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Review of UK Covered Bond Framework

Background

On 6 April 2011, the UK Financial Services Authority ("FSA") and HM Treasury ("HMT") published a consultation paper setting out a joint review of the UK Regulated Covered Bonds Regulations (the "UK Regulations") with the stated aim of ensuring the UK Regulations continue to support the UK covered bond market and to help UK issuers compete on a level playing field with issuers from other jurisdictions. The consultation paper also proposes some minor changes to the UK Regulations.

Covered bonds have been issued by UK issuers since 2003 when HBOS Treasury Services launched the inaugural issuance of UK covered bonds. Unlike many other European jurisdictions, the UK did not, however, have the benefit of a statutory framework underpinning covered bond issuances until the UK Regulations were enacted in 2008.

The UK covered bond market has continued to grow following the introduction of the UK Regulations. The consultation paper notes that there are currently ten registered issuers of covered bonds under the UK Regulations and in excess of £100 billion principal amount of outstanding registered covered bonds. This trend is likely to continue in the future. Covered bond issuances have held up well compared with many other financial instruments during the financial crisis, including residential and commercial mortgage securitisations. There is also increasing concern on the part of investors in relation to unsecured senior bank debt in view of the fact that an increasing amount of such debt is likely to be required to be subject to bail-in provisions under international initiatives led by the Financial Stability Board and the Basel Committee on Banking Supervision and supported by recent consultation papers by the EU Commission.[1]

The main advantages for UK issuers in issuing covered bonds under the UK statutory framework established by the UK Regulations are to enable the bonds to comply with criteria set out in Article 22(4) of the existing UCITS III Directive (to be superseded by Article 52(4) of the new UCITS IV Directive), which enables the bonds to obtain more favourable regulatory capital treatment under the Capital Requirements Directive[2] in the EU and to benefit from the fact that UCITS funds are permitted to hold up to 25% of their assets in regulated covered bonds issued by a single issuer (as opposed to a 5% limit in respect of non-regulated bonds).

The current structure utilised in the issuance of registered UK covered bonds largely follows the same structure used by issuers prior to the introduction of the UK Regulations. Unlike many European jurisdictions, the UK

[1] See European Resolution and Recovery Framework for Financial Institutions, 17 February 2011, http://www.mofo.com/files/Uploads/Images/110217-European-Resolution-Recovery-Framework.pdf.
[2] EU Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC), http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1985/L/01985L0611-20050413-en.pdf.

Regulations do not provide for an integrated structure where the cover pool of assets remains under the direct ownership of the issuer of the cover bonds. Covered bonds under the UK Regulations must be issued by an institution incorporated in the UK and authorised to accept deposits. The issuer must lend the sums derived from the issue of the covered bonds to the owner of the cover pool of assets, which must be a separate legal entity (either a company or limited liability partnership) having its registered office and centre of main interests in the UK. The owner must use the sums lent to it by the issuer to acquire, maintain and administer the cover pool and guarantee the obligations of the issuer under the covered bonds, secured by a priority security interest in the cover pool.

The FSA and HMT acknowledge the growing importance of covered bonds in the UK and state that their desire is that the UK Regulations should help UK issuers of covered bonds compete on a level playing field with issuers from other jurisdictions.

Proposed Changes to UK Regulations

The FSA and HMT conclude that there are no major weaknesses in the UK regime. They do, however, recommend a number of changes to seek to increase the visibility of the UK Regulations and provide greater clarity for investors. These proposed changes include:

- **Segregation of asset types**: The FSA and HMT note that, although the UK Regulations allow a variety of assets to be included in the cover asset pool backing issuances of covered bonds, all issuances of UK regulated covered bonds to date have been backed exclusively by UK residential mortgages. They note, however, that the cover pool could change during the life of a transaction and that if regulated covered bonds currently backed by residential mortgages come to be backed by other asset types, this may have an impact on investors' view of the product and make the bonds potentially less attractive for certain investors. Although the FSA and HMT note that many UK issuers commit themselves in the programme documents to using a single asset type in the cover pool, they believe that issuers should be required to designate their regulated covered bond programmes as either a single asset type or a mixed asset type. Single asset type programmes would be permitted to contain eligible property from just one of the classes of permitted collateral.

- **Eligible assets**: Securitisations of eligible assets are currently permitted to form part of the cover pool under the UK Regulations, subject to meeting certain criteria (including having a AAA credit rating), although no existing UK covered bond issuances contain such assets in the cover pool. The FSA and HMT believe there should be a clear distinction between securitisations and covered bonds and that securitisations should be excluded from the definition of eligible property under the UK Regulations. No other changes are proposed to the list of assets eligible for inclusion in UK covered bonds, although the FSA and HMT invite views as to whether there are any additional assets that should be included.

