

Proposals for a UK Regulated Covered Bonds legislative framework: summary of responses and final Impact Assessment

February 2008



HM TREASURY



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CONTENTS

		Page
Chapter 1	A Summary of Consultation Responses	3
Annex A	List of Consultation Respondents	11
Annex B	Final Impact Assessment	13
Annex C	Statutory Instrument	21

A SUMMARY OF CONSULTATION RESPONSES

A SUMMARY OF CONSULTATION RESPONSES

Introduction

1.1 This document summarises the responses to HM Treasury’s consultation on a proposed legislative framework for UK Regulated Covered Bonds. The consultation was launched on 23 July and closed on 15 October 2007 and ran alongside the FSA’s consultation on its proposed implementation of the regime. The relevant text from the final version of the Statutory Instrument is provided at Annex C.

The consultation document

1.2 The consultation document outlined the proposed approach for a UK legislative framework for covered bonds that was compliant with Article 22(4) of Directive 85/611 EC on the co-ordination of laws, regulation and administrative provisions relating to undertakings for collective investment in transferable securities (‘the UCITS directive’).

The provisions of Article 22(4) of the UCITS Directive are reproduced in Article 22(4) of Directive 92/49/EEC on the co-ordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance, and Article 24(4) of Directive 2002/83/EEC on the co-ordination of laws, regulations and administrative provisions relating to direct life assurance. The UK legislative framework for covered bonds will comply with all three Directives. All references in this paper shall be to the UCITS Directive.

1.3 UCITS-compliant covered bonds benefit from higher prudential investment limits and a preferential risk weighting. The proposed framework adopted a principles-based approach, designed to provide the necessary underpinnings for UCITS 22(4) compliance while allowing for market innovation and development.

CONSULTATION QUESTIONS

1. Do you agree in the first case, subject to the other requirements of the regime, that any credit institution with its registered office in the UK should be able to issue UK Recognised Covered Bonds?
2. Do you agree that the location of the registered office of the issuing credit institution should be broadened if enforcement will be deliverable?
3. What are your views on possible obstacles to the integrity of the enforcement regime?
4. Do you think anything further should be added to the proposed legislative regime to impose more detailed quality requirements on the market such as the minimum level of over collateralisation or the LTV limits for the mortgages?
5. Do you agree with our general approach?
6. Do you agree with the functions we propose to give the FSA and the recognition process for issuers and their programmes?

7. Do you agree with the proposed time limits for the recognition process?
8. Do you think there should be different time limits for recognition of the covered bonds where the issuer has already been recognised?
9. Do you agree with the rationale for the enforcement provisions and the enforcement powers the FSA will have for this regime?
10. Are the types of assets permitted in the asset pool defined appropriately in Regulation 2?
11. Is it appropriate to widen the list of eligible property beyond the BCD list?
12. Are you satisfied that the definition of eligible property in regulation 3 has the correct balance between flexibility in eligible assets and their suitable quality?
13. Is there a better way to define the eligible property so as to provide flexibility while ensuring the quality of the assets in the pool?
14. Do you think it is appropriate to define the location of the eligible property backing the pool?
15. Are you happy with our proposed definition of the suitable location of such assets?
16. Do you agree that the Regulations should adopt the “copy-out” approach with regards to capability to pay? Or do you think that for reasons of legal certainty the Treasury should include examples of different ways in which the capability test may be met?
17. Do you think there are other methods for assessing capability?
18. Which do you think are the most suitable methods for assessing capability?
19. Do you have any comments on the ring-fencing in the Regulations and the requirements placed in the owner, issuer and liquidator?
20. Do you think that the protected period in regulation 25 (10) is the correct length?
21. Do you agree that service providers can be paid as an expense of the winding up?
22. Do you agree with our analysis of the set-off position?
23. Do you think we should put the set off position beyond doubt?

SUMMARY OF RESPONSES

1.4 The consultation sought views on the proposed legislative framework for UCITS-compliant covered bonds. 14 responses to the consultation were received, including from firms, trade associations and other representative bodies. A full list of consultation respondents is provided at Annex A.

HMT’s general approach

1.5 The legislative framework set out in the July consultation document was developed in close consultation with industry and the FSA. It reflected the views of industry at that time for a flexible regime that provided robust bondholder protection but could accommodate market development and innovation.

1.6 However, consultation coincided with a period of market turbulence and many of the responses were informed by these events. Whilst respondents remained fully

supportive of the implementation of a UCITS-compliant regime, they stressed that in order to deliver a liquid product in which investors could have a high degree of confidence, the legislation needed to focus on quality rather than flexibility.

1.7 HMT have made a number of amendments to ensure the legislation meets this objective. These include restricting the structure of UK Regulated Covered Bond programmes; refining the list of eligible property; restricting the location of eligible property; and the inclusion of a high quality marker.

Restricting the Structure of UK Regulated Covered Bond Programmes

1.8 Article 22(4) of Directive 85/611/EEC does not prescribe a particular structure for covered bond programmes, but sets out the objectives a regime must fulfil in order to ensure the quality of the portfolio and that, on insolvency, the assets securing the bonds are available for the benefit of the bondholders (and not other creditors of the issuer).

1.9 The framework that was proposed in the consultation document provided for two models of ring-fencing the assets in order to provide bondholder protection (the Special Purpose Vehicle model (SPV) and the integrated model).

1.10 The SPV model is used in existing UK structured covered bonds. It involves the setting up of an SPV as a separate legal entity to whom eligible assets are transferred from the issuer on a true sale basis.

1.11 The integrated approach, common in other Member States, involves the setting up of a legislative ring-fence around the asset pool, which remains on the issuing bank's balance sheet.

1.12 Several respondents questioned whether the legislative ring-fence for the integrated model was sufficiently robust given existing UK insolvency law. As the technical issues raised by these concerns would take time to address, and respondents were keen for homogenous bond programmes, we do not propose to include the integrated approach at this stage. However, this position will be reconsidered when the legislation is reviewed one year after implementation.

Overarching Quality Provision

1.13 Respondents stressed the need for the legislation to have a clearer focus on the quality of the regime, to help increase investor confidence and ensure the development of liquid products.

1.14 It was suggested that the inclusion of an overarching quality provision in the Regulations would help to deliver this by making explicit HMT's intention to deliver a high quality regime.

1.15 HMT has accepted respondents views and has inserted quality markers into the regime. One of the functions of the FSA will be the need to preserve investor confidence in, and the desirability of maintaining the good reputation of, the Regulated Covered Bonds sector in the UK by the issuance of high quality Regulated Covered Bonds. They will also have the power to refuse an application for registration of a Regulated Covered Bond or an issuer if the FSA considers that granting it would be detrimental to the interests of investors in Regulated Covered Bonds or to the maintenance of the good reputation of the Regulated Covered Bond sector in the UK. In addition, issuers and

owners must make arrangements so that the asset pool is of sufficient quality to give investors confidence that there will be a low risk of default in the timely payment of claims attaching to a Regulated Covered Bond.

The Asset Pool and Eligible Property

1.16 In line with industry’s preferences at the time, the approach set out in the consultation document permitted a broad range of assets to be included in the cover pool backing the covered bonds.

1.17 It included a “copy out” approach to eligible assets mentioned in point 68 of Annex 6 of the Banking Consolidation Directive (BCD), allowing credit institution investors in covered bonds (backed by these assets) to qualify for a reduced risk weighting and hold less capital than would be required for other bonds. The assets permitted related to mortgages, public sector loans, shipping mortgages, and exposures to credit institutions.

1.18 In addition, the proposed legislation contained a “catch-all” provision, making eligible any asset rated Credit Quality Step 2 (as defined in Annex 6 of the BCD) or better.

1.19 These conditions were consistent with delivering a flexible regime, and permitted a greater potential diversity and composition of UK Regulated Covered Bonds (without necessarily reducing their quality). However, many respondents indicated that the benefits of restricting the range of eligible property would include:

- Increased homogeneity of bonds issued under the framework;
- Increased transparency for investors;
- Reduced analytical requirements for investors;
- Increased perceived credit strength of the bonds;
- Increased liquidity of all bonds issued under the UK regime.

1.20 Accordingly, HMT has removed the “catch-all” provision and revised the provisions around eligible property. The BCD list has been restricted by limiting exposures to Credit Quality Step 1 bodies only; and limiting exposures to residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS) to those backed by assets that the issuer or affiliate has originated or acquired, with a minimum AAA rating. This will improve transparency and give investors confidence in the credit of the assets securing the covered bond.

1.21 One respondent question the inclusion of social housing as eligible property. However, we propose to retain this on the basis there has never been a Housing Association default and the sector benefits from regulation by the Housing Corporation. We will also retain as eligible property loans relating to Public Partnership Projects where these are secured by a Public body with step-in rights.

