

EXPLANATORY MEMORANDUM TO
THE REGULATED COVERED BOND REGULATIONS 2008

2008 No. 346

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 The Regulated Covered Bond Regulations 2008 ("the Regulations") provide a legislative framework for covered bonds in the UK in order to meet requirements of EU legislation. Covered bonds are a class of corporate bond, generally issued by banks, and backed by certain assets which are ring-fenced. The Regulations provide for a register of issuers and a register of regulated covered bonds to be maintained by the Financial Services Authority ("the FSA") which is to supervise the new regime.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 The Regulations (which are made under the power conferred by section 2(2) of the European Communities Act 1972) provide for the establishment of a UK covered bonds regime that is compliant with Article 22(4) of Council Directive 85/611/EC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ("UCITS Directive"); Article 22(4) of Council Directive 92/49/EC of 18 June 1992 on the co-ordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance ("Third Non-Life Insurance Directive"); and Article 24(4) of Directive 2002/83/EC of the European Parliament and of the Council concerning life assurance ("Consolidated Life Directive"). The relevant requirements of the UCITS Directive, the Third Non-Life Directive and the Consolidated Life Directive are in the same terms. Reference will only be made to the UCITS Directive in this Memorandum.

4.2 Article 22(4) of the UCITS Directive provides that investment limits may be raised:

"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 bondholders. In particular, sums deriving from the issues of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of accrued interest."

- 4.3 The Regulations establish a legislative framework designed to protect bondholders in accordance with the UCITS Directive. The FSA is to be responsible for implementation and supervision of the regime. The Regulations provide powers to the FSA to give guidance, to make directions and impose requirements in relation to registration of issuers and regulated covered bonds, notifications and reporting, to take enforcement action and to make rules about the levying of fees.
- 4.4 The Government submitted an explanatory memorandum dated 6 July 2000 (doc. 9124/00) on Commission proposals to amend Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). The House of Commons Select Committee on European Scrutiny reported on these proposals in report 24 (1999-2000), and cleared the proposal relating to UCITS Article 22(4) (as set out in doc. 21338) on 12 July 2000.
- 4.5 The Banking Consolidation Directive (Directive 2006/48/EC) was considered in Explanatory Memorandum on European Community Legislation 11545/04. The European Scrutiny Committee of the House of Commons considered the Explanatory Memorandum on 20 October 2004 and recommended a debate that took place on 8 November 2004. The Directive was cleared in the House of Lords on 13 March 2007, and in the House of Commons on 21 March 2007.
- 4.6 Directive 2002/83/EC concerning life assurance (the consolidated life assurance Directive) was cleared in the in the House of Lords on 13 March 2007. Directive 92/49/EEC of 18 June 1992 on the co-ordination of laws, regulation and administrative provisions relating to direct insurance other than life assurance (the third non-life Directive) was cleared in the House of Commons on 06 November 2006 and in the House of Lords on 31 October 2006.
- 4.7 A Transposition Note is attached as an annex to this Memorandum.

5. Territorial Extent and Application

- 5.1 This instrument applied to all of the United Kingdom.

6. European Convention on Human Rights

- 6.1 As this instrument is subject to negative resolution procedure and does not amend primary legislation no statement is required.

7. Policy background

Policy general

- 7.1 Covered bonds (known as ‘structured’ covered bonds) have been issued in the UK since 2003. Structured covered bonds are issued by credit institutions. The issuer lends sums derived from those bonds to a separate legal entity (the owner). The owner uses the sums to purchase property which it holds in an asset pool. The owner agrees to guarantee the issuer’s obligations to the covered bond holders in the event

of a default. In the event that the guarantee is called, the loan is only repaid once the bond holders' claims to the principal and accrued interest have been met. The issuer normally provides many of the services necessary to maintain and administer the asset pool.

7.2 The lack of a legislative framework providing specific supervision means that structured covered bonds issues in the UK are not UCITS compliant and therefore cannot benefit from higher prudential investment limits for UCITS firms or the more favourable credit risk weighting for investing banks.

