

Proposals for a UK Recognised Covered Bonds legislative framework

July 2007



HM TREASURY





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EXECUTIVE SUMMARY

The Treasury is consulting on a proposed new legislative framework for covered bonds in the UK. At the same time the FSA is consulting on its proposed principles based implementation of the regime and its accompanying guidance. These proposals will allow UK-issued covered bonds to benefit from options on EU directives which will increase their attractiveness to investors which should enhance and deepen the market.

A covered bond is a class of corporate bond, generally issued by banks and backed by certain assets, generally mortgages or public sector loans. In other words, they are a secured loan made to the issuer. The interest of the bond and the repayment of the principal is 'guaranteed' by the ring-fenced assets backing the bond. Thus covered bonds are viewed as high quality debt and will often achieve high credit ratings.

The EU has established criteria for covered bonds which meet strict quality criteria. These criteria are prescribed in Council Directive 85/611/EC on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ('the UCITS directive').

Covered bonds that comply with the UCITS directive benefit from higher prudential investment limits. UCITS can invest up to 25 % (rather than 5%) of their assets in the compliant covered bonds of one issuer. The limit for insurance undertakings is 40%. According to the Capital Requirements directive, covered bonds will benefit from a preferential credit risk weighting if they are (amongst other things) UCITS compliant.

Currently, there is no UK legislative framework for covered bonds. 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. Since 2003, covered bonds (known as structured covered bonds) have been issued in the UK backed largely by local authority and mortgage assets. These covered bonds have the key feature that the assets to be used to meet the claims of the bondholders are transferred to a different legal person (a Special Purpose Vehicle). HM Treasury believes it is both important and appropriate for UK issuers to be able to compete on a level playing field within the EU open market. We have therefore developed, in close consultation with FSA and industry, a legislative framework for UK recognised covered bonds.

The legislative framework is designed to provide the necessary underpinning for UCITS 22(4) compliance. It provides a principles based and outcomes focussed framework with the necessary legal requirements for the regime and its regulation. It will be supported by FSA regulation with the necessary guidance (also contained in this consultation document) and also the underlying bond contracts themselves. We believe this approach will deliver a legislative regime which is flexible enough to permit product development and market innovation, enhancing competition within the market and market growth while at the same time providing robust bondholder protection.

The legislative proposals contained in this consultation provide for the 5 requirements of the UCITS directive in UK law:

- the issuer must be a credit institution with its registered office in the UK;
- UK recognised covered bonds will be regulated by the FSA with particular regard to the protection of bondholders;
- the bonds will be supported by an asset pool containing (amongst other things) the sums raised by the issue of the bonds or eligible property of an equivalent value;
- the asset pool must have sufficient collateral to cover bondholder claims throughout the whole term of the covered bond; and
- in the event of the issuer's insolvency, bondholders have a priority claim on those assets.

The consultation period will run for 12 weeks from 23 July 2007 until 15 October 2007. Comments are invited on the proposals generally and the specific questions posed in this document.

HM Treasury expects to be able to present the final regulations to Parliament in Q4 2007 so that the new regime can come in to force on 1 January 2008

INTRODUCTION

What are covered bonds? 1.1 Covered bonds are a class of corporate bond, generally issued by banks and backed by certain assets, generally mortgages or public sector loans. In other words, they are a secured loan made to the issuer. The interest of the bond and the repayment of the principal is 'guaranteed' by the ring-fenced assets backing the bond. Thus covered bonds are viewed as high quality debt and will often achieve high credit ratings.

EU legislation 1.2 The EU has established strict quality criteria for covered bonds. These criteria are prescribed in Council Directive 85/611/EC¹ on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ('the UCITS directive').

1.3 Article 22(1) of the UCITS directive provides that a UCITS may invest no more than 5% of its assets in transferable securities (including bonds) issued by the same body. Article 22 (3) gives Member States the option to raise that 5% limit to 35% where bonds issued or guaranteed by governments are concerned.

1.4 Article 22 (4) ('UCITS 22 (4)') contains a similar option for covered bonds, providing:

'Member states may raise the 5% limit laid down in the first sentence of paragraph 1 to a maximum of 25% in the case of certain bonds where these are issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principle and payment of accrued interest.'

1.5 In April 2003, Commission Services identified the essence of EU covered bonds:²

'For covered bonds, the content of the contract between issuers and bondholders is largely set by law (the legal criteria for the eligibility of assets as collateral, requirement for bonds to be fully secured) and private enforcement is replaced by supervisory enforcement (restriction of issuers to EU credit institutions, special public supervision)'

1.6 Broadly speaking, this means a covered bond must be issued by a credit institution, have an asset pool covering the bonds which contains eligible assets and be ring-fenced from the assets of the issuer on its insolvency. Additionally, the bonds must be subject to special public supervision (which is regarded throughout the EU as regulation) which is specifically designed to protect the bondholder. The key element of a UCITS 22(4) covered bond is discussed in more details in Chapter 2.

1.7 In addition to the limits for investment by UCITS being raised for compliant covered bonds, insurance undertakings are permitted to invest up to 40% (instead of the maximum of 5%) of their assets in UCITS compliant covered bonds of the same

¹ As amended by Council Directive 2001/108/EC of 21 January 2002

² Working Paper of the Commission Services on the Treatment of Covered Bonds, 7 April 2003, p4

issuer.³ According to the Banking Consolidation Directive (BCD)⁴, covered bonds will also benefit from a preferential credit risk weighting if (amongst other things) they are UCITS compliant. Thus issuers of compliant covered bonds have access to a larger investor base within the EU.

EU market 1.8 Covered bonds are issued by a variety of corporate and institutional borrowers in the EU, especially in Germany, Denmark, Sweden, France and Spain. The value of the existing covered bonds in the EU at the end of 2005 was €1.8 trillion, backed largely by local authority and mortgage assets.⁵

1.9 Covered bonds play a significant role in European capital markets and in the funding of mortgage and sovereign lending in Europe. Covered bonds offer a number of benefits to the macro economy, business and investors they:

- promote cost-effective long-term investment activity, bringing greater stability and certainty to business borrowing decisions, while promoting greater efficiency in capital markets by adding investment choice and diversity;
- enable more efficient management of funding maturity. This means that banks can more easily match borrowing to lending commitments (which is helpful for the development of a longer term fixed rate mortgage market);
- increase liquidity and diversification for borrowing and investment;
- provide funding stability as borrowers are not subject to sudden, unexpected demands to repay loans and do not have to refinance their borrowings; and
- provide cheaper funding, because of their greater security commercial issuers can potentially borrow at rates very close to those paid by governments.

Existing UK arrangements 1.10 At present, there is no legislative framework for covered bonds in the UK. David Miles in his report to HM Treasury on long-term mortgage market stability in 2004⁶, listed the absence of a formal UK regime as a factor restricting the development of long-term fixed rate mortgage lending.

1.11 Since 2003, covered bonds (known as structured covered bonds) have been issued in the UK. The value of the existing covered bonds in the UK at the end of 2005 was €2.5 billion, again backed largely by local authority and mortgage assets.⁷

1.12 Existing UK covered bonds broadly follow one structure with the key feature that the assets to be used to meet the claims of the bondholders are transferred to a different legal person (an SPV).

³ Directives 92/96/EEC and 92/49/EEC

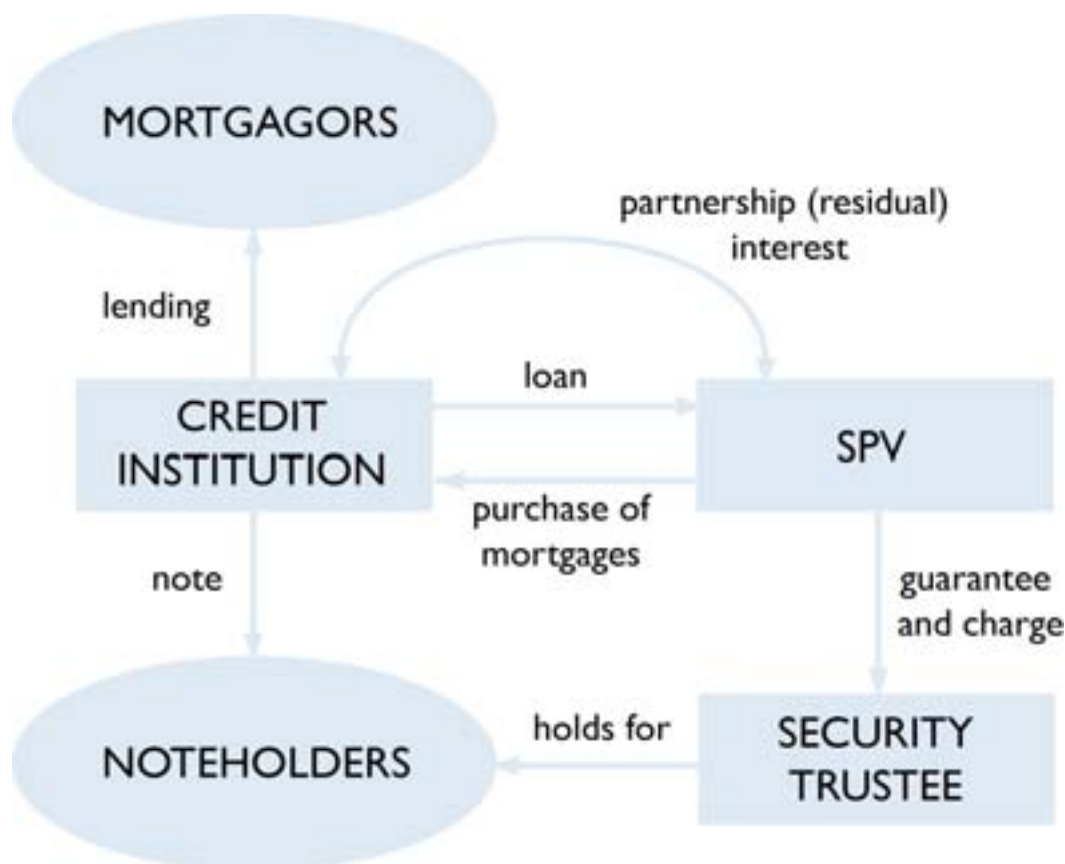
⁴ Directive 2006/48/EC

⁵ European Covered Bond Council, European Covered Bonds Fact Book, August 2006

⁶ David Miles The UK Mortgage Market: Taking a Longer-Term View. Final Report and Recommendations. (March 2004).

⁷ European Covered Bond Council, European Covered Bonds Fact Book, August 2006

1.13 At its simplest, (where bond issuance and mortgage origination both take place within the same legal entity), the covered bonds arrangements are as follows leading to a new special purpose vehicle (SPV) being established:



1.14 To date, all SPVs have been established as limited liability partnerships (under the Limited Liability Partnerships Act 2000), with the issuer being a member of that partnership.

1.15 The covered bond is issued by a credit institution. The issuer applies the proceeds of the covered bond issue to make a loan to the SPV. The SPV uses the proceeds of the loan to purchase a portfolio of mortgage assets from the issuer.

1.16 The aggregate outstanding principal balance of the mortgage assets sold to the SPV by the issuer is greater than the aggregate principal amount outstanding of the covered bonds and hence the loan made to the SPV. This difference constitutes the “over-collateralisation” in the mortgage pool sold to the SPV. The amount of over collateralisation in a mortgage portfolio held by an SPV is driven by the quality of the mortgage portfolio and the desired ratings of the covered bonds.

1.17 The over-collateralisation is ‘paid for’ by the SPV by the grant of the capital (or “membership”) interest of the issuer in the SPV. The issuer is also entitled to deferred consideration from the excess revenue receipts in the SPV.

1.18 The sale of the mortgage assets to the SPV is structured as a “true sale” i.e. once sold to the SPV, neither a creditor, administrator or liquidator would be able successfully to claim the transferred assets back.

1.19 In consideration of the loan from the issuer, the SPV grants a guarantee in favour of the trustee for the covered bondholders, in respect of the issuer's obligations under the covered bonds. This guarantee is secured over all the assets of the SPV.

1.20 In the event that the issuer defaults in respect of its obligations under the covered bonds, then notice to pay will be served on the SPV, and the SPV will be obliged to make payments of scheduled interest and scheduled principal under the covered bonds to the covered bondholders. These payments will be funded from the monies received by the SPV from time to time on the mortgage assets, and from the sale of those mortgage assets.

1.21 During the life of the covered bond, the SPV is obliged to maintain the pool of mortgage assets in an amount that will cover the claims of Covered Bondholders. Asset coverage is tested on a monthly basis. The SPV uses principal receipts on the Covered Bonds to acquire more mortgage assets or other eligible assets from the issuer, and the issuer is expected to sell mortgage assets to the SPV on a continuing basis, to ensure that there is sufficient asset coverage.

1.22 UK covered bonds are based on well-accepted market standards and benefit from a high level of legal certainty. The lack of a legislative framework providing special public supervision, however, means UK covered bonds do not comply with UCITs 22(4) and thus cannot have the benefit of higher investment thresholds and more favourable risk weighting under UCITS and BCD.

1.23 HM Treasury believes it is both important and appropriate for UK issuers to be able to compete on a level playing field within the EU open market. We have therefore developed, in close consultation with FSA and industry, a proposed legislative framework for UK recognised covered bonds.

1.24 The legislative framework is designed to provide the necessary underpinning for UCITS 22(4) compliance. It is not designed to prescribe the complete design and contractual arrangements for the product. Other Member States have adopted an approach where the asset pool is a part of the issuer, but ring fenced by legislative provisions. We would like to cater for this integrated approach, albeit by adopting a less prescriptive model than exists in many other Member States. The legislation provides a principles based and outcomes focussed framework with the necessary legal requirements for the regime and its special public supervision. The regime will be supervised by the FSA's principles based regulation which will be supported by guidance (also contained in this consultation document).

1.25 The regulations will apply to Scotland and Northern Ireland and will reflect the same policy objectives described in this consultation document. We recognise that some further adaptations are required to the draft regulations to fully reflect the legal position in Scotland, and these will be made during the consultation period. Likewise the regulations do not currently include provisions which specifically cater for the legal positions in Northern Ireland and this is a matter which we shall resolve with our colleagues in Northern Ireland during the consultation period.

1.26 We believe this approach will deliver a legislative regime which is flexible enough to permit product development and market innovation (should the market so wish), competition within the market and market growth while at the same time providing robust bondholder protection.

	1.27	This consultation contains HM Treasury's and FSA's proposals for the regime.
Chapter 2		Sets out HM Treasury's legislative proposals
Chapter 3		Sets out FSA's principles based approach to the implementation of the regime.
Chapter 4		Sets out the partial Impact Assessment for the proposals
Annex A		Sets out the draft statutory instrument
Annex B		Sets out the recognition process
Annex C		Sets out the recognition application form
Annex D		Sets out the draft handbook text

1.28 This consultation document should be read in conjunction with the partial Impact Assessment which lays out implementation options and considers qualitative and where possible quantitative costs and benefits for these options. A copy of the Partial Impact Assessment can be found on HMT's website (www.hm-treasury.gov.uk) or requested from HM Treasury's Correspondence and Enquiries Unit (Tel.: 020 7270 4558).

1.29 HM Treasury and FSA invite views on the questions posed in this paper. HM Treasury and FSA also invite comments more generally on any of the proposals in this consultation, the drafting of the proposed statutory instrument, the drafting of the proposed guidance and the Partial IA.

HOW TO RESPOND

1.30 The consultation period will begin on 23 July 2007 and run for 12 weeks until 15 October 2007. Please ensure that your response reaches us by that date. Please send responses to this consultation document to:

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 London SW1A 2HQ

Tel: (+44) (0) 207 270 4381
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1.31 When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents, and where applicable, how the views of members were assembled.

CONFIDENTIALITY

1.32 All responses will be shared with FSA. All written responses may be made public on HM Treasury's website unless the author specifically requests otherwise in writing. In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of e-mails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response.

1.33 Even where confidentiality is requested, if a request for disclosure of the consultation response is made in accordance with the freedom of information legislation, and the response is not covered by one of the exemptions in the legislation, the Government will have to disclose the response in whole or in part.

1.34 Subject to the previous paragraphs, if you wish part (but not all) of your response to remain confidential, please supply two versions – one for publication on the website with the confidential information deleted, and another confidential version for the Treasury and FSA.

2

PROPOSALS FOR THE LEGISLATIVE FRAMEWORK

UCITS requirements

- 2.1** Article 22(4) of the UCITS directive sets out 5 defining features of covered bonds:
1. the issuer must be a credit institution which has its registered office in a Member State;
 2. the issuance of covered bonds must be subject by law to special public supervision designed to protect bondholders;
 3. the bonds are supported by an asset pool with specified assets, in particular the sums raised by the issue of the covered bonds can only be invested in eligible assets as prescribed by law;
 4. bondholders claims against the issuer must be fully secured by sufficient collateral to cover bondholder claims throughout the whole term of the covered bond; and
 5. in the event of the issuer's insolvency, bondholders have a priority claim on those assets.

THE ISSUER MUST BE A CREDIT INSTITUTION WHICH HAS ITS REGISTERED OFFICE IN A MEMBER STATE

2.2 A credit institution is defined at Article 4(1) of the BCD (in so far as relevant) as 'An undertaking whose business is to receive deposits or other repayable fund from the public and to grant credits for its own account.'