Location of Eligible Property

1.22 Although the UCITS Directive does not prescribe where eligible property may be located, it is clear that the security and availability of assets is very important. In developing our proposals we felt a good measure of availability is whether a UK judgement would be enforceable against assets held in other jurisdictions. In addition

to EEA states, which are subject to the Recognition and Enforcement of Judgements Regulation, we also proposed countries or territories listed in Section 426 of the 1986 Act and countries or territories which have given effect to the UNCITRAL model law. Although this was consistent with industry's preferences at the time, consultation respondents felt the list was too broad.

1.23 HMT has therefore decided to restrict the location of eligible property to EEA states and a number of other jurisdictions, specifically the USA, Japan, Canada, Switzerland, Australia, New Zealand, the Channel Islands and the Isle of Man. This is in line with the position in other Member States. In addition, as part of the registration process and as part of complying with ongoing requirements under the regulations, the FSA will expect issuers to obtain confirmation that the law of the relevant jurisdiction or territory does not adversely impact on the security and availability of those assets located outside the UK.

Priority of Payment

1.24 UCITS 22(4) requires bondholders to have a priority claim on assets in the cover pool in the event of the failure of the issuer. Some respondents suggested that the UK legislation should allow ranking to be determined by the contractual arrangements of each bond programme. In our view the obligations contained in Article 22(4) must be applied to the issuer/SPV package as a whole and because some contractual arrangements put the claims of other creditors above the claims of bondholders, we could not accept the above suggestion as being compliant with the Directive requirements. However, in accordance with the practice in other Member States, we are proposing to allow the claims of bondholders and those persons necessary for the operation of the asset pool and the bond structure to rank *pari passu* on the failure of the owner. In addition, and in line with other Member States, we have not displaced the general rule that a liquidator, administrator or receiver should obtain their expenses in priority to other claims. We have clarified that those expenses necessary for the operation of the asset pool and the bond structure will qualify as expenses on the failure of the owner and we have provided that such expenses will be paid in priority to all other expenses.

Location of Issuer

1.25 Respondents strongly supported the proposal that any credit institution with its registered office in the UK should be able to issue covered bonds, subject to the other requirements of the regime.

1.26 Respondents also acknowledged the benefits of extending recognition to EEA issuers/owners. However, it was stressed that this extension should not be permitted at the expense of delivering a robust and transparent regime in which investors have high levels of confidence.

1.27 Such confidence is in part dependent on the FSA being able to supervise and enforce the regime effectively. After careful consideration, HMT believe that the current arrangements for EU co-operation and co-ordination for the supervision and insolvency regarding covered bonds mean that extending the regime to include branches of an EEA credit institution at this stage would run counter to the objective of establishing a robust regime in which investors can have confidence.

1.28 On this basis HMT have decided to restrict issuance to UK authorised credit institutions only. The regulations also stipulate that the SPV's centre of main interest

(COMI) must be in the United Kingdom in order to ensure that insolvency proceedings fall under the jurisdiction of the UK.

1.29 However, we are aware that there may be benefits to extending the regime to UK-branches of EEA issuers and will therefore reconsider this position when we review the legislation one year after implementation.

Set-Off

1.30 Respondents suggested that, to the extent possible, HMT should take steps to establish the set-off position to a reasonable degree of certainty.

1.31 However, set-off is a general principle of insolvency law that, under current legislative arrangements, applies to all creditors of a bank, including depositors. In our view depositors should not be unfairly disadvantaged on insolvency depending on whether or not their assets are part of a covered bond asset pool, a circumstance over which they have no control or knowledge. We therefore do not propose to clarify the set-off position in this legislation.

Capability

1.32 Respondents were broadly of the view that a “copy-out” approach should be taken with regards to the capability to pay. Only one respondent argued that a capability test should be set out in the legislation (if not set out in the FSA’s guidance).

1.33 Capability to pay could be determined in a number of ways such as: setting minimum over-collateralisation levels; setting requirements in relation to prudent valuation methodologies for the underlying asset pool; ECAI models that stress test portfolio parameters such as probability of default, exposures at default, loss given default and maturity using a weighted averaging methodology.

1.34 HMT agree with the majority of industry that a too simplistic and prescriptive approach set out in the regulations could unduly constrain assessment techniques and give rise to a false sense of security.

Functions of the FSA and enforcement

1.35 Respondents agreed that public supervision is a key aspect of ensuring the robustness of the UK regime, and broadly supported the functions given to the FSA.

1.36 Some respondents argued that the FSA’s powers should be extended to prevent a material change to a Regulated Covered Bond programme, if there is a risk that it would subsequently fail to meet the requirements of the regulations. Accordingly, HMT have introduced a provision in order to prevent this. HMT has also included a provision to ensure that any person proposing to take over the obligations of the issuer under a Regulated Covered Bond must first be registered as an issuer.

1.37 In addition, some respondents questioned whether the FSA should be given the power to impose a penalty on the owner of an SPV, on the grounds that this type of fine would penalise bondholders. HMT have decided to provide the FSA with this power as it is more proportionate than relying on a court’s order and is consistent with FSA’s broader penalty powers under FSMA. It is important to stress that the FSA will consider the full circumstances of the case when assessing if it is appropriate to use this power.

Timeframe for decision making

1.38 The Consultation documents proposed a six-month time frame in which the FSA would complete application for registration and take decisions on changes, such as changes to the owner or issuer.

In line with respondents views we have reduced the time period for changes from six to three months. However, we consider six months an appropriate timescale for registration. The FSA needs sufficient time to assess applications and analyse information relating to the pool, for example, and firms' systems and controls. While the FSA will, where possible, endeavour to complete applications for registration as quickly as possible, the majority of respondents agreed that six months was an appropriate backstop.

Other issues raised during consultation

1.39 Other comments received went wider than the specific issues being consulted on and are addressed below.

1.40 It was suggested covered bonds should be listed and that disclosures should be made via a Regulatory Information Service (as approved by the FSA) to allow disclosures to be undertaken on a timely and accurate basis and increase transparency for investors.

1.41 HMT believe that requiring covered bonds to be listed could be burdensome, as programmes not already listed and issuers wishing to issue a tranche from an existing programme would be required to meet additional criteria. In relation to the suggestion that disclosures be made via a Regulatory Information Service, the proposed legislative framework does not create new public disclosure obligations on the issuer. Existing public disclosure obligations, which are applicable, will continue, as will the existing methods for fulfilling such obligations.

1.42 One respondent also thought that the lack of a formal register, could give rise to greater opportunity for disputes by other creditors in the event of issuers' insolvency. HMT have considered this, but believe that the flagging of assets required by the legislation already fulfils this objective.

Conclusions

1.43 Given the responses received, the Government is content that the proposed regime should remain principles-based but with a clearer focus on quality and increased transparency for investors.

1.44 The Government believes that implementation of this regime will deliver a more level playing field in the EU for UK credit institutions issuing covered bonds, and allow UK Regulated Covered Bonds to benefit from a preferential credit risk weighting.

Next Steps

1.45 Final regulations will be laid before Parliament by 14 February.

1.46 It is intended that the legislation will enter into force on 6 March.

A

LIST OF CONSULTATION RESPONDENTS

RESPONDENTS

- AIG
- Anglo Irish Bank
- Bank of Ireland Group
- BBA
- Financial Services Consumer Panel
- Fitch Ratings
- Genworth Financial
- IMA
- London Stock Exchange
- Nationwide
- Price Waterhouse Coopers
- Slaughter and May
- Standard and Poor's
- The Insolvency Service

FINAL IMPACT ASSESSMENT

Department: HM Treasury	Impact Assessment of the proposals for a UK Regulated Covered Bonds legislative framework
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Stage Implementation	Version Draft	Related Publications Proposals for a UK Regulated Covered Bonds legislative framework.
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Available to view or download at: www.hmtreasury.gov.uk

Contact name for enquiries: Henry Rigg

Telephone number: 020 7270 4704

What is the problem under consideration? Why is government intervention necessary?

Problem: There is currently no legislative framework for UK covered bonds, preventing issuers meeting the identical criteria prescribed in Council Directive 85/611/EEC ('the UCITS Directive'), Council Directive 92/49/EEC ('the third non-life insurance Directive') or Council Directive 2002/83/EC ('the Consolidated Life Directive') . The absence of a compliant regime means that UCITS and insurance firms cannot benefit from the higher investment thresholds and credit institution investors cannot benefit from the more favourable risk weightings allowed by Directive 2006/48/EC ('the Banking Consolidation Directive') (BCD).

