligible assets referred to in sub-paragraph (e) of paragraph 68 of Annex VI of the banking consolidation directive and liquid assets.

(1B) Assets in the following categories—

(a) exposures to a body which does not qualify for credit quality step 1 on the credit quality assessment scale set out in Annex VI of the banking consolidation directive; and

(b) senior units, issued by French Fonds Communs de Creances or equivalent securitisation entities governed by the laws of the United Kingdom or an EEA State, securitising residential real estate or commercial real estate exposures;

shall not be eligible property for the purposes of paragraph (1)(a) or (1A).”.

(4) In regulation 7, after paragraph (1), insert—

“(1A) The register of regulated covered bonds shall be divided into two parts.

(1B) Part one shall be a register of mixed asset class regulated covered bonds.

(1C) Part two shall be a register of single asset class regulated covered bonds.

(1D) Any covered bonds or programme of covered bonds included on the register of regulated covered bonds immediately before the relevant date—

(a) shall be included in part two of the register of regulated covered bonds if the issuer certifies to the Authority at least one month before the relevant date—

(i) that the eligible property (other than liquid assets) in the asset pool for the covered bond or programme of covered bonds in question all falls within one and only one of the classes specified in regulation 2(1A); and

(ii) that the issuer wishes the regulated covered bond or bonds in question to be single-asset class regulated covered bonds;

(b) shall otherwise be included in part one of the register of regulated covered bonds.".

(5) In regulation 8, for paragraph (b) substitute—

"(b) for the covered bond or the programme of covered bonds to be admitted to—

(i) part one of the register of regulated covered bonds, or

(ii) part two of the register of regulated covered bonds.".

(6) In regulation 10—

(a) in paragraph (1), for "regulation 8(b)" substitute "regulation 8(b)(i) or (ii)";

(b) after paragraph (2), insert—

"(3) The Authority may only grant an application under regulation 8(b)(ii) if it is satisfied that the eligible property (other than liquid assets) in the asset pool all falls within one and only one of the classes specified in regulation 2(1A).".

(7) In regulation 14, for paragraph (1)(b), substitute—

"(b) the covered bond or the programme of covered bonds to—

(i) part one of the register of regulated covered bonds, in the case of an application under regulation 8(b)(i); or

(ii) part two of the register of regulated covered bonds in the case of an application under regulation 8(b)(ii).".

(8) In regulation 15, for paragraph (1)(b), substitute—

"(b) the bond is admitted to part one or part two of the register of regulated covered bonds.".

(9) In regulation 17(2)—

(a) at the end of sub-paragraph (c), omit "and";

(b) insert after sub-paragraph (d)—

"(e) the eligible property in the asset pool of a single asset class bond consists only of eligible property of the same class as the eligible property included in the asset pool of the regulated covered bond when it was registered;

(f) the total principal amounts outstanding in respect of eligible property in the asset pool is more than [x percent] of the total principal amounts outstanding in relation to the bonds to which the asset pool relates; and

(g) the total amount of interest payable in the period of twelve months following any given date in respect of eligible property in the asset pool is not less than the interest which would be payable in relation to the regulated covered bonds issued under the programme in that period, assuming that the reference rates applicable on the given date do not change in that period.".

(c) insert after paragraph (2)—

"(2A) In determining whether the requirement in paragraph (2)(e) is satisfied, no account shall be taken of eligible property which is liquid assets.

(2B) In ensuring that the arrangements satisfy the requirements in subparagraphs (f) and (g) of paragraph (2), the issuer may take account of any hedging agreements which it has entered into in relation to the assets in the asset pool and the regulated covered bonds.

(2C) Nothing in this regulation shall prevent the Authority directing an issuer to observe additional requirements in relation to its asset pool.".

(10) After regulation 17, insert—

"Asset pool monitor

17A.—(1) An issuer of a regulated covered bond must appoint an asset pool monitor for each asset pool maintained for the regulated covered bonds it has issued.

(2) The person appointed as asset pool monitor must—

(a) be eligible for appointment as a statutory auditor of the issuer under Part 42 of the Companies Act 2006;

(b) not be disqualified from acting as a statutory auditor of the issuer by section 1214 of that Act (independence requirement).