2.3 Under this definition, the undertaking must engage in both liabilities side and assets side operations. In some Member States, only certain types of credit institution, generally credit institutions whose primary or sole business is mortgage lending, are permitted to issue covered bonds. While some credit institutions in the UK have larger mortgage books than others, UK undertakings offer a range of services. The definition of a credit institution within the directives is a broad one and we do not propose to restrict that definition within our legal framework. It will therefore be open to any type of credit institution to issue covered bonds.

2.4 As well as being a credit institution, to issue a covered bond under the European framework, an undertaking must have a registered office in an EEA state.⁸ Other Member States have restricted that requirement to the undertaking having a registered office in that Member State. We think this approach is driven largely by the need to ensure the enforcement of the regime is robust.

2.5 As a starting point, we consider it preferable to require an issuer, or indeed an owner to have a registered office in an EEA state. We do not, however, want to compromise the integrity of the regime. In the absence of co-operation procedures in the UCITS Directive relevant to covered bonds, we need to be assured that the regime

⁸ The Financial Services and Markets Act 2000 speaks in terms of EEA States. "EEA State" is defined as "a State which is a contracting party to the agreement on the European Economic Area signed at Oporto on 2 May 1992 as it has effect for the time being" (paragraph 8 of Schedule 3, Part II FSMA).

can be enforced against EEA issuers owners and that UK insolvency law (including our proposed modifications as to priority) can apply. We are still considering the various issues and will conclude our analysis during the consultation period.

2.6 Regulation 6(2) presently provides that anyone wishing to be a recognised issuer must be a credit institution with a registered office in the UK. Unless we satisfy ourselves that robust enforcement can be delivered to an issuer with a registered office in an EEA state we propose to retain that limit on the implementation of the Directive within our regime.

Do you agree in the first case, subject to the other requirements of the regime, that any credit institution with its registered office in UK should be able to issue UK Recognised Covered Bonds?

Do you agree that the location of the registered office of the issuing credit institution should be broadened if enforcement will be deliverable?

What are your views on possible obstacles to the integrity of the enforcement regime?

THE ISSUANCE OF COVERED BONDS MUST BE SUBJECT BY LAW TO SPECIAL PUBLIC SUPERVISION DESIGNED TO PROTECT BONDHOLDERS

2.7 Given that credit institutions are already subject to general public supervision under the BCD, the Treasury considers that the intention of UCITS 22(4) is for the special public supervision designed to protect bondholders to be additional to that required by the BCD. Further, it appears from various different language translations of the article and the approach taken by other Member States, that there needs to be specific legislation setting out the arrangements for special public supervision of the bonds which is specifically designed to protect bondholders rather than consumers generally. We have therefore considered the level of detail that needs to be contained in Treasury legislation and what can and should be left to FSA guidance.

2.8 In order to establish the regime as quickly as possible, HM Treasury is proposing a legislative framework that will be introduced using Government's powers under section 2(2) of the European Communities act 1972. Given the restrictions on the powers of sub-delegation contained at Schedule 2 of the European Communities Act 1972 it is necessary for the overarching principles and, framework (including enforcement) of the regime to be contained in Treasury legislation made under section 2(2) of the European Communities Act 1972.

The approach of the framework

General approach **2.9** The framework for the special public supervision is prescribed in the proposed legislation. We have taken a principles based approach and have not adopted a prescriptive regime.

2.10 UCITS 22(4) focuses on assets, how they should be treated and what that treatment needs to achieve. In particular, it envisages the ring fencing of the assets from the general insolvency of the issuer but does not prescribe the means of achieving that outcome. There appear broadly to be two approaches to this issue within the EU: either the assets continue to be owned by the issuer and ring fenced by legislation (the integrated model); or the assets are transferred to an owner other than the issuer (the

SPV model). Under the existing UK issues, a person other than the issuer, typically a special purpose vehicle owns the assets backing the bond. These structures are based on robust and recognised legal principles and we believe that the legislation should support such an arrangement.

2.11 In addition, as Treasury's aim is to provide choice and flexibility for the future we have included a form of integrated model within the legislation so that industry participants may decide which structure best suits their particular circumstances. Our approach has been principles based so the integrated model does not reflect the prescriptive approach taken in some other Member States. Instead, it will be for those industry participants who adopt this option, to use the legislative framework as a starting point and develop their own contractual provisions which will support the legislative underpinning. Our proposals are designed to provide the overarching principles for both situations. We believe this will provide a flexible regime which gives the market room to develop while not prescribing the specific courses any issuer must take.

2.12 A key distinguishing feature of the UCITS-compliant covered bond market is the high quality of the bonds which are widely viewed as low risk and as being comparable with government debt. This is shown by the fact that within the EU, UCITS-compliant covered bonds are generally rated AAA or AA. There are no explicit requirements in the Directives for the covered bonds to achieve a particular level of quality. We think it is however implicit in the requirements of the UCITS directive and the benefits which attach to compliant bonds (see paragraphs 1.4 and 1.7) that compliant bonds are of good quality. The existing UK covered bonds are all rated AAA.

2.13 Within our flexible approach to delivering robust bondholder protection, the draft regulations do not impose detailed qualitative criteria on the asset pool. Ways of doing this might include setting the minimum level of over collateralisation and the loan to value (LTV) ratios for any mortgages in the pool. While our expectation is that UK Recognised Covered Bonds will be of a very high quality, our preference is not to be prescriptive in this regard. However, we would welcome views on whether the proposed legislative framework should have some prescription as to the quality of UK Recognised Covered Bonds.

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 mortgages?

Do you agree with our general approach?

Special public supervision

2.14 It is clear that special public supervision needs to attach to the assets backing the bond and their sufficiency. As a starting point, the special public supervision needs to capture the issuer and ensure any necessary topping up of the asset pool takes place. It also needs to attach to both the issuer and the owner of the asset pool especially if they are different people.

2.15 Our legislative proposals, taking the lead from the UCITS 22(4) approach, therefore focus on the asset pool (with obligations relating to it always attaching to at least one person, generally the issuer and the owner of the asset pool).

2.16 The FSA's role will be to recognise issuers and suitable covered bonds, to enforce the regime and provide guidance as to its operation.

2.17 In accordance with the directive,⁹ the FSA will be required to maintain a register of UK Recognised Covered Bond issuers and their UK Recognised Covered Bonds programmes. Only those issuers and programmes on the FSA's register will be UK Recognised Covered Bonds.

2.18 The FSA will be required to notify the Commission of:

- UK Recognised Covered Bond programmes issued under UK legislation;
- issuers admitted to the register of UK Recognised Covered Bond issues; and
- the status of guarantees offered.

2.19 The process for admittance to the register of UK Recognised Covered Bond issuers and UK Recognised Covered Bonds will be a recognition process rather than the more onerous authorisation process. It will be necessary for an issuer to apply to the FSA for admission to the register of UK Recognised Covered Bond issuers in such manner as required by the FSA (the details of this proposed process are at x).

2.20 The regulations set out the minimum criteria for admission to the register of UK Recognised Covered Bond issuers. An applicant must be a credit institution which is authorized in the UK¹⁰ to carry on regulated activities and both the issuer and the proposed owner of the asset pool must satisfy:

- the requirements imposed upon a UK Recognised Covered Bond issuer and owner by the Regulations; and
- any other requirements imposed by the FSA in relation to the application.

2.21 The procedures for decision making within the regulations mirror the procedures set out in the Financial Services and Markets Act 2000 (FSMA). The FSA must make a decision within six months and give reasons when refusing an application. Where the FSA refuses an application for recognition, the applicant may refer the matter to the Tribunal.

2.22 Where it is proposed that the asset pool is transferred to a new owner, the FSA must be content that the new owner meets the requirements of the Directive, before the transfer can take place.

2.23 The regulations also set out elements of on-going supervision which are imposed on both the issuer and the owner. These are high-level requirements which are designed to enable the FSA to monitor the situation. They are described in detail below.

2.24 With any regime, some of the confidence in it comes from the strength of the enforcement arrangements and the belief people hold in them. Given the light touch of the legislative framework we propose and the flexibility it gives, Treasury believe it is important that there are robust enforcement procedures in place. This does not mean that we expect them to be necessary, but they will ensure that the FSA will be able to deliver robust special public supervision in all circumstances.

2.25 Specifically, we propose that the FSA will have the power to remove issuers from the list of UK Recognised Covered Bond issuers. This will mean an issuer is unable to issue more UK Recognised Covered Bonds. It will not, however, in any way affect the

⁹ Article 22(4) third sub-paragraph.

¹⁰ Please note paragraphs 2.4-2.6

status of programmes already admitted to the register of UK recognised covered bonds. The FSA will also have the power to require issuers to top up the asset pool if it is not satisfied that the assets contained within the asset pool are sufficient to cover all claims attaching during the whole period of the validity of the bonds.

2.26 Further to these specific powers, some of the general enforcement tools that the FSA has in other regimes shall apply to covered bonds, for instance:

- power to give directions when it appears that a person has failed, or is likely to fail to comply with an obligation imposed by the regulations;
- power to impose financial penalties for a failure to comply with the regulations;
- power of the court to make an order restraining or remedying a contravention;
- offence of misleading the FSA.

2.27 The powers listed above will apply equally to the issuer and to the owner in the first instance, and on the owner when the issuer no longer exists. The requirements which the regime places on the owner will be high level and the FSA's enforcement of those requirements will rely heavily on the owner providing information to evidence compliance. It is important that the FSA should have the right tools to ensure that the owner does not undermine the regime. We considered whether it would be possible to rely on the FSA's direction making powers and the court's order making powers as the sole means of enforcement against the owner. However, the costs of any direction enforced by an injunction or court order would be substantial and, particularly in the case where the issuer no longer exists, would be borne by the asset pool. In these circumstances, we considered that the availability of a penalty regime, especially for matters such as failure to submit information required by the FSA, would be a more proportionate response rather than a reliance on direction making powers and court orders.

2.28 Although in the absence of the issuer, penalties certainly will be borne by the asset pool, as with all regimes, the FSA will need to take into account all the circumstances of the case in arriving at the appropriate and proportionate response. It will be required by the Regulations to establish a policy with regard to the imposition and the amount of penalties. In determining the amount of a penalty, the FSA will be required to have regard to the seriousness and nature of the contravention and the extent to which the contravention was reckless or deliberate. It will also be possible for the issuer or the person holding the asset pool to refer the matter to the Tribunal if the FSA exercises the powers. This is discussed in more detail at Chapter 4.

Do you agree with the functions we propose to give the FSA and the recognition process for issuers and their programmes?

Do you agree with the proposed time limits for the recognition process?

Do you think there should be different time limits for recognition of the covered bonds where the issuer has already been recognised?

Do you agree with the rationale for the enforcement provisions and the enforcement powers the FSA will have for this regime?

THE BONDS ARE SUPPORTED BY AN ASSET POOL WITH SPECIFIED ASSETS, IN PARTICULAR THE SUMS RAISED BY THE ISSUE OF THE COVERED BONDS CAN ONLY BE INVESTED IN ELIGIBLE ASSETS AS PRESCRIBED BY LAW

2.29 To comply with UCITS 22(4), it is necessary for our proposed legislation to prescribe what assets should be in the cover pool so that the sums deriving from the issue of the bond are invested in conformity with the law. This means the legislation needs to identify the types of assets that are eligible for the asset pool and their location.

2.30 Article 22(4) does not provide a list of eligible assets for investment. We therefore need to decide on a suitable definition for eligible assets.

Eligible assets in the pool

2.31 We propose defining the asset pool as those assets recorded as comprising the asset pool. In terms of assets that can be recorded, we propose enabling the inclusion of the types of assets set out in regulation 2. Once again, the starting point is UCITS 22(4).

2.32 First, the sums derived from the issue of the bonds must be transferred to the asset pool for the benefit of the bondholders. In order to maintain the quality of assets in the pool, those monies could only be used to purchase eligible property. This does not mean the actual monies received from the bondholders must be transferred, rather sums or eligible property of equivalent value. The draft regulations therefore impose a requirement that an issuer must transfer all monies it receives from the sale of a recognized covered bond and/or equivalent property to the asset pool. In practice, based on existing structures, this would be an SPV, but the Treasury does not consider it necessary to include the detailed structure of the SPV/issuer relationship in legislation and the legislation will permit different arrangements.

2.33 Once again, to ensure a level of control over the quality of the assets in the pool we propose, in line with other Member States, to define the eligible property that can be transferred in to the pool in place of the sums received from the bondholders. This is set out in more detail from paragraph 2.37 below.

2.34 An asset pool is not and indeed should not be static. There will be a return on the assets in the pool which should be taken into account both when assessing the capability of the pool and funds available for any further investment. Therefore, the pool will include the return on the assets in the pool.

2.35 In order to ensure that the bonds do not accelerate on the insolvency of the issuer, it will be necessary for the asset pool to have hedging instruments, interest rate swaps and possibly insurance. We do not propose imposing a restriction on the type of asset which may be purchased with income derived from the assets in the pool. We think this will ensure that all financial instruments necessary to support and run the pool can be purchased particularly in order to manage the continued payment of monies due to the bondholders in the event of the issuer's insolvency.

2.36 Finally, the issuer or the FSA may decide it is appropriate to add assets to the pool based on the performance of the assets already contained within it to ensure the necessary level of security for the bondholders.

Eligible property

2.37 Member States with existing covered bonds legislation have limited eligible property to mortgages or mortgages and public sector loans. One Member State also allows investment in shipping mortgages. Given the objectives of the Directive, it is appropriate for the assets in the cover pool to be of a high quality. Indeed, the level of over collateralisation needed to support poor quality assets, to ensure that the asset pool is capable of paying the bondholders, would make a cover pool a very inefficient use of the credit institution's assets. There are, however, more types of good quality assets than mortgages and public sector loans.

2.38 As a starting point, Annex VI to the BCD, which came into effect on 1 January 2007, sets out a list of assets with limits which may form the collateral backing a covered bond (for the purposes of a credit institution investing in these bonds). If a credit institution invests in bonds backed by the listed assets it will qualify for a lower risk weight, with the result that it will be able to hold less capital than would be required for normal bonds. The assets relate to public sector loans (para 68(a) and (b) BCD), mortgages (para 68(d) and (e)), shipping mortgages (para 68(f)) and exposures to institutions with specified characteristics (para 68(c)).

2.39 Credit institutions, however, are not the only investors in this product. Insurance companies and UCITS currently have nothing to gain in prudential terms by purchasing covered bonds the collateralising assets of which are restricted to those contained on the BCD list. Given that the objective of Article 22(4) is to provide guarantees and safeguards against bankruptcy which would enable covered bonds to be treated as equivalent to State bonds,¹¹ the Treasury thinks it is important to define 'eligible property' such that it captures high quality assets, but does not stifle the market by reducing flexibility both in the development of products and the assets an investor wants to see backing a bond. We therefore propose to include within the definition of eligible property:

- assets from the list at Annex VI to the BCD;
- social housing and public private partnership loans (because these are secured by a repayment stream from public monies); and
- any other asset held in relation to a body which has a credit assessment equivalent to a AAA or AA rating.

2.40 The Treasury is content for the legislation to allow a covered bond to be backed by an asset pool which contains a mixture of the eligible property listed in regulation 3 as well as the other types of assets listed in regulation 2.

Are the types of assets permitted in the asset pool defined appropriately in Regulation 2?

Is it appropriate to widen the list of eligible property beyond the BCD list?

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?

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?

¹¹ COM(86)315 (final).

Location of assets **2.41** The location of eligible assets is not discussed in Article 22(4). Different Member States have taken different views as the following table shows.

Table 1.1

Member State	Location allowed
Spain	Spain
Ireland	EEA (no limits), US, Canada, Japan, Switzerland (15% of pool)
Luxembourg	OECD (no limits)
France	EEA, French overseas Territories, Switzerland, US, Canada, Japan.
Germany	EEA and Switzerland (with Limits). ¹²

2.42 The Directive is silent as to the permitted location of eligible assets, though given its objectives it is plainly necessary for Member States to have in mind the overriding requirement that the property must be capable of covering claims attaching to the bonds. The choice of permitted location is therefore informed by the need for security and availability of such assets when they are held outside the UK. A good measure of availability is whether judgement obtained in the UK is enforceable against assets held in other jurisdictions. This is a relatively simple issue in the EEA because we have the Recognition and Enforcement of Judgements Regulation¹³. For jurisdictions outside the EEA, the Treasury regards additional suitable locations as those where the law is still based on old or revised English law principles and countries which are signatories to the UNCITRAL Model Law¹⁴. Many jurisdictions still based on English law principles have been designated for the purpose of judicial assistance in insolvency proceedings under section 426 of the Insolvency Act 1986.

2.43 The Treasury therefore proposes in regulation [3(2)] to restrict the location of the eligible property in the asset pool to the EEA, Australia, Canada, Switzerland, Japan, the US, Anguilla, The Bahamas, Bermuda, the Cayman Islands, the Falkland Islands, Gibraltar, Montserrat, New Zealand, St. Helena and the Turks and Caicos Islands, the Channel Islands, the Isle of Man, Hong Kong, Tuvalu, the Virgin Islands, Malaysia, the Republic of South Africa, Brunei, Darussalam, Romania, Columbia, Eritrea, Mexico, Serbia, Montenegro, the British Virgin Islands.

Do you think it is appropriate to define the location of the eligible property backing the pool?

Are you happy with our proposed definition of the suitable location of such assets?

¹² Extracted from Covered Bonds by DG Credit Research 2/9/2002.