Government intervention: One requirement of the UCITS Directive is that Covered bonds regimes must be subject to special supervision, specifically designed to protect bondholders. Government intervention is required to enable supervision and for UK covered bonds to be UCITS compliant.

What are the policy objectives and the intended effects?

The policy intention is to develop a UK covered bonds regime compliant with Undertakings for Collective Investment in Transferable Securities ('UCITS') and the above mentioned Insurance Directives.

The delivery of the Regulated Covered Bonds regime will enable:

- (a) UCITS investors to increase the percentage of their assets invested in covered bonds issued by a single issuer from 5% to 25%;
- (b) insurance firms to increase the percentage of their assets invested in covered bonds issued by a single issuer from 5% to 40%;
- (c) credit institution investors to reduce the risk-weightings currently applied from 20% to 10%, implying a reduction in capital requirements of approx. £100 million. More significantly we expect the required special public supervision and reduced risk weighting to increase the potential pool of investors, by creating a level playing field for UK covered bonds in the EU.

What policy options have been considered? Please justify any preferred option.

Option 1 - do nothing.

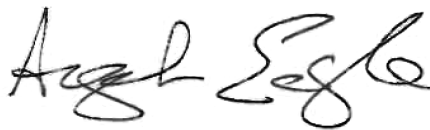
Option 2 - Deliver a Principles-base legislative framework compliant with UCITS, Third Non-life Insurance Directive and Consolidated Life Directive that supports market development by focusing on quality, robustness and transparency for investors. This will enable UCITS and insurers to be able to invest a higher proportion of their assets in the covered bonds of one issuer. It will also enable credit institution investors in compliant covered bonds to benefit from a reduced risk weighting provided for under the BCD .

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? 2009

Ministerial Sign-off For final proposal/implementation stage Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister:



Date: 07.02.08

Policy Option 2		Description; Deliver a UCITS compliant principles based legislative framework.	
ANNUAL COSTS One off (Transition) £ 2 m Yrs <input type="text"/> Average Annual Cost (excluding one-off) £ 250,000		Description and scale of key monetised costs by 'main affected groups' The key monetised cost will effect credit institutions who issue Regulated Covered Bonds. £ 4.3 m	
Other key non-monetised costs by 'main affected groups'			
ANNUAL BENEFITS One off £ None Yrs <input type="text"/> Average Annual Benefit (excluding one-off) £ 3. 6375 m		Description and scale of key monetised benefits by 'main affected groups' The Key monetised benefits will fall to Regulated Covered Bond holders, who will benefit from reduced risk weightings. ££ 33. 9 m	
Other key non-monetised benefits by 'main affected groups' Conservative investors may be better able to diversify their portfolios.			
Key Assumption/Sensitivities/Risks Key assumptions include, the rate at which bond holders will reduce actual capital held, relative to the regulatory capital reduction.			
Price Base Year 2007	Time Period Years 10	Net Benefit Range (NPV) £ 16.9m - 42.3m	NET BENEFIT (NPV Best estimate) £ 29.6 m
What is the geographic coverage of the policy/option?			UK
On what date will the policy be implemented?			6 March 2008
Which organisation(s) will enforce the policy?			FSA
What is the total annual cost of enforcement for these organisations?			£ 125,000
Does enforcement comply with Hampton principles?			Yes
Will implementation go beyond minimum EU requirements?			No
What is the value of the proposed offsetting measure per year?			£ N/A

What is the value of changes in greenhouse gas emissions?			Negligible	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Med	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			Net Impact	£ (Increase - Decrease) N/A
Increase of	£ N/A	Decrease of		
Key:			Annual Cost: Constant Prices	(Net) Present Value

Evidence Base for Summary Sheets

OVERVIEW

At present there is no legislative framework in the UK to enable the issuance of UCITS, Third Non-life Insurance Directive and Consolidated Life Directive - compliant covered bonds. This prevents UK UCITS and insurance firm investors benefiting from higher prudential investment limits and credit institution investors from benefiting from reduced risk weighting under BCD.

The costs and benefits of the Government's proposals are set out below, with a greater emphasis given to the costs and benefits associated with a UCITS-compliant principles-based legislative framework that supports market development through a focus on quality.

Option 1 costs and benefits

At present there is no legislative framework for covered bonds in the UK; however structured covered bonds have been issued in the UK since 2003. These bonds are based on well-accepted market standards and benefit from a high degree of legal certainty because of their SPV structures.

Option 1 is for no change. UK issuers could continue to issue covered bonds that are not UCITS compliant.

Benefits

No incremental benefits will occur, as this option maintains the status quo. However, notable benefits of this option include:

- No external or internal costs associated with the regulation are imposed on banks.
- UK covered bonds issuers would be able to continue issuing non-regulated structured covered bonds.

Costs

There are no incremental costs associated with Option 1 as it maintains the status quo. However, the difficulties associated with current structured covered bond would continue, these include:

- UK structured covered bonds do not currently comply with the UCITS, Third Non-life Insurance Directive and Consolidated Life Directive, implying lower prudential investment limits for UCITS and insurance investors. UCITS and insurance firms can currently only invest up to 5% of their assets in the covered bonds of a single UK issuer, reducing potential demand for UK products.

- UK structured covered bonds do not currently benefit from the reduced risk-weighting of 10% provided for in the BCD because they are not UCITS compliant
- David Miles in his report to HM Treasury on long-term mortgage market stability listed the absence of a formal UK regime as a factor restricting the development of long-term fixed rate mortgage lending.

Option 2-Costs and benefits

Option 2 involves the implementation of a legislative framework designed to provide the necessary underpinnings for UCITS, Third Non-life Insurance Directive and Consolidated Life Directive compliance. The legislation is principles based and outcomes-focused with the necessary legal requirements for the regime and its special supervision. It will be supported by more detailed guidance of the FSA.

The policy intention is to develop an overarching legislative framework for UCITS, Third Non-life Insurance Directive and Consolidated Life Directive compliant covered bonds that is principles based rather than prescriptive. It is expected that the legislative framework will enable UK issuers to access the larger investor base of the Euro 2 trillion European markets. The framework is intended to support existing issues with minimal change to the underlying contractual arrangements.

Benefits

The benefits from Option 2 will include:

- The proposed covered bonds regime will reduce risk-weightings for credit institution investors from the 20% currently applied to 10%, implying a reduction in capital requirements of approximately £100 million.
- We estimate this reduction in risk weighting would reduce annual compliance by less than £5million. This estimate assumes a marginal cost of capital of 3.5% per annum¹. This is an upper limit estimate of the cost reduction – bondholders may in practice reduce actual capital held by less than the regulatory capital reduction². To estimate a lower limit of the cost reduction we assume bond holders reduce actual capital held to a level 35% above the required amount, reducing annual compliance by £2.275 million.
- More significantly, we expect the required special public supervision (in part by increasing transparency and reducing information asymmetries), the reduced risk weighting and increasing of prudential investment limits (which are by-products of the UCITS 22(4) compliant regime), to increase the potential pool of customers for UK-issued Regulated Covered Bonds. We understand firms (such as banks based in other EU member states) have limits imposed on them from purchasing bonds that fall outside the UCITS regime. The increase in demand is likely to lead to a greater volume of covered bonds issuance in the UK and a decline in the spread over German Pfandbriefe (in the range of 3-7 basis points).

¹ See CP 06/03 Annex 2 for the derivation of the 3.5%

² See CP 06/03 Annex 2 for a discussion of how firms react to changes in regulatory capital

- The increase in issuance volume and decrease in spreads is likely to lead to three welfare increases. First, conservative investors may be better able to diversify their portfolios. Second, the cost of capital for UK banks will fall, either increasing their profits or reducing the cost of capital to UK borrowers. Finally, a deeper and more liquid market will be less vulnerable to periodic liquidity shortages, implying a more stable source of mortgage funding.
- The preferential risk-weighting and considerably increased customer base may attract increased entry into the covered bond issuing market. Currently there are eight structured covered bond issuers in the UK. The largest barrier to the market is the ability to generate enough assets (cover pool) to meet the requirements of the covered bond asset class. Jumbo issuances (above 1 billion Euro) are the market norm. In the UK a small number of banks and building societies, around 10, could reasonably be expected to meet these minimum requirements.
- A requirement of the proposed regime is special public supervision and a condition of this will be independent third party verification that the structure meets these rules. This could be expected to improve the quality of the product. However, the existing UK structured covered bonds market is set up to mimic that of regimes which are able to apply a preferential risk-weighting. Consequently the products offered in the UK have had to be extremely competitive and constantly evolving in order to make up for the pricing difference between the markets.