- **Minimum over-collateralisation**: The FSA and HMT note that, unlike many other jurisdictions, the UK Regulations do not currently contain an explicit fixed minimum over-collateralisation requirement. They state that certain factors, including the FSA stress testing required in the UK Regulations, result in most issuances having significant over-collateralisation. To ensure better consistency with other covered bonds regimes, it is proposed that a fixed minimum over-collateralisation level and an interest coverage ratio be introduced into the UK Regulations. It is envisaged that the minimum collateralisation level would be fixed well below current over-collateralisation levels in the UK. The ratio would be set by reference to outstanding principal payments relative to the total principal amounts outstanding under the assets in the cover pool, taking into account interest and currency hedging.

- **Asset pool monitor**: The consultation paper notes that the existing UK Regulations provide for monitoring and scrutiny by the FSA and independent third parties. Unlike other jurisdictions with covered bond legislation, the UK Regulations do not currently provide for a formal asset pool monitor. The FSA and HMT propose introducing such a requirement into the UK Regulations for each asset pool.

The asset pool monitor will be required to be eligible to act as an independent auditor and to have the power to inspect all relevant records and information held by the issuer. It will be required to conduct a biannual inspection of the issuer's compliance with its duties under the UK Regulations and to submit an annual report to the FSA.

- **Investor reporting**: It is proposed that the reporting obligations be extended to seek to ensure consistent standards of reporting across registered covered bond issuances. The proposals include requiring issuers to place certain information on a secure, subscription-only website for investors, including key transaction documents, a link to the latest prospectus, a revised and updated notification form on the characteristics of the cover pool and quarterly loan level information on the cover pool.
- **Other changes**: A number of changes to the information to be provided to the FSA have been proposed and some minor changes are also proposed to the FSA sourcebook. For the time being, the FSA and HMT propose no change to the provisions of the UK Regulations that limit eligible issuers of UK regulated covered bonds to issuers incorporated in the UK.

No Movement to Integrated Model

As mentioned above, the UK Regulations largely maintained the pre-existing segregated structure of UK covered bonds involving a separation of the cover pool of assets from the issuer of the bonds. The main obstacle to moving to an integrated approach, common in many European jurisdictions, is the changes to UK insolvency laws necessary to make an integrated approach work for UK issuers and provide an effective ring-fencing of the cover pool in favour of holders of covered bonds in the event of the issuer's insolvency. When the UK Regulations were first introduced, HMT committed to a review of whether changes to UK insolvency regime should be proposed so that UK covered bonds could in the future be issued under an integrated approach.

The FSA and HMT conclude in the consultation paper that there is no pressing case for the integrated approach to be facilitated under the UK Regulations. This is based partly on the fact that the FSA and HMT do not believe there is a strong correlation between covered bond spreads and whether the issuance is affected on an integrated or segregated basis. They therefore believe that the costs of introducing an integrated model (including changes to UK insolvency law) and consequent market disruption would outweigh the benefits in making the change. They do, however, invite views to the contrary. It is perhaps surprising that the integrated model has been rejected so firmly in the consultation paper. It is not obvious that the necessary changes to UK insolvency law would be hugely difficult to introduce, particularly if these are limited to registered covered bonds. It is also not clear that there would be huge market disruption as a result of such change. The covered bond legislation being considered in the U.S. at present would proceed on the basis of an integrated approach (U.S. covered bond issuances to date having been under a segregated model). It is not clear that the challenges in introducing an integrated model in the U.S. are materially less difficult than in the UK.

Resolution Regimes and Bail-In

The consultation paper notes that there is ongoing work internationally in relation to resolution and recovery regimes for banks (including the UK's special resolution regime under the Banking Act 2009) and ongoing international discussions about requiring banks to issue debt (or a certain amount of debt) subject to bail-in provisions. The recent EU consultation papers on crisis management and resolution and recovery plans recommend either (i) requiring all future senior debt of banks (subject to certain exemptions including covered bonds and other secured debt) to be subject to a write-down or conversion into equity upon being required to do so by relevant supervisors or (ii) requiring banks to issue a certain amount of debt subject to such bail-in provisions. The interim report of the UK's Independent Commission on Banking issued on 12 April 2011[3] also

[3] Independent Commission on Banking, Interim Report Consultation on Reform options, April 2011, http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf.

