
Minutes

**Minutes of the meeting of the
UK REGULATED COVERED BOND FORUM
Held on 14 December 2011 - 15:00
At CONFERENCE ROOM A&B, 25 THE NORTH COLONNADE**

Present:

Industry

John Hale (Manager, Investment Affairs, ABI)
James Kotomitis (Managing Director, Capital Markets Division, AFME)
Nathalie Aubry-Stacey (Secretariat, CBIC)
Christiane Valansot (General Counsel, IMA)
Julian Le Fanu (Policy Advisor, Investment Regulation & Funding, NAPF)
Sophia Johnston (Senior ABS and Covered Bond Analyst, L&G)
Frank Will (RBS Research)
Lucette Yvernault (Fund Manager, Schroders)
Mark Robinson (Financial Institutions Credit Research, M&G)
Rahul Kalia (Credit Analyst, Aberdeen Asset Management)
Luca Bertalot (Head of ECBC)
Irene Graham (Director, Prudential, Capital & Risk, BBA)
Chris Fielding (Executive Director, UK RCBC)
Stephen Hynes (Head of Securitisation, RBS)
Jared Zakrzewski (Senior Manager, Structured Funding, Abbey National Treasury Services plc)
Jon Katovsky (Head of Secured Funding, The Co-operative Bank plc)
Andrew Turvey (Head of Liquidity Planning, Coventry Building Society)
Gary Staines (Head of Mortgage Backed Funding, Lloyds Banking Group)
Mark Stubley (Senior Funding, HSBC)
Steven Penketh (Chairman of RCBC, Head of Secured Funding, Barclays)
Rob Collins (Head of Asset Backed Funding, Nationwide Building Society)

FSA/ HM Treasury/ Bank of England

Anna Simons (Chair – Manager, Capital Markets Team)
Stephanie Tetu (Capital Markets Team)
John Wu (Capital Markets Team)
Jonathan Latcham (Minutes - Capital Markets Team)
Mark Burgess (Structured Finance, FSA)
Stephen Drayson (Recovery & Resolution, FSA)
Peter Cardinali (Fees Policy, FSA)
Eleanor Riley (Banking and Credit, HM Treasury)
Ed Lidington (Banking and Credit, HM Treasury)
Charles Gundy (Bank of England)
Simon Ainsworth (Bank of England)

Apologies: Jozef Prokes (Fund Manager, BlackRock)
Richard Hopkin (Managing Director, Securitisation Division, AFME)
Nicolas Walsh (Treasury, Leeds Building Society)
Nicola Pittam (Treasury Legal Advisors, HM Treasury)
Nicola Veall (Large Complex UK Banks Supervision, FSA)
Gurmaj Dhillon (Asset Encumbrance Policy, FSA)
Pavel Izmaylov (Asset Encumbrance Policy, FSA)
Nick Bertram (General Counsel, FSA)
Jody Kettringham (Financial Crime Policy, FSA)
James London (Financial Crime Policy, FSA)

**Minute
No**

1. **Opening remarks from the Chair**

Anna Simons (Capital Markets Team, FSA) welcomed the delegates and introduced her team and the speakers to the floor. AS noted that it was the second covered bond forum to be hosted by the FSA following the inaugural meeting on 23 June 2011. AS commented that although market conditions had been erratic due to ongoing Eurozone concerns, overall issuance of covered bonds under the UK regime had increased significantly and two new programmes had been admitted to the register, Coventry Building Society and The Co-operative Bank, both of whom had made successful debut issues. In addition during the year the FSA had concluded a consultation of the UK Regulated Covered Bond legislative framework and the Sourcebook, the details of which would be touched upon later in the forum.

2. **Developments in the UK Market**

Jared Zakrzewski (Abbey National Treasury Services plc) presented to the forum a timeline of global events during 2011 which has impacted the secured and unsecured funding conditions across the market. Most notably;

- the impact of the Japanese tsunami and the Arab Spring in Q1;
- the Eurozone crisis throughout the year; and
- the S&P credit downgrade of the US in Q3.

JZ explained that despite these tumultuous conditions, overall issuance has risen £7-10bn year-on-year. He went on to describe the sterling market had proven itself to be relatively deep and viable. He noted that it was promising that The Co-operative Bank successfully issued their inaugural issuance in sterling. JZ explained that Abbey National issued two sterling regulated covered bonds during the year and looked closely at the US\$ covered bond market but it subsequently deteriorated. JZ explained that the sweet spot emerged during April and May at which time the dollar covered bond market started to open up. He noted that RBS, Barclays, Coventry, the Co-op and Santander successfully executed in volatile markets in late summer. JZ went on to explain that the second half of the year was characterised by “windows of opportunities”. He added that Abbey National successfully issued throughout the year a total of c.€200m N-bonds at roughly 30-40bps through secondaries.