7.3 The policy objective is to take account of the existing structure of UK covered bonds to create a regime which provides UCITS Directive compliance and enables issuers of UK covered bonds to compete on a level playing field in the EU.

Consultation

7.4 A public consultation on the Government's intended approach, including draft legislation and a partial Regulatory Impact Assessment, was launched on 23 July and closed on 15 October 2007. Fourteen responses were received and a copy of the Summary of Responses is available on the Treasury website (www.hm-treasury.gov.uk).

7.5 The framework that was proposed during consultation reflected industry's preference – at the time – for legislation that was flexible and could accommodate market innovation. It therefore allowed for a fairly broad definition of eligible property (i.e. those assets eligible for inclusion in the asset pool backing the bond) and a broad list of jurisdictions in which these assets could be located. Respondents were supportive of the implementation of a UCITS Directive compliant regime; however, many emphasised the need for the legislation to impose stricter requirements, with a clearer focus on quality and increased transparency for investors. As a result, the Government has introduced further requirements relating to the quality of assets to be kept in asset pools. The definitions of the asset pool and eligible property have been restricted and the location of assets has also been limited.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 Any impact on the public sector will fall principally on the FSA, which will be responsible for maintaining registers of issuers and regulated covered bonds and for enforcing requirements imposed under the Regulations.

9. Contact

Hannah Gurga at HM Treasury (tel. 020 7270 4345 or e-mail hannah.gurga@hm-treasury.gsi.gov.uk) can answer any queries regarding this instrument.

IMPLEMENTING ARTICLE 22(4) OF THE UCITS DIRECTIVE 85/611/EC, ARTICLE 22(4) OF THE THIRD NON-LIFE DIRECTIVE 1992/49/EEC, ARTICLE 24(4) OF THE CONSOLIDATED LIFE DIRECTIVE 2002/83/EC AND PARAGRAPH 68 OF ANNEX 6 TO THE BANKING CONSOLIDATION DIRECTIVE 2006/48/EC

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A TRANSPOSITION NOTE

Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to **undertakings for collective investment in transferable securities (UCITS)**, as last amended by Directives 2001/107/EC and 2001/108/EC (OJ of 13.2.2002, L41, p.20 and p.35).

Directive 92/49/EEC of 18 June 1992 on the co-ordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance (the third non-life Directive), was last amended by Directive 2007/44/EC of 5 September 2007.

Directive 2002/83/EC of 5 November 2002 concerning life assurance (the consolidated life assurance directive), was last amended by Directive 2007/44/EC of 5 September 2007.

Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions has not been amended (BCD).

These regulations do what is necessary to implement Article 22(4) of the UCITS Directive and paragraph 68 of Annex 6 of the BCD, including making consequential modifications to domestic legislation to ensure coherence in the area to which they apply.

Article	Objective	Transposition	Responsibility
22(4) UCITS, 22(4) Third Non-life Insurance Directive, 24(4) Consolidated Life Directive	To allow Member States to raise investment limits for investment funds (UCITS) and insurance undertakings regarding their investment in covered bonds which meet the requirements set out in this provision.	Regulated Covered Bond Regulations 2008 (the 2008 Regulations)	The Treasury, through regulations made under section 2(2) of the European Communities Act 1972. The FSA, through exercise of their supervisory and direction making powers under the 2008 Regulations.
Paragraph 68 of Annex 6 to the BCD	An option to allow credit institutions to obtain a lower risk weight for covered	Regulation 2 of the 2008 Regulations and	The Treasury, through regulations made

	<p>bonds compliant with Article 22(4) the UCITS Directive and collateralized by specified assets.</p>	<p>Rules 3.4.106 to 3.4.110 of the FSA Prudential Sourcebook for Banks, building societies and investment firms.</p>	<p>under section 2(2) of the European Communities Act 1972.</p> <p>The FSA through the exercise of their rule-making powers under the Financial Services and Markets Act 2000.</p>
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Proposals for a UK Recognised Cover Bonds legislative framework:

summary of responses and final
Impact Assessment
February 2008

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ISBN 978-1-84532-350-9

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A SUMMARY OF CONSULTATION RESPONSES

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Introduction

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

The consultation document

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

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

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

CONSULTATION QUESTIONS

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

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

SUMMARY OF RESPONSES

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

HMT's general approach

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

1.6 However, consultation coincided with a period of market turbulence and many of the responses were informed by these events. Whilst respondents remained fully supportive of the implementation of a UCITS-compliant regime, they stressed that in order to deliver a liquid product in which investors could have a high degree of confidence, the legislation needed to focus on quality rather than flexibility.

