

# Thematic overview on the Regulated Covered Bond Regime: the role of Asset Pool Monitor

December 2012



1. Following the publication of the amended Regulated Covered Bond (RCB) Regulations and Sourcebook respectively in November and December 2011, market participants requested clarification on a newly established requirement, that of the role of the Asset Pool Monitor (APM).
2. Under regulation 17A(3), the APM shall inspect the compliance of the issuer with the requirements in regulations 16 and 17 once every 12 months and prepare an annual report on the quality of the assets in the asset pool and on the steps the issuer has taken to comply with the respective requirements. A copy of the report must be sent to the FSA.
3. Regulation 42 of the RCB legislative framework provides that the FSA, as supervisor of the covered bond regime, can issue guidance on the operation of the Regulations, its functions under the Regulations, or any other matters that it thinks it should give information or advice on. Issuing guidance on the report of the APM more specifically is also contemplated by regulation 17A(3)(b) of the RCB Regulations and will supplement RCB 2.3.18G and the other guidance provisions relating to the APM report and inspection in Chapter 3 of the RCB Sourcebook.
4. The purpose of this paper is to set out the FSA's further guidance on the scope of the inspection and report of the APM.
5. While this guidance is the result of a request from the market, we believe it will bring more consistency to existing audit reports, which currently vary a lot across RCB issuers, as well as allow cross comparisons across RCB programmes.
6. This guidance does not aim to impose additional requirements to the RCB legislation, but responds to an industry request and provides guidance on the scope of the Asset Pool Monitor's inspection. Informal discussions with the largest accounting firms indicated an incremental cost arising solely from this guidance of approximately £5,000-£15,000 (as a result of potentially having to report more errors due to a lower level of tolerance than firms may currently use or conduct more tests). This estimation does not cover the incremental costs arising from the new regulatory requirements, as these have already been factored into the Treasury's Impact Assessment in April 2011 through feedback received from market participants.

### **Regulatory requirements and the FSA's interpretation of the rules**

7. Asset Pool Monitors (APMs) have a regulatory obligation to comply with the RCB Regulations in relation to the inspection of the asset pool in RCB programmes. Under regulation 17A(3), APMs have the duty to:
- “(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); and
  - (ii) the accuracy of the records kept in relation to each asset in the asset pool, once every 12 months; and
- (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.”
8. The report should cover the steps the issuer has taken to comply with these requirements and the quality of the assets in the asset pool. APMs are also under an obligation in regulation 17A(6) to report to the FSA in writing if it appears to the APM that the issuer has failed to comply with the requirements in regulation 17.
9. APMs are therefore expected to come to a view about whether the respective issuer is in compliance with the relevant provisions of the RCB Regulations according to the procedures agreed.
10. While we want to give some flexibility to APMs and will not be prescriptive in terms of, for example, how the quality of assets should be inspected, an acceptable proposal suggested by some APMs is highlighted in paragraph 16.
11. While the responsibilities of the APM are set out in the RCB Regulations and Sourcebook, we reiterate some of them below as a complement to those already set out in paragraph 7.
- a. The role and regulatory responsibilities of the asset pool monitor are set out in Regulation 17A and in our guidance in section 2.3.18 and Chapter 3 of the RCB sourcebook. This includes checks to the level of OC, checks on the issuer’s due diligence on the attributes of the assets, and checks that the issuer’s analysis of the assets is correct. Accordingly, from 1 January 2013 asset pool monitors will be subject to certain new regulatory responsibilities and duties under the RCB regime.
  - b. APM’s reports should be undertaken on a random sample of loans statistically significant at a 99% confidence level (RCB 2.3.18G).
  - c. We request to be notified by issuers when the APM is replaced, with details of the substitute and reason for the change.
  - d. The issuer must provide a copy of the APM’s report to the FSA when it sends the annual confirmation of compliance required by this section to the FSA.
  - e. As required under Regulation 17A of the RCB Regulations, if it appears to the asset pool monitor that the issuer has failed to comply with the requirements set out in Regulation 17 (or, on the insolvency of the issuer, the compliance of the owner with Regulation 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.