¹³ Council Regulation (E.C.) No. 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgements in Civil and Commercial Matters.

¹⁴ The Model Law on cross-border insolvency as adopted by the United Nations Commission on International Trade on 30th May 1997.

BONDHOLDERS CLAIMS AGAINST THE ISSUER MUST BE FULLY SECURED BY SUFFICIENT COLLATERAL TO COVER BONDHOLDER CLAIMS THROUGHOUT THE WHOLE TERM OF THE COVERED BOND

2.44 In terms of bondholder protection, arguably the key provision to the legislative framework is the requirement that the assets in the asset pool are capable of covering all claims attaching to the bond and the sums required for the maintenance, administration and winding up of the asset pool for the whole period of the bond. This obligation is placed on the issuer at regulation 13, the owner of the asset pool at regulation 16 and to the administrator in regulation 24. Thus at all possible stages in the life of the pool, this requirement is directed at someone.

2.45 The draft regulations impose a requirement on the UK recognised covered bond issuer to take such steps as are necessary to ensure that during the whole period of the validity of the bonds, the assets in the asset pool are capable of covering all claims attaching to the UK recognised covered bonds.

2.46 The requirement regarding the pool's capability goes beyond the payment of the bondholders because there will be costs incurred running the pool which will need to be accounted for if the interests of the bondholders are to be protected. In the event of the insolvency of the issuer the assets in the pool will need to be sufficient both to pay the liabilities to the bondholders as they fall due in a timely manner and the costs of running the pool including any liabilities to financial instruments counter parties. The latter costs largely drive the need to over-collateralise the asset pool. Thus the requirement is wide enough to capture the assets needed to pay the bonds and the over collateralisation necessary to service the pool and service financial instruments to ensure the necessary liquidity of the pool and ultimately, the payment of the bondholders.

2.47 The aim would be that on the insolvency of the issuer, the bonds would not accelerate, but that the asset pool would continue to meet the claims attaching to the bonds during the remaining period of validity. This is the approach taken in most other Member States.

2.48 'Capable' has not been defined in the Directives. It must therefore be given a plain English meaning. In other words it means there are sufficient assets in the pool with the necessary liquidity to pay claims of the bondholders as they fall due in a timely manner. The FSA, as part of its public supervision, of the regime will also need to satisfy itself that there are sufficient assets in the pool to pay the bond holders. The Treasury's preference would be not to prescribe in the Regulations how capability to pay should be assessed but to follow a "copy-out" approach (and this is the approach taken in the draft Regulations). It would then be for the FSA set relevant standards and procedures as supervisor of the new regime subject to its own consultation and cost-benefit analysis (although the ultimate arbiter would, of course, be the European Court of Justice).

2.49 However, the Treasury would be interested in views on the merits or otherwise of setting out in the Regulations, for indicative purposes, some of the different methods for assessing the capability of the asset pool to meet the claims of the bondholders as they fall due in a timely manner. This may assist in providing greater legal certainty for issuers that there is available a choice of different methods to meet the capability test

and because the list would be indicative, market development of other methods of a similar nature would not be hampered. Possible options could include:

- **Setting minimum over collateralisation levels.** The regime could have benchmarks against which the strength of the asset pool would be assessed. This is the approach adopted in several Member States. While this has the benefit of certainty and simplicity, such an approach is likely to be crude (in terms of being able to reflect the differences in asset pools) and less flexible than some of the other options;
- **Restricting the assets contained within the pool.** The regime could, for instance, restrict eligible assets only to those listed in Annex VI of the BCD. Again this would have the benefits of certainty and simplicity. However, we think that the asset eligibility requirements set within the regulations are set out the right level in terms of the overarching regime and wonder if further requirements would add undue complexity. The market has well-established methodologies for addressing asset quality and volatility considerations in a more sophisticated way than could arguably be achieved through the regulatory framework.
- **Setting requirements in relation to prudent valuation methodologies for the underlying asset pool.** This approach has been used in other Member States, has the benefits of certainty and simplicity but may be less able to take account of future innovation.
- **Instituting regular reporting by owners/issuers combined with monitoring procedures undertaken by the FSA.** Information is obviously an important element of any regulatory regime. The principles of good data and good data collection suggest that data should be risk based; allow the adequate assessment and monitoring of risk; ideally be selected from data already produced; be accurate, focused, sufficiently detailed and adequately validated; where cost is minimised for both regulator and regulated. This approach should allow flexibility and innovation. However, extensive reporting and monitoring would require a high level of resources for both the FSA and issuers.
- **Performing similar analysis to that already performed by the ECAI.**¹⁵ Undertaking such analysis would undoubtedly meet the Directive requirements and would be flexible. However, recreating the already extensive analytical process already undertaken by issuers and the rating agencies would duplicate a function already carried out with a high degree of professionalism by third parties. It would also require heavy resource commitments by the FSA which in turn would need to be recouped by higher fees payable by issuers.
- **Use the rating provided by an ECAI.** In setting the rating ECAs take account of the quality and size of the asset pool, amongst other things, and thus a rating provides a further third party verification as regards capability to pay whilst remaining flexible. However, given that there are other aspects

¹⁵ ECAs are credit rating agencies which the FSA formally recognise as satisfying the requirements set out in the Capital Requirements Directive (CRD), Annex VI, part 2 and elaborated in CEBS' Guidelines on the recognition of ECAs (GL07). ECAI credit ratings are applied for capital requirement purposes under the Standardised Approach and the Securitisation Ratings-Based Approaches of the CRD. To date, in line with supervisor consensus across Europe, the FSA has formally recognised Fitch Ratings, Moody's Investors Services, Standard and Poor's, and DBRS¹⁵ as ECAs.

included within the rating such as the credit quality of the issuing institution and the legal framework supporting the bonds [we do not consider that it would be appropriate to use a rating as the sole indicator of capability/ it is clear that the other options are focused solely on the sufficiency of the assets].

- **Have regard to reviews undertaken by independent experts.** It is clear from an issuer's perspective that there should be appropriate controls in place for the determination and monitoring of the asset pool to confirm that it is capable of meeting bondholders' claims. The design of these controls should ensure that the risks to the ongoing sufficiency of the pool can be analysed and where appropriate mitigated. In line with the principles based approach to the framework and the requirements of the regulations, senior management will have the primary responsibility for ensuring that these controls are in place and acted upon in practice. As mentioned with the other options, there are mechanisms used by the market to assess the sufficiency of assets, such as asset coverage tests, that are well established and in general derive from rating agency processes upon which it is possible to obtain independent verification. We consider that obtaining independent verification that the market mechanisms work appropriately and that there are enough assets there to meet the claims of bond holders achieves Directive compliance and enables the regime to remain flexible while not duplicating the use of resources. It may well be appropriate to prescribe the form of this verification and the type of analysis and assessments to be made in reaching an opinion.

Do you agree that the Regulations should adopt the "copy-out" approach with regard 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?

Do you think there are other methods for assessing capability?

Which do you think are the most suitable methods for assessing capability?

2.50 Existing covered bonds provide a mechanism for the marshalling of the views of the bondholders and for those to be taken in to account in the operation of the pool. The current mechanism is the appointment of a bondholder trustee. This is the same with other corporate bonds and a safeguard bondholders appear to want. The requirements placed on the issue at regulation [20] are broad enough to capture such a mechanism.

IN THE EVENT OF THE ISSUER'S INSOLVENCY, BONDHOLDERS HAVE A PRIORITY CLAIM ON THOSE ASSETS

2.51 The Directive requires that sums derived from the issue of the bonds must be invested in asset which will be capable of paying the claims of the bondholders and the payment of the principal and accrued interest on insolvency. This means, not only that the asset pool must be sufficiently funded, but also that on insolvency it is available for the benefit of the bondholders and not for the benefit of the general creditors of the issuer. For this reason we need to ensure that the asset pool is ring fenced in order to protect it from the general creditors of the issuing bank.

2.52 There are different ways to achieve ring fencing as evidenced by the different approaches of other Member States. Article 22(4) does not mandate a particular structure for a covered bonds regime, but rather sets out the objectives it must fulfil in order to ensure that the quality of the portfolio is maintained.

2.53 There are broadly two ways of ring-fencing, the first, as explained in paragraphs 1.13 to 1.22 above, is to establish a legal entity separate from the issuer (the SPV) and ensure that any transfer of the sums derived from the sale of the covered bonds, or equivalent property, are transferred to this entity on a true sale basis. This model is based on existing legal principles and the relationship between the issuer, the SPV and the bondholder is established by contract. The second method is to create a legislative ring fence around the asset pool, which remains integrated in the issuing bank. This option has been adopted in other Member States and the relationship between the issuer, the bondholder and cover pool can be determined in the relevant legislation to a greater or lesser degree.

2.54 The Treasury is content that segregating the asset pool into an SPV provides the necessary ring fence of the assets as the first step to ensure the priority claim of the bondholders. The starting point for the development of the framework was therefore to develop a legislative framework which supported the existing arrangements.

2.55 In line with HM Treasury's general approach to directive implementation, the framework is designed to be as flexible as possible, to accommodate innovation, and as simple and light touch as possible. We have therefore provided issuers with a choice as to whether to adopt the SPV option to ring-fencing or an integrated option in which the ring-fencing is achieved by legislative means. The result in both cases is the same, although in one case the ring-fencing is established by contract and in the other the ring-fencing is established by the regulations. We have not adopted the example of other Member States and proscribed exhaustive details as to the relationship between the bondholder, the issuer and the asset pool. Instead, in both cases, we have taken a light touch approach and established a framework. In the case of the integrated approach this framework will need to be complemented by contractual provisions and in the case of the SPV approach the framework floats above the pre-existing contractual position.

2.56 This means that the framework is primarily concerned with the asset pool and how it is maintained rather than by whom. We have not prescribed who must own the asset pool and the requirements are the same whichever model is chosen. On the insolvency of the issuer the asset pool will continue in existence, however, slightly different arrangements legally are required to achieve this.

2.57 In the case of the SPV option the separation has already been achieved by contract. The only provision that we have included in the regulations to deal with the post-insolvency position of the issuer, is a requirement for the liquidator to transfer any remaining interests (e.g. the legal title to the asset in the pool) to the SPV. In practice, this is already provided for in the contractual position, but in order to fully signal compliance with the Directive, we have included a provision in the legislation.

2.58 In the case of the integrated approach we have needed to turn off or modify various provisions of the existing insolvency law. For instance, the duties of the insolvency practitioners will now need to accommodate the requirements relating to the asset pool so that the interests of the bondholders remain protected. At the same time we have had to consider the interests of the creditors of the issuing bank and have therefore provided that any residue after the payment of the bondholders must be

returned to the issuer and all other creditors of the cover pool, when the asset pool is wound up.

2.59 The Directive requires that in the event of the failure of the issuer, the assets in the pool would be used on a priority basis for the reimbursement of the principal and payment of accrued interest. We therefore consider that an element of priority must be provided to the bondholder over the assets in the asset pool, wherever they are held.

2.60 It is noticeable that other jurisdictions have taken the view that the requirement for priority has not barred other claimants from ranking parri passu with the bond holders. France, Luxemburg and Ireland, for example, have allowed the counterparties of hedging instruments to rank parri passu with the bond holders. It is also apparent that during the period of insolvency the expenses and re-numeration of insolvency practitioners are allowed. This means that service providers¹⁶ which are needed to make the pool function can be paid on an on going basis.

2.61 In order to ensure that the system in the UK is workable we intend to enable the claims of service providers, the counterparties of hedging instruments on insolvency parri passu with the bondholders. This will ensure together with the requirement that the pool is funded to account for such claims, that on insolvency the persons who have made the structure work for the benefit of the bondholders, will get paid. For the period after the onset of insolvency we consider that service providers and counterparties of hedging instruments could be paid as an expense of the insolvency practitioner, for he must obtain the means to run the pool from somewhere until it is wound up.

Set-off 2.62 The legal transfer of the assets from the issuer to the SPV means that generally set-off does not apply in the case of a general creditor of the bank over the assets of the SPV. There is, however, no case law on this and the SPV faces a residual risk that set-off will operate. To mitigate this risk, issuers add further over collateralisation to the asset pool. This does not appear to be an efficient use of the credit institution's assets. It is open to us to put the situation beyond doubt and indeed that would arguably lead to the further increased certainty, robustness and efficiency of the regime. However, this would wholly exclude the potential for customers of an insolvent bank from claiming set off. Given the broader benefits of the covered bonds regime, we think there is a strong argument for putting the issue beyond doubt. We would like your views on this and an explanation of any arguments we have not considered.

Do you have any comments on the ring-fencing in the Regulations and the requirements placed on the owner, issuer and liquidator?

Do you think that the protected period in regulation 25(10) is the correct length?

Do you agree that service providers can be paid as an expense of the winding up?

Do you agree with our analysis of the set-off position?

Do you think we should put the set-off position beyond doubt?

¹⁶ Examples of service providers include the paying agents, the servicer, the account manager, the corporate services provider, the asset monitor and the Swap counterparties.

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 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 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 regard 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 on 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?

INTRODUCTION

3.1 In February 2006 we (the Financial Services Authority (FSA)) advised the industry¹⁷ that, following discussions with HM Treasury (the Treasury) and industry representatives, we proposed to consult on the implementation of a UK covered bond regime that was compliant with EU legislation. This will improve access to a highly efficient capital market instrument currently issued in large volumes in Europe.

3.2 We concluded that, consistent with our principles of good regulation, the regime should facilitate innovation and promote competition.

3.3 Some of the expected benefits of the regime include:

- for institutional capital markets, facilitation of further development of a highly liquid, long-dated and cost-effective debt instrument;
- for issuers and investors alike, improving what is already a highly effective means of managing long-term liquidity risk and interest rate risk;
- for the macro-economy, greater choice and efficiency in investment markets;
- for consumers, the development of a longer-term fixed-rate mortgage market;
- for UK issuers, a potential reduction in the premium currently borne by covered bond issues; and
- for investors subject to the Capital Requirements Directive¹⁸ (CRD), a preferential regulatory capital treatment that benefits all CRD-compliant covered bonds.

3.4 In order to implement the regime it was necessary for the Treasury to make new regulations. 'The Recognised Covered Bond Regulations 2007' (the Regulations) are being consulted on as part of this joint consultation paper. Our part of the consultation outlines how we propose to implement these new regulations. It covers policy decisions and how the regime will operate in practice, including the application process for issuers seeking FSA recognition. Handbook text can be found in Annex D.

3.5 The purpose of our part of the consultation is to give industry and other interested parties (e.g. professional advisors and insolvency practitioners) the opportunity formally to respond on how we propose to implement the Regulations. We will publish these responses and how they have been taken into consideration in implementing the Regulations later this year in a Policy Statement. In doing this we will also need to consider the impact of any changes to the Regulations resulting from the consultation. If the Regulations, as they currently stand, change such that we consider it necessary to re-consult on parts of the Regime this will delay implementation.

¹⁷Letter of intent: www.fsa.gov.uk/pages/Library/Other_publications/EU/other_documentation/cbsg/index.shtml

¹⁸ Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions (recast)

3.6 This Consultation Paper sets out a number of specific questions we would like responses to. The consultation is not limited to these questions and we invite respondents to comment on any aspect of the proposed regime.

3.7 In considering how to implement the Regulations, we have taken account of:

- principles-based regulation;
- senior management responsibility;
- risk-based application of our resources; and
- current good market practices.

3.8 We believe this approach will help market innovation and avoid the need to continually update our requirements.

3.9 While we are responsible for carrying out 'special public supervision' designed to protect bondholders for the purposes of Article 22(4) of the Undertakings for Collective Investment in Transferable Securities Directive (UCITS), this should not be interpreted as meaning the bonds are backed by a government or regulatory guarantee. Issuers should make it clear to investors that, however unlikely, there is no guarantee against losses.

LEGAL FRAMEWORK

3.10 Article 22(4) of UCITS provides the overarching requirements which must be satisfied by Member State to enable UCITS schemes to increase their exposure to covered bonds from a single issuer. Other Directives¹⁹ have repeated this definition to recognise the relatively low risk of covered bonds and therefore provide either lower risk weightings or higher holding limits for investors in the product.

3.11 The Regulations create the framework by which instruments compliant with the definition set out in Article 22(4) can be issued. A key aspect of this is the provision of our duties and powers which are required to operate a UK covered bond regime (the Regime). These powers and duties are additional and separate to those under the Financial Services and Markets Act 2000 (FSMA).

3.12 We will have the power to give guidance, make directions and requirements in relation to recognising covered bond programmes, notifications and reporting (e.g. on quantity and quality of assets in the pool), take enforcement action and to make rules about the levying of fees.

3.13 Existing UK covered bonds are governed largely by contract. These contracts include tests²⁰ which dictate how the issuer will operate the covered bond programme in certain circumstances. In deciding whether a covered bond programme is recognised, we must be satisfied that the contractual arrangements seek to ensure compliance with the Regulations and that mechanisms are in place to achieve this in an orderly manner throughout the life of the bond. This will include having procedures and mechanisms in place to ensure bondholder interests and views will be considered in an appropriate and timely way.

¹⁹ Consolidated Life Directive, 3rd Non-Life Directive and the Capital Requirements Directive

²⁰ Asset coverage test and Amortisation test

UCITS Schemes

3.14 The UCITS Directive contains provisions on spread and concentration of investments for authorised collective investment schemes. These provisions are implemented in the Handbook Specialist Sourcebook, New Collective Investment Schemes, chapter 5 (COLL 5).