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

Restricting the Structure of UK Regulated Covered Bond Programmes

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

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

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

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

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

Overarching Quality Provision

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

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

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

granting it would be detrimental to the interests of investors in Regulated Covered Bonds or to the maintenance of the good reputation of the Regulated Covered Bond sector in the UK. In addition, issuers and owners must make arrangements so that the asset pool is of sufficient quality to give investors confidence that there will be a low risk of default in the timely payment of claims attaching to a Regulated Covered Bond.

The Asset Pool and Eligible Property

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

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

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

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

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

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

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

Location of Eligible Property

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

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

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

Priority of Payment

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

Location of Issuer

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

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

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

1.28 On this basis HMT have decided to restrict issuance to UK authorised credit institutions only. The regulations also stipulate that the SPV's centre of main interest (COMI) must be in the United Kingdom in order to ensure that insolvency proceedings fall under the jurisdiction of the UK.

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

Set-Off

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

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

Capability

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

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

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

Functions of the FSA and enforcement

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

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

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

Timeframe for decision making

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

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

Other issues raised during consultation

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

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

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

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

Conclusions

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

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

Next Steps

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

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



LIST OF CONSULTATION RESPONDENTS

RESPONDENTS

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

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FINAL IMPACT ASSESSMENT

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

Contact name for enquiries: Henry Rigg

Telephone number: 020 7270 4704

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

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

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

What are the policy objectives and the intended effects?

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

The delivery of the Regulated Covered Bonds regime will enable:

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

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

Option 1 - do nothing.

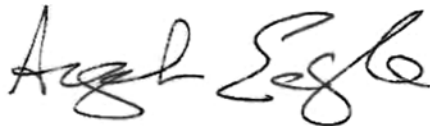
Option 2 - Deliver a Principles-base legislative framework compliant with UCITS, Third Non-life Insurance Directive and Consolidated Life Directive that supports market development by focusing on quality, robustness and transparency for investors. This will enable UCITS and insurers to be able to invest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

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

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

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

Signed by the responsible Minister:

A handwritten signature in black ink, appearing to read 'Aengus Egan', written in a cursive style.

Date: 07.02.08

Policy Option 2

Description; Deliver a UCITS compliant principles based legislative framework.

<p>ANNUAL COSTS</p> <p>One off (Transition) <input type="checkbox"/> £ 2 m</p> <p>Average Annual Cost (excluding one-off) £ 250,000</p>		<p>Description and scale of key monetised costs by 'main affected groups'</p> <p>The key monetised cost will effect credit institutions who issue Regulated Covered Bonds.</p> <p style="text-align: right;">£ 4.3 m</p> <p style="text-align: right;">Total Cost (PV)</p>	
<p>Other key non-monetised costs by 'main affected groups'</p>			
<p>ANNUAL BENEFITS</p> <p>One off <input type="checkbox"/> £ None</p> <p>Average Annual Benefit (excluding one-off) £ 3.6375 m</p>		<p>Description and scale of key monetised benefits by 'main affected groups'</p> <p>The Key monetised benefits will fall to Regulated Covered Bond holders, who will benefit from reduced risk weightings.</p> <p style="text-align: right;">££ 33.9 m</p>	
<p>Other key non-monetised benefits by 'main affected groups'</p> <p>Conservative investors may be better able to diversify their portfolios.</p>			
<p>Key Assumption/Sensitivities/Risks</p> <p>Key assumptions include, the rate at which bond holders will reduce actual capital held, relative to the regulatory capital reduction.</p>			
Price Base Year 2007	Time Period Years 10	Net Benefit Range (NPV) £ 16.9m - 42.3m	NET BENEFIT (NPV Best estimate) £ 29.6 m