Minute No

JZ was of the opinion that dollar covered bond traders were taking time to do the credit work before investing. He added that US investors with an ABS background were pleased with the provision of loan level data which will assist them in their analyses of the underlying mortgage pool, but noted this was different to the attitudes surveyed by other covered bond investors who were more or less indifferent.

JZ concluded that covered bond spreads are generally slow at both rising and falling and explained that he couldn't see a rationale for spreads falling until the problems in the Eurozone were adequately resolved.

Anna Simons (Capital Markets Team, FSA) thanked JZ for his presentation and opened up the floor for comment with respect to 2011 and the funding outlook for 2012.

It was highlighted by an issuer that there had been windows of opportunity in 2011 for both RMBS and RCBs. The issuer considered that the trend would continue into 2012 and will seek to take opportunities when they arise.

An investor noted that loan-level data reporting is a positive step particularly when assessing a pool of revolving mortgages and appreciated that it has been burdensome for issuers to resist breaching confidentiality clauses. AS added that the FSA are looking to lead the way in terms of transparency and although loan level reporting is a tall order to implement and with data protection issues to be carefully managed, she expected this to be the direction of travel for other jurisdictions across Europe and would be discussed in more detail in the next agenda item.

3. **Changes to the Regulations and Sourcebook supporting the Regulated Covered Bond Regime**

Ed Lidington (Banking and Credit, HM Treasury) and Stephanie Tetu (Capital Markets Team, FSA) presented on the changes to the regulations following the consultation during the year.

EL explained that the consultation was published in April 2011. HM Treasury received 16 written and a number of informal responses. After due consideration, HM Treasury published the response document on 29th November which was shortly followed by the FSA's policy statement on the 9th December.

EL described three of the six key proposed changes as follows;

1. Designation of asset pools – implemented for clarity and to align to other jurisdictions. The proposal was supported by most respondents. Some asked for a wider definition of assets which HM Treasury resisted. ST added that a deadline of 1 September 2012 has been set for issuers to come back to the FSA with respect to how they intend to designate their programme.
2. Excluding securitisations in RCBs – implemented to enhance the distinction between covered bonds and securitisation. EL explained that it should not

Minute No

cause any material change in practice as no issuer has registered securitised assets within their cover pool. EL explained that investors are broadly in favour of the approach.

3. Fixed minimum OC – EL explained that such a formalised approach aligns the UK regime with that of Austria, France and Spain. He added that virtually all respondents agreed with the approach but opinions varied with respect to the quantum level of OC ranging from 2-25%. It was agreed to settle at 8%; this figure is well below the current OC levels set by rating agencies and required by the FSA.

EL explained that three further issues had been explored, specifically;

- Whether to widen eligible assets beyond mortgages. This option was dropped for the time being but may be considered if a further review of the regulations is undertaken in the future (whilst taking into consideration the wider covered bond market and the European legislation underpinning it).
- Whether to introduce an integrated model for covered bonds in the UK. This option was opposed by most respondents. EL explained that the current legislation provides clear safeguards for investors in regulated covered bonds.
- Whether to allow non-UK banks to issue UK covered bonds. EL explained that it would prove difficult in terms of cross border supervision and that the Government is not minded to amend the regulations.

ST went on to describe the final changes made to the FSA Sourcebook.

4. Formalising the role of the asset pool monitor – aligns with current market practice which checks that the asset pool meets the necessary requirements of the regulations. ST explained that the majority of respondents agreed with the proposals. Some issuers raised concerns with respect to burden of additional costs. HMT was cognisant of this and as such changed the requirement to an annual inspection from the originally proposed bi-annual audit. ST also mentioned that the FSA expects the asset pool monitor's reports to be conducted on an Agreed Upon Procedures basis, using a random statistical sampling of the pool at a 99% confidence level. Finally, issuers are expected to notify the FSA in the event of any changes to the asset pool monitor including a rationale for such a change.
5. Introduction of enhanced standards of investor reporting - ST explained that this change received a significant number of responses. It was generally perceived positive for the regime as a whole but concerns were raised with respect to data protection, additional costs of providing loan level data and whether investors would use this information in practice.

In terms of data protection, the Capital Markets Team engaged with FSA colleagues from the financial crime division to consider risks inherent to the provision of loan level data. These discussions have been factored into the nature of the information requested and the channel through which it will be made available to the market.