3.15 In the Consultation Paper 135 (April 2002) New Collective Investment Scheme products we chose not to implement the national discretion to allow UCITS schemes to gain increased exposure to covered bonds from a single issuer. In the Policy Statement 135 (November 2002) New Collective Investment Scheme products we said we would reconsider this question if there was enough demand by UCITS schemes to invest in covered bonds.

3.16 In light of the proposed regime, we now plan to consult in the October Quarterly Consultation Paper on implementing the national discretion for UCITS schemes, alongside an equivalent relaxation for non-UCITS retail schemes. If taken forward, we would expect the new provisions to come into force by early 2008.

Consolidated Life Directive and Third Non-Life Directive

3.17 Article 24 of the Consolidated Life Directive and article 22 of the Third Non-Life Directive contain provisions on investment diversification for insurers. These provisions are implemented in the Handbook Prudential Sourcebook for insurers, chapter 2 (INSPRU 2.1). So far we have chosen not to implement the national discretion to allow the higher investment limits for covered bonds provided for by these articles.

3.18 In the light of the proposed regime, we are currently consulting in our July Quarterly Consultation Paper (CP 07/13)²¹ on implementing this national discretion. If taken forward, we would expect the new provisions to come into force by early 2008.

Capital Requirements Directive

3.19 Annex VI Part 1 point 66, Article 87(8) and Annex VII Part 2 point 8 (part) of the CRD contain provisions on reduced capital charges for banks, building societies and investment firms, that invest in UCITS compliant covered bonds (subject to asset eligibility criteria), under both the Standardised and Internal Ratings Based Approaches. These provisions are implemented in the Handbook Prudential Sourcebook for Banks, Building Societies and Investment Firms, chapter 3 and 4 (BIPRU 3.4.107 to 3.4.110 and BIPRU 4.4.34 to 4.4.35).

CURRENT MARKET PRACTICE

3.20 A covered bond is structured to operate differently as circumstances change. We have illustrated this using a typical example of the current UK 'structured' covered bond. This provides some of the context for how the regime will operate in practice for these and other covered bond structures (e.g. the integrated model).

3.21 The three stages a covered bond can go through are:

- issuer solvent (dynamic asset pool);
- issuer event of default e.g. insolvency (static asset pool); and

²¹ http://www.fsa.gov.uk/pubs/cp/cp07_13.pdf

- static asset pool event of default.

Issuer solvent

3.22 While the issuer is solvent, the issuer remains liable to meet bondholder claims for principal and interest. The covered bond is backed by a dynamic asset pool which is maintained by the issuer. Current structures in the UK have an 'Asset Coverage Test' in place to determine the level at which the pool should be maintained. A breach of this test constitutes a trigger event or an issuer event of default.

Issuer event of default, for example insolvency

3.23 In the event of issuer insolvency, the asset pool does not become part of the insolvency of the issuer. In current structures bondholder protection is achieved through private law arrangements by transferring the assets to a Special Purpose Vehicle (SPV). These arrangements must also make sure transfers of assets to the SPV are not vulnerable to being clawed back by the insolvency estate of the issuer e.g. as preferences or transactions at undervalue. The asset pool becomes static and the bondholders are directly exposed to the risk of a change in value of the asset pool. In current structures a new test is performed the 'amortisation test' to ensure that the assets in the pool are capable of covering the bondholders' claims throughout the remaining life of the bond in a timely manner. The amortisation test determines, among other things, whether there are sufficient assets in the pool to cover not only potential credit losses on the assets in certain stress scenarios, but the negative carry that may arise from the liquidation of the mortgage or other assets prior to the original scheduled maturity date of the bonds. For so long as the amortisation test (and certain other tests) are satisfied, the SPV will use the collections and liquidation proceeds from the asset pool to pay the covered bonds on their original scheduled maturity dates. To maintain the asset pool, funds generated (e.g. income, principal pre-payments and sales proceeds) can be reinvested.

Static asset pool event of default

3.24 If the amortisation test has been breached this triggers an asset pool default. The bonds are accelerated by liquidating the assets and passing the proceeds to the bondholders on an equal basis without preference between them. This is after taking account of amounts owing to certain third parties who assist the SPV in servicing the assets or the bonds (e.g. bond-holder trustees).

3.25 If the asset pool is not sufficient to meet all the bond-holders' claims and the shortfall is not covered by an unsecured claim by the bond-holder against the issuer's estate, the bondholder will experience a loss.

OPERATIONAL

3.26 The regime has parallels with work conducted by the UK Listings Authority located within our Markets Division, therefore we have decided the regime will be operated out of the Markets Division.

3.27 The step by step process for recognition is set out in Annex 1. Firms will need to submit an application form (as outlined in Annex 2) that details the particulars of the programme, explains how the requirement for the assets to be capable of repaying the claims of bond-holders have been met, and the process for ensuring the orderly

continuation of the bonds upon insolvency, together with the relevant declarations and the fee.

3.28 Issuers may submit a draft application to us in advance of implementation as part of preliminary discussions from the beginning of October 2007. However, recognition will only be possible once the Regulations come into effect, expected to be 1 January 2008. The time limits under the Regulations for our consideration of applications will begin at that date including those applications submitted in advance.

3.29 We will continue with the industry Covered Bond Standing Group to support implementation of the regime up to and after 1 January 2008. The purpose and remit of the CBSG can be found on our website²².

SPECIALIST SOURCEBOOK

3.30 It is proposed that the Directions, Rules and Guidance made in relation to the Regulations will form a separate specialist sourcebook within the Handbook, called RCB (Recognised Covered Bonds).

Do you agree with having a separate specialist sourcebook? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

SPECIAL PUBLIC SUPERVISION

3.31 Special public supervision is designed to protect bond-holders each aspect of which is considered in the following section.

- Recognition
- FSA Register of Recognised Covered Bonds
- Notification to the Commission
- Assets must be 'capable' of covering claims attaching to the bond (Regulation 16)
- Orderly continuation of business and bond-holder representation
- Skilled person's report
- Fees
- Enforcement

3.32 In line with our more principles based approach to regulation the primary focus will be on senior management responsibilities and the issuer will be required to demonstrate to our satisfaction that they comply, and continue to comply, with the Regulations.

Recognition

3.33 The issuer and owner have various obligations under the Regulations (e.g. asset pool is capable of meeting the claims of the bondholders) and are responsible for

²² <http://www.fsa.gov.uk/Pages/About/What/International/basel/csg/cbsg/index.shtml>

ensuring they comply with them. This means an issuer will need to have adequate procedures in place to deliver this (e.g. internal audit and procedures for obtaining legal advice where necessary). We propose that the issuer will be required to formally declare compliance with the regulations at recognition. In addition to this there must also be a declaration of compliance from a suitably qualified independent third-party professional adviser.

3.34 Using third-party verifications provides clear resource and costing benefits for us and, in turn, issuers in the form of reduced fees. Resource should be more flexible and can better accommodate short-term demand spikes (e.g. for multiple programme recognition) and reduce the risk of bottlenecks and delays in getting issues to market. The cost of obtaining the third party professional adviser declaration should be marginal as third-party experts are typically already engaged by the issuer in putting the structure together and managing it through its life (e.g. preparation of offering circular, investor reports and work for rating agencies). We do not propose, unless the application raises particularly unusual circumstances, examining professional opinions which have been given in relation to the transaction. Recognition by us in relation to a particular structure should therefore not be taken as a validation of professional opinions that may have been obtained for the benefit of the parties. So, for example where the SPV route is used, the parties must satisfy themselves that their private law arrangements, as assessed by the 'true sale' opinions they normally obtain, are effective to achieve the necessary ring-fencing of assets.

3.35 The declarations on recognition will use standard wording (see Handbook).

Do you agree with the proposed approach of an issuer declaration at recognition? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Do you agree with the proposed approach of a professional adviser declaration at recognition? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

FSA Register of Recognised Covered Bonds

3.36 Once recognised, the name of the issuer(s) and their issuing programme(s) will be published in a register on our website as soon as possible.

3.37 We are not required by the Regulations to publish further details of each bond and do not propose doing so.

Do you agree with the proposed approach to the Register? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Notification to the Commission

3.38 We will notify the Commission in writing of the name of issuer(s) and recognised covered bond programme(s) as soon as possible.

3.39 For the requirement to notify the ‘status of guarantees’, we will include a brief standard form statement referring to the protections offered to bondholders under the Regulations.

Do you agree with the proposed approach to notifications? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Assets must be 'capable' of covering claims attaching to the bond (Regulation 16)

3.40 A fundamental requirement of the Regulations is to determine whether the asset pool is, and can confidently be expected to continue being, capable of covering claims attaching to the Recognised Covered Bond (RCB) throughout the life of the bond.

3.41 Senior management should consider in detail the risks which could impact this outcome and how they have been accounted for. Examples of risks which might be considered include: interest rates; exchange rates; matching; pre-payments; concentration; liquidity; asset quality and asset transfer in the event of issuer failure; how these risks are analysed (e.g. stress testing); and measures taken to mitigate them (e.g. systems and controls to ensure there are sufficient assets and over-collateralisation). These must be captured in full by the contractual provisions governing the bond (e.g. asset coverage test and amortisation test),

3.42 At recognition we must be satisfied that the covered bond meets and will continue to meet the Regulations and in particular Regulation 16. In forming our opinion we will have regard to the underlying documents (i.e. the contractual arrangements in place) and representations made by Senior Management in their application form.

3.43 We intend to adopt a risk-based approach to recognition, in practice this will mean that if we have concerns over firms' systems and controls, the rating of the bond or location of the assets we will require more due diligence from firms to enable us to form our opinion. However we will gain comfort if, for example, a firm has good systems and controls, the bond rating is AAA, there are high degrees of over-collateralisation and/or the assets are located in the in a jurisdiction where there are minimal risks as to the availability of the assets.

3.44 This requirement (i.e. capability) is ongoing under the Regulations. Regulation 17 enables us to direct that certain information be provided to us to assess compliance with the capability requirement and other requirements. We propose that firms submit to the FSA a declaration of compliance with those requirements annually. These declarations must be given by senior management and, for the reasons outlined above in relation to recognition, be verified by a suitably qualified independent third-party professional adviser. If the issuer becomes insolvent we would seek to receive an additional declaration within a month of this event (or 2 weeks from the appointment of the liquidator in the case of the integrated model). This should, in most cases enable the person making the declaration to make use of the routine verification of the asset pool which as a matter of current market practice occurs on a monthly basis.

3.45 Routine reporting, in addition to the annual issuer and third-party professional declarations, was considered unduly burdensome, so instead exception-based event-driven reporting is proposed. The regulations specifically provide for immediate

notification in writing in the event of the asset pool not being capable or not likely to be capable of covering bond-holder claims. This form of exception-based event-driven reporting will form a key part of our ongoing review of compliance with this requirement.

3.46 The Treasury are consulting on whether indicative measures of capability should be defined in law for reasons of legal certainty. Currently the regulations do not incorporate these options. Given this, we do not propose to pre-empt consideration of Treasury's consultation on this point by providing such a list of options in our guidance.

Do you agree with the proposed approach of an annual issuer declaration? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Do you agree with the proposed approach of an annual professional adviser declarations? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Do you agree with the proposed approach to reporting? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Do you agree with the proposed approach not to set out in detail guidance on 'capability'? If not please describe what you think should be in guidance and explain why including an assessment of the costs and benefits.

Orderly continuation of business and bondholder representation

3.47 Given the Regulations do not require us to undertake any role in actively managing the asset pool at any stage a fundamental part of the requirement that the asset pool must be administered and maintained so that it is capable of meeting the claims of bondholders is the 'orderly continuation of business'. This is particularly important in the event of issuer default, after which the covered bond should continue uninterrupted to meet bondholder claims.

3.48 A key element of orderly continuation of business arises out of the obligations under regulation [16]²³. As part of this there must be procedures and mechanisms in place to ensure that bondholder interests and views will be taken account of in an appropriate and timely way. We envisage this will entail bondholders being represented by a suitably qualified, adequately resourced and independent third party.

3.49 This is so we and other interested parties (e.g. bond-holders) continue to have a point of contact, throughout the life of the bond, who is contractually obliged to represent the interests of the bond-holders and authorised to take decisions on their behalf. This function is particularly important in stressed situations (e.g. insolvency of the issuer), as it maybe necessary to take commercial decisions, for example if and when to liquidate the asset pool. The consequences of these decisions may have a significant impact on the interests of the bondholders.

²³ Arrangements for the maintenance and administration of the asset pool so that asset pool is capable of covering bond-holder claims and that there is timely payment of such claims.

3.50 This function already exists in some form as part of good market practice and is typically provided for in bondholder trustee functions. As part of the recognition process, we will expect to see provision for identical or similar arrangements.

Is the purpose of requiring there to be a bondholder representative function clear? If not please describe what further explanation is necessary.

Skilled person's report

3.51 We have the ability to require a skilled person's report at the issuers' expense as and when deemed necessary. This power is similar to FSMA section 166 skilled person's report.

Do you agree with the proposed approach? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Fees

3.52 While issuers will be credit institutions authorised for regulated activities, the covered bond regime is separate to our statutory duties under FSMA. So, we believe it is reasonable that the costs of the regime be borne by those who choose to benefit from it, namely issuers. This means regular fees for the Regime will be in addition to the fees already paid for regulated activities. The alternative of spreading the cost across the industry, including those not involved in the RCB market was not considered fair.

3.53 We propose recovering the costs of implementing the regime through two types of fees payable by recognised covered bond issuers: a recognition fee on application and an ongoing fee paid each year from 1 April 2008.

3.54 Costs are based on using ECAI ratings as one of a number of factors in deciding if assets backing a covered bond are 'capable of covering claims attaching to the bond'. Other options, such as us developing an in-house credit modelling capability, will be significantly more expensive (many multiples of the £125,000 per annum currently estimated) and this will be reflected in increased fees.

Recognition Fee 3.55 For 2007/08 we propose a recognition fee of £25,000. The recognition fee for 2008/09 and beyond is expected to stay at this level, although we would consult publicly on any changes that may be needed in future.

3.56 The recognition fee is payable in advance, either before or with the application for recognition. The fee is non-refundable, in line with our fees for other one-off transactions. This is because we commit resources to processing applications, regardless of the outcome.

Ongoing Fee 3.57 From 1 April 2008, we propose levying an ongoing annual fee on issuers to recover our yearly costs of operating the regime. Recognised covered bond issuers on the FSA register on 31 March each year will be liable for this fee. [Issuers that become recognised during the year will pay a pro-rated amount, depending on the quarter in which they become recognised. Periodic fees are pro-rated by 25% per quarter of our financial year. So an issuer recognised in June 2008 will pay 100% of the 2008/09

periodic fee, and 25% of the periodic fee if it is recognised in February 2009. We will issue invoices for periodic fees.

3.58 In the first full financial year of operating the regime (2008/2009), we propose charging all issuers a flat fee of £20,000. We will keep this approach under review and may consider alternatives in future years, such as a tiered fee structure, differentiating between issuers based, for example, on the size of the asset pool. We will consult every year in January/February on the ongoing fees payable by issuers for the financial year ahead, as part of our normal annual consultation on regulatory fees and levies.

3.59 At present, we estimate total supervision costs of £125,000 per annum spread across all issuers, expected initially to be about seven issuers.

3.60 There will be no ongoing fee between 1 January to 31 March 2008 as the benefits of collecting these fees is not expected to be justified by the cost to industry and us. If we do incur other substantial costs during this time, these will be recovered through future annual fees.

3.61 We propose that the costs of operating the regime will only be borne by issuers. We have considered whether owners of the asset pool should be liable for ongoing regular fees if an issuer becomes insolvent. However, we do not think that charging owners an ongoing fee is appropriate. This would cause an administrative burden on us and also impose additional costs on the covered bond programme. Any shortfall in one year's funding requirement would be carried over to the following year, and recovered from the population of issuers on the FSA Register at 31 March.

3.62 Regulation 36 (which adopts paragraph 16 of Schedule 1 FSMA with modifications) requires us to operate and publish a scheme to ensure financial penalties imposed under Regulation 35 are applied for the benefit of issuers. In consulting on how we intend to deal with financial penalties received, we are discharging our obligations under paragraph 16(7) of Schedule 1 FSMA.

3.63 We propose to distribute any financial penalties received in one financial year back to issuers, as a deduction from their following year's ongoing (periodic) fees. We will aggregate any fines received in one year, and calculate these as a uniform percentage deduction from the next year's fees. This fee deduction is distinct from any deductions made to periodic fees under FSMA, relating to issuers' regulated activities.

Do you agree with the proposal to recover the costs of the Regime through a combination of recognition and ongoing fees payable by solvent issuers rather than owners? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Do you agree with the proposal that any financial penalties received in one financial year should be distributed to issuers as a deduction from their ongoing fees in the following year? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Administration Fee **3.64** The reporting requirements include exception-based reporting and the annual issuer and third-party professional adviser declarations. These are a fundamental part of special public supervision. For these requirements to be effective reports must be submitted to us in a timely manner. Pursuing firms that fail to comply with our regulatory reporting requirements incurs extra regulatory costs and places an unfair burden on most firms, who submit their reports on time. This approach was introduced

in CP 05/2 and outlined in our Supervision Handbook (SUP 16.3.14). For the purposes of this regime we intend to adopt the same approach by charging an administrative fee of £250 for late submission of reports. This proposal is in addition to our existing power to take enforcement action against firms that do not submit their returns on time, or at all.