12. Following discussions with market participants, we believe it would be helpful to clarify our interpretation of a number of requirements set out in the RCB Regulations and the relevant guidance in Chapter 3 of the RCB Sourcebook, as well as some observations on market practice. These include:
- a. The APM must inspect compliance with Regulations 16, 17 and (if relevant) 24 on an annual basis, even if the asset pool has not materially changed over the past year.
  - b. While the APM's inspection is expected to be conducted on an 'agreed upon procedures' basis as per current market practice, we expect the report to cover more than just a list of errors (or 'exceptions') found as a result of the tests conducted. APMs have to inspect the issuers' compliance with the relevant regulations (whether or not they are part of the scope of an AUP audit) and report to the FSA on the outcome of it. Further details are provided in paragraph 16.
  - c. As per Regulation 17A, the AUP inspection should be conducted every 12 months and exclusively apply to the entire pool of assets acting as security in the regulated covered bond programme at the time the audit sample is being randomly selected.
  - d. We note that the Regulations provide for the issuer to appoint 'an' APM for each asset pool (Regulation 17A (1)). We believe that the work required for the annual confirmation is very much linked to that of the APM report, which is the reason why the APM report must be submitted along with the annual confirmation of compliance. As a result, we expect that only one APM be appointed for each RCB programme.
  - e. For the avoidance of doubt, we note that the validation of the Asset Coverage Test, Over-collateralisation Test and Interest Coverage Test falls under the responsibilities of the APM, as set out in Regulation 17.
  - f. As per Regulation 17A, the person appointed as APM must (a) be eligible for appointment as a statutory auditor of the issuer under Part 42 of the Companies Act 2006; and (b) not be disqualified from acting as a statutory auditor of the issuer by section 1214 of that Act (independence requirement). As a result, we expect that the independent APM be a third-party auditor fulfilling these requirements. Provided these are met, we do not object the APM being the current third-party auditor of the RCB issuer.
  - g. While we will not be imposing one specific sampling methodology, we expect asset pool monitors to identify in their report the methodology they are using and explain why they believe it is appropriate. When selecting the sample, APMs are expected to use best efforts in determining appropriate expected and maximum error rates. We however note that market practice is to use a sample method based on a 0% expected error rate and 1% maximum error rate.
  - h. Market practice would suggest that an engagement letter be produced between issuers and APMs. Issuers should consider whether a document formally describing the role of the asset pool monitor may be beneficial for the programme and/or whether prospectuses and

relevant transaction documents should be updated (as it should be the case for the other new regulatory requirements).

- i. The introduction of the role of the APM provides additional scrutiny to the oversight of regulated covered bond programmes and should not be seen as a substitute to the role of the compliance and/or internal audit functions.

### Our guidance

13. In relation to the tests to be carried out as part of the inspection of the APM to check the accuracy of records, we have outlined in Appendix 1 what we expect in terms of content of the tests and tolerance levels.
14. It is our understanding that the tests outlined in Appendix 1 are already performed by audit firms, although not in all programmes and with slight nuances from one programme to another. The purpose of having one set of tests is to bring more consistency and allow cross-comparison across RCB programmes.
15. In relation to the content of the APM report, we expect it to cover:
  - a. a description of the analysis of the pool AUP being conducted;
  - b. a description of the method used (incl. sampling methodology) and procedures that have been followed throughout the APM's inspection;
  - c. a description of the pool sample and population used in the AUP;
  - d. a description of the scope of the AUP work;
  - e. a summary of the finding which, with regard to the accuracy of records, may cover the elements set out in Appendix 2;
  - f. an assessment of the steps taken by the relevant issuer to comply with Regulations 16 and 17, and on the quality of the assets in the asset pool (Reg. 17A (3) (b)); and
  - g. the APM's conclusion about the compliance of the issuer with the regulations 16 and 17 (Reg. 17A(3), RCB 3.2.12G & RCB 3.2.14G).
16. With respect to paragraph 15(f) above, we understand that there are a range of approaches under which the APM could carry out the assessment. One possible approach could be to: i) describe the steps that an issuer has taken to comply with regulations 16 and 17; ii) assess whether these steps have been implemented and applied in practice; and iii) report the factual outcome of the testing. This is particularly relevant to assessing compliance with regulation 17(2)(d) where we expect more than just the recalculation of the tests. The assessment in this particular case may also include ensuring that the eligibility criteria are being followed; the stress testing is being conducted according to the issuer's stresses and written procedures; and the asset selection process, or any other steps that the issuer has taken to ensure that the cover pool is of high quality, have been implemented and followed in practice.

