
Minutes

**Minutes of the meeting of the
UK REGULATED COVERED BOND FORUM**

Held on 23 June 2011 - 15:00

At CR 1 & 2, 25 TNC

Present:

Industry

Chris Fielding (Executive Director) - RCBC
Chris Parrish (Treasurer) – Yorkshire BS
Christiane Valansot (General Counsel) - IMA
Claus Toft-Neilsen (Chair) - CBIC
Gregory Turnbull-Schwartz (Investment manager) - Aegon
Irene Graham (Director, Prudential, Capital & Risk) - BBA
James Kotomitis (Managing Director Capital Markets Division) - AFME
Jane Lowe (Markets Director) - IMA
Jeremy Palmer (Head of Financial Policy) - BSA
John Hale (Manger, Investment Affairs) - ABI
Jozef Prokes (Portfolio Manger) - Blackrock
Luca Bertalot (Head of ECBC) - ECBC
Mark Gull (Co-head of ALM) - Pension Corporation
Mark Hedges, (Head of Structured Finance) – Nationwide BS
Mark Robinson (Financial Institutions Credit Research) - M&G
Nathalie Aubrey-Stacey (Secretariat) - CBIC
Paul O’Conner (Deputy Chairman) - ECBC
Richard Hopkin (Managing Director Securitisation Division) - AFME
Ryan Lindstrom - Natixis
Stephen Hynes (Head of Securitisation) - RBS
Steven Penketh (Head of Secured Funding) - Barclays

FSA/HM Treasury/ Bank of England

Anna Simons (Chair – Manager, Capital Markets Team)
Ashley Kibblewhite (Structured Finance Team)
Charles Gundy (Bank of England)
Dashiell Caldwell (HM Treasury –Banking and Credit)
Eleanor Riley (HM Treasury -Banking and Credit)
Gurmaj Dhillon (Credit Risk Team)
Jonathan Latcham (Minutes – Market Monitoring)
John Wu (Capital Markets Team)
Lara Joseph (Capital Markets Team)
Nicola Pittam (HM Treasury – Treasury Legal Advisors)
Nicola Veall (Large Complex UK Banks Supervision)
Nick Bertram (General Counsel)
Ramnik Ahuja (Groups Policy Team)
Simon Ainsworth (Bank of England - Collateral Mangement)
Stephanie Tetu (Capital Markets Team)

Apologies: Allen Rad (Head of Covered Bond Trading) – RBS
Gary Staines (Director, Structured Securitisation) - LBG
Tom Ranger (Head of Mortgaged Backed Funding) - Santander

**Minute
No**

1. **Opening remarks**

Anna Simons welcomed the delegates and introduced her team and the speakers to the floor. It was noted that the FSA intends to hold the forum approximately twice per annum. Minutes will be circulated and subsequently available on the FSA covered bond web page.

2. **Developments in the UK market**

Steve Penketh (Head of Secured Funding at Barclays Capital) presented Barclays' view of the growth and performance of the primary and secondary covered bond market.

The UK primary markets have experienced extraordinary growth in the year to date, having already exceeded the total covered bond issuance in 2010 of €18.9bn, and likely to exceed the 2006 peak of €23.5bn by year end.

It was suggested that this due to the diversification of platforms by product and location, the general market positioning into secured funding, and greater uptake in anticipation of Basel 3 capital buffers. SP also contrasted the UK and Germany's domestic spreads of covered bonds relative to their respective government bonds. The UK spread is approximately 120bps over Gilts, relative to the German spread of approximately 45bps to Bunds.

From a secondary markets perspective it was noted that the z-spreads in other European countries, other than Spain, Portugal and Ireland have fallen since Q2 2009.

Opinion from the floor

- Greater uptake on the buy side could be due to the current concerns over European sovereign risk

3. **Consultation on the Regulated Covered Bond Framework**

Dashiell Caldwell (Policy advisor, HM Treasury) provided an overview of the measures proposed in the joint HMT FSA consultation paper "Review of the UK's regulatory framework for covered bonds" and encouraged feedback from the industry before the 1 July deadline.