(3) The asset pool monitor shall—

(a) inspect the compliance of the issuer with the requirements in regulations 16 and 17, and in particular—

(i) the extent to which the asset pool satisfies the conditions set out in regulation 17(2);

(ii) the accuracy of the records kept in relation to each asset in the asset pool,

once every six months;

(b) prepare an annual report in accordance with guidance issued by the Authority on the steps the issuer has taken to comply with regulations 16 and 17, and on the quality of the assets in the asset pool.

(4) Guidance issued to the asset pool monitor of an individual issuer under paragraph (4)(b) may identify particular issues to be addressed in the report for that issuer.

(5) A copy of the report prepared by the asset pool monitor shall be delivered to the Authority at such time as the Authority may direct.

(6) If it appears to the asset pool monitor that the issuer has failed to comply with the requirements set out in regulation 17, or that the issuer has not provided the monitor with all the information and explanations to which the monitor is entitled under this regulation, the asset pool monitor shall report in writing on that fact to the Authority as soon as possible.

(7) The asset pool monitor—

(a) has a right of access at all times to all books, accounts and vouchers of the issuer and of the owner of the relevant asset pool which are related to that asset pool, in whatever form they are held, and

(b) may require any of the persons referred to in paragraph (8) to provide such information and explanations as the asset pool monitor thinks necessary for the performance of the monitor's duties under this regulation.

(8) The persons referred to in paragraph (7)(b) are—

(a) any officer or employee of the issuer or the owner;

(b) any person holding or accountable for any of the books, accounts or vouchers of the issuer or the owner;

(c) any person who fell within either sub-paragraph (a) or (b) at a time to which the information or explanations required by the asset pool monitor relates or relate.

(9) A statement made by a person in response to a requirement under this regulation may not be used in evidence against him in criminal proceedings, except proceedings for an offence under section 398 of the Act in connection with the giving of information pursuant to requirements imposed by or under these Regulations.

(10) On the insolvency of the issuer of a regulated covered bond—

(a) the asset pool monitor appointed by the issuer shall continue to act as asset pool monitor for the owner of the relevant asset pool;

(b) any subsequent appointment of an asset pool monitor required under paragraph (1) of this regulation shall be made by the owner of the relevant asset pool;

(c) references in paragraphs (2), (3), (4) and (6) to the issuer shall be understood as references to the owner of the relevant asset pool; and

(d) references in paragraph (3) to regulations 16 and 17 shall be understood as references to regulation 24.".

(11) In regulation 18, insert after paragraph (3)—

"(4) Any information required under paragraphs (1) and (2), or any part of that information, must, if the Authority so directs, be published as directed by the Authority.

(5) Nothing in paragraph (4) entitles the Authority to direct publication of information which the issuer would be entitled to refuse to disclose in court proceedings on grounds of legal professional privilege.".

(12) In regulation 22—

(a) renumber the existing provision as paragraph (1) of that regulation;

(b) insert after paragraph (1)—

“(2) Any eligible property acquired for the asset pool of a single asset class bond under paragraph (1) must be eligible property of the same class as the eligible property included in the asset pool of the regulated covered bond when it was registered.”.

(13) In regulation 24—

(a) in paragraph (1)(a), after paragraph (iii), insert—

“(iv) the asset pool of a single asset class bond consists only of eligible property of the same class as the assets included in the asset pool of the regulated covered bond when it was registered;

(v) the total principal amounts outstanding in respect of eligible property in the asset pool is more than [x percent] of the total principal amounts outstanding in relation to the regulated covered bond; and

(vi) the total amount of interest payable in the period of twelve months following any given date in respect of eligible property in the asset pool is not less than the interest payable in relation to the regulated covered bonds issued under the programme in that period, assuming that the reference rates applicable on the given date do not change in that period;”;

(b) after paragraph (2), insert—

“(2A) In determining whether the requirement in paragraph (1)(a)(iv) is satisfied, no account shall be taken of eligible property which is liquid assets.

(2B) In ensuring that the arrangements satisfy the requirements in sub-paragraphs (a)(v) and (vi) of paragraph (1), the owner may take account of any hedging agreements which it has entered into in relation to the assets in the asset pool and the regulated covered bonds.

