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Simon Hills  
Director  
British Bankers' Association  
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23 October 2008

Our Ref:

Your Ref: PS/JR

Dear Simon

## **Covered Bond Issuance and Asset Encumbrance**

### **Background**

Further to our previous letter on covered bond issuance and asset encumbrance of August 2005, we are writing to set out the FSA's current approach to assessing asset encumbrance. The 2005 letter addressed the structural subordination of unsecured creditors in the context of covered bonds and we highlighted the possibility of additional capital being required under Pillar 2 as covered bond issuance increased. In the letter, we said we would evaluate, on a case by case basis, the relative impact of:

- the potential enhancement to liquidity and funding offered by covered bond issuance that could improve the issuer's general creditworthiness; and
- the extent to which the claims of covered bondholders on the asset pool could result in a smaller and potentially lower quality pool of assets being available to meet the claims of unsecured creditors.

Since 2005 there have been significant changes in both the market, and in market conditions. Firms have historically used secured funding sources to fund assets; however in the current stressed market conditions firms are increasingly utilising the assets on their balance sheet to gain liquidity. As a firm increases the assets pledged for the benefit of secured investors, the adequacy of the remaining assets used to meet unsecured creditors' claims may be diminished.

### **Current Position**

Whilst covered bonds can present significant risks to the claims of unsecured creditors when they are a material source of funding, other secured funding methods such as securitisations, securities financing transactions and repo financing can also pose risks to the unsecured creditors.

**We wish to let you know that with immediate effect, the FSA expects to discuss with firms, in advance, all plans for covered bond issuance or any other significant new asset encumbrance.** This letter supersedes the August 2005 letter and the quantitative limits contained therein.

Firms should be clear that the FSA's case-by-case assessment may result in supervisory outcomes, including an additional Pillar II capital charge, a cap on covered bond issuance, and/or a limit on the term of issuance.

### **Supervisory Assessment**

In reaching a judgement we will consider, but will not be limited to, the following factors:

- The volume of encumbered assets as a proportion of the firm's total assets, and the level of over-collateralisation. Firms should consider what level of encumbrance they think is sustainable for their firm across a range of timeframes and should be ready to justify this level to supervisors. They should also consider how this could be affected by factors outside of their control, such as a continued fall in house prices or an increase in arrears levels;
- The firm's current and long-term funding plan;
- The potential causes and subsequent effects of any credit rating downgrade that might be suffered by the firm. The firm should be able to quantify the operational and financial consequences resulting from a ratings downgrade;
- The firm's ability to maintain a covered bond or other programme given the firm's contractual obligation to maintain asset levels in the programme, and the potential for bifurcation of quality between the secured and unsecured assets on balance sheet;
- The level of senior management understanding and involvement. The firm's senior management should have a full understanding of the firm's covered bond or other programme, including knowledge of the programme's triggers and the implications of any breach; and
- The degree of recourse the covered bond or other programme enjoys over the remaining assets of the firm.

### **Future Developments**

In due course we will be reviewing our policy on encumbrance of assets with the aim of introducing a clear prudential framework which adequately reflects the degree of prejudice experienced by other creditors. The framework is likely to lead to capital charges that adequately reflect the risks to other creditors; in some cases this charge could potentially be in excess of the level of over-collateralisation. We would intend to consult on this framework using our normal process.

If you would like to discuss this issue in greater detail then feel free to contact me. If your members would like to discuss the prudential treatment of covered bonds, and other secured funding methods, they should contact their FSA supervisor directly.

A copy of this letter will be sent to the Covered Bond Standing Group members and posted on our website.

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. Sharma', with a small flourish at the end.

Paul Sharma  
Director  
Wholesale and Prudential Policy