Costs

We expect the FSA would incur costs in implementing and supervising the proposals. We estimate on-going costs of around £250,000 per year. The intention is to charge these costs directly to covered bond issuing firms as fees.

There will be additional on-going compliance costs for firms arising from reporting requirements, but we do not expect these to be large as issuers currently supply much of this information to third parties. The proposed regime also requires third party verification. But firms indicate this is unlikely to create incremental costs since rating agencies already require similar independent verification. To elaborate, rating agencies that deal with existing UK structured covered bonds require legal opinion (in an acceptable form) among other things: that the transaction documents are legal, valid, binding and enforceable; and that the assets have been effectively ring-fenced. These are the principal requirements of independent verification.

One concern is that higher issuance of covered bonds might increase the risk to issuers' unsecured creditors, in particular depositors, in the unlikely event of issuers' insolvency. The existence of the FSCS would spread this risk across depositors and firms that pay the FSCS levy. To address this issue 4% and 20% notification thresholds are proposed, which are intended to act as triggers for supervisors considering other forms of intervention to protect depositors by taking actions such as reviewing Pillar 2 capital requirements.

Industry has also indicated they will face costs of up to £2m in order upgrade their existing programmes.

IMPACT ON SMALL FIRMS

A small business is defined as a firm with up to 250 employees. We do not think a credit institution of this size will want to issue covered bonds, but there is no barrier in the legislation preventing them from doing so (provided they have sufficient assets).

IMPACT ON COMPETITION

It is anticipated that the proposed legislation will not have a significant impact on competition.

It will not directly or indirectly limit the number of issuers. Though branches of EEA registered credit institutions in the UK will not be permitted to issue Regulated Covered Bonds (due to concerns around supervision and enforcement), this is to be reviewed after one year. However, subsidiaries will continue to be able to issue structured covered bonds.

The proposal presently restricts the structure of Regulated Covered Bonds by not allowing for the use of an integrated model. However, no prospective issuers propose to use this model, and its suitability for inclusion will be reconsidered in one year.

In the interests of competition, the FSA has stated that all current structured covered bond programmes seeking to issue Regulated Covered Bonds will be recognised on the same date.

In addition, the regulation will not prevent issuers from innovating and developing current or future structured covered bonds programmes.

Specific Impact Tests - Checklist

Type of testing undertaken	Results in Evidence Base? (Y/N)	Results annexed? (Y/N)
Competition Assessment	Y	N
Small Firms Impact Test	Y	N
Legal Aid	N/A	N
Sustainable Development	N/A	N
Carbon Assessment	N/A	N
Other Environment	N/A	N
Health Impact Assessment	N/A	N
Race Equality	N/A	N
Disability Equality	N/A	N
Gender Equality	N/A	N
Human Rights	Y	N
Rural Proofing	N	N



STATUTORY INSTRUMENT

STATUTORY INSTRUMENTS

2008 No.

FINANCIAL SERVICES AND MARKETS

The Regulated Covered Bonds Regulations 2008

Made - - - - []th February 2008
Laid before Parliament []th February 2008
Coming into force - - 6th March 2008

The Treasury are a government department designated for the purposes of section 2(2) of the European Communities Act 1972(a) in relation to—

- (a) credit and financial institutions and the taking of deposits or other repayable funds from the public(b); and
- (b) measures relating to securities and rights in securities(c).

The Treasury, in exercise of the powers conferred by section 2(2) of that Act, make the following Regulations:

PART 1

INTRODUCTION

Citation, commencement and interpretation

1.—(1) These Regulations may be cited as the Regulated Covered Bonds Regulations 2008 and come into force on 6th March 2008.

(2) In these Regulations—

“the 1986 Act” means the Insolvency Act 1986(d);

“the 2006 Act” means the Companies Act 2006(e);

“the 1989 Order” means the Insolvency (Northern Ireland) Order 1989(f);

“the Act” means the Financial Services and Markets Act 2000(g);

“asset” means any property, right, entitlement or interest;

“asset pool” has the meaning given by regulation 3;

“the Authority” means the Financial Services Authority;

(a) 1972 c.68; section 2(2) was amended by the Legislative and Regulatory Reform Act 2006 (c. 51).

(b) S.I. 2001/3495.

(c) S.I. 2000/3057.

(d) 1986 c.45.

(e) 2006 c.46.

(f) S.I. 1989/2405 (N.I. 19).

(g) 2000 c.8.

“banking consolidation directive” means Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions(a);

“centre of main interests” has the same meaning as in Article 3(1) of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings(b);

“connected person” has the meaning given by regulation 5;

“covered bond” means a bond in relation to which the claims attaching to that bond are guaranteed to be paid by an owner from an asset pool it owns;

“eligible property” has the meaning given by regulation 2;

“hedging agreement” means an agreement entered into or asset held as protection against possible financial loss;

“issuer” means a person which issues a covered bond;

“owner” has the meaning given by regulation 4;

“programme” means issues, or series of issues, of covered bonds which have substantially similar terms and are subject to a framework contract or contracts;

“registered office” has the meaning given by section 287 of the Companies Act 1985(c) (registered office) until the coming into force of section 86 of the 2006 Act (a company’s registered office) when it will have the meaning given in that section;

“register of issuers” means the register maintained under regulation 7(1)(a);

“register of regulated covered bonds” means the register maintained under regulation 7(1)(b);

“regulated covered bond” means a covered bond or a programme of covered bonds, as the case may be, which is admitted to the register of regulated covered bonds;

“relevant asset pool” in relation to a regulated covered bond means the asset pool from which the claims attaching to that bond are guaranteed to be paid by the owner of that pool in the event of the failure of the issuer;

“relevant persons” has the meaning given by regulation 27(2);

“the Tribunal” means the Financial Services and Markets Tribunal established under section 132 of the Act (the Financial Services and Markets Tribunal).

(3) Unless otherwise defined, any expression used in these Regulations and in Article 22(4) of directive 85/611/EEC of the Council of 20 December 1985 relating to undertakings for collective investment in transferable securities(d) has the same meaning as in that Article of that Directive.

Eligible property

2.—(1) In these Regulations “eligible property” means any interest in—

- (a) eligible assets specified in and compliant with the requirements contained in paragraph 68 of Annex VI of the banking consolidation directive, provided that—
 - (i) exposures to a body qualifying for credit quality step 2 on the credit quality assessment scale set out in that Annex shall not be eligible property; and
 - (ii) senior units, issued by French Fonds Communs de Creances or by equivalent securitisation entities governed by the laws of the United Kingdom or an EEA state, securitising residential real estate or commercial real estate exposures may only be assessed as eligible assets if—
 - (aa) the residential real estate or commercial real estate exposures secured were originated or acquired by the issuer or a connected person; and

(a) O.J. No L 771, 30.6.2006, p.1.

(b) O.J. No. 160, 30.6.2000, p.1.

(c) 1985 c.6.

(d) O.J. No L 375, 31.12.85, p.3.

- (bb) the senior units have a credit assessment by a nominated external credit assessment institution which is the most favourable category of credit assessment made by that external credit assessment institution;
 - (b) loans to a registered social landlord or, in Northern Ireland, to a registered housing association where the loans are secured—
 - (i) over housing accommodation; or
 - (ii) by rental income from housing accommodation;
 - (c) loans to a person (“A”) which provides loans directly to a registered social landlord or, in Northern Ireland, to a registered housing association, where the loans to A are secured directly or indirectly—
 - (i) over housing accommodation; or
 - (ii) by rental income from housing accommodation;
 - (d) loans to a project company of a project which is a public-private partnership project where the loans are secured by payments made by a public body with step-in rights;
 - (e) loans to a person (“B”) which provides loans directly to a project company of a project which is a public-private partnership project where the loans to B are secured directly or indirectly by payments made by a public body with step-in rights.
- (2) Eligible property (and any relevant security) must be situated in an EEA state, Switzerland, the United States of America, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man.
- (3) In this regulation—
- “the 1996 Act” means the Housing Act 1996(a);
 - “the 2001 Act” means the Housing (Scotland) Act 2001(b);
 - “housing accommodation”—
 - (a) in England and Wales, has the meaning given by section 63 of the 1996 Act (minor modifications: Part 1);
 - (b) in Scotland, has the meaning given by section 111 of the 2001 Act (interpretation); and
 - (c) in Northern Ireland, has the meaning given by Article 2 of the Housing (Northern Ireland) Order 1981(c);
 - “project company” has the meaning given by paragraph 4H of Schedule A1 to the 1986 Act or, in Northern Ireland, paragraph 12 of Schedule A1 to the 1989 Order;
 - “public body” means a body which exercises public functions;
 - “public-private partnership project” has the meaning given by paragraph 4I of Schedule A1 to the 1986 Act or, in Northern Ireland, paragraph 13 of Schedule A1 to the 1989 Order;
 - “registered housing association” means a body registered as a housing association under Chapter II of Part II of the Housing (Northern Ireland) Order 1992(d);
 - “registered social landlord”—
 - (a) in England and Wales, means a body registered as a social landlord under Part 1 of the 1996 Act; and
 - (b) in Scotland, means a body registered as a social landlord under Part 3 of the 2001 Act;
 - “step-in rights” has the meaning given by paragraph 4J of Schedule A1 to the 1986 Act or, in Northern Ireland, paragraph 14 of Schedule A1 to the 1989 Order.
- (4) Unless otherwise defined, any expression used in this regulation and the banking consolidation directive has the same meaning as in that directive.