(2C) Nothing in this regulation shall prevent the Authority directing the owner to observe additional requirements in relation to its asset pool.”.

(14) In regulation 38, insert after paragraph (1)—

“(1A) For the purposes of section 398 of the Act, as applied to requirements imposed by or under these Regulations, information provided to the asset pool monitor in response to a requirement under regulation 17A(7) shall be treated as being given to the Authority.”.

(15) In regulation 42—

(a) for paragraph (2), substitute—

“(2) The Authority must give guidance consisting of—

(a) information as to which government securities, credit institutions and currencies are specified for the purposes of the definition of “liquid assets” in regulation 1(2);

(b) information and advice about the quality of an asset pool for the purposes of the requirement specified in regulation 17(2)(d) and the manner in which it will assess the issuer’s and owner’s compliance with that requirement;

(c) information and advice about the contents of the annual report required for the purposes of regulation 17A(3)(b).”.

Review

3.—(1) Before the end of each review period, the Treasury must—

(a) carry out a review of regulation 2,

(b) set out the conclusions of the review in a report, and

(c) lay the report before Parliament.

(2) In carrying out the review the Treasury must, so far as is reasonable, have regard to how Article 52(4) of Council Directive 2009/65/EC[a] (which is implemented by means of the Regulated Covered Bond Regulations 2008 as amended by these Regulations) is implemented in other member States.

(3) The report must in particular—

(a) O.J. L302/32, 27.11.2009.

(a) set out the objectives intended to be achieved by the regulatory system established by that regulation,

(b) assess the extent to which those objectives are achieved, and

(c) assess whether those objectives remain appropriate and, if so, the extent to which they could be achieved with a system that imposes less regulation.

(4) "Review period" means—

(a) the period of five years beginning with the day on which regulation 2 comes into force, and

(b) subject to paragraph (5), each successive period of five years.

(5) If a report under this regulation is laid before Parliament before the last day of the review period to which it relates, the following review period is to begin with the day on which that report is laid.

Name
Name
date Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of these Regulations)

These Regulations amend the Regulated Covered Bonds Regulations 2008 (SI 2008/346) (the "principal Regulations"). The principal Regulations provide a legislative regime for covered bonds in the UK, implementing in particular Article 52(4) of Council Directive 2009/65/EC of 13 July 2009 (previously Article 22(4) of Council Directive 85/611/EC of 20 December 1985) on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities. A Transposition Table setting out how Article 52(4) is transposed into UK law is available from the Banking and Credit Team, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ. The Transposition Table is also available on HM Treasury's website (www.hm-treasury.gov.uk).

Regulation 2(2) inserts additional definitions into regulation 1.

Regulation 2(3) provides for a new definition of "eligible property" to apply in relation to single asset class regulated covered bonds. For this new class of bond, the eligible property used to secure the issuer's obligations under the bond must be limited to one of the following classes of assets: public sector assets, residential mortgage assets or commercial mortgage assets.

Regulation 2(4) amends regulation 7, to provide for the register of regulated covered bonds to be kept in two parts. Part one will contain the register of mixed asset class regulated covered bonds. Part two will contain the register of single asset class covered bonds. Regulation 2(5) to (8) make amendments to regulations 8, 10, 14 and 15 consequential on this change.

Regulation 2(9) amends regulation 17 to impose additional requirements in relation to the asset pool maintained to secure the obligations of the issuer under the regulated covered bond.

Regulation 2(10) inserts regulation 17A which requires the issuer to appoint an asset pool monitor to inspect the issuer's compliance with the requirements set out in the principal Regulations. The asset pool monitor will prepare a report, which must be delivered to the Financial Services Authority (FSA). The asset pool monitor is given power to require the provision of information from the issuer where necessary for his functions. Statements provided to the asset pool monitor under this power may not be used in criminal proceedings against the person giving the statement, except in proceedings for misleading the FSA under section 398 of the Financial Services and Markets Act 2000.

Regulation 2(11) amends regulation 18 to give the FSA power to direct issuers to publish information given to the FSA.