Do you agree with the proposal to charge an administrative fee of £250 for failure to submit reports on time? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Enforcement

Directions 3.65 Our direction-making powers are triggered when there has been, or it appears to us that there is likely to be, a breach of the Regulations. However, in considering whether to exercise these powers, we would take account of the relevant circumstances. Such as the contractual procedures agreed in advance between the parties to deal with such breaches including where appropriate liquidation of the asset pool and also the views of the bondholders as gathered by arrangements made by the owner. So we would, for example, only envisage having to use our direction-making powers to force the liquidation of the asset pool to pay bondholders in exceptional circumstances.

Do you agree with the proposed approach to directions? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

Financial Penalties 3.66 We are required under Regulation 35 (which references s210 FSMA) to prepare and issue a statement of policy with respect to the imposition and amount of penalties. This is set out in the paragraphs below and in our guidance.

3.67 We propose to use our power to impose a financial penalty under the Regulations in a manner which is consistent with the FSA's policy on imposing a financial penalty under FSMA.

3.68 When determining the level of financial penalty (if any) we will consider all the relevant circumstances of a case that is appropriate and in proportion to the breach concerned, including, where relevant, the factors currently set out in Chapter 13 of the Enforcement manual (ENF). We would also consider the likely impact of the financial penalty on the interests of bond-holders. We envisage that we would impose a financial penalty only in exceptional circumstances.

3.69 The policy factors in ENF13 formed part of the review in CP07/02 and it is proposed that the policy as amended by any revisions arising out of the consultation will be included in a new Decision Procedures and Penalties (DEPP) module of the Handbook and in the Enforcement Guide (EG), a new regulatory guide. If approved by the FSA's Board, DEPP and EG are due to be published in a policy statement on 27 July 2007 and come into effect on 28th August 2007.

3.70 Once we finalise our proposals, after considering responses to this CP, we will identify and make any necessary changes to other parts of the Handbook, including, for

example, to reflect the use of our power to take Enforcement action and impose penalties under the Regulations in the DEPP and EG.

Do you agree with the proposed approach on penalties? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

PILLAR 2 – ENCUMBRANCE OF ASSETS

3.71 The prudential supervision of the issuer includes the Supervisory Review and Evaluation Process (SREP) - Pillar 2 as described in the revised Basel Accord. One regulatory concern is the encumbrance of an issuer's assets which results in structural subordination of unsecured creditors (e.g. depositors) to the point at which their interests are unacceptably prejudiced. The risk that this encumbrance presents is one of the risks reviewed by us under the SREP.

3.72 Supervisory notification thresholds have been communicated to the industry and are currently based on covered bond issuance thresholds of 4% and 20% of total assets. Details are set out in an exchange of correspondence between us and the British Bankers Association²⁴. These thresholds are not, and were never intended to be, hard limits but trigger points at which issuers should engage in discussions with their supervisor.

3.73 These thresholds will be reviewed as part of Pillar 2 and encumbrance of assets which is a generic risk rather than one specific to covered bonds alone. The approach to Pillar 2 is not to publish 'reference points' as these might lead to them being mistakenly regarded as thresholds or minimum standards. Instead, firms are expected to consider their own risks and the capital that they need to hold according to their own particular circumstances. However, we considered it appropriate to explain the existence and nature of these reference points. Also that their use should lead to greater consistency of assessment where common risks exist while still leaving adequate scope for tailoring them to the specific circumstances of an issuer, which may vary with time.

While Pillar 2 does not form part of the Regulations or the Regime it is an important consideration for many covered bond issuers and investors. Ahead of the work planned on Pillar 2 and the encumbrance of assets do you have any comments?

COMPATIBILITY STATEMENT

Introduction

3.74 This section sets out our views on how the proposals in this Chapter and Annexes B and C are compatible with our regulatory objectives and the principles of good regulation.

Compatibility with the regulatory objectives under the Regulations

²⁴ http://www.fsa.gov.uk/pubs/international/cbsg_bba_letter.pdf http://www.fsa.gov.uk/pubs/international/cbsg_psletter.pdf

3.75 Our proposals in this Chapter and the draft Handbook text that accompanies it are aimed at meeting our objective of bondholder protection as described within the Regulations.

Compatibility with our the principles of good regulation

3.76 In discharging our general functions under FSMA we must have regard to seven principles of good regulation (s 2(3) of FSMA). We consider it appropriate to bear these in mind when implementing this Regime. The key aspects of these principles which are relevant to this regime are:

- competitive position of the UK;
- facilitating innovation;
- proportionality; and
- use of our resources in the most efficient and economic way.

3.77 By implementing the Regime, firms will be able to issue and invest in a new and widely-recognised product which we believe will maintain the international competitive position of the UK. Innovation will be promoted through principles-based regulation which has been used to articulate regulatory outcomes rather prescribe how these outcomes should be achieved.

3.78 We are taking a proportionate and practical approach to implementing the Regime. In particular, by adopting annual confirmations of compliance and exception-based, event-driven reporting, use of senior management and professional adviser declarations and targeting the cost of the regime at those who benefit most, i.e. the issuers. By using exception-based, event-driven reporting we will be using our resources in the most efficient and economic way.

3.79 In implementing the Regime we have not been super-equivalent.

4

REGULATORY IMPACT ASSESSMENT

HM TREASURY: IMPACT ASSESSMENT OF PROPOSALS FOR A LEGISLATIVE FRAMEWORK FOR UK RECOGNISED COVERED BONDS

Available to view or download at: www.hm-treasury.gov.uk/consultations_and_legislation/ukrec_covbonds/consult_ukrec_covbonds.cfm

Contact name for enquiries: Charlette Holt-Taylor

Telephone number: 020 7270 4392

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

For UCITS, insurers and credit institutions to be able to invest a high proportion of their assets in the covered bonds of one issuer, the covered bonds must comply with the requirements of UCITS Directive (and the Capital Requirements Directive in the case of credit institutions). At present, there is no legislative framework to enable the issue of UCITS compliant covered bonds in the UK. David Miles in his report to HM Treasury on Long-term mortgage market stability in 2004, listed the absence of a formal UK regime as a factor restricting the development of long-term fixed rate mortgage lending

What are the policy objectives and the intended effects?

The policy intention is to develop an overarching legislative framework for UCITS compliant covered bonds that is principles based rather than prescriptive. This will provide choice and flexibility for now and the future and enable innovation in the market. It is expected that the legislative framework will enable UK issuers to access the larger investor base of the Euro 1.8 trillion European market. The framework is intended to support existing issues with minimal change to the underlying contractual arrangements.

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

- An over arching legislative framework supporting the existing arrangements and allowing market development and innovation drawing from the alternative arrangements in other Member States. (Preferred)
- - An over arching legislative framework solely supporting the existing arrangements
- A prescriptive legislative regime which sets out all the details of the arrangement in legislation.

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

01/2011

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options

Signed by the responsible Minister:

Kitty Usher

Economic Secretary to the Treasury

19th July 2007

Policy Option		Description			
ANNUAL COSTS One off (Transition) £ <input type="text"/> Yrs <input type="text"/> Average Annual Cost (excluding one-off) <input type="text" value="£ 125,000"/>		Description and scale of key monetised costs by 'main affected groups' Further details below <div style="text-align: right;">Total Cost (PV) £ <input type="text"/></div>			
Other key non-monetised costs by 'main affected groups'					
ANNUAL BENEFITS One off £ <input type="text"/> Yrs <input type="text"/> Average Annual Benefit (excluding one-off) <input type="text" value="£ 5 million"/>		Description and scale of key monetised benefits by 'main affected groups' Further details below <div style="text-align: right;">Total Benefit (PV) £ <input type="text"/></div>			
Other key non-monetised benefits by 'main affected groups' 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.					
Key Assumption/Sensitivities/Risks The existing costs of issuing covered bonds will not substantially increase.					
Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £		
What is the geographic coverage of the policy/option?		UK			
On what date will the policy be implemented?		1 January 2008			
Which organisation(s) will enforce the policy?		FSA, the Courts			
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?		N/A			
Will the proposal have a significant impact on competition?		No			
Annual cost (£-£) per organisation (excluding one-off)		Micro 0	Small 0	Med	Large
Are any of these organisations exempt?		No	/No	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices)				£ (Increase - Decrease)	
Increase of £ <input type="text"/>		Decrease of £ <input type="text"/>		Net Impact	

Key:

Annual Cost: Constant Prices

(Net) Present Value

EVIDENCE BASE FOR SUMMARY SHEETS

Background

4.1 The EU has established criteria for covered bonds which are of a particularly high quality. These criteria are prescribed in Council Directive 85/611/EC²⁵ on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ('the UCITS directive').

4.2 Article 22(1) of the UCITS directive provides that a UCITS may invest no more than 5% of its assets in transferable securities (including bonds) issued by the same body. Article 22 (3) gives Member States the option to raise that 5% limit to 35% where bonds issued or guaranteed by governments are concerned.

4.3 Article 22 (4) contains a similar option for covered bonds, providing:

'Member states may raise the 5% limit laid down in the first sentence of paragraph 1 to a maximum of 25% in the case of certain bonds where these are issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principle and payment of accrued interest.'

4.4 Broadly speaking, this means a covered bond must be issued by a credit institution, have an asset pool covering the bonds which contains eligible assets and be ring-fenced from the assets of the issuer on its insolvency. Additionally, the bonds must be subject to special public supervision (which is regarded throughout the EU as regulation) which is specifically designed to protect the bondholder.

4.5 At present, there is no legislative framework for covered bonds in the UK. David Miles in his report to HM Treasury on Long-term mortgage market stability in 2004²⁶, listed the absence of a formal UK regime as a factor restricting the development of long-term fixed rate mortgage lending.

4.6 Since 2003, covered bonds (known as structured covered bonds) have been issued in the UK.

4.7 UK covered bonds are based on well-accepted market standards and benefit from a high level of legal certainty. The lack of a legislative framework providing special public supervision, however, means UK covered bonds do not comply with UCITS 22(4) thus cannot have the benefit of higher investment thresholds and more favourable risk weighting under UCITS and BCD.

²⁵ As amended by Council Directive 2001/108/EC of 21 January 2002

²⁶ David Miles The UK Mortgage Market: Taking a Longer-Term View. Final Report and Recommendations. (March 2004).

4.8 HM Treasury believes it is both important and appropriate for UK issuers to be able to compete on a level playing field within the EU open market. We have therefore developed, in close consultation with FSA and industry, a legislative framework for UK recognised covered bonds.

Legislative proposals and options

4.9 The proposed legislative framework is designed to provide the necessary underpinning for UCITS 22(4) compliance. [It is not designed to prescribe the complete design and contractual arrangements for the product.] As such, the legislation provides a principles based and outcomes focussed framework with the necessary legal requirements for the regime and its special public supervision. It will be supported by the slightly more detailed principles based guidance of the FSA (which is also contained in this consultation document) and also the underlying bond contracts.

4.10 We believe this approach will deliver a legislative regime which is flexible enough to permit product development and market innovation (should the market so wish), competition within the market and market growth while at the same time providing robust bond holder protection. It will be for industry participants who wish to issue covered bonds under this regime to use the legislative framework as a starting point and develop their own contractual provisions which will support the legislative underpinning.

4.11 The alternative to this option was to follow the prescriptive approach taken in other Member States. This would mean all aspects of the regime and the relationships between all relevant parties would be prescribed in legislation and fetter the options for issuers. Likewise an option based solely on the existing regime would fetter market development and innovation. Our proposals are designed to provide the overarching principles for both situations. We believe this will provide a flexible regime which gives the market room to develop while not prescribing the specific courses any issuer must take. This is the approach that industry favours.

4.12 UK covered bonds are not expected to materially change to comply with the requirements in the legislation and become UK Recognised Covered Bonds. Therefore the proposed policy is expected to require little change in current practices.

4.13 This policy and impact assessment is informed by substantial dialogue between FSA, HM Treasury, the European Covered Bond Council and industry. This CBA draws out the costs and benefits of the proposed regime against the baseline of the current UK structured covered bond market.

4.14 Implementation of the proposed regime will bring about two notable changes; Special public supervision required to be UCITS 22 (4) compliant, and a reduction in risk weighting. We analyse the impact of these changes below.

Benefits

4.15 Directly, the proposed covered bonds regime will reduce risk-weightings from the 20% applied currently to 10%, implying a reduction in capital requirements of approximately £100 million (at current levels of UK covered bonds issuance).

4.16 We estimate this reduction in risk-weighting would reduce annual compliance by less than £5 million. This estimate assumes a marginal cost of capital of 3.5 % per

annum²⁷. This is an upper limit estimate of the cost reduction – bond holders may in practice reduce actual capital held by less than the regulatory capital reduction (see Annex 2 of CP06/3 for a discussion of how firms react to changes in regulatory capital).

4.17 More significantly, we expect the required special public supervision and the reduced risk weighting, which are by-products of the UCITS 22(4) compliant regime, to increase the potential pool of customers for UK-issued 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).

4.18 This increase in issuance volume and decrease in spreads is likely to lead to two 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.

4.19 The preferential risk-weighting and considerably increased customer base may attract increased entry into the covered bond issuing market. Currently there are seven 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.

4.20 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 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. So any increase in quality is expected to be small.

Costs

4.21 We expect the FSA would incur costs in implementing and supervising the proposals. We estimate on-going costs of around £125,000 per year. The intention is to charge these costs directly to covered bond issuing firms as fees.

4.22 There will be additional on-going compliance costs for firms arising from reporting requirements, but we do not expect these to be large. 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.

4.23 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'

²⁷ See CP 06/3 Annex 2 for the derivation of the 3.5%.

insolvency. The existence of the FSCS would spread this risk across depositors and firms that pay the FSCS levy. This issue is being considered further by the FSA and they will present further policy proposals in due course.

SPECIFIC IMPACT TESTS - CHECKLIST

Type of testing undertaken	Results in Evidence Base? (Y/N)	Results annexed? (Y/N)
Competition Assessment		N
Small Firms Impact Test	A small business is defined as a firm with up to 250 employees. We do not think an undertaking of this size will want to issue covered bonds but there is no barrier in the legislation to them doing so if they have sufficient assets.	N
Legal Aid	N/A	
Sustainable Development	N/A	
Carbon Assessment	N/A	
Other Environment	N/A	
Health Impact Assessment	N/A	
Race Equality	N/A	
Disability Equality	N/A	
Gender Equality	N/A	
Human Rights	We do not think the proposals interfere with any Human Rights	
Rural Proofing	N/A	

2007 No.

FINANCIAL SERVICES AND MARKETS

The Recognised Covered Bond Regulations 2007

<i>Made</i>	- - - -	***
<i>Laid before Parliament</i>		***
<i>Coming into force</i>	- -	[1st January 2008]

The Treasury are a government department designated for the purposes of section 2(2) of the European Communities Act 1972⁽²⁸⁾ in relation to—

- (a) credit and financial institutions and the taking of deposits or other repayable funds from the public⁽²⁹⁾; and
- (b) measures relating to securities and rights in securities⁽³⁰⁾.

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 Recognised Covered Bond Regulations 2007. Regulations 1 to 3, 6(1), 7(2), 9(1) and (2), 10, 14(2), 17(1) and (2), 23(4), 24(3), 25(3) and (8), 35, 36, 43, 46 and 48 come into force on 3 December 2007 and the remainder of the Regulations come into force on 1st January 2008.

(2) In these Regulations—

“the Act” means the Financial Services and Markets Act 2000⁽³¹⁾;

“the 1986 Act” means the Insolvency Act 1986⁽³²⁾;

“the 1996 Act” means the Housing Act 1996⁽³³⁾;

⁽²⁸⁾ 1972 c.68; amended by the Legislative and Regulatory Reform Act 2006 (c. 51).

⁽²⁹⁾ S.I. 2001/3495.

⁽³⁰⁾ S.I. 2001/3057.

⁽³¹⁾ 2000 c.8.

⁽³²⁾ 1986 c.45.

⁽³³⁾ 1996 c.52.

- “asset” means any property, right, entitlement or interest;
- “the Authority” means the Financial Services Authority;
- “banking consolidation directive”⁽³⁴⁾ 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;
- “categories” has the meaning given by the third sub-paragraph of Article 22(4) of the UCITS directive;
- “Commission” means the European Commission;
- “covered bond” means a bond in relation to which the repayment of the principal and interest is guaranteed by the owner;
- “credit institution” has the meaning given by Article 4(1) of the banking consolidation directive;
- “owner” means the owner of the assets in the asset pool whether by right of his position under these Regulations or otherwise;
- “insolvency” has the meaning given by section 247(1) of the 1986 Act and includes [receiverships];
- “issuer” means a person who issues a recognised covered bond;
- “liquidation” has the meaning given by section 247(2) of the 1986 Act;
- “register of issuers” means the register referred to in regulation 4(a);
- “register of recognised covered bonds” means the register referred to in regulation 4(b);
- “recognised covered bond” means a category of covered bond recognised under regulation 6;
- “the Tribunal” means the Financial Services and Markets Tribunal established under section 132 of the Act; and
- “UCITS directive”⁽³⁵⁾ means Directive 85/611/EC of the Council of 20 December 1985 relating to undertakings for collective investment in transferable securities.