(a) 1996 c.52.
 (b) 2001 ASP 10.
 (c) S.I. 1981/156 (N.I. 3).
 (d) S.I. 1992/1725 (N.I. 15).

Asset Pool

3.—(1) Subject to paragraph (2), in these Regulations an “asset pool” comprises the following assets—

- (a) sums derived from the issue of regulated covered bonds and lent to the owner in accordance with regulation 16;
- (b) eligible property which is acquired by the owner using sums lent to it in accordance with regulation 22;
- (c) eligible property transferred to the asset pool by the issuer or a connected person to enable the issuer or owner, as the case may be, to comply with—
 - (i) the requirements specified in regulation 17(2);
 - (ii) a direction of the Authority under regulation 30; or
 - (iii) an order of the court under regulation 33;
- (d) eligible property transferred to the asset pool by the issuer or a connected person for the purpose of over collateralisation;
- (e) contracts relating to the asset pool or to a regulated covered bond;
- (f) eligible property acquired by the owner using sums derived from any of the assets referred to in sub-paragraph (b), (c), (d) or (e);
- (g) sums derived from any of the assets referred to in sub-paragraph (b), (c), (d), (e) or (f); and
- (h) sums lent by persons (other than the issuer) to the owner to enable it to comply with the requirements specified in regulation 24(1)(a).

(2) Any of the assets referred to in sub-paragraphs (a) to (f) and (h) of paragraph (1) may only form part of an asset pool at any time if they are recorded at that time, pursuant to arrangements made in accordance with regulation 17, 23 or 24, as being in that pool.

(3) In paragraph (1), “over collateralisation” means the provision of additional assets that assist the payment from the relevant asset pool of claims attaching to a regulated covered bond in the event of the failure of the issuer.

Owner

4. In these Regulations “owner” means a person which —

- (a) owns an asset pool; and
- (b) issues a guarantee to pay from that asset pool claims attaching to a regulated covered bond in the event of a failure of the issuer of that bond.

Connected person

5.—(1) In these Regulations “connected person” in relation to an issuer means a person which—

- (a) is—
 - (i) a parent undertaking of the issuer;
 - (ii) a subsidiary undertaking of the issuer; or
 - (iii) a subsidiary undertaking of a parent undertaking of the issuer;
- (b) has its registered office in the United Kingdom; and
- (c) either—
 - (i) has its centre of main interests in the United Kingdom; or

- (ii) is authorised under Part 4 of the Act (permission to carry on regulated activities) to carry on the regulated activity referred to in article 5 (accepting deposits) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001^(a).

(2) In paragraph (1) “parent undertaking” and “subsidiary undertaking” have the meanings given by section 1162 of the 2006 Act (parent and subsidiary undertakings).

PART 2

THE AUTHORITY

Functions of the Authority

- 6.**—(1) The Authority is to have the functions conferred on it by these Regulations.
- (2) The Authority’s general functions are—
- (a) its functions in relation to the giving of guidance under regulation 42; and
 - (b) its function of determining the general policy and principles by reference to which it performs particular functions under these Regulations.
- (3) In discharging its general functions the Authority must have regard to—
- (a) the need to preserve investor confidence in, and the desirability of maintaining the good reputation of, the regulated covered bonds sector in the United Kingdom by the issuance of high quality regulated covered bonds;
 - (b) the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
 - (c) the need to use its resources in the most efficient and economic way;
 - (d) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
 - (e) the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions;
 - (f) the desirability of facilitating competition in relation to regulated covered bonds.

PART 3

REGISTRATION

Registers

- 7.**—(1) The Authority must maintain—
- (a) a register of issuers; and
 - (b) a register of regulated covered bonds.
- (2) The Authority must publish the registers in such manner and at such times as it may determine.

Applications for registration

8. A person who proposes to issue a covered bond or a programme of covered bonds may apply to the Authority, in such manner as the Authority may direct—

^(a) S.I. 2001/544 as amended by the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002 (S.I. 2002/682).

- (a) for admission to the register of issuers; or
- (b) for the covered bond or the programme of covered bonds to be admitted to the register of regulated covered bonds.

Applications for admission to the register of issuers

9. Subject to regulation 11, the Authority must grant an application under regulation 8(a) if it is satisfied that the applicant—

- (a) has its registered office in the United Kingdom;
- (b) is authorised under Part 4 of the Act (permission to carry on regulated activities) to carry on the regulated activity referred to in article 5 (accepting deposits) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001;
- (c) will comply with the requirements imposed upon issuers by or under these Regulations; and
- (d) complies with any other requirements imposed by the Authority in relation to the application.

Applications for admission to the register of regulated covered bonds

10.—(1) The Authority may not entertain an application under regulation 8(b) in respect of a covered bond or programme of covered bonds unless it knows—

- (a) the identity of the owner of the relevant asset pool;
- (b) the assets intended to be included in that asset pool; and
- (c) the arrangements to be made under regulation 17.

(2) The Authority may grant an application under regulation 8(b) if it is satisfied that—

- (a) the applicant is an issuer which is admitted to the register of issuers;
- (b) the applicant and the owner of the relevant asset pool will comply with the requirements imposed upon them by or under these Regulations; and
- (c) the applicant complies with any other requirements imposed by the Authority in relation to the application.

Refusal of applications for registration

11. An application under regulation 8 may be refused if, for any reason relating to—

- (a) in the case of an application under regulation 8(a), the applicant; or
- (b) in the case of an application under regulation 8(b), the issuer, the owner of the relevant asset pool or the quality of that asset pool,

the Authority considers that granting it would be detrimental to the interests of investors in regulated covered bonds or to the maintenance of the good reputation of the regulated covered bond sector in the United Kingdom.

Applications: supplementary

12.—(1) The applicant must provide any information which the Authority requires in connection with an application under regulation 8 in such form, and verified in such manner, as the Authority may direct.

(2) At any time after receiving an application under regulation 8 and before determining it, the Authority may require the applicant to provide such further information as it reasonably considers necessary to enable it to determine the application.

(3) Different directions may be given, or requirements imposed, by the Authority with respect to different applications or categories of application.

Decision on the application

13.—(1) The Authority must notify the applicant of its decision on an application under regulation 8—

- (a) before the end of the period of six months beginning with the date on which the application is received; or
- (b) if within that period the Authority has required the applicant to provide further information in connection with the application, before the end of the period of six months beginning with the date on which that information is provided.

(2) The applicant may withdraw its application by giving the Authority written notice at any time before the Authority determines it.

(3) If the Authority decides to grant an application under regulation 8, it must give the applicant written notice of its decision.

(4) If the Authority proposes to refuse an application under regulation 8, it must give the applicant a warning notice.

(5) The Authority must, having considered any representations made in response to the warning notice—

- (a) if it decides to refuse the application under regulation 8, give the applicant a decision notice; or
- (b) if it grants the application, give the applicant written notice of its decision.

(6) If the Authority decides to refuse an application under regulation 8, the applicant may refer the matter to the Tribunal.

Admission to the registers

14.—(1) If the Authority decides to grant an application under regulation 8 it must, within seven days of the date on which it gave written notice under regulation 13(3) or (5)(b), admit—

- (a) the applicant to the register of issuers; or
- (b) the covered bond or the programme of covered bonds to the register of regulated covered bonds.

(2) The Authority may remove a regulated covered bond from the register of regulated covered bonds only after the expiry of the whole period of validity of that bond.

PART 4

ISSUERS

Acting without registration

15.—(1) A person may not issue, or purport to issue, a regulated covered bond unless—

- (a) it is admitted to the register of issuers; and
- (b) the bond is admitted to the register of regulated covered bonds.

(2) A person which has been removed from the register of issuers may not make any further issue under a programme of covered bonds which has been admitted to the register of regulated covered bonds.

(3) Contravention of the prohibition in paragraph (1) or (2) by a person is a contravention of a requirement imposed on it by these Regulations, but does not—

- (a) make any transaction void or unenforceable; or
- (b) give rise to any right of action for breach of statutory duty.