In terms of benefits, ST explained that in order to preserve confidence in the

**Minute
No**

product, it is essential for investors to conduct their own due diligence. She added that this point has been touched upon within the third set of regulatory proposals on credit rating agencies released by the EU Commission in November 2011. These proposals cover a wide range of financial institutions, including asset managers, and would require these institutions to make their own credit assessments and “not to solely or mechanistically rely on credit ratings for assessing credit worthiness on an entity or financial instrument”.

In terms of additional costs, ST explained that issuers will only be requested to provide loan level data where bonds are issued after 1 January 2013. ST added that the loan level template will have to be completed on a ‘comply or explain’ basis. The extent to which issuers fail to fill in a number of fields and any penalty attached to noncompliance will be one for supervisory judgement. The FSA appreciates that in some instances it would be challenging for some issuers to provide particular elements of the template as data may not have been captured for loans underwritten decades ago. As such, issuers are encouraged to approach the FSA as soon as possible to explain how they intend to implement the loan level data requirements and whether they expect any issues in providing the information.

6. Regulatory reporting - ST explained that the FSA updated and consolidated its reporting requirements to reflect current supervisory practices. The amendments included changes to existing forms and inclusion of new forms. A number of issuers commented on the frequency of the proposed reporting of the Asset & Liability Profile Form, and on the additional information being requested in the application form. ST explained that the FSA decided to reduce the frequency of the reporting on the Asset & Liability Profile Form to quarterly from monthly, but maintained the level of information requested for new applications.

ST explained that additional minor changes had been made to align developments in supervisory practice, including allowing directors to be a signatory of the annual confirmation of compliance, providing further guidance on the definition of liquid assets which ensures consistency with BiPRU, and including off-sets as an area of risk that the FSA may consider in its stress testing.

Finally, ST provided an update on other policy areas that may have an impact on UK RCBs, more specifically:

- Large exposures – it is anticipated that the guidance paper will be issued for consultation during Q1 2012.
- Asset encumbrance – a survey was conducted at the beginning of the year. A report should be released in due course but the FSA cannot at this time disclose further information.
- Liquidity policy – the policy is being finalised to determine whether regulated covered bonds will be included within the liquidity asset buffers.
- Recovery & Resolution – (Stephen Drayson, FSA) described how bail-in might affect RCBs. The UK authorities had been clear in the April RCB consultation that in the exercise of any bail-in powers, secured creditors’ rights to collateral should not be overridden and that the claims of covered

Minute No

bond holders in relation to the asset pool of a covered bond, including under a guarantee which forms part of the covered bond arrangement, should not be affected. The Independent Commission on Banking (“ICB”) had also emphasised in its recently published proposals that imposing losses on secured debt would fundamentally undermine the concept of taking security under English law.

- SD went onto explain that bail-in, if applied, could only affect any unsecured exposure arising from RCBs. The nature of the RCB instrument, in particular the high quality of the underlying assets and the significant degree of over-collateralisation meant in his opinion that the probability of such an unsecured exposure ever arising (i.e. if the pool was insufficient to pay out the bonds in full) was very low.
- SD explained that the ICB had proposed two complementary bail-in powers. A ‘primary bail-in power’ would apply to all unsecured debt with a term of at least 12 months at the time of issue. If exercise of the primary bail-in power on its own proved insufficient, the authorities would be able to exercise a ‘secondary bail-in power’ that would allow them to impose losses on all other unsecured liabilities. The ICB did not address the point explicitly but SD explained that it seems likely that any unsecured residual claim for a secured creditor that arose from a covered bond (i.e. if the pool were insufficient to pay out the bonds in full) would be subject to the secondary bail in power. SD added that it should also be noted that the UK Government had not yet responded to the ICB’s proposals, but was expected to do so by the end of the year. In the meantime, no Government decisions had been taken to introduce bail-in powers of a particular type.
- An issuer asked whether a change in structure to the integrated model could be beneficial. AS explained that the integrated model was reviewed and there was not sufficient demand to justify the costs.
- An investor explained that the investment industry would want explicit carve out from bail in provisions. The Chairman of the RCBC pointed out that the bail-in provisions will only realistically affect the senior unsecured creditors. Given the fact there is substantial OC in the cover pool, in the event of an issuer default, there will be a stand alone claim against the LLP which should have sufficient assets to cover the liabilities and as such there should be no requirement to rely on a claim as an unsecured creditor. SP added that stress tests are run on a monthly basis across all issuers to test that there are sufficient assets to meet liabilities as they fall due. ST added that the 8% OC level is a statutory *minimum* that provides comparison across different jurisdictions. The actual OC level the FSA requests issuers to hold is much greater in practice and is derived from the FSA stress testing of individual programmes.
- An analyst noted that in the recent German legislation¹ on bank resolution there had been a carve-out for covered bonds and asked whether the UK is

¹ The German Pfandbrief Act was changed accordingly to clarify that the preferential claims of holders would not be affected by the resolution regime. Nevertheless, as we understand it, with reference to Section 5 §30(6) and §36a; in the event of an issuer default, and if there are insufficient assets in the cover pool to fully satisfy the Pfandbrief liabilities, the holders would have to enter into a separate claim (which would rank *pari passu* with other unsecured claims) against the general bankruptcy administrator in order to attempt to recover the sum outstanding.