Regulation 2(12) amends regulation 22 to clarify that eligible property acquired for the asset pool of a single asset class regulated covered bond after it has been registered must be property of the same class as the property originally included in the asset pool on registration.

Regulation 2(13) amends regulation 24 to impose the additional requirements imposed on the issuer under regulation 17 on the owner of the asset pool as well.

Regulation 2(14) amends regulation 38 to ensure that a person who gives false or misleading information to the asset pool monitor may be prosecuted under section 398 of the Financial Services and Markets Act 2000.

Regulation 2(15) makes consequential amendments to regulation 42 to reflect the provisions of regulation 17A.

Regulation 3 requires the Treasury to review the operation and effect of these Regulations and lay a report before Parliament within five years after they come into force and within every five years after that. Following a review it will fall to the Treasury to consider whether the Regulations should remain as they are, or be revoked or be amended. A further instrument would be needed to revoke the Regulations or to amend them.

An impact assessment of the effect that this instrument will have on the costs of business and the voluntary sector is available from the Banking and Credit Team, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ, and is published with the Explanatory Memorandum alongside the instrument on www.legislation.gov.uk.

B Draft FSA Sourcebook amendments

REGULATED COVERED BOND SOURCEBOOK (AMENDMENT NO 2) INSTRUMENT 2011

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Regulated Covered Bond Regulations 2008 (SI 2008/346):

(1) Regulation 8 (Applications for registration)
(2) Regulation 9 (Applications for admission to the register of issuers);
(3) Regulation 18 (Notification requirements); and
(4) Regulation 42 (Guidance).

Commencement

B. This instrument comes into force on 31 December 2012.

Amendments to the Handbook

C. The Glossary of definitions is amended in accordance with Annex A to this instrument.

D. The Regulated Covered Bond Specialist sourcebook (RCB) is amended in accordance with Annex B to this instrument.

Citation

E. This instrument may be cited as the Regulated Covered Bond Sourcebook (Amendment No 2) Instrument 2011.

By order of the Board
[ ] 2011

Annex A

Amendments to the Glossary of definitions

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

asset pool monitor	a *person* appointed under Regulation 17A of the *RCB Regulations*.

Annex B

Amendments to the Regulated Covered Bonds sourcebook (RCB)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated,

2 Applications for registration

…

2.2 Applying for registration

Form, manner and verification of application

…

2.2.5 G The *FSA* will not treat the application as having been received until it receives the registration fee (see *RCB* 5.2.5R) and all relevant documentation requested by the *FSA* before its on-site review of the application.

2.2.6 D The *issuer* must ensure that a *director* or a *senior manager* of the *issuer* verifies the application by confirming on the *FSA's* form that the *issuer* has obtained the appropriate third party advice or reports as required by *RCB* 2.3.16D and is satisfied that:

…

…

2.3 Determination of registration

…

2.3.8 G (1) …

(2) Where, for example, the *asset pool* includes residential mortgages the relevant factors which the *FSA* may consider include:

…

(f) the purpose and terms of the mortgage (for example, owner occupied, buy-to-let, interest only, repayment, fixed rate, variable rate, off-set or endowment).

…

…

2.3.18 G (1) The *FSA* expects the report from the accountants to address at least the following matters:

…

(b) that appropriate due diligence procedures (which should include an analysis of a representative statistical sample of the *assets* in the *asset pool*) have been carried out to check whether:

…

…

Liquid assets

2.3.20 G *Assets* which would be eligible for inclusion in a liquidity buffer under *BIPRU* 12.7 can be liquid assets for the purposes of the definition in Regulation 1(2) of the *RCB Regulations*. The *FSA* will also expect that liquid assets which consist of deposits should be held in the same currency or currencies as the *covered bonds* issued by the *issuer.*

2 Annex 1 Application for the admission to the register of issuers and register of regulated covered bonds

The form in RCB 2 Annex 1D is deleted and replaced with the form below. The new text is not underlined

[link to new application for the admission to the register of issuers and register of regulated covered bonds form]

Amend the following as shown.

3 Notifications

3.1 Application and purpose

Application

3.1.1 G This chapter applies to *issuers*, *asset pool monitors* and *owners*.

Purpose

3.1.2 G This chapter sets out the reporting and notifications requirements under Regulations 17A, 18, 20, 24 and 25 of the *RCB Regulations*.

