

Guidance consultation

Thematic Overview: Regulated Covered Bond Regime

December 2011



1. The Markets Division of the FSA is the specialist supervisor with regard to the UK-regulated covered bond (RCB) regime. As part of its supervisory function, the FSA is committed to promoting transparency and investor understanding of the UK's regulated covered bond regime.
2. While Guidance on the role of the compliance function was published 1 November 2011, the FSA decided to issue further Guidance on additional areas of the RCB regime to set out minimum expectations and highlight current good market practice. These areas cover the scope and depth of engagement that the signatory of the annual confirmation of compliance (RCB 3 Annex 1D) has with the programme, the content of Management Information and the appropriateness of systems and controls.
3. Regulation 42 of the RCB legislative framework provides that we, in our capacity as supervisor of the covered bond regime, can issue guidance on the operation of the regulations themselves, our functions under the regulations, or any other matters we consider appropriate to give information or advice. The RCB regulations also provide that the FSMA obligations of consultation apply to general guidance we may give.
4. The Guidance on management information, the appropriateness of systems and controls, and the role of the signatory of the annual confirmation of compliance constitutes guidance according to Regulation 42 of the RCB legislation and therefore requires consultation.
5. The purpose of this paper is to set out our minimum expectations in relation to these three areas and seek feedback from market participants on them.
6. It is standard practice for the FSA to assess costs when consulting on guidance. As a result, we will be contacting RCB issuers on a bilateral basis to consider cost implications, if any.

Our expectations

7. In relation to the production and content of **Management Information (MI)** of all regulated programmes, we expect that at a minimum:
 - MI should include clearly defined responsibilities and processes for extracting data, sense checking (including trend analysis/anomalies) and sign off before use in MI;
 - MI should include regular reporting of current risks and performance indicators, including trend analysis and risk indicators;
 - reporting frequency should be at least in line with key committee meetings;
 - the content, quality, and accuracy of MI should be sufficient to support the appropriate level of discussion and decision making;
 - reporting should incorporate predictive/stressed pool performance, forward-looking analysis of key tests/risks, information on eligible unencumbered assets, potential/actual breaches;
 - issuers should be able to articulate how this MI is monitored and show how it is used to support or challenge decision making; and
 - issuers should be able to articulate monitoring of risk and escalation mechanisms outside of regular committee meetings.

8. We expect issuers to be able to evidence the **systems and controls environment** for regulated programmes includes the following at a minimum:
 - Clear identification, mitigation and monitoring of operational risks.
 - Clearly defined roles and responsibilities for business areas involved in the management of regulated programmes, including the identification of key man risks and mitigating strategies.
 - Clear process for posting collateral for swaps, contingency arrangements and sensitivity of RCB rating(s) to key drivers.
 - Defined controls with clearly designated roles and responsibilities for producing data files, calculating contractual tests, reviewing inputs/outputs and escalating breaches.
 - Limited level of manual processes embedded in the management of the programme with identification of any corresponding operational risks and appropriate mitigation.
 - Relevant IT infrastructure is adequate to support programme management and facilitate clear audit trail, including the production of accurate reporting data and information, and the management of cover pool programme cash flows on a timely basis.
 - Models used are adequate to capture risks and processes. Model validation, controls and stress testing fit for purpose, taking into account risks specific to the issuer. Model output to form an effective part of MI.

- Key personnel have a clear understanding of limits on issuance and relevant factors (e.g. risk appetite, asset encumbrance, origination strategy).
 - Key personnel have a clear understanding of how retail/origination strategy generates available/eligible collateral for regulated programmes. Issuers should be able to articulate monitoring and management of risks arising from business strategy/implementation.
9. We expect that the senior manager who acts as **signatory of the annual confirmation of compliance** for all regulated programmes should at a minimum:
- Have a clear understanding of key risks and issues (incl. current triggers/breaches/outstanding RCB issues) and mitigating actions.
 - Understand the key regulatory responsibilities and requirements relating to the programme. Be able to articulate where authority/oversight has been delegated and escalation mechanisms. Be able to take action on escalated matters on a timely basis.
 - Be able to clearly articulate issuance plans, overall funding strategy (SLS repayment, ALM mismatch, etc) and operational capacity to issue and have the ability to challenge decisions related to the management of the programme.
 - Demonstrate a clear understanding of constraints on issuance (asset encumbrance, market issues). Be able to outline how these are monitored and where/how strategic decisions on issuance are taken.
 - Demonstrate a clear understanding of the market view of RCB, depth and concentration of investors (region, type) and associated risks. Be able to articulate investor feedback relating to the RCB programme/UK market.
 - Have a formal and appropriate level of interaction with the compliance function and other key functions before sign-off of the annual confirmation of compliance.
 - Act as the person ultimately responsible for signing the annual confirmation of compliance of the programme.

10. Question: Do you have any comments?

How to respond to the consultation

11. Written responses to this consultation are requested by **Friday 27 January 2012**. Please ensure that responses are received by the closing date. We cannot guarantee that responses received after this date will be considered.
12. Responses can be sent by email to rcb@fsa.gov.uk or posted to:

Covered Bonds Team
Capital Markets
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Telephone: 020 7066 2240

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

13. 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.