**Minute
No**

disadvantaged by not having a safe harbour. Eleanor Riley (Banking and Credit, HM Treasury) explained that legislation is a long way from being finalised across Europe and that the Government will provide a formal response to the ICB proposals by the end of the year.

4. **Regulated Covered Bond supervision and guidance for issuers**

Anna Simons (Capital Markets Team) explained that the FSA undertakes quarterly stress testing across all twelve programmes. In addition, the FSA conducts annual reviews to each firm and interviews the individuals engaged with the day to day management of the programme.

AS explained that at least a couple of reviews have been performed across the population of firms (with the exception of the recently approved issuers) since the UK issuers became registered in November 2008. As such the FSA has sought to identify and document best practice and its expectations going forward. Guidance was released by the FSA in November with respect to the role of the compliance function. The FSA is due to consult further on its expectation of Management Information, Systems & Controls and the role of the senior manager responsible for the annual confirmation of compliance. AS explained that she sees it as a way of being open with what the FSA expects of issuers based upon best practice observed at each of the firms.

Stephanie Tetu (Capital Markets Team) explained that the issued guidance on the role of compliance focussed on the FSA expectations that the function should demonstrate a clear understanding of the RCB regulations and requirements, that it should demonstrate a formalised interaction with the programme, provide internal advice and challenge where appropriate, and be appraised of regulatory developments. ST noted that the guidance aims to improve transparency of the FSA's minimum expectations.

ST explained that the second set of guidance will have the same objective as the first and will set out FSA's minimum expectations in the following areas of the regime:

- Production and content of Management information – to ensure reliability of data produced and enough substance to support appropriate level of discussions and decision making within the firms.
- Appropriateness of Systems and Controls – to ensure clear identification, monitoring and mitigation of operational risks; and adequacy of the relevant IT infrastructure to support appropriate management of the programme.
- Role of the Signatory of the annual confirmation of compliance – to ensure that the signatory is suitably appraised prior to the annual attestation and on an ongoing basis of its role and key responsibilities within the programme; and is informed of key risks and issues as and when they arise. The FSA places significant emphasis on their involvement in the oversight of the

**Minute
No**

programme.

The guidance is expected to be published for consultation in the next couple of days. The consultation period will last 6 weeks. Market participants are invited to respond.

An investor noted that the loan-level data requirement has been put in place so that investors are able to make informed choices. The investor asked how the FSA intends to monitor whether investors adequately use the data. AS explained that as previously mentioned, the CRA3 proposals would require these institutions to make their own credit assessments. AS said that as these proposals are still under negotiation, not yet legislation and it is too early to comment on how the FSA would propose to supervise compliance.

An issuer asked whether the FSA has room to manoeuvre if the investment community seeks only specific data fields. AS explained that the proposals come into force on 1 January 2013. Investors are heterogeneous and have differing views on what analysis they undertake. As such some investors have an appetite to use more loan level data than others. Over the coming year the FSA will aim to hold forums between both the buy and sell sides to ensure the introduction of loan level reporting runs smoothly and is effective. The FSA's position on the 'comply or explain' aspect with respect to loan level data will be made using supervisory judgement.

An issuer added that the issuers are having parallel discussion with the Bank of England with respect to 'comply or explain'. AS noted that the FSA engages regularly with the Bank of England and endeavours to be as close as possible given both organisations operate within different frameworks. AS added that loan level reporting won't always be identical and the FSA will monitor developments going forward.

An issuer asked what the regulatory consequences are on 'comply or explain'. AS explained that the FSA would want an explanation for failure to comply and how the firm would go about remediating the failure. If the reasons for non-compliance were not sufficient then the FSA would consider other supervisory/ enforcement measures.

An issuer asked whether there would be any change to the standardised AUP audit which is common across the industry, currently covering 25-30 fields and whether the scope of which will be extended to all mandatory fields. AS noted that there are no proposals to change the scope of the audit.

5. AOB

AS explained that the forum had come to a close and explained that delegates from the respective issuers and HM Treasury would remain seated to discuss changes being made to the Regulated Covered Bond fee structure.

**Minute
No**

-End-