What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	6 March 2008
Which organisation(s) will enforce the policy?	FSA
What is the total annual cost of enforcement for these organisations?	£ 125,000
Does enforcement comply with Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	No
What is the value of the proposed offsetting measure per year?	£ N/A

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

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

Evidence Base for Summary Sheets

OVERVIEW

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

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

Option 1 costs and benefits

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

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

Benefits

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

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

Costs

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

- UK structured covered bonds do not currently comply with the UCITS, Third Non-life Insurance Directive and Consolidated Life Directive, implying lower prudential investment limits for UCITS and insurance

investors. UCITS and insurance firms can currently only invest up to 5% of their assets in the covered bonds of a single UK issuer, reducing potential demand for UK products.

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

Option 2-Costs and benefits

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

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

Benefits

The benefits from Option 2 will include:

- The proposed covered bonds regime will reduce risk-weightings for credit institution investors from the 20% currently applied to 10%, implying a reduction in capital requirements of approximately £100 million.
- We estimate this reduction in risk weighting would reduce annual compliance by less than £5million. This estimate assumes a marginal cost of capital of 3.5% per annum¹. This is an upper limit estimate of the cost reduction – bondholders may in practice reduce actual capital held by less than the regulatory capital reduction². To estimate a lower limit of the cost reduction we assume bond holders reduce actual capital held to a level 35% above the required amount, reducing annual compliance by £2.275 million.

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

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

- More significantly, we expect the required special public supervision (in part by increasing transparency and reducing information asymmetries), the reduced risk weighting and increasing of prudential investment limits (which are by-products of the UCITS 22(4) compliant regime), to increase the potential pool of customers for UK-issued Regulated Covered Bonds. We understand firms (such as banks based in other EU member states) have limits imposed on them from purchasing bonds that fall outside the UCITS regime. The increase in demand is likely to lead to a greater volume of covered bonds issuance in the UK and a decline in the spread over German Pfandbriefe (in the range of 3-7 basis points).
- The increase in issuance volume and decrease in spreads is likely to lead to three welfare increases. First, conservative investors may be better able to diversify their portfolios. Second, the cost of capital for UK banks will fall, either increasing their profits or reducing the cost of capital to UK borrowers. Finally, a deeper and more liquid market will be less vulnerable to periodic liquidity shortages, implying a more stable source of mortgage funding.
- The preferential risk-weighting and considerably increased customer base may attract increased entry into the covered bond issuing market. Currently there are eight structured covered bond issuers in the UK. The largest barrier to the market is the ability to generate enough assets (cover pool) to meet the requirements of the covered bond asset class. Jumbo issuances (above 1 billion Euro) are the market norm. In the UK a small number of banks and building societies, around 10, could reasonably be expected to meet these minimum requirements.
- A requirement of the proposed regime is special public supervision and a condition of this will be independent third party verification that the structure meets these rules. This could be expected to improve the quality of the product. However, the existing UK structured covered bonds market is set up to mimic that of regimes which are able to apply a preferential risk-weighting. Consequently the products offered in the UK have had to be extremely competitive and constantly evolving in order to make up for the pricing difference between the markets.

Costs

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

There will be additional on-going compliance costs for firms arising from reporting requirements, but we do not expect these to be large as issuers currently supply much of this information to third parties. The proposed regime also requires third party verification. But firms indicate this is unlikely to create incremental costs since rating agencies already require similar independent verification. To elaborate, rating agencies that deal with existing

UK structured covered bonds require legal opinion (in an acceptable form) among other things: that the transaction documents are legal, valid, binding and enforceable; and that the assets have been effectively ring-fenced. These are the principal requirements of independent verification.

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

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

IMPACT ON SMALL FIRMS

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

IMPACT ON COMPETITION

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

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

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

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

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

Specific Impact Tests - Checklist

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