Asset pool

2. In these Regulations “asset pool” means—

- (a) sums derived from the issue of recognised covered bonds;
- (b) eligible property acquired with sums derived from the issue of recognised covered bonds;
- (c) sums derived from assets in the asset pool;
- (d) assets purchased with sums derived from assets in the asset pool; or
- (e) assets transferred or allocated to the asset pool by the issuer in accordance with—
 - (i) regulation 13;
 - (ii) a direction of the Authority under regulation 29; or
 - (iii) an order of the court under regulation 32

recorded under regulation 16(c).

Eligible property

3.—(1) In these Regulations “eligible property” means—

- (a) eligible assets mentioned in paragraph 68 of Annex VI of the banking consolidation directive;
- (b) loans to a registered social landlord secured—
 - (i) over housing accommodation; or
 - (ii) by rental income from housing accommodation;

⁽³⁴⁾ O.J. No L 771, 30.6.2006, p.1.

⁽³⁵⁾ O.J. No L 375, 31.12.85, p.3.

- (c) loans to a person providing loans directly to a registered social landlord secured—
 - (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 secured by payments made by a public body with step-in rights;
 - (e) loans to a person providing loans directly to a project company of a project which is a public-private project secured by payments made by a public body with step-in rights; or
 - (f) other assets held in relation to a body that has a credit assessment applied to it—
 - (i) by an ECAI recognised as eligible for exposure risk-weighting purposes under the 2006 Regulations⁽³⁶⁾; and
 - (ii) which is equivalent to credit quality step 1 or 2 on the credit quality assessment scale set out in Annex VI to the banking consolidation directive;
- (2) Eligible property must be situated in—
- (i) an EEA State;
 - (ii) Switzerland;
 - (iii) countries or territories listed in section 426 of the 1986 Act;
 - (iv) countries or territories listed in regulations made under section 426 of the 1986 Act; or
 - (v) countries or territories which have given effect to the UNCITRAL Model Law.

(3) In this regulation—

“2006 Regulations” means the Capital Requirements Regulations 2006;

“ECAI” has the meaning given by regulation 21 of the 2006 Regulations;

“exposure risk-weighting purposes” has the meaning given by regulation 21 of the 2006 Regulations;

“housing accommodation” has the meaning given by section 63 of the 1996 Act;

“project company” has the meaning given by paragraph 4H of Schedule A1 to the 1986 Act;

“public body” means a body which exercises public functions;

“public-private partnership projects” has the meaning given by paragraph 4I of Schedule A1 to the 1986 Act;

“registered social landlord” means a body registered as a social landlord under Part 1 of the 1996 Act;

“step-in rights” has the meaning given by paragraph 4J of Schedule A1 to the 1986 Act; and

“the UNCITRAL Model Law” means the Model Law on cross-border insolvency as adopted by the United Nations Commission on International Trade on 30th May 1997.

- (4) Unless otherwise defined, expressions used in these Regulations and the banking consolidation directive have the same meaning as given in that directive.

PART 2

RECOGNITION

Maintenance of registers

4. The Authority must maintain and in such manner and at such time as it may determine publish a register of—
- (a) issuers; and
 - (b) recognised covered bonds.

⁽³⁶⁾ S.I. 2006/3221.

Notification of the Commission

5.—(1) The Authority must in such manner and at such time as it may determine notify the Commission of—

- (a) issuers on the register in regulation 4(a);
- (b) recognised covered bonds on the register in regulation 4(b); and
- (c) the status of the guarantees offered.

(2) In this regulation “the status of the guarantees offered” has the meaning given by the third subparagraph of Article 22(4) of the UCITS directive.

Applications for recognition

6.—(1) Recognition—

- (a) as an issuer; or
- (b) for a recognised covered bond

may be granted by admission to the register of issuers or to the register of recognised covered bonds only on an application made to the Authority in such manner as the Authority may direct.

(2) The Authority may not entertain an application for recognition unless it is made by a person authorised under Part 4 of the Act to carry on the regulated activity referred to in article 5 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁽³⁷⁾.

(3) The Authority may grant an application for recognition if it is satisfied that the applicant and the owner—

- (a) will comply with the requirements imposed upon an issuer or an owner, as the case may be, by these Regulations; and
- (b) complies with any other requirements imposed by the Authority in relation to the application.

(4) If it appears to the Authority that the applicant and the owner comply with the requirements in paragraph (3), it may recognise—

- (a) the applicant as an issuer by adding him to the register of issuers; or
- (b) the category of covered bond as a recognised covered bond by adding it to the register of recognised covered bonds.

(5) An application for recognition may be refused if, for any reason relating to the applicant or the owner, the Authority considers that granting it would be detrimental to the interests of investors in recognised covered bonds.

7.—(1) At any time after receiving an application for recognition 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.

(2) Information which the Authority requires in connection with an application must be provided in such form, or verified in such manner, as the Authority may direct.

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

Decision on the application

8.—(1) The Authority must notify the applicant of its decision on an application for recognition—

- (a) before the end of a 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.

⁽³⁷⁾ S.I. 2001/544.

- (2) The applicant may withdraw his application, by giving the Authority written notice, at any time before the Authority determines it.
- (3) If the Authority decides to grant an application for recognition, it must give the applicant written notice of its decision.
- (4) If the Authority proposes to refuse an application for recognition, 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 for recognition, 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 for recognition, the applicant may refer the matter to the Tribunal.

Change of owner

9.—(1) Where an owner proposes to transfer the asset pool to a new owner he must make arrangements to give the Authority—

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

as the Authority may direct.

- (2) The information required in 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 new owner will comply with the requirements in regulation 6(3)(a) it must give the owner written notice of its decision before the end of a period of [3] months beginning with the date on which the information required by paragraph (1) is provided.
- (4) If it appears to the Authority that the proposed new owner will be unable to comply with the requirements in regulation 6(3)(a) it may direct the owner not to transfer the asset pool to that proposed new owner.
- (5) The owner may not transfer the asset pool to a proposed new owner—
 - (a) before it has received a written notice under paragraph (3);
 - (b) if a warning notice has been given and a notice of discontinuance has not been given; or
 - (c) if the matter has been referred to the Tribunal.
- (6) If the Authority proposes to make a direction under paragraph (4), it must give the owner a warning notice.
- (7) The Authority must, having considered any representations made in response to the warning notice—
 - (a) if it decides to do so, make a direction under paragraph (4); or
 - (b) if it decides not to give a direction, give the owner a notice of discontinuance.
- (8) If the Authority gives a direction under paragraph (4), the owner may refer the matter to the Tribunal.

Guidance

10. The Authority's powers to give guidance under section 157 of the Act (guidance) are exercisable in relation to any persons subject to these Regulations but with the following modifications—

- (a) in subsection (1), omit paragraphs (a) and (c);

- (b) for “rules” substitute “an obligation or requirement imposed by or under these Regulations”;
- (c) in subsection (3), omit “as they apply to proposed rules”;
- (d) for “a regulated person” substitute “any person subject to these Regulations”;
- (e) omit subsection (6).

PART 3

RECOGNISED COVERED BOND ISSUERS

Prohibition

11. No person may issue a recognised covered bond, unless—

- (a) he is recognised by admission to the register of issuers; and
- (b) the category of covered bond is on the register of recognised covered bonds.

Acting without recognition

12.—(1) If a person purports to issue a recognised covered bond—

- (a) without being recognised by admission to the register of issuers; or
- (b) by issuing a category of covered bond that is not on the register of recognised covered bonds

he is taken to have contravened a requirement imposed upon him by or under these Regulations.

(2) The contravention does not—

- (a) make the person guilty of an offence;
- (b) make any transaction void or unenforceable; or
- (c) give rise to any right of action for breach of statutory duty.

General requirements

13.—(1) An issuer must, in relation to all sums derived from the issue of a recognised covered bond—

- (a) transfer, or where the owner is the issuer allocate, such sums to an asset pool; or
- (b) use such sums to acquire eligible property and transfer, or where the owner is the issuer allocate, that eligible property to an asset pool.

(2) An issuer must ensure that the asset pool is, during the whole period of validity of the bond, capable of covering—

- (a) claims attaching to the bond; and
- (b) sums required for the maintenance, administration and winding up of the asset pool.

(3) But paragraph (2) does not apply in the event of the insolvency of the issuer.

Notification requirements

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

- (a) any recognised covered bond he issues; and
- (b) the steps he has taken to comply with regulation 13

as the Authority may direct.

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

PART 5

THE OWNER OF THE ASSET POOL

Prohibition

15.—(1) No person may become an owner unless he has his relevant office in the United Kingdom.

(2) In this regulation “relevant office” means—

- (a) in relation to a person which has a registered office, his registered office; or
- (b) in relation to any other person, his head office.

(3) The owner may be the issuer or a person other than the issuer.

Requirements relating to the asset pool

16. The owner must make arrangements for the maintenance and administration of the asset pool so that—

- (a) during the whole period of the validity of a recognised covered bond—
 - (i) the asset pool is capable of covering—
 - (aa) all claims attaching to that bond; and
 - (bb) sums required for the maintenance, administration and winding up of the asset pool; and
 - (ii) there is timely payment of claims attaching to that bond to the recognised covered bond holder;
- (b) on the owner’s insolvency, the asset pool is used to reimburse the principal and pay accrued interest to the holders of the recognised covered bond; and
- (c) a record is kept of each asset in the asset pool.

Notification requirements

17.—(1) An owner must make arrangements to give the Authority such information in respect of—

- (a) his compliance with regulation 16; and
- (b) the assets in the asset pool

as the Authority may direct.

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

18.—(1) This regulation applies where the owner is the issuer.

(2) Where the asset pool is not capable or is not likely to be capable of meeting the requirements in regulation 16(a) or (b) the owner must inform the Authority.

19.—(1) This regulation applies where the owner is a person other than the issuer.

(2) Where the asset pool is not capable or is not likely to be capable of meeting the requirements in regulation 16(a) or (b) the owner must inform the issuer and the Authority.

Transfer to new owner

20.—(1) This regulation applies where the owner is the issuer.

(2) Where an issuer is failing to satisfy a requirement to maintain adequate financial resources imposed under the Act, it must assign or transfer—

- (a) all interests in the assets in the asset pool; and
- (b) the benefits and obligations under all contracts relating to the asset pool

to a person other than the issuer.

Change of owner

21.—(1) A new owner must provide written notice to the Authority of a change of ownership within [one] month of the date on which the change became effective.

(2) These Regulations apply to any new owner as they applied to the original owner.

PART 6

INSOLVENCY

Arrangements

22.—(1) This regulation applies where the owner is the issuer.

(2) No interest in the asset pool may form the subject matter of—

- (a) a voluntary arrangement under Part 1 of the 1986 Act; or
- (b) a compromise or arrangement made under Part 26 of the Companies Act 2006⁽³⁸⁾

made between the issuer and his creditors or any class of them.

(3) In this regulation “voluntary arrangement” has the meaning given by section 1 of the 1986 Act.

Administration

23.—(1) This regulation applies where the owner is the issuer.

(2) The administrator of an issuer must not deal with the asset pool except for the purposes of regulation 16.

(3) But paragraph (2) does not apply to any assignment or transfer of—

- (a) all interests in the assets in the asset pool; and
- (b) the benefits and obligations under all contracts relating to the asset pool

to a person other than the issuer.

(4) The administrator must, at such times and in such manner as the Authority may direct, give written confirmation to the Authority that the asset pool complies with the requirements at regulation 16.

Provisional liquidation

24.—(1) This regulation applies where the owner is the issuer.

(2) The provisional liquidator of an issuer must not deal with the asset pool except for the purposes of regulation 16.

(3) But paragraph (2) does not apply to any assignment or transfer of—

- (a) all interests in the assets in the asset pool; and
- (b) the benefits and obligations under all contracts relating to the asset pool

to a person other than the issuer.

(4) The provisional liquidator must, at such times and in such manner as the Authority may direct, give written confirmation to the Authority that the asset pool complies with the requirements at regulation 16.

Winding up of the issuer

25.—(1) This regulation applies where the owner is the issuer.

⁽³⁸⁾ 2006 c.46.

- (2) On the application of the liquidator, the Authority may give a direction in writing extending the protected period.
- (3) The application shall be made in such manner as the Authority may direct.
- (4) During the protected period the asset pool is not to be treated as assets of the issuer in the winding up.
- (5) During the protected period the liquidator must not deal with the asset pool except for the purposes of regulation 16.
- (6) But paragraph (5) does not apply to an assignment or transfer under paragraph (7).
- (7) The liquidator must take all reasonable steps, before the end of the protected period, to assign or transfer—

- (a) all interests in the assets in the asset pool; and
- (b) the benefits and obligations under all contracts relating to the asset pool

to a person other than the issuer.

- (8) The liquidator must, at such times and in such manner as the Authority may direct, give written confirmation to the Authority that the asset pool complies with the requirements at regulation 16.
- (9) If a transfer and assignment is not made in accordance with paragraph (7), the asset pool shall be wound up in accordance with regulation 28.
- (10) In this regulation “the protected period”, in relation to an issuer, means the period of [one] year beginning with the date on which the issuer goes into liquidation.

Transfer of interests to the person holding the asset pool

26.—(1) This regulation applies where the owner is a person other than the issuer.

- (2) Where the issuer holds any interest on behalf of the owner in an asset in the asset pool, the liquidator appointed to wind up the issuer must transfer that interest to the owner.

Receivers

27.—(1) Paragraph (2) applies in the case of an owner, where a receiver is appointed on behalf of the holders of any fixed or floating charges created by the owner over the asset pool.

- (2) If possession is taken, by or on behalf of a fixed or floating charge holder, of any property comprised in or subject to the charge, and the owner is not at that time in the course of being wound up, the claims in regulation 28(1) shall be paid out of the assets coming into the hands of the receiver in priority to any claims for principal or interest in respect of those charges.
- (3) The claims in paragraph (2) shall rank equally among themselves after the expenses of the receiver and shall be paid in full, unless the property comprised in or subject to the charge is insufficient to meet them, in which case they abate in equal proportions.

Winding up

28.—(1) Where an asset pool is included in a winding up, the claims of—

- (a) recognised covered bond holders; and
- (b) persons providing services or securities for the benefit of bondholders

shall be paid from the asset pool in priority to all other creditors.

- (2) The claims in paragraph (1) shall rank equally among themselves after the expenses of the winding up and shall be paid in full, unless the asset pool is insufficient to meet them, in which case they abate in equal proportions.
- (3) In so far as the asset pool available for payment of the claims in paragraph (1) is insufficient to meet them, those claims have priority over the claims of holders of any fixed or floating charges created by the owner over the asset pool, and shall be paid accordingly out of any property comprised in or subject to that charge.

- (4) All assets remaining in the asset pool after the payment of recognised covered bondholders and all other creditors shall be the property of the issuer.

PART 7 ENFORCEMENT

Authority's power to give directions

29.—(1) This regulation applies if it appears to the Authority that a person has failed, or is likely to fail, to comply with any obligation or requirement imposed on it by or under these Regulations.

(2) The Authority may direct the person —

- (a) to take specified steps for the purpose of securing his compliance with any requirement or obligation imposed upon it by or under these Regulations;
- (b) to wind up the asset pool in accordance with regulation 28.

(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⁽³⁹⁾.

Revoking recognition

30.—(1) The recognition of an issuer may be revoked by the removal of the issuer from the register of issuers, at the request, or with the consent of the issuer.

(2) If it appears to the Authority that an issuer is failing, or has failed, to comply with any requirement or obligation imposed on it by or under these Regulations, the Authority may revoke that issuer's recognition by removing it from the register of issuers.

(3) But these Regulations apply to a person whose recognition has been revoked in relation to any recognised covered bond that was issued prior to the date on which the revocation took effect, as if he were an issuer.

Directions and revocation: procedure

31.—(1) Before—

- (a) giving a direction under regulation 29; or
- (b) revoking the recognition of an issuer under regulation 30

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) revoke the recognition

the Authority must give that person a decision notice.

(3) If the Authority decides not to—

- (a) make a direction; or
- (b) revoke the recognition

it must give that person written notice of its decision.

(4) If the Authority decides to—

- (a) make a direction; or
- (b) revoke the recognition

the person concerned may refer the matter to the Tribunal.

⁽³⁹⁾ 1988 c.36.

Powers of the court

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

- (a) there is a reasonable likelihood that any person will contravene a requirement imposed by or under these Regulations; or
- (b) any person has contravened a requirement imposed by or under these Regulations and that 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) any person has contravened a requirement imposed 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 and the Court of Session.

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

Financial penalties

33.—(1) If the Authority considers that a person has contravened a requirement imposed on him by or under these Regulations, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate.

(2) A penalty under this section 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 him under regulation 34.

34.—(1) If the Authority proposes to impose a penalty under regulation 33, it must give the person concerned a warning notice.

(2) The warning notice must state the amount of the penalty.

(3) If, having considered any representations made in response to the warning notice, the Authority decides to impose a penalty under regulation 33, 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 33, he may refer the matter to the Tribunal.

35. Sections 210 (statements of policy) and 211 (statements of policy: procedure) of the Act are to apply for the purposes of these Regulations as they apply for the purposes of Part 14 of the Act but with the modification that in section 210(1), at the end add—

“(c) the amount of penalties under the Recognised Covered Bond Regulations 2007.”.