Sums derived from the issue of regulated covered bonds

16. An issuer must lend sums derived from the issue of a regulated covered bond to the owner of the relevant asset pool.

General requirements

17.—(1) An issuer of a regulated covered bond must enter into arrangements with the owner of the relevant asset pool for the maintenance and administration of that pool.

(2) The arrangements must provide for the following requirements—

- (a) a record is kept of each asset in the asset pool;
- (b) the asset pool is, during the whole period of validity of the regulated covered bond, capable of covering—
 - (i) claims attaching to the bond; and
 - (ii) sums required for the maintenance, administration and winding up of the asset pool;
- (c) there is timely payment of claims attaching to the bond to the regulated covered bond holder; and
- (d) the asset pool is of sufficient quality to give investors confidence that in the event of the failure of the issuer there will be a low risk of default in the timely payment by the owner of claims attaching to the bond.

(3) This regulation does not apply in the event of the insolvency of the issuer.

Notification requirements

18.—(1) An issuer must give the Authority such information in respect of—

- (a) any regulated covered bond it issues;
- (b) any series of covered bonds issued or proposed to be issued under a regulated covered bond;
- (c) the assets in the relevant asset pool;
- (d) the steps it has taken to comply with regulation 16 or 17;

as the Authority may direct.

(2) The issuer of a regulated covered bond must inform the Authority if at any time any of the requirements specified in regulation 17(2) are not, or are not likely to be, satisfied in respect of the relevant asset pool.

(3) The information required under paragraphs (1) and (2) must be given at such times, in such form and verified in such manner, as the Authority may direct.

Change of issuer

19.—(1) An issuer of a regulated covered bond may transfer the benefits and obligations accruing to or falling upon it under all contracts relating to the relevant asset pool to another person only if that person has been admitted to the register of issuers.

(2) Where a transfer takes place in accordance with paragraph (1), that person shall be an issuer of that regulated covered bond for the purposes of these Regulations.

Material changes to the regulated covered bond

20.—(1) Where an issuer of a regulated covered bond proposes to make a material change to the contractual terms of the bond, it must give the Authority such—

- (a) notice of the proposed change; and
- (b) information in respect of the proposed change;

as the Authority may direct.

(2) The information required under paragraph (1) must be given at such time, in such form and verified in such manner, as the Authority may direct.

(3) If it appears to the Authority that the proposed change will not prevent the issuer and owner of the relevant asset pool from continuing to comply with the requirements imposed on them by or under these Regulations, it must give the issuer written notice of its decision to approve the change before the end of a period of 3 months beginning with the date on which the information required under paragraph (1) is provided.

(4) If it appears to the Authority that the proposed change may prevent the issuer or the owner of the relevant asset pool from complying with the requirements imposed upon them by or under these Regulations, it may decide not to approve the change and give the issuer a decision notice.

(5) If the Authority proposes to give a decision notice under paragraph (4), it must give the issuer a warning notice before the end of a period of 3 months beginning with the date on which the information required under paragraph (1) is provided.

(6) The Authority must, having considered any representations made in response to the warning notice—

- (a) if it decides to do so, give a decision notice under paragraph (4); or
- (b) if it decides not to give a decision notice, give the issuer a notice of discontinuance and written notice of its decision to approve the change.

(7) If the Authority gives a decision notice under paragraph (4), the issuer may refer the matter to the Tribunal.

(8) The issuer may not make the proposed change before it has received a written notice from the Authority approving the change.

PART 5 OWNERS

Prohibition

21.—(1) A person may not be an owner unless it—

- (a) is a company or limited liability partnership; and
- (b) has its registered office and centre of main interests in the United Kingdom.

(2) Regulation 15(3) applies to a contravention of the prohibition in paragraph (1) as it applies to a contravention of the prohibition in regulation 15(1) or (2).

(3) In paragraph (1)—

“company” has the meaning given by section 1 of the 2006 Act (companies);

“limited liability partnership” has the meaning given by section 1 of the Limited Liability Partnerships Act 2000 (limited liability partnerships)(a).

Sums derived from the issue of regulated covered bonds

22.—(1) The owner of the relevant asset pool must—

- (a) use all sums lent to it by the issuer of a regulated covered bond to acquire eligible property; and
- (b) keep such property in the relevant asset pool.

(2) Until the owner uses the sums referred to in paragraph (1) to acquire eligible property, it must keep such sums in the relevant asset pool.

(a) 2000 c.12.

Requirements relating to the asset pool

23.—(1) The owner of the relevant asset pool must enter into arrangements with the issuer of a regulated covered bond for the maintenance and administration of the asset pool.

(2) The arrangements must provide for the requirements specified in regulation 17(2).

24.—(1) On the insolvency of the issuer of a regulated covered bond, the owner of the relevant asset pool must—

- (a) make arrangements for the maintenance and administration of the asset pool which provide for the following requirements—
 - (i) a record is kept of each asset in the asset pool;
 - (ii) the asset pool is capable of covering—
 - (aa) claims attaching to the bond; and
 - (bb) sums required for the maintenance, administration and winding up of the asset pool;
 - (iii) there is timely payment of claims attaching to the bond to the regulated covered bond holder;
- (b) give the Authority such information in respect of—
 - (i) the composition of the asset pool; and
 - (ii) the steps it has taken to comply with sub-paragraph (a);
as the Authority may direct; and
- (c) inform the Authority if at any time any of the requirements set out in sub-paragraph (a)(ii) or (iii) are not, or are not likely to be, satisfied.

(2) The information required under paragraph (1)(b) and (c) must be given at such times, in such form and verified in such manner, as the Authority may direct.

Change of owner

25.—(1) Where a regulated covered bond has been issued and the owner of the relevant asset pool proposes to transfer ownership of the asset pool and the benefits and obligations accruing to or falling upon it under all contracts relating to the asset pool to another person, it must make arrangements to give the Authority such—

- (a) notice of the proposed change of ownership; and
- (b) information in respect of the proposed new owner;

as the Authority may direct.

(2) The information required under paragraph (1) must be given at such time, in such form and verified in such manner, as the Authority may direct.

(3) If it appears to the Authority that the proposed owner will comply with the requirements imposed by arrangements made pursuant to regulation 23 or, as the case may be, 24(1)(a) it must give the owner written notice of its decision to approve the change before the end of a period of 3 months beginning with the date on which the information required under paragraph (1) is provided.

(4) If it appears to the Authority that the proposed owner will be unable to comply with any of those requirements it may decide not to approve the change and give the owner a decision notice.

(5) If the Authority proposes to give a decision notice under paragraph (4), it must give the owner a warning notice before the end of a period of 3 months beginning with the date on which the information required under paragraph (1) is provided.

(6) The Authority must, having considered any representations made in response to the warning notice—

- (a) if it decides to do so, give a decision notice under paragraph (4); or

- (b) if it decides not to give a decision notice, give the owner a notice of discontinuance and written notice of its decision to approve the change.

(7) If the Authority gives a decision notice under paragraph (4), the owner may refer the matter to the Tribunal.

(8) The owner may not transfer the asset pool to a proposed new owner before it has received a written notice from the Authority approving the change.

Transfer of title

26. Where an issuer of a regulated covered bond or a connected person holds any interest in an asset in the relevant asset pool on behalf of the owner, a liquidator or administrator appointed to wind up that issuer or connected person must, as soon as reasonably practicable, transfer or assist in the transfer of that interest to the owner.

PART 6

PRIORITY OF PAYMENT

Priority in a winding up

27.—(1) Subject to—

- (a) section 115 of the 1986 Act (expenses of voluntary winding up) or, in Northern Ireland, article 100 of the 1989 Order (expenses of voluntary winding up); and
- (b) the priority of the expenses of the winding up in a compulsory liquidation;

where an owner is wound up, the claims of relevant persons shall be paid from the relevant asset pool in priority to all other creditors.

(2) “Relevant persons” are—

- (a) regulated covered bond holders;
- (b) persons providing services for the benefit of those bond holders;
- (c) the counter-parties to hedging instruments which are incidental to the maintenance and administration of the asset pool or to the terms of the regulated covered bond; and
- (d) persons (other than the issuer) providing a loan to the owner to enable it to satisfy the claims of the persons mentioned in sub-paragraph (a), (b) or (c).

(3) The claims of the persons mentioned in paragraph (2)(b), (c) and (d) may rank equally with, but not in priority to, the claims of the persons mentioned in paragraph (2)(a).