favours banks being subject to such bail-in requirements, although concerns were raised that the first option promulgated by the EU Commission would encourage banks to structure around the rules. The FSA and HMT note that existing safeguards under the special resolution regime contained within the Banking Act 2009 protect creditors of covered bonds. They also state their view that any introduction of bail-in powers should not affect the claims of covered bond holders in relation to the cover pool, including the guarantee from the owner of the cover pool. The FSA and HMT state that an exemption for covered bonds from any bail-in provisions would have the effect that only a covered bondholder's residual unsecured claims after realisation of collateral or recovery under the guarantee would be subject to bail-in rules. In this regard, it is interesting to note that the EU consultation papers envisage there where a bank's debt is subject to bail-in provisions, the trigger point for any write-down or conversion to equity would be prior to the point of non-viability of the bank and with a view to avoiding its insolvency or liquidation. It is also envisaged that the occurrence of such trigger should not trigger an event of default or acceleration of other debt of the bank. In this event, there should therefore be no acceleration of any covered bonds issued by the bank or realisation of the collateral comprised in the cover pool at the time any bail-in provisions contained in other debt of the bank take effect, in which case it would appear that there should not be any write-down or conversion of any residual claim of the covered bond holders as envisaged by the FSA and HMT. The consultation paper also states that as international negotiations about bail-in powers progress, relevant authorities should consider carefully the mechanisms by which creditors could call upon any guarantee forming part of a covered bond arrangement.

Other Regulatory Issues

Other regulatory issues considered in the consultation paper include:

- **Asset encumbrance**: It is noted that encumbering assets for a particular transaction, including the cover pool under a covered bond transaction, results in such assets not being available to meet claims of unsecured creditors including depositors protected by the UK's Financial Services Compensation Scheme. This could therefore increase costs to taxpayers in the event of the bank's failure. It is noted that the FSA monitors covered bond issuances and other forms of asset encumbrance on a case by case basis and makes an assessment of the volume of encumbered assets as a proportion of the firm's total assets and the level of over collateralisation in the cover pool. Firms with high levels of encumbrance may be required to hold additional capital. It is stated that the FSA is conducting a review to develop its asset encumbrance policy.
- **Set-off**: The consultation paper considers the risk to investors in covered bonds of borrowers in respect of assets in the cover pool exercising rights of set-off if the bank fails to meet obligations under amounts the bank otherwise owes to such borrower (e.g., in respect of a deposit held by such borrower at the bank). It believes, however, that the existence of the UK Financial Services Compensation Scheme providing a guarantee in respect of retail deposits up to £85,000 means it is unlikely this will be a material risk in practice.
- **Liquidity regulation**: The FSA and HMT note that considerable work has been undertaken in the UK and internationally to address liquidity problems of the type many banks faced during the financial crisis. They also note that under the new Basel III rules, banks will be required to comply with liquidity ratios and there is ongoing work as to which assets, including covered bonds, will be treated as liquid assets for such purpose. It is noted that the UK is actively engaged in the process and the FSA will consider how best to adopt the international framework once this has been finalised.

Conclusion

The review proposes no radical changes to the UK registered bond regime but focuses on areas designed to provide better understanding for investors and make some areas more consistent with other European regimes. It also provides some useful clarity in relation to certain regulatory aspects of covered bonds, not least the view of the FSA and HMT that covered bonds should not be subject to any regulatory bail-in provisions. This is likely to help in maintaining investor confidence in covered bonds. The consultation paper also helpfully notes that the FSA is establishing and chairing a UK Covered Bond Forum to propose industry-wide awareness of relevant issues. In view of the size and importance of the UK's covered bond market and the likelihood of this market continuing to grow, it is surprising that more radical changes, particularly the possibility of facilitating an integrated structure in the UK, are not given greater consideration. Although there would be costs involved in making relevant changes to UK insolvency law, these should be largely one-off costs. It is also not clear that such changes would give rise to major market disruption. An integrated model is likely to assist UK covered bond issuers and, in the longer run, reduce operational costs in establishing and maintaining a separate entity to hold the cover asset pool and the ongoing transfer of assets between the issuer and the owner. Although the FSA and HMT state there is no material difference in spreads between UK registered covered bonds and those that incorporate an integrated structure, our understanding is that there is likely to be at least some premium in spreads resulting from the segregated approach. The FSA and HMT point to an analysis of covered bond spreads by the Bank of International Settlements in 2007 to support their view. It would, however, be interesting to know if there more recent data, as to whether this continues to be the case. In relation to matters such as ensuring that UK covered bonds are not subject to bail-in requirements, the discussions on this point in the consultation paper demonstrate that there are added complexities that are involved that arise from having a separation between the issuer and the cover pool and the existence of a guarantee from the holder of the cover pool.

The consultation is open until 1 July 2011.

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