3.2 Annual confirmations of compliance and asset pool monitor

Form of confirmation and use of third party advisors and asset pool monitor's report

…

3.2.2 D Before providing the confirmation required by this section, the *issuer* must

obtain and consider written advice or reports from suitable independent third party advisers parties such as accountants the *asset pool monitor* and, where appropriate, lawyers.

…

3.2.4 G The *FSA* expects the *asset pool monitor's* reports ~~from accountants~~ to address at least the matters to be checked and due diligence procedures set out in *RCB* 2.3.18G. The *FSA* may also specify additional matters that the *asset pool monitor's* report should address in relation to a particular *issuer*.

3.2.4A G The *FSA's* use of its power under Regulation 18 of the *RCB Regulations* may include requiring the *issuer* to provide to the *FSA* copies of the advice or reports referred to in *RCB* 3.2.2D to the FSA.

3.2.4B D The *issuer* must provide a copy of the *asset pool monitor's* report to the *FSA* when it sends the confirmation required by this section to the *FSA*.

…

Verification of confirmation

3.2.9 D The *issuer* must ensure that a *director* or a *senior manager* signs the annual confirmation and confirms on the *FSA's* form that the issuer has obtained the appropriate third party advice or reports required by this section.

3.2.9A G Where possible, the *director* or *senior manager* who signs the annual confirmation should be the same *director* or *senior manager* who has verified the application for registration under RCB 2.2.6D. If the *director* or *senior manager* is different to the *director* or *senior manager* who verified the application for registration, the *issuer* should notify the *FSA* at least one month before sending the confirmation to the *FSA*.

Notifications by the owner

…

3.2.11 D (1) …

(2) The *owner* must obtain appropriate advice in the same manner as set out in RCB 3.2.2D and must provide a copy of the *asset pool monitor's* report to the *FSA* as set out in RCB 3.2.4BD.

Review by asset pool monitor

3.2.12 G In addition to requiring the *asset pool monitor* to prepare an annual report to the *issuer*, the *owner* and the trustee, Regulation 17A of the *RCB Regulations* requires that the *asset pool monitor* must inspect the compliance of the *issuer* or *owner* (as the case may be) with the requirements in regulations 16, 17 or 24 of the *RCB Regulations* every 6 months.

3.2.13 G The *FSA* expects the inspection by the *asset pool monitor* of the compliance of the *issuer* or *owner* (as the case may be) with the relevant requirements in the *RCB Regulations* to address at least the matters to be checked and due diligence procedures set out in RCB 2.3.18G

3.2.14 G As required under Regulation 17A of the *RCB Regulations*, if it appears to the *asset pool monitor* that the *issuer* or *owner* (as the case may be) has failed to comply with the requirements set out in Regulations 17 or 24 of the *RCB Regulations*, or has not provided all relevant information or explanations, the *asset pool monitor* must report that to the *FSA* in writing as soon as possible.

3.3 Asset pool notifications

Form of notifications

3.3.1 D The *issuer* must send to the *FSA* information relating to the *asset pool*, in the form set out in *RCB* 3 Annex 2D (asset notification form), and information relating to the *covered bonds* issued under the *programme*, in the form set out in *RCB* Annex 3D (liability structure form).

3.3.2 D The *issuer* must send the ~~form~~ forms to the *FSA* within one *month* of the end of each ~~quarter~~ previous *month* following the *registration date*.

3.3.2A D The *issuer* must send to the *FSA* loan-by-loan level data relating to the *asset pool* within one *month* of the end of each quarter following the *registration date*

Notifications by the owner

3.3.3 D If the *issuer* is in insolvency, the *owner* must send to the *FSA* the ~~*asset pool*~~ notifications set out at *RCB* 3.3.1D and *RCB* 3.3.2AD by the same dates as the dates the notifications under those directions are due.

Due diligence

3.3.4 G The *issuer* or the *owner*, as the case may be, should carry out, or make arrangements to carry out, appropriate due diligence to check that the analysis in the ~~*asset pool*~~ information provided to the *FSA* is correct.