Realisation of a charge

28.—(1) Subject to regulation 29, if—

- (a) any asset comprised in the asset pool is charged as security for claims in priority to any charge over that asset granted to secure the claims of relevant persons; and
- (b) the charge which has priority is realised at any time when the owner is not in the course of being wound up;

the proceeds of the realisation of that charge must, after payment of the expenses referred to in regulation 29 and any other expenses relating to that charge, be first applied to satisfy the claims of relevant persons at such time as those claims fall due for payment.

(2) Subject to regulation 29, if—

- (a) any asset comprised in the asset pool is charged as security for several claims;
- (b) any agreement between the creditors of that charge gives priority to the claims of any person above the claims of the relevant persons; and

(c) that charge is realised at any time when the owner is not in the course of being wound up; the proceeds of the realisation of that charge must, after payment of the expenses referred to in regulation 29 and any other expenses relating to that charge, be first applied to satisfy the claims of the relevant persons at such time as those claims fall due for payment.

Expenses

29.—(1) Costs properly incurred by a liquidator, provisional liquidator, administrator, administrative receiver, receiver or manager of the owner in relation to—

- (a) persons providing services for the benefit of regulated covered bond holders;
- (b) the counter-parties to hedging instruments which are incidental to the maintenance and administration of the asset pool or to the terms of the regulated covered bond; or
- (c) persons (other than the issuer) providing a loan to the owner to enable it to meet the claims of regulated covered bond holders or pay costs falling within sub-paragraph (a) or (b);

shall be expenses incurred in a winding up, administration, administrative receivership or receivership of the owner, as the case may be.

(2) Such expenses shall be payable out of—

- (a) the proceeds of the realisation of the charge, in the case of a receivership; or
- (b) the assets of the owner, in an administration, winding up or provisional liquidation,

and shall rank equally among themselves in priority to all other expenses.

PART 7

ENFORCEMENT

Authority's power to give directions

30.—(1) If it appears to the Authority that a person has failed, or is likely to fail, to comply with any requirement imposed on it by or under these Regulations, the Authority may direct that person to take specified steps for the purpose of securing its compliance with any such requirement.

(2) If it appears to the Authority that an owner has failed, or is likely to fail, to comply with any requirement imposed on it by or under these Regulations, the Authority may direct the winding up of that person.

(3) A direction under this regulation is enforceable, on the application of the Authority, by an injunction or, in Scotland, by an order for specific performance under section 45 of the Court of Session Act 1988^(a)(restoration of possession and specific performance).

Removal from the register

31.—(1) The Authority may remove an issuer from the register of issuers—

- (a) at the issuer's request;
- (b) with its consent; or
- (c) if it appears to the Authority that the issuer is failing, or has failed, to comply with any requirement imposed on it by or under these Regulations.

(2) But these Regulations (apart from regulation 15(2)) apply to a person which has been removed from the register of issuers as if it were still a person which is admitted to the register.

(a) 1988 c.36.

Directions and revocation: procedure

32.—(1) Before—

- (a) giving a direction under regulation 30; or
- (b) removing an issuer from the register of issuers under regulation 31(1)(c),

the Authority must give a warning notice to the person concerned.

(2) If, having considered any representations, the Authority decides to—

- (a) make the direction; or
- (b) remove the issuer from the register of issuers,

the Authority must give that person a decision notice.

(3) If the Authority decides not to—

- (a) make a direction; or
- (b) remove the issuer from the register of issuers,

it must give that person written notice of its decision.

(4) If the Authority decides to—

- (a) make a direction; or
- (b) remove the issuer from the register of issuers,

the person concerned may refer the matter to the Tribunal.

Powers of the court

33.—(1) If, on the application of the Authority, the court is satisfied that—

- (a) there is a reasonable likelihood that a person will contravene a requirement imposed on it by or under these Regulations; or
- (b) a person has contravened any such requirement and there is a reasonable likelihood that the contravention will continue or be repeated,

the court may make an order restraining (or in Scotland an interdict prohibiting) the contravention.

(2) If, on the application of the Authority, the court is satisfied that—

- (a) a person has contravened a requirement imposed on it by or under these Regulations; and
- (b) there are steps which could be taken for remedying the contravention;

the court may make an order requiring that person, and any other person who appears to have been knowingly concerned in the contravention, to take such steps as the court may direct to remedy it.

(3) The jurisdiction conferred by this regulation is exercisable by the High Court, the Court of Session and the Northern Ireland High Court.

(4) In paragraph (2), references to remedying a contravention include references to mitigating its effect.

Financial penalties

34.—(1) The Authority may impose a penalty of such amount as it considers appropriate on a person which has contravened a requirement imposed on it by or under these Regulations.

(2) A penalty imposed under this regulation is payable to the Authority.

(3) The Authority may not take action against a person under this regulation after the end of the period of two years beginning with the first day on which it knew of the contravention unless proceedings against that person, in respect of the contravention, were begun before the end of that period.

(4) For the purposes of paragraph (3)—

- (a) the Authority is to be treated as knowing of a contravention if it has information from which the contravention can reasonably be inferred; and
- (b) proceedings against a person in respect of a contravention are to be treated as begun when a warning notice is given to it under regulation 35.

35.—(1) Where the Authority proposes to impose a penalty under regulation 34, it must give the person concerned a warning notice.

(2) The warning notice must state the amount of the proposed penalty and the Authority’s reasons for imposing it.

(3) If, having considered any representations made in response to the warning notice, the Authority decides to impose a penalty under regulation 34, it must without delay give the person concerned a decision notice.

(4) The decision notice must state the amount of the penalty.

(5) If the Authority decides to impose a penalty on a person under regulation 34, that person may refer the matter to the Tribunal.

36. Sections 210 (statements of policy) and 211 (statements of policy: procedure) of the Act are to apply in respect of the imposition of penalties under these Regulations and the amount of such penalties as they apply in respect of the imposition of penalties under Part 14 of the Act (disciplinary measures) and the amount of penalties under that Part of that Act.

37. Paragraph 16 (penalties) of Schedule 1 to the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act but with the following modifications—

- (a) in sub-paragraph (1) for “this Act” substitute “the Regulated Covered Bonds Regulations 2008”;
- (b) in sub-paragraph (2) for “authorised persons” substitute “issuers (within the meaning given by regulation 1(2) of the Regulated Covered Bond Regulations 2008)”;
- (c) omit sub-paragraphs (3) and (13).

Offence of misleading the Authority

38.—(1) Subsections (1) and (3) of section 398 (misleading the Authority: residual cases) of the Act are to apply in respect of requirements imposed by or under these Regulations as they apply in respect of requirements imposed by or under the Act.

(2) Section 400 (offences by bodies corporate etc) and subsections (2), (3), (5) and (6) of section 401 (proceedings for offences) of the Act are to apply for the purposes of paragraph (1) as they apply for the purposes of the Act.

PART 8

THE TRIBUNAL

Functions of the Tribunal

39. The Tribunal is to have the functions conferred on it by these Regulations.

Hearings and appeals

40. Part 9 of the Act (hearings and appeals) is to apply for the purposes of these Regulations as it applies for the purposes of the Act.

PART 9

MISCELLANEOUS

Notification of the Commission

41. The Authority must, in such manner and at such times as it may determine, notify the European Commission of—

- (a) issuers included in the register of issuers;
- (b) regulated covered bonds included in the register of regulated covered bonds; and
- (c) the status of the guarantees offered in respect of such bonds.

Guidance

42.—(1) The Authority may give guidance consisting of such information and advice as it considers appropriate—

- (a) with respect to the operation of these Regulations;
- (b) with respect to any matters relating to functions of the Authority under these Regulations;
- (c) with respect to any other matters about which it appears to the Authority to be desirable to give information or advice.

(2) The Authority must give guidance consisting of information and advice about the quality of an asset pool for the purposes of the requirement specified in regulation 17(2)(d) and the manner in which it will assess the issuer's and owner's compliance with that requirement.

(3) Guidance given under paragraph (2) must include information and advice on the factors which the Authority will take into account, such as—

- (a) fluctuations in the value of assets and the income from assets;
- (b) fluctuations in the value of interest and exchange rates;
- (c) geographical concentration and diversification of assets in the asset pool;
- (d) the risk of loss if a person fails to perform its obligations, or fails to perform them in a timely manner; and
- (e) counterparty credit risk, in particular, in relation to any interest rate, currency or other hedging instruments relating to the asset pool.

(4) Subject to paragraph (5), if the Authority proposes to give guidance under this regulation to issuers or owners generally, or to a class of issuer or owner, subsections (1), (2)(d) and (4) of section 155 of the Act (consultation) apply to the proposed guidance as they apply to proposed rules made under the Act, unless the Authority considers that the delay in complying with them would be prejudicial to the interests of regulated covered bond holders.