17. With respect to paragraph 15(g) above, the analysis may focus on the defined processes the issuer has designed and implemented to comply with regulations 16 and 17. The APM should be able to report on the result of this analysis, i.e. on any apparent failure by the issuer to comply with these regulations.
18. We understand that the obligation of the issuer to comply with regulation 16 is achieved by the terms of certain transaction documents, such as the intercompany loan agreement. Additional comfort is generally obtained by independent legal opinions from the issuer's legal counsel, which typically confirm the existence and legal binding and enforceable nature of these terms. In such cases, APMs would not be expected to also report on the terms of these documents, but ensure that they have been adhered to, e.g. by confirming from the relevant bank statements and other accounting records of the Limited Liability Partnership the recording of the relevant intercompany debt.
19. When checking an issuer's compliance with regulation 17(2)(b), APMs are expected to conduct an annual inspection; as such the analysis should be done at a point in time rather than through the 'whole period of validity'.
20. Should further clarification or guidance be necessary on the scope of the APM due diligence, we would encourage issuers and/or APMs to contact us directly and bilaterally. The purpose of this guidance is to provide some additional high-level guidance on APM reports and inspections required under the RCB Regulations, while allowing some flexibility to accommodate different practices that meet the relevant APM obligations under the RCB Regulations.

### Appendix 1: List of AUP tests for assessing accuracy of records

The tests set out in Table 1 have been defined on the assumption that cover pools are made of residential mortgages, as it is currently the case for RCB programmes. We reserve the right to revisit these tests at a later stage if the composition of cover pools changes.

The tests set out below are not meant to change an issuer's mortgage underwriting policy.

#### Key

- 1) Where the underlying document is not found for a specific test, an exception due to missing documentation should be recorded.
- 2) Any difference, which can be reconciled by supporting documentation, should not count as an exception.
- 3) To the extent that data is not captured in accordance with the issuer's written underwriting policy or procedure, no exception should be recorded.
- 4) If the pool sampling is to be conducted on an aggregated basis and where multiple sub-accounts exist for a given aggregated loan, we expect the APM to inspect each of these sub-accounts, where appropriate.
- 5) For the purposes of recording exceptions, where evidence of data or information has not been retained by the issuer prior to the time of inspection, such instances should be recorded as exceptions (even though evidence may be documented during or following the inspection).
- 6) As general rule, exemptions are meant to remove sample noise and not minimise the number of exemptions reported.

#### Tests

Test	Category	Description	Tolerance level <sup>1</sup>
1	Name	The borrower(s)' first name (or initials) and surname shown on the primary system of record agrees to at least one of the following:  a) mortgage offer letter;	Legal change of borrower(s)'s names (due to e.g. marriage/divorce) should not count as an exception provided that there is evidence of such change

<sup>1</sup> Differences between sample data and its corresponding source information should not be recorded as an exception if they fall within the limit(s) set out in this column. Rounding errors and spelling mistakes which are of immaterial significance to the correctness of the data and do not raise any identification issues should not be counted as 'exception'. For the avoidance of doubt, the following example should not be considered as a spelling mistake:  
Address in record: '1 high street' ; Exact address: '1A high street' (or vice versa).

		<p>b) certificate of title (COT) or report on title (ROT); or</p> <p>c) title deed.</p>	<p>recorded on the issuer's primary system of record.</p> <p>In instances where there are changes to the loan that are permitted by the lender, the relevant document evidencing such changes may replace the original offer letter for the purposes of this test.</p> <p>Immaterial spelling mistakes (such as reversing initials or names) where there is no ambiguity raised about the identity of the borrower(s), should not count as exceptions.</p> <p>Note: references to 'borrower(s)' relate to <i>all named</i> borrowers on the mortgage in accordance with the issuer's written underwriting policy or procedure.</p>
2	Address	<p>Check that the property address and postcode shown on the primary system of record are confirmed to be in England, Scotland, Wales or Northern Ireland and agree to at least one of the following:</p> <p>a) mortgage offer letter;</p> <p>b) certificate of title (COT), report on title (ROT), or title deed;</p> <p>c) land registry;</p> <p>d) valuation report;</p> <p>e) solicitor's confirmation letter</p>	<p>New build properties by their nature could be subject to postcode changes. In such circumstances confirm an outcode rather than a full postcode.</p> <p>Differences that relate to changes in boundaries or property address and which can be evidenced should not count as exceptions.</p>