Addition or removal of assets from the asset pool

3.3.5 D If the *issuer* or the *owner* (as the case may be) proposes to add or remove *assets* to or from the *asset* pool which change the level of *over collateralisation* by 5% or more, it must notify the *FSA* using the form set out in *RCB* 3 Annex 2D (asset notification form) at least 5 business days prior to the proposed transfer, giving details of the size and composition of the transfer.

3.4 Covered Bond issuance notifications

3.4.1 D The *issuer* must inform the *FSA* of the information relating to bond issuances from a *regulated covered bond* in the form set out in ~~*RCB* 3 Annex 3D (series notification form)~~ *RCB* 3 Annex 4D (indicative terms form) at least 3 business days ~~on or~~ before the date of issuance.

3.4.2 D On the date of issuance, the issuer must send to the *FSA*:

(1) the information in the form set out in *RCB3* Annex 5D (issuance form);

(2) the information in the form set out in *RCB3* Annex 3D (liability structure form); and

(3) the final terms of the *covered bonds* and signed copies of swap documents.

3.5 Other notifications

…

Notification of cancellation

3.5.9 D The *issuer* must notify the *FSA* if it proposes to cancel a *covered bond* or *programme* at least 3 *business days* before the cancellation will take effect.

3.5.10 D The *issuer* must send to the *FSA* the information in the form set out in *RCB* 3 Annex 6D on the date of cancellation of the *covered bond* or *programme*.

Publication of asset pool information and transaction documents

3.5.11 D The issuer must publish the asset notification forms sent to the *FSA* under *RCB* 3.3.1D.

3.5.12 D The *issuer* must publish the information relating to the individual loan *assets* in *asset pool* in the form set out in *RCB* 3 Annex 7D (loan level disclosure) within one *month* of the end of each quarter following the registration date.

3.5.13 D The issuer must publish the transaction documents (excluding legal opinions) relating to the *covered bond* or *programme*.

3.5.14 G The publication of the information and documents required under *RCB* 3.5.11D, *RCB* 3.5.12D and *RCB* 3.5.13D should be made on a subscription-only, secure, password protected website. This website should also contain a link to the latest published *prospectus* relating to the relevant *covered bond* or *programme*.

3.5.15 G The transaction documents published under *RCB* 3.5.13D should include the asset sale agreement, the servicing agreements, the administration and cash management agreements, the trust deed, the security deed, the agency agreements, the account bank agreement; the guaranteed investment contract, the master definitions agreement, intercompany loan agreements and if applicable, liquidity facility agreements.

3.5.16 D If the *issuer* is in insolvency, the *owner* must publish the information set out at *RCB* 3.5.11D and *RCB* 3.5.12D in accordance with those directions.

3 Annex 2D Asset pool notification form

The form in RCB 3 Annex 2D is deleted and replaced with the form below. The new text is not underlined

[link to new asset pool notification form]

3 Annex 3D ~~Series issuance notification form~~ <u>Liability structure form</u>

This annex consists only of one or more forms. Forms are to be found through the following address:

~~Series issuance notification form~~ *<u>Liability structure form</u>*

The form in RCB 3 Annex 3D is deleted and replaced with the form below. The inserted text is not underlined

[link to liability structure form]

After RCB 3 Annex 3D insert the following new annexes. The text is not underlined.

3 Annex 4D Indicative terms form

This annex consists only of one or more forms. Forms are to be found through the following address:

Indicative terms form

[Link to new indicative terms form]

3 Annex 5D Issuance form

This annex consists only of one or more forms. Forms are to be found through the following address:

Issuance form

[Link to issuance form]

3 Annex 6D Cancellation form

This annex consists only of one or more forms. Forms are to be found through the following address:

Cancellation form

[Link to cancellation form]

3 Annex 7D Loan level disclosure form

This annex consists only of one or more forms. Forms are to be found through the following address:

Loan level disclosure form

[Link to loan level disclosure form]

FSA Compatibility Statement

C.1 This section sets out our (the FSA's) assessment of the compatibility of the proposals outlined in this consultation with our functions under Part 2 of the Regulations.