(5) Paragraph (4) shall not apply to the first guidance given pursuant to paragraph (2).

(6) The Authority may—

- (a) publish its guidance;
- (b) offer copies of its published guidance for sale at a reasonable price; and
- (c) if it gives guidance in response to a request made by any person, make a reasonable charge for that guidance.

Disclosure of information

43.—(1) Sections 348 (restrictions on disclosure of confidential information by Authority), 349 (exceptions from section 348) and 352 (offences) of the Act apply to confidential information disclosed under these Regulations as they apply to confidential information under the Act.

(2) In paragraph (1) “confidential information” has the meaning given by section 348 of the Act.

Warning notices and decision notices

44. Part 26 of the Act (notices) is to apply for the purposes of these Regulations as it applies for the purposes of the Act.

Authority's exemption from liability in damages

45. The functions of the Authority under these Regulations are to be treated for the purposes of paragraph 19 (exemption from liability in damages) of Part 4 of Schedule 1 to the Act as functions conferred on the Authority under that Act.

Modifications of primary and secondary legislation

46. The Schedule (which modifies primary and secondary legislation) has effect.

[] February 2008

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Two of the Lords Commissioners of Her Majesty's Treasury

SCHEDULE

Regulation 46

MODIFICATIONS TO PRIMARY AND SECONDARY LEGISLATION

PART 1

PRIMARY LEGISLATION

Modification of the Companies Act 1985

1. Section 196 (payment of debts out of assets subject to floating charge (England and Wales)) of the Companies Act 1985 shall not apply to an owner.

Modifications of the 1986 Act

2.—(1) Sections 40 (payment of debts out of assets subject to floating charge) and 43 (power to dispose of charged property) of the 1986 Act shall not apply to an owner.

(2) Section 107 of the 1986 Act (distribution of company's property) shall apply only after payment has been made of the claims of relevant persons.

(3) Section 156 of the 1986 Act (payment of expenses of winding up) shall apply only after payment has been made of the expenses referred to in regulation 29.

(4) Section 175 (preferential debts (general provision)) and 176A (share of assets for unsecured creditors) of the 1986 Act shall not apply to an owner.

(5) Paragraphs 65(1) and 66 of Schedule B1 (distributions) to the 1986 Act shall apply only after payment has been made of the claims of relevant persons.

Modifications of the Act

3. Section 165 (Authority's power to require information) of the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act but with the modification that for references to "an authorised person" there is substituted references to "a person to whom the Regulated Covered Bonds Regulations 2008 apply".

4. Section 166 (reports by skilled persons) of the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act but with the modification that for the reference in subsection (2)(a) to “an authorised person” there is substituted a reference to “a person to whom the Regulated Covered Bond Regulations 2008 apply”.

5. Paragraph 17 (fees) of Part 3 of Schedule 1 to the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act, but with the following modifications—

- (a) in sub-paragraph (1), omit paragraphs (b) and (c);
- (b) for the reference in sub-paragraph (2) to “penalties imposed by it under this Act” there is substituted a reference to “penalties imposed by it under the Regulated Covered Bonds Regulations 2008”; and
- (c) omit sub-paragraph (3).

Modification of the 2006 Act

6. Where an owner is wound up, section 754 of the 2006 Act (priorities where debentures secured by floating charge) shall apply only after payment has been made of the claims of relevant persons.

PART 2

SECONDARY LEGISLATION

Modifications of the Insolvency Rules 1986

7.—(1) Rule 4.181(1) of the Insolvency Rules 1986(a) (debts of insolvent company to rank equally) shall apply only after payment has been made of the claims of relevant persons.

(2) Rules 2.67, 4.218 and 4.219 of the Insolvency Rules 1986 (priority of expenses) shall apply to an owner subject to the provisions of regulation 29.

Modification to the Insolvency (Scotland) Rules 1986

8. Rule 4.67 of the Insolvency (Scotland) Rules 1986(b) (order of priority of expenses of liquidation) shall apply to an owner subject to the provisions of regulation 29.

Modifications of the 1989 Order

9.—(1) Article 50 (payment of debts out of assets subject to floating charge) of the 1989 Order shall not apply to an owner.

(2) Where regulation 27 or 28 applies—

- (a) article 93 of and paragraphs 66(1) and 67 of Schedule B1 to the 1989 Order (distribution of company’s property) shall apply only after payment has been made of the claims of relevant persons;
- (b) article 134 of the 1989 Order (payment of expenses) shall apply only after payment has been made of the expenses referred to in regulation 29; and
- (c) articles 149 (preferential debts (general provision)) and 150A (share of assets for unsecured creditors) of the 1989 Order shall not apply.

(a) S.I. 1986/1925.

(b) S.I. 1986/1915 (S 139).

Modifications of the Insolvency Rules (Northern Ireland) 1991

10.—(1) Rule 4.190(1) of the Insolvency Rules (Northern Ireland) 1991(a) (debts of insolvent company to rank equally) shall apply only after payment has been made of the claims of relevant persons.

(2) Rules 2.068, 4.228 and 4.229 of the Insolvency Rules (Northern Ireland) 1991 (priority of expenses) shall apply to an owner subject to the provisions of regulation 29.

Modification of the Cross-Border Insolvency Regulations 2006

11. The Cross-Border Insolvency Regulations 2006(b) shall not apply to an owner.

Modification of the Cross-Border Insolvency (Northern Ireland) Regulations 2007

12. The Cross-Border Insolvency (Northern Ireland) Regulations 2007(c) shall not apply to an owner.

EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations provide a new legislative framework for covered bonds in the UK. The Regulations implement Article 22(4) of Council Directive 85/611/EC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (“UCITS Directive”) (as inserted by Directive 2001/108/EC of 21 January 2002); Article 22(4) of Council Directive 92/49/EC of 18 June 1992 on the co-ordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance (“Third Non-Life Directive”); and Article 24(4) of Directive 2002/83/EC of the European Parliament and of the Council concerning life assurance (“Consolidated Life Directive”). The relevant requirements of the UCITS Directive, the Third Non-Life Directive and the Consolidated Life Directive are in the same terms. These Regulations also implement paragraph 68 of Annex 6 to Directive 2006/48/EEC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (“the Banking Consolidation Directive”).

A covered bond is a class of corporate bond, issued by credit institutions and backed by certain assets, normally mortgages or public sector loans. Interest and repayments of principal is payable out of ring-fenced assets (“an asset pool”) backing the bond. Covered bonds that comply with the UCITS Directive (and equivalent requirements in the other Directives referred to above) benefit from higher prudential investment limits under the UCITS Directive and lower risk weights under the Banking Consolidation Directive.

The Regulations establish a new regime supervised by the Financial Services Authority (the Authority) and take account of UK practice in relation to covered bonds. In the UK, covered bonds are issued by credit institutions. The issuer lends the sums derived from the bonds to a separate legal entity owned by another person (“the owner”). The owner uses the sums to purchase property which it holds in an asset pool. The owner agrees to guarantee the issuer’s obligations to the covered bond holders. The loan is repaid once the bond holders’ claims to the principal and accrued interest have been met.

Part 1 of the Regulations provides definitions. Part 2 sets out the functions of the Authority and provides for it to have regard to certain considerations, including the need to preserve investor confidence in regulated covered bonds in the UK. Part 3 requires the Authority to maintain a

(a) S R. 1991 No.364.

(b) S.I. 2006/1030.

(c) S.R. 2007 No. 115.

register of issuers and a register of regulated covered bonds and sets out the registration process. Part 4 imposes requirements on issuers and Part 5 imposes requirements on owners. In particular, the issuer and the owner must make arrangements for the maintenance and administration of the asset pool so that the claims of bond holders and other specified parties may be met. Part 6 establishes that regulated covered bond holders and other specified persons must be paid in priority to all other creditors, after the payment of expenses of the receivership or winding up etc. Part 6 also provides for certain expenses incurred by a receiver or liquidator etc. to rank above the payment of all other expenses. Part 7 sets out the enforcement powers of the Authority and the Courts. Part 8 confers functions on the Financial Services and Markets Act Tribunal and Part 9 (and Schedule 1) contain provision for notification of the European Commission, guidance to be issued by the Authority and various modifications of primary and secondary legislation.

A Transposition Table setting out how the elements of the above Directives will be transposed into UK law is available from the Financial Stability and Regulatory Policy Team, HM Treasury, 1 Horseguards Road, London, SW1A 2HQ. The Transposition Table is also available on HM Treasury's website (www.hm-treasury.gov.uk).

A Regulatory Impact Assessment has been produced for this instrument and has been deposited in both Houses of Parliament. It is available either at the above address or on HM Treasury's website.

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