**Minute
No**

These are:

- Introducing a consistent minimum standard of investor reporting, including loan level data.
- Segregating covered bond programmes by asset type. This is designed to formalise existing practice by codifying it in the legal framework of the regime.
- Excluding securitisations as eligible assets. This proposal responds to request from investors for greater certainty over eligible cover pool assets and underlines the distinction between covered bonds and securitised products.
- Introducing a legal requirement for issuers to request an independent external audit of the SPV on an annual basis. This formalises existing UK practice, aligning the UK with other European jurisdictions.
- Introducing a fixed minimum level of overcollateralisation in legislation, to increase comparability between the UK and other jurisdictions. The regulatory level of OC will continue to be set on a case by case basis by the FSA, reflecting the risks and underlying collateral of individual pools.
- The RCB sourcebook will be updated to reflect FSA reporting requirements.

Opinion from the floor

- Some investors questioned the operation of the guarantee issued by the LLP under resolution, arguing that there is some uncertainty around the impact of potential bail-in and that there may be greater clarity if the ‘integrated’ (on balance sheet) model is adopted. In response, it was noted that the consultation paper on changes to the regime provides an explanation of the UK Authorities’ position on bail-in. This sets out that the UK believes that in the exercise of any bail-in powers secured creditors’ rights to collateral should not be overridden, including claims under a guarantee that forms part of a covered bond arrangement.
- In informal discussions with market participants prior to the consultation, the consensus was that investors were on the whole comfortable with the SPV model and that there are transitional implications and costs by switching
- Although it was acknowledged that overall resolution and bail-in policy is subject to some uncertainty, this is outside of the scope of the review of the regulated covered bond regime, and the final outcome depends on European developments.
- With regard to excluding securitisations from eligible cover pool

**Minute
No**

assets, an issuer noted that this may limit the flexibility of issuers to quickly transfer assets into their cover pools.

- It was, however, suggested that as using RMBS as cover pool collateral is highly collateral inefficient compared to using raw loans, this would limit the volume of RMBS used in this way by issuers.
- In response, it was noted that from a regulatory perspective, covered bonds are subject to different capital treatment and liquidity assets buffer eligibility under European legislation, and so the option to use RMBS as eligible cover pool assets blurs these distinctions and could facilitate regulatory arbitrage.
- Investors also noted that one of the strengths of the UK regime is its simplicity, and that including RMBS would increase the complexity of the UK product and blur the distinction between covered bonds and RMBS that many investors draw.

4. **Transparency Standards for Regulated Covered Bonds**

Lara Joseph (FSA – Capital Markets) spoke about the measures proposed in the UK consultation to introduce loan level reporting. is the view of the UK Authorities that great disclosure will support the development of greater liquidity and confidence in the market over the medium term. Developing high standards for transparency allows investors to undertake a thorough analysis of what they are buying, and evidence the high quality of assets supporting UK regulated covered bonds.

The FSA-HMT are cognisant of other initiatives being developed in Europe, and believe that the UK should lead the way in developing and supporting more detailed standards for disclosure and would like to encourage greater harmonisation of these requirements between the UK and other jurisdictions.

The FSA and the Bank of England intend to align their proposed templates for loan level reporting.

It was noted that the UK Authorities welcome the measures proposed in the Covered Bond Investor Council’s consultation on setting voluntary minimum standards of disclosure for covered bonds across Europe.