		for new builds, where applicable.	
3	Term	Latest agreed term of the loan as recorded in the primary system of record, agrees to the latest mortgage contract(s). <sup>2</sup>	<p>In instances where the latest mortgage contract does not contain the correct term information and this can be evidenced, no exception should be recorded.</p> <p>Where the term of the loan is calculated and therefore not shown on the primary system of record, an extraction file is acceptable.</p>
4	Amount advanced	Amounts advanced, as recorded in the primary system of record, agree to the relevant mortgage contract(s).	<p>0.5% of the amount advanced.</p> <p>Differences due to fees, charges and product transfers should not count as exceptions.</p>
5	Mortgage balance	Mortgage balance on the AUP extraction file equals the balance recorded in the primary system of record at the corresponding date of extraction.	0.5% of the outstanding mortgage balance.
6	Completion date	Completion date of original loan recorded in the primary system of record agrees to date on the certificate of title (COT), report on title (ROT), or completion statement.	<p>+/- 1 month</p> <p>In instances where, for a remortgage, the completion date does not match the date shown on the relevant document, no exception should be recorded.</p>
7	Valuation amount	Valuation amount shown in the primary system of record agrees to relevant valuation conducted according to the issuer's	<p>None</p> <p>Where according to its</p>

<sup>2</sup> This may also include latest mortgage offers or any other mortgage documentation which is in a final and official form.

The above is also relevant for tests 4, 13, 14, 17, 18 and 20.



		underwriting policy or procedure. For buy-to-let mortgage loans confirm that the valuation report included likely rental income.	written policy or procedure, the issuer has recorded a valuation amount that it deems prudent, no exception should be recorded.
8	Valuation date	Valuation date in the primary system of record agrees to the date on the relevant valuation report and should be confirmed to be within one year of completion date.	+/- 1 month  If the valuation requirement was waived or where the conduct of the valuation did not correspond to the timing of the loan advance, in accordance with the issuer's written underwriting policy or procedure, no exception should be recorded.
9	Signatures	The following documents have been signed or acknowledged electronically in accordance with the issuer's written underwriting policy or procedure:  a) mortgage offer letter;  b) certificate of title (COT) or report on title (ROT);  c) application form;  d) valuation report, where available.	In instances where the issuer's written underwriting policy or procedure does not require the signature of a specific document (or only in an electronic format), no exception should be recorded in relation to that document.
10	Arrears	Aggregate arrears data in the extraction file reconciles the figures shown in the primary system of record at cut-off date.	0.1% of the outstanding mortgage balance.  Where an issuer records arrears in months (as opposed to amounts), this field should be determined and validated by dividing the total amount of overdue payments by the monthly repayment amount.  In instances where differing

			<p>amounts are due to payment processing timing differences and are reconcilable, no exception should be recorded.</p> <p>In instances where differing amounts are due to differences in the issuer's method of record over time and are reconcilable, no exception should be recorded.</p>
11	Income	Evidence that the issuer has carried out income verification, if required in accordance with its written underwriting policy or procedure.	None
12	Property tenure	Property tenure (freehold, leasehold, etc) on the primary system of record agrees to valuation report or land registry.	Where valuation reports or land registry information are not available in the case of new builds, no exception should be recorded.
13	Maturity date	Maturity date of each mortgage on the primary system of record reconciles to latest mortgage contract(s).	<p>+/- 1 month</p> <p>Where the maturity date is calculated and therefore not shown on the primary system of record, reconciliation on an extraction file is acceptable.</p>
14	Repayment type	Repayment type (repayment/ interest only, etc.) shown on the primary system of record matches the latest mortgage contract(s).	<p>In instances where the loan is flexible and the variations can be reconciled, no exception should be recorded.</p> <p>In instances where the latest mortgage contract does not contain the correct repayment type and this can be evidenced, no exception</p>