36. Paragraph 16 of Schedule 1 (penalties) 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) for “the Act” substitute “the Regulations”;
- (b) in subparagraph (2) for “authorised person” substitute “issuers”;
- (c) omit subparagraph (3); and
- (d) at the end, add—

“(14) In this paragraph “issuer” has the meaning given by regulation 1(2) of the Recognised Covered Bond Regulations 2007.”.

Offence of misleading the Authority

37. Section 398 (misleading the Authority: residual cases) of 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) for “this Act” substitute “the Recognised Covered Bond Regulations 2007”; and
- (b) omit subsection (2).

38. Section 400 (offences by bodies corporate) of the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act.

39. Section 401 (proceedings for offences) 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 Act” substitute “the Recognised Covered Bond Regulations 2007”.

PART 8 THE TRIBUNAL

Functions of the Tribunal

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

Hearings and appeals

41. Part IX of the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act.

PART 9 MISCELLANEOUS

Functions of the Authority

42. The Authority is to have the functions conferred on it by these Regulations.

Authority’s exemption from liability in damages

43.—(1) Neither the Authority nor any person who is, or is acting as, a member, officer or member of staff of the Authority is to be liable in damages for anything done or omitted in the discharge, or purported discharge, of the Authority’s functions.

(2) Paragraph (1) does not apply—

- (a) if the act or omission is shown to have been in bad faith; or

- (b) so as to prevent an award of damages made in respect of an act or omission on the ground that the act or omission was unlawful as a result of section 6(1) of the Human Rights Act 1998⁽⁴⁰⁾.

Authority’s investigation powers

44. 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 following modifications—

- (a) for “an authorised person” substitute “a person to whom the Regulations apply”;
- (b) at the end, add—

“(12) “The Regulations” means the Recognised Covered Bond Regulations 2007.”.

45. 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 in subsection (2) at the end add—

“(e) a person to whom the Recognised Covered Bond Regulations apply.”.

Disclosure of information

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

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

Warning notices and decision notices

47. Part XXVI of the Act is to apply for the purposes of these Regulations as it applies for the purposes of the Act.

Fees

48. Paragraph 17 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 subparagraph (1), omit paragraphs (b) and (c); and
- (b) omit subparagraph (3).

Modifications of primary legislation

49. Schedule 1 (which modifies the 1986 Act) has effect.

SCHEDULE 1 regulation [49]
MODIFICATIONS TO THE 1986 ACT

Administration orders

50.—(1) This paragraph applies where the owner is the issuer.

(2) Where a person is appointed as administrator of an issuer, Part 2 of the 1986 Act (administration orders) applies with the following modifications—

- (a) in subsection 8(3)—
 - (i) omit paragraphs (a) to (d) as they apply in relation to an asset pool; and

⁽⁴⁰⁾ 1998 c.42.

(ii) at the end add—

“(3A) The purposes for whose achievement an administration order may be made in relation to an asset pool are—

- (a) the survival in compliance with regulation 16 of the asset pool as part of the company as a going concern; or
- (b) the assignment or transfer of—
 - (i) all interests in the asset pool; and
 - (ii) the benefits and obligations under all contracts relating to the asset pool to a person other than the issuer,

and the order shall specify the purpose or purposes for which it is made.”.

(b) in section 14, after subsection (1) insert—

“(1A) But the administrator of an issuer must in relation to the asset pool exercise the powers in subsection (1) subject to the requirements of regulation 16.”.

(c) in section 15, after subsection (2) insert—

“(2A) Where the administrator makes an application under subsection (2) in relation to an asset pool, the court must be satisfied that the disposal would be likely to promote one or more of the purposes under section 8(3A) specified in that order.”.

(d) in section 22, in subsection (2) at the end insert—

“(f) for issuers, a record of the assets in the asset pool required by regulation 16(c).”.

Winding up

51.—(1) This paragraph applies where the owner is the issuer.

(2) Where an issuer goes into liquidation Part 4 of the 1986 Act (winding up of companies registered under the Companies Acts) applies with the following modifications—

(a) in section 87 (effect on business and status of company), at the end add—

“(3) But during the protected period an issuer shall carry on its business in relation to the asset pool under the 2007 Regulations until an assignment or transfer is made under regulation 25(7) or the asset pool is wound up under regulation 28.”.

(b) in section 127 (avoidance of property dispositions), after subsection (1) insert—

“(1A) But subsection (1) shall not apply to an assignment or transfer of the asset pool under regulation 24(3) or 25(7).”.

(c) in section 143 (general functions in winding up by the court), after subsection (1) insert—

“(1A) But the functions of a liquidator of an issuer are, in relation to the asset pool—

- (a) to comply with regulation 16; and
- (b) to assign or transfer during the protected period—
 - (i) all interests in the assets in the asset pool; and
 - (ii) the benefits and obligations under all contracts relating to the asset pool to a person other than the issuer.”.

(1B) In the event that no assignment or transfer is made during the protected period, the functions of the liquidator are to secure that the assets in the asset pool are got in, realised and distributed under regulation 28 of the 2007 Regulations.”.

(d) in section 135 (appointment and powers of provisional liquidator), at the end insert—

“(6) But the functions of a provisional liquidator of an issuer are, in relation to the asset pool—

- (a) to comply with regulation 16; and
- (b) to assign or transfer—

- (i) all interests in the assets in the asset pool; and
- (ii) the benefits and obligations under all contracts relating to the asset pool to a person other than the issuer.”.

(e) in section 167 (winding up by the court), after subsection (1) insert—

“(1A) But during the protected period an issuer shall carry on its business in relation to the asset pool under the 2007 Regulations until an assignment or transfer is made under regulation 25(7) or the asset pool is wound up under regulation 28.”.

(f) in section 169 (supplementary powers (Scotland)), after subsection (1) insert—

“(1A) But during the protected period an issuer shall carry on its business in relation to the asset pool under the 2007 Regulations until an assignment or transfer is made under regulation 25(7) or the asset pool is wound up under regulation 28.”.

(g) in section 239 (preferences (England and Wales)), at the end add—

“(8) This section shall not apply to any allocation to an asset pool made under regulation 13 of the 2007 Regulations.”.

(h) in section 243 (unfair preferences (Scotland)), after subsection (6) insert—

“(6A) This section shall not apply to any allocation to an asset pool made under regulation 13 of the 2007 Regulations.”.

(i) in section 251 (expressions used generally)—

- (i) after the definition of “administrative receiver” insert ““asset pool” has the meaning given by regulation 2 of the 2007 Regulations;”;
- (ii) after the definition of “floating charge” insert ““issuer” has the meaning given by regulation 1(2) of the 2007 Regulations;”;
- (iii) after “otherwise requires” insert ““2007 Regulations” means the Recognised Covered Bond Regulations 2007;”; and
- (iv) after the definition of “prescribed” insert ““protected period” has the meaning given by regulation 25(10) of the 2007 Regulations;”.

52.—(1) This paragraph applies to an owner.

(2) Where an owner goes into liquidation Part 4 of the 1986 Act (winding up of companies registered under the Companies Acts) applies with the following modifications—

(a) In section 40 (payment of debts out of assets subject to floating charge), after subsection (2) insert—

“(2A) But subsection (2) shall not apply to an owner.”.

(b) in section 107 (distribution of company’s property), at the end add—

“(2) But subsection (1) shall not apply to an owner.”.

(c) in section 175 (preferential debts), after subsection (1) insert—

(d) “(1A) But subsection (1) shall not apply to an owner.”.

(e) section 176A (share of assets for unsecured creditors) is to be read as if after subsection (6), there is inserted—

“(6A) But the net property of a company to which the 2007 Regulations apply does not include the asset pool.”.

(f) in section 251 (expressions used generally), after the definition of “the official rate” insert ““owner” has the meaning given by regulation 1(2) of the 2007 Regulations;”.

Administration

53.—(1) This paragraph applies where the owner is the issuer.

(2) Where a person is appointed as administrator of an issuer, Schedule B1 to the 1986 Act (administration) applies with the following modifications—

- (a) In paragraph 3 (purposes of administration)—
 - (i) omit sub-paragraphs (1) to (4) as they apply in relation to the asset pool; and
 - (ii) at the end, add—

“(5) The administrator of an issuer must comply with regulation 16 and must perform his functions in relation to the asset pool with the objective of assigning or transferring—

- (a) all interests in the assets in the asset pool; and
- (b) the benefits and obligations under all contracts relating to the asset pool

to a person other than the issuer.”;

- (b) in paragraph 49 (administrator’s proposals)—
 - (i) after sub-paragraph (1) insert—

“(1A) The administrator of a company to which the 2007 Regulations apply shall make a separate statement setting out proposals for achieving the purpose of administration at paragraph 3(5).”;

- (ii) after sub-paragraph (3) insert—

“(3A) But paragraph (3) shall not apply to any statement of proposals required by sub-paragraph (1A).”;

- (iii) after sub-paragraph (4) insert—

“(4A) The administrator of an issuer shall send a copy of the statement of the proposals required by sub-paragraph (1A) to—

- (a) the registrar of companies;
- (b) every creditor with a claim over the asset pool of whose claim and address he is aware; and
- (c) every member of the company of whose address he is aware.”; and

- (iv) in sub-paragraph (6), after “(4)(c)” insert “(4A)(c)”.

- (c) in paragraph 50 (creditors’ meeting)—

- (i) in the unnumbered paragraph of sub-paragraph (1), after “company” insert “or a meeting of creditors of the company with claims over the asset pool”; and
- (ii) in sub-paragraph (1)(b), after “company” insert “or creditors of the company with claims over the asset pool”.

- (d) in paragraph 51(1) (requirement for initial creditors meeting), after “49(4)(b)” insert “or 49(4A)(b)”;

- (e) in paragraph 52 (requirement for initial creditor’s meeting), after sub-paragraph (1) insert—

“(1A) But paragraph (1) shall not apply in relation to a statement of proposals made under paragraph 49(1A).”;

- (f) in paragraph 59 (general powers), after sub-paragraph (1) insert—

“(1A) But the administrator of an issuer must, in relation to the asset pool, exercise the powers in subsection (1) subject to the requirements of regulation 16.”;

- (g) in paragraph 65 (distribution), at the end add—

“(4) A payment may not be made by way of distribution under this paragraph using assets in the asset pool.”;

- (h) in paragraph 66 (distribution), at the end add—

“(2) A payment may not be made under this paragraph using assets in the asset pool.”;

- (i) in paragraph 73 (protection for secured or preferential creditors), after sub-paragraph (2) insert—

“(2A) But paragraph (2) shall not apply to any statement of proposals required by sub-paragraph 49(1A).”;

- (j) in paragraph 111(1) (interpretation)—

- (i) under “Schedule” add ““2007 Regulations” means the Recognised Covered Bond Regulations 2007.”;

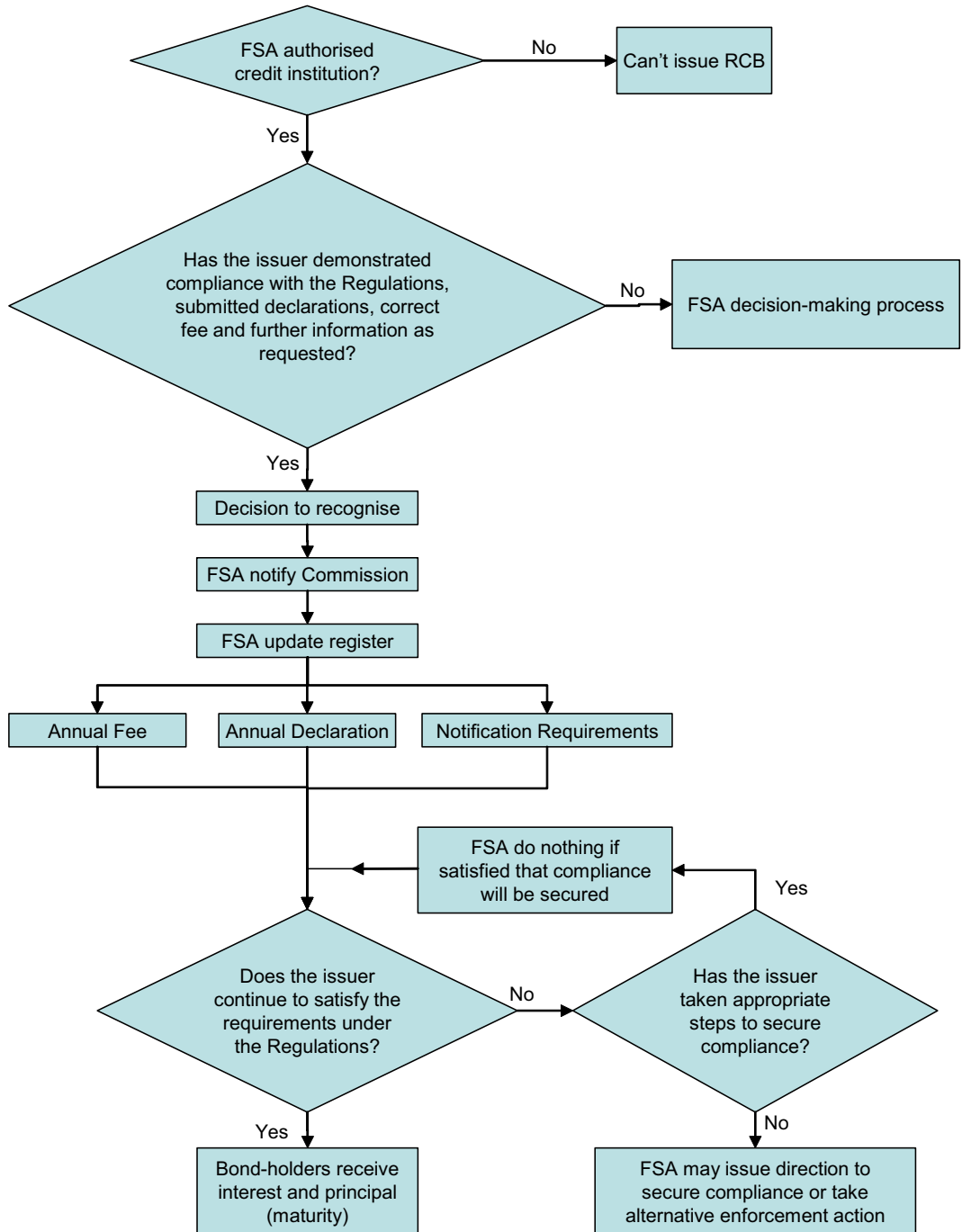
(ii) after the definition of “administrator” add ““asset pool” has the meaning given by regulation (1) of the 2007 Regulations;”; and
 after the definition of “in administration” insert ““issuer” has the meaning given by regulation 1(1) of the 2007 Regulations;” .

B

RCB RECOGNITION PROCESS

- The Regulations require that an issuer must be an FSA authorised credit institution.
- The recognition process requires satisfactory compliance with FSMA and our 11 Principles for Businesses. Issuers should have ongoing regard to FSMA threshold conditions (e.g. financial soundness, systems and controls) and the Principles for Businesses.
- Recognition must be achieved for ‘categories of bonds’ i.e. for each covered bond programme, not each covered bond. An issuer can have more than one programme.
- Issuers can apply for recognition of categories of bonds which have already been issued.
- An issuer will need to comply with the Regulations on an ongoing basis, including at the time of each subsequent issue.
- An issuer wishing to apply for recognition will need to submit the necessary information (see Annex 1), issuer and professional adviser declarations and a fee.
- The application form covers the key features of a covered bond programme. We may request further information as necessary to determine whether to grant recognition.
- Key features include participants in the transaction (e.g. name of bond trustee) and details of the asset pool, including whether or not the asset pool will be BCD41 compliant.
- Issuers must explain how they will ensure the assets are capable of covering claims during the whole life of the bond. And they must be able, on request, to give us adequate supporting documents which should detail the risks considered in reaching this conclusion.
- This process is set out in the following flow-diagram which also includes what happens post-recognition.

⁴¹ Banking Consolidation Directive Annex VI point 68





APPLICATION FORM

1.	<u>Applicant</u> Issuer name _____ FSA Reference number _____
2.	<u>Contact Details</u> Principal contact person <ul style="list-style-type: none">▪ Name _____▪ Telephone number _____▪ Email address _____▪ Address _____▪ Fax number _____
3.	Is the issuer a credit institution authorised by the FSA? Yes <input type="checkbox"/> No <input type="checkbox"/>
4.	<u>Programme Details</u> Name of Programme _____ Size of Programme _____ Description of the structure of the transaction including a structure diagram Ownership structure of LLP (if applicable)
5.	Issuer strategy and business plan in relation to the recognised covered bond programme
6.	Annual reporting date _____ [dd/mm/yyyy]
7.	Please provide names and contact details for the following parties; <ul style="list-style-type: none">▪ Owner (including legal status and registration number)▪ Bondholder representative;▪ Cover Pool Monitor;▪ Servicer; and▪ Seller
8.	<u>Asset Pool</u> Provide details of assets to be included in the cover assets pool and any other collateral of which holders of recognised covered bonds will directly or indirectly have the benefit. An issuer should also state if the programme will be BCD compliant.
9.	<u>Assets capable of covering the claims</u> A description of how the issuer satisfies the condition of ensuring that the assets are capable of covering claims attaching to the recognised covered bonds during the whole life of the bond.