Opinion from the floor

- Issuers raised questions about the level of demand from investors for this data, and the utility of the analysis that could be undertaken, suggesting that stratification tables may be more appropriate.
- It was noted that there is a degree of cost associated with providing and maintaining this data, which could be considerable, and that there are issues relating to data security and protection of privacy. In addition, where investors don’t have the capacity to analyse this data,

**Minute
No**

the size of the investor base may shrink

- In response, investors noted that whilst there is a difference in approach between starting from a ‘bank perspective’ or a ‘credit perspective’ there is appetite to undertake detailed analysis. Relatively high standards of disclosure are considered a strength of the UK market.
- Investors provided examples of how they would utilise loan level data, noting that this forms a useful check on the assets as detailed in the programme documentation, and that this could be used to detect ‘early warning’ of deterioration in the quality of the cover pool.
- It was highlighted by issuers that unlike RMBS, as the cover pool is refreshed on a monthly basis trend analysis may not be meaningful.
- The Bank of England noted that, following an issuer event of default the cover pool freezes therefore they look to undertake analysis utilising loan level data in evaluating covered bonds placed as collateral with their operations, and that similar analysis could usefully be undertaken by investors.
- Investors expressed support for proposals that would develop a ‘gold standard’ of disclosure, and noted that the crisis in 2008 was exacerbated by a lack of clarity over the content and quality of collateral pools.
- Issuers noted that there is cost involved in supplying this data, with some discussion of the relative size of the fixed costs of creating operational capacity and the ongoing costs of continuing to supply data (e.g. resourcing and control environment). In addition, issues around data protection were raised. Investors also raised costs of being able to analyse data.
- The FSA set out that in developing standards for loan level disclosure, the FSA had taken account of burden imposed on issuers and therefore it is intended that the FSA and Bank of England templates should be aligned.
- In particular, careful consideration had been given to the risk relating to identity fraud or financial crime, with input from the FSA’s legal and financial crime teams. The templates proposed by the FSA balances detailed information with the need to reduce the risk to consumers, LJ emphasized the need for issuers to implement adequate controls around access to this data.
- LJ asked for submissions from issuers and investors of the costs and any potential pricing impact to be included in formal responses submitted to the consultation paper.
- There was some debate as to whether substantially different standards

**Minute
No**

of disclosure would distinguish the UK as a high quality jurisdiction or indicate that there may be a problem with the underlying assets. HM Treasury and investors expressed a view that the former was more likely.

- Anna Simons (FSA – Capital Markets) highlighted that there is a push from the US under the Dodd Frank Act for investors to perform fundamental analysis, and therefore is an increased desire from regulators and investors for more transparency.

5. **Use of Ratings for Covered Bonds**

John Wu (FSA Capital Markets) presented on the use and number of programme ratings and questioned whether the floor thought a risk was posed by programmes dropping a credit rating and whether two rather than three ratings was sufficient.

Opinion from the floor

- Chris Parrish (Yorkshire BS) noted that unanimous consent was obtained from investors to drop the programme's S&P rating. CP noted that bond pricing was subsequently unaffected.
- It was noted that a third rating is inherently more expensive than two ratings and didn't consider an added benefit to a third. In addition, it was highlighted that whilst ratings are used as a piece of information by investors, however it is considered good practice not to place sole reliance on rating agency output.
- A change to a credit rating has a material impact in their required capital requirements and by having two ratings rather than three results in a lower probability of a change in rating. It was also highlighted that as there is a regulatory incentive for insurers to buy them under Solvency 2, the impact of ratings volatility is exacerbated.
- Anna Simons explained that the FSA's stress testing approach does not have oversight of credit rating agency's methodology.
- It was suggested by investors that dropping one rating is likely to be acceptable, but issuers cannot drop all ratings. It was highlighted that greater transparency over swap arrangements is needed - LJ confirmed that this is in consultation and regulatory standards will be aligned to those proposed by the Bank of England.

6. **AOB**

DC set out the timeframe for responses to the consultation, and laying out the legislation.

In response to invitations to suggest future agenda items, following points were raised: implications for covered bonds arising from Solvency II, CRD 4 and retail ring fencing. (AS noted that the Commission for Banking is

**Minute
No**

responsible for developing policy proposals in this area).

In addition, a request was made for an update on asset encumbrance policy. LJ explained that a survey has been sent out to firms by the FSA, and work is ongoing to update policy in this area.

7. **Actions**

FSA to publish minutes