			should be recorded.
15	Employment status	Borrower(s)' employment status shown on the primary system of record agrees to the relevant application form.	<p>In instances where the issuer's written underwriting policy or procedure refers to alternative supporting documentation, such alternative evidence should be used for the purposes of this test.</p> <p>Note: references to 'borrower(s)' relate to <i>all named</i> borrowers on a specific mortgage in accordance with the issuer's written underwriting policy or procedure.</p>
16	Flag	Mortgage loan in the primary system of record (or primary medium where loans are being flagged) is correctly being flagged or has been identified as being used solely for the purpose of the covered bond pool.	None
17	Interest rate	Interest rate, interest rate type (e.g. fixed, variable, tracker), interest rate index and interest rate margin shown on the primary system of record agrees to the relevant latest mortgage contract(s).	<p>In instances where the loan is flexible and the variations can be reconciled, no exception should be recorded.</p> <p>Note: this test should be conducted at a loan (or 'sub-account') level. Interest rate index and margin are relevant for loans on a floating rate.</p>
18	Reversionary date	Reversionary date, where one exists on a loan, in the primary system of record agrees to the latest mortgage contract(s).	<p>None</p> <p>Note: this test should be conducted at a loan (or 'sub-account') level.</p>

19	Year of Birth	Borrower(s)'s year of birth shown on the primary system of record agrees to application form.	<p>None</p> <p>Note: references to 'borrower(s)' relate to <i>all named</i> borrowers on a specific mortgage in accordance with the issuer's written underwriting policy or procedure.</p>
20	Property occupancy status	The property occupancy status (e.g. owner occupied, buy to let) in the primary system of record confirms to the latest mortgage contract(s) or application form, where relevant.	<p>None</p> <p>Note: this test should be conducted at a loan level.</p>
21	Account number	The account number in the AUP extraction file agrees with that from the primary system of record.	<p>None</p> <p>Note: the term 'account number' refers to the issuer's unique identifier used in distinguishing individual loans.</p>
22	Credit score	Evidence of credit score being obtained and recorded in the primary system of record.	<p>Note: where relevant, this check is appropriate to <i>all named</i> applicants in accordance with the issuer's written underwriting policy or procedure.</p>

## Appendix 2: Template for Asset Pool Monitor (APM) findings with respect to accuracy of records (residential mortgage assets)

Template: Asset Pool Monitor Findings																												
<b>Cover pool information</b>																												
		RCB programme																										
		APM																										
		Total number of loans in cover pool																										
		Number of audited loans																										
		Cover pool cut-off date																										
		Date of AUP																										
<b>Aggregate Findings</b>																												
				Test 1	Test 2	Test 3	Test 4	Test 5	Test 6	Test 7	Test 8	Test 9	Test 10	Test 11	Test 12	Test 13	Test 14	Test 15	Test 16	Test 17	Test 18	Test 19	.	.	Test 28			
		Number of data																										
		Total number of exceptions found																										
		Number of exceptions found due to missing data or missing documentation																										
		Error statistic calculated																										
<b>Loan-level Findings: Number of exceptions found on loans</b>																												
Data Sample ID	Loan Account ID	Total Number of exceptions found on loan		Test 1	Test 2	Test 3	Test 4	Test 5	Test 6	Test 7	Test 8	Test 9	Test 10	Test 11	Test 12	Test 13	Test 14	Test 15	Test 16	Test 17	Test 18	Test 19	.	.	Test 28			
1																												
2																												
3																												
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<b>Guidance on Completion</b>																												
-Replace test [●] headings with actual names of tests																												
-In loan-level findings, flag instances where exceptions have been found and provide reason why the data audited was interpreted as exception. Note that if the inclusion of commentary on exceptions results in awkward presentation in terms of format, option available to provide the commentary under separate appendix (see below).																												
- This template should form part of the APM report.																												
<b>Appendix: Exceptions Commentary</b>																												
Data Sample ID	Loan Account ID	Test No	Data in file	Actual Data in data tape	Exception Description	Management Representation of exception (incl. on the nature of and reasons for, individual error) <sup>1</sup>																						
1																												
2																												
3																												
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<sup>1</sup> APMs are not expected to validate management representations for the purposes of completing this appendix.																												