C.2 The proposals for amending the Regulations and guidance concerning the UK's regulated covered bond regime are primarily designed to facilitate international comparability between the UK and other covered bond regimes and increase transparency to the market. They relate closely to our requirements to have regard to:

- the international character of financial services and markets and the desirability of maintaining the competitive position of the UK; and
- the need to preserve investor confidence in, and the desirability of maintaining the good reputation of the regulated covered bond sector in the UK by the issuance of high quality regulated covered bonds.

C.3 The quality of the assets supporting regulated covered bonds issued under the UK regulatory regime are widely perceived as high in comparison with international peers. However, there are some features of the regulation, specifically, the absence of prescriptive rules, which may make it more costly for investors to compare the UK with other markets, for example, as they may be required to see additional legal advice. This could make investors either decline to participate in the UK market or demand a higher yield to invest in UK regulated covered bonds compared with those issued in other jurisdictions.

C.4 By better reflecting the existing requirements and features of the UK regime in the Regulations, market outcomes could be improved:

- by removing uncertainty for investors; and
- by helping issuers to credibly and clearly communicate the features of the regime and quality of existing regulated covered bonds.

C.5 Section 2(3) of the Regulations requires that in carrying out our general functions we also have regard to the following.

The need to use our resources in the most efficient and economic way

C.6 The proposed changes to the Regulations and Sourcebook are not expected to have a material impact on the FSA's resourcing requirements. Compliance with the proposed rules will be monitored in the course of our existing supervision and enforcement responsibilities – in some cases, the proposed changes could facilitate our supervision and enforcement.

The principle that a burden or restriction should be proportionate to the expected benefits.

C.7 The changes proposed in this review result from consultation with the market and our experience of the operation of the UK regulated covered bond regime since 2008. The key benefits from these proposals are in the form of increasing transparency to investors about the quality of UK regulated covered bonds, especially when comparing UK regulated covered bonds with covered bonds from other jurisdictions.

C.8 Where possible, we have developed policy proposals with regard to existing systems, for example further development of FSA Notification forms. In relation to the new policy on public disclosures, we have tried to make use of existing reporting requirements to minimise the need for further development of systems and procedures. The costs to issuers of the individual measures have been discussed above in the context of each measure, and are believed to be marginal in most cases.

Facilitating competition and minimising adverse affects on competition

C.9 The proposed changes to the UK regulated covered bond regime support the FSA's duty to have regard to the competitive position of the UK by facilitating greater comparability between the UK and other jurisdictions, and between UK issuers.

Compatibility with our duties under equalities legislation

C.10 We have conducted an assessment of the equality issues that arise in our proposals and do not believe that our proposal give rise to any discrimination prohibited by equality legislation.

C.11 We would welcome your comments on whether you agree with this assessment.

D How to respond to the consultation

D.1 This paper is available on the Treasury website at www.hm-treasury.gov.uk.

D.2 Written responses from those interested in the issues raised in this consultation are requested by Friday 1 July. The specific questions on which the Treasury and FSA would particularly welcome responses are set out on page 36.

D.3 Please ensure that responses are received by the closing date. The Treasury and FSA cannot guarantee that responses received after this date will be considered.

D.4 Responses can be sent by email to coveredbondreview@hmtreasury.gsi.gov.uk. Responses will be shared between the Treasury and FSA.

D.5 Responses can also be posted to:

Covered Bond Review
Banking and Credit Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

There is no need to submit a response by post if you are also submitting an email response.

D.6 When responding, please state whether you are doing so as an individual or on behalf of an organisation. It is helpful if you include your contact details with your response, in case there is a need to seek further detail on any issues you raise.

Confidentiality

D.7 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

D.8 If you would like the information that you provide to be treated as confidential, mark this clearly in your response. Please be aware, however, that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

D.9 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

Code of practice for written consultation

D.10 This consultation process is being conducted in line with the Government Code of Practice on Consultation, which sets out the following criteria:

- When to consult. Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises. Consultations should normally last for at least 12 weeks, with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercises. Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- The burden of consultation. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

D.11 A copy of the code of practice on consultation is available on the following website: http://www.bis.gov.uk/Policies/better-regulation/consultation-guidance.

D.12 If you feel that this consultation does not meet these criteria, please contact:

Better Regulation Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-1-84532-862-7