10.	<p><u>Insolvency</u></p> <p>Demonstrate the arrangements in place to ensure a smooth transition of the assets from the issuer to the cover pool in the event of issuer default. In particular issuers should detail the roles performed by each party in the process.</p>
11.	<p><u>Fees</u></p> <p>Have you included the appropriate fee within the application?</p> <p>Yes <input type="checkbox"/> No <input type="checkbox"/></p>
12.	<p>Supporting Documentation [for example a copy of the offering circular]</p>
13.	<p><u>Warning</u></p> <p>Knowingly or recklessly giving us information, which is false or misleading in a material particular, may be a criminal offence (Regulation 37 of the Recognised Covered Bond Regulations and section 398 of the Financial Services and Markets Act 2000).</p> <p><u>Declarations:</u></p> <p>I confirm that the information supplied in this form is complete and correct to the best of my knowledge at the time of application.</p> <p>I undertake to tell the FSA immediately of any material changes in the information provided before receiving the FSA's decision on the application.</p> <p>I confirm I am satisfied that (having taken reasonable care to ensure that this is the case) the arrangements relating to the bond programme will comply with the requirements of the Recognised Covered Bond Regulations 2007 and the FSA's RCB sourcebook</p> <p><u>Senior Management of Issuer:</u></p> <p>Signature: Name: Position: Issuer:</p> <p><u>Professional Adviser⁴²:</u></p> <p>Signature: Name: Position: Firm:</p>

⁴² suitably qualified independent third party professional adviser to the issuer.



RECOGNISED COVERED BOND SPECIALIST SOURCEBOOK INSTRUMENT 2007

Draft: FSA 2007 / XX

RECOGNISED COVERED BOND SPECIALIST SOURCEBOOK INSTRUMENT 2007

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions of the Recognised Covered Bond Regulations 2007 (“the Regulations”):
- (1) Regulation 6 and 7 (Applications for recognition);
 - (2) Regulation 10 (Guidance);
 - (3) Regulation 9, 14, 17, 23-25 (Notification requirements); and
 - (4) Regulation 48 (Fees).

Commencement

- B. This instrument comes into force on 1 January 2008.

Amendments to the Handbook

- C. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- D. The Recognised Covered Bond Specialist Sourcebook is created in accordance with Annex B to this instrument.

Citation

- E. This instrument may be cited as the Recognised Covered Bond Specialist Sourcebook Instrument 2007.

By order of the Board
6 December 2007

A. AMENDMENTS TO THE GLOSSARY OF DEFINITIONS

In this Annex, text is new and is not underlined. Insert the following new definitions in the appropriate alphabetical position in the Glossary:

<i>administrator</i>	(in RCB) an administrator who is covered by the RCB Regulations.
<i>asset</i>	(in RCB) (as defined in Regulation 1 of the RCB Regulations) any property, right, entitlement or interest.
<i>asset pool</i>	(in RCB) as defined in Regulation 2 of the RCB Regulations.
<i>issuer</i>	(in RCB) (as defined in Regulation 1 of the RCB Regulations) a person who issues a recognised covered bond.
<i>liquidator</i>	(in RCB) a liquidator who is covered by the RCB Regulations.
<i>owner</i>	(in RCB) (as defined in Regulation 1 of the RCB Regulations) the owner of the assets in the asset pool whether by right of his position under the RCB Regulations or otherwise.
<i>protected period</i>	(in RCB) (as defined in Regulation 25 of the RCB Regulations) the period of one year beginning with the date on which the issuer goes into liquidation (within the meaning of section 247(2) of the 1986 Insolvency Act) subject to any extension directed by the FSA.
<i>provisional liquidator</i>	(in RCB) a provisional liquidator who is covered by the RCB Regulations.
<i>recognised covered bond</i>	(in RCB) (as defined in Regulation 1 of the RCB Regulations) a category of bond recognised under Regulation 6 of those regulations.
<i>recognition date</i>	(in RCB) the date of the FSA's decision to recognise a recognised covered bond.
<i>RCB</i>	The Recognised Covered Bond specialist sourcebook.
<i>RCB Regulations</i>	The Recognised Covered Bond Regulations 2007 (SI 2007/xxx).

B. THE RECOGNISED COVERED BOND SPECIALIST SOURCEBOOK (RCB)

The Recognised Covered Bond Specialist Sourcebook is created in this Annex. This is all new text and is not underlined.

1 Introduction

Application

- 1.1 G This sourcebook applies to *issuers, owners, administrators, provisional liquidators and liquidators*.

Purpose

- 1.2.1 G The general purpose of this sourcebook is to set out the guidance, directions and rules made by the *FSA* under the *RCB Regulations*. Those regulations enable bonds to be issued which comply with Article 22(4) of the *UCITS Directive*.

- 1.2.2 G This sourcebook should be read together with the *RCB Regulations*.

2 Applications for recognition

Application

- 2.1 G This chapter applies to *issuers*.

Purpose

- 2.2 G This chapter sets out the requirements that an *issuer* must follow to apply for recognition as a *recognised covered bond issuer* and for recognition of a *recognised covered bond* under Regulations 6 of the *RCB Regulations*

Form and manner of application

- 2.3.1 D The *issuer* must use the *FSA*'s form.
 2.3.2 D The *issuer* must send the form electronically to the address stated on the form.
 2.3.3 D The *issuer* must send the recognition fee with the application (see 6.5 R). The *FSA* will only treat the application as complete when it receives the fee.

Determination of recognition

- 2.4.1 G To enable the *FSA* to be satisfied that the *issuer* and *owner* will comply with requirements imposed on the *issuer* or *owner* as the case may be by or under the *RCB Regulations*, the applicant must use the application form to provide relevant details of the bond issue or programme and demonstrate how each of the requirements will be complied with.
- 2.4.2 G The *FSA* will not normally consider applications for issuer recognition in isolation from the application for recognition of the covered bond. For the first application the *FSA* expects the *issuer* to apply for recognition of a covered bond at the same time and on the same form as they apply for recognition to be a *recognised covered bond issuer*. But, once an *issuer* has been admitted to the register of *issuers* it will only need to apply for recognition of the particular covered bond.
- 2.4.3 G In relation to recognition as an *issuer* the *FSA* will need to be satisfied that the *issuer's* compliance with the requirements of the *regulatory system* has been adequate and does not give rise to any material cause for concern over the *issuer's* ability to issue recognised covered bonds in compliance with the *RCB Regulations*.
- 2.4.4 G To demonstrate that the *issuer* and *owner* will comply with Regulation 13(2) and Regulation 16(a) of the *RCB Regulations* (obligation to ensure the asset pool is, during the period of validity of the bond, capable of covering claims attaching to the bond), the *issuer* should set out the risks it has considered to the regulation not being complied with and show how those risks have been adequately mitigated.

- 2.4.5 G The *FSA* expects the *issuer* to demonstrate that there are provisions in the programme that adequately deal with:
- (1) the identification and rectification of any breach of Regulations 13(2) and 16(a) of the *RCB Regulations*, and
 - (2) The orderly winding up of the asset pool in the event that the timely rectification of breaches of Regulations 13(2) and 16(a) does not occur.
- 2.4.6 G The *FSA* expects the *issuer* to demonstrate, as part of showing that Regulation 16(a) will be complied with, that there are provisions in the programme which enable the views and interests of investors in the *recognised covered bond* to be taken account of in an appropriate and timely way by a suitably qualified, adequately resourced, independent third party.
- 2.4.7 G The *FSA* expects the *issuer*, for the purposes of demonstrating compliance with Regulations 2 and 3 (composition and situation of *asset pool*), to give details of the types of *assets* in the *asset pool* and the situation of those *assets*.
- Verification of information
- 2.5 D *Senior management* of the *issuer* and a suitably qualified independent third party professional advisor, must verify the application by confirming on the *FSA*'s form that they are satisfied that:
- (1) the information provided in the application is correct and complete,
 - (2) the arrangements relating to the bond programme will comply with the requirements in the *RCB Regulations* and this sourcebook.

3 Notifications

Application

- 3.1 G This chapter applies to *issuers, owners, administrators, provisional liquidators, and liquidators*.

Purpose

- 3.2 G This chapter sets out the reporting and notifications requirements under Regulations 14, 17-19, 23, 24 and 25 of the *RCB Regulations*
Manner, timing and verification of notifications by *issuer* under Regulation 13 of the *RCB Regulations*

- 3.3 D The issuer must send to the *FSA* written confirmation of compliance with Regulation 13(1) (transfer and allocation of sums to asset pool) and Regulation 13(2) (ensuring asset pool capable of covering claims) of the *RCB Regulations*.

Timing of confirmation

- 3.4.1 D The first confirmation date is the earlier of, any date the *issuer* selects, or the date 12 months from the *recognition date*. The *issuer* must make subsequent confirmations on the anniversary of the first confirmation date.
- 3.4.2 D The *issuer* must send the confirmation to the *FSA* within 1 month after the relevant confirmation date.

Period covered by confirmation

- 3.5.1 D The first confirmation must cover compliance during the period from the

- 3.5.2 D *recognition date* up to the confirmation date referred to in 3.4.1 D above. Subsequent confirmations must cover compliance for the duration of the period from the last confirmation to the date of the current confirmation.
- Verification of confirmation
- 3.6.1 D *Senior management* of the *issuer* must verify confirmation of compliance with Regulation 13(1).
- 3.6.2 D Both *senior management* of the *issuer*, and a suitably qualified independent third party professional advisor must verify compliance with Regulation 13(2).
- Manner, timing and verification of notifications by the *owner* under Regulation 17 of the *RCB Regulations*
- 3.7.1 D The *owner* must send or ensure that the *issuer* sends the *FSA* written confirmation of compliance with Regulations 3(2) and 16 of the *RCB Regulations* (requirements relating to the asset pool).
- 3.7.2 D The *owner* must send or ensure that the *issuer* sends the confirmation to the *FSA* annually and at the same time as the date confirmations under 3.5 D are due. The confirmation must cover the same period as under 3.5 D above.
- 3.7.3 D Where the *owner* is a person other than the *issuer*, and the *issuer* has gone into insolvency (as defined in Regulation 1 of the *RCB Regulations*), the *owner* must send a confirmation of compliance to the *FSA* within 1 month from that date. The *owner* must in addition continue to send annual confirmations under 3.7.2 D.
- 3.7.4 D *Senior management* of the *issuer* must verify the confirmation. A suitably qualified independent third party professional advisor must, in addition, verify compliance with Regulation 16 (a).
- 3.7.5 D But, confirmation of compliance with Regulation 16 (a) will not be required if the *issuer* has, in respect of the same period, sent written confirmation of compliance with Regulation 13 (under 3.3 to 3.5 D above).
- Change of owner
- 3.8.1 D Where an *owner* proposes to transfer the asset pool to a new *owner* he must provide the following information in writing to the *FSA* at least 3 months before the proposed transfer date:
- (1) Name, address and contact details of the new *owner*
 - (2) Reasons for the transfer
 - (3) An explanation of how the new *owner* will comply with the requirements imposed on it by the *RCB Regulations*
- 3.8.2 D A suitably qualified independent third party professional advisor must confirm in writing that they are satisfied that the information provided is complete and correct.
- 3.8.3 D Where Regulation 20 of the *RCB Regulations* (obligation to transfer when *issuer* fails to meet adequacy of resources requirements) applies, the *owner* must provide the information required in 3.8.1 D immediately.

Notifications to the *FSA* under Regulations 18 and 19 of the *RCB Regulations* (assets

not capable or not likely to be capable of covering claims)

- 3.9.1 G The *FSA* expects *owners* or other persons to make notifications under regulations 18, 19 (asset pool not capable or not likely to be capable of covering claims) immediately in writing.
- 3.9.2 G The *owner* or other person should include details of proposals to rectify the breach when they notify, or as soon as practicable after that time.

Manner, timing, and verification of notifications by the *administrator*, *provisional liquidator* and *liquidator*

- 3.10.1 D The *administrator*, *provisional liquidator* or *liquidator* must confirm compliance with Regulation 16 within 2 weeks of their appointment and after that annually from the date of appointment. They must send the confirmation to the *FSA* within 1 month of the relevant confirmation date.
- 3.10.2 D Confirmations must cover compliance for the period from the last confirmation to the date of the current confirmation.
- 3.10.3 D A suitably qualified independent third party professional advisor must verify the confirmation of compliance with Regulation 16a) of the *RCB Regulations*.
- 3.10.4 G The directions in 3.10 D apply where the *issuer* and the *owner* are the same person.
- 3.11 R If an *issuer*, *owner*, *provisional liquidator*, *liquidator* or *administrator* does not provide a notification to the *FSA* of the sort required by directions 3.3, 3.4.2, 3.7.1, 3.7.2, 3.8 or 3.11.1 by the date required, then that *issuer*, *owner*, *provisional liquidator*, *liquidator* or *administrator* must pay to the *FSA* an administrative fee of £250.

4 Applications for extension of the *protected period*

Application

- 4.1 G This chapter applies to *liquidators*.

Purpose

- 4.2 G This chapter sets out guidance and directions on making applications for extension of the *protected period*.

Manner and timing of applications

- 4.3 D *Liquidators* must apply in writing 4 months before the end of the *protected period* giving details of:

- (1) the period of extension asked for;
- (2) the reasons why the extension period is necessary;
- (3) the proposed action during the proposed extension; and
- (4) views of the investors in the relevant *recognised covered bond*.

- 4.4 G The *FSA* will consider all relevant circumstances and in particular whether the extension of the *protected period* is in the interests of the investors in the relevant *recognised covered bond*.
- 4.5 G The *FSA* will aim to make a decision on the extension application 2 months

before the end of the *protected period*.

5 Enforcement powers

Application

- 5.1 G This chapter contains guidance for *issuers, owners, administrators* and *provisional liquidators, liquidators* and other persons subject to the *RCB Regulations* on the use of the *FSA's* enforcement powers under those regulations.

Purpose

- 5.2 G To give guidance on the *FSA's* approach to use of its enforcement powers under the *RCB Regulations* and to set out the *FSA's* policy on the imposition and amount of financial penalties.

The *FSA's* enforcement powers

- 5.3.1 G The *FSA's* approach to exercise of its enforcement powers will be consistent with its approach in *DEPP* and *EG* so far as possible.

- 5.3.2 G (1) When deciding to take enforcement action under Part 7 of the *RCB Regulations*, and what form of enforcement action to take, the *FSA* will consider all relevant facts, including:
- (a) whether any contractual or other arrangements agreed between the parties can be used effectively to address any perceived failure under the *RCB Regulations*; and
 - (b) the interests of investors in the relevant *recognised covered bond*
- (2) The *FSA* does not normally expect to use its enforcement powers where the *issuer, owner, provisional liquidator, liquidator, or administrator* are in the process of rectifying non-compliance and where they have taken account of the views and interests of investors in the *recognised covered bond*.

Financial penalties

- 5.4.1 G The *FSA's* policy on imposing financial penalties and amounts of financial penalties under the *RCB Regulations* will be consistent with that as set out in *DEPP* and *EG*) with appropriate modifications.
- 5.4.2 G When considering, whether to impose a financial penalty, the amount of penalty, and whether to impose the penalty on the *issuer* or the owner, the *FSA* will have regard, where relevant to:
- (1) the particular arrangements between the *issuer* and the *owner*.
 - (2) the likely impact of the penalty on the interests of investors in a *recognised covered bond*.

6 Fees

Application

- 6.1 R This chapter applies to *issuers*.

Purpose

- 6.2 G This chapter provides for an initial fee for recognition of a *recognised covered bond* and subsequent ongoing annual fees.
- 6.3 G The recognition fee is for the *FSA's* work in dealing with an *issuer's* application for recognition of a *recognised covered bond*.
- 6.4 G The ongoing annual fee is a fee for the *FSA's* ongoing costs in administering the *recognised covered bond* regime. Like the recognition fee, it is charged to *issuers* in respect of their participation in the regime.
- 6.5 G Fees are not refundable.

Recognition Fees

- 6.6 R An *issuer* applying for recognition of a *recognised covered bond* must pay the FSA the recognition fee set out in the table at 6.8 R below.
- 6.7 R The *issuer* must pay the fee in full on or before the date set out in the table below. The *issuer* must pay the fee by bankers draft, cheque, or other payable order.

- 6.8 R Table of recognition fees

(1) Fee payer	(2) fee payable	Due date
An applicant for recognition of a <i>recognised covered bond</i> under the <i>Regulations</i> .	[£25,000]	On or before the date application is made

Ongoing Annual Fees

- 6.9 R An *issuer* must pay the FSA the ongoing annual fee set out in the table at 6.12 R below.
- 6.10 R The *issuer* must pay the fee in full on or before the date set out in the table below. The *issuer* must pay the fee by bankers draft, cheque, or other payable order.
- 6.11 R The *issuer* must pay the fee for each financial year in which the *issuer* is on the register of *issuers* as at 31 March of the previous financial year. This will apply for the financial year beginning 1 April 2008, and following financial years.

- 6.12 R Table of ongoing annual fees

1 Fee payer	2 Fee payable	3 Due date
<i>Issuers</i> on the register as at 31 March of the financial year immediately preceding the period 1 April to 31 March to which the fee relates	[£20,000]	Within 30 days of the date of the invoice.

- 6.13 R For the first year in which the *issuer* becomes recognised, the *issuer* must pay the proportion set out in the table at 6.14 R of the ongoing annual fee, within 30 days of the date of the invoice.

- 6.14 R Table of proportion of ongoing annual fee:

1 April to 30 June inclusive	100%
1 July to 30 September inclusive	75%
1 October to 31 December inclusive	50%
1 January to 31 March inclusive	25%

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