

# UK Regulated Covered Bonds: Assuring and monitoring quality and confidence



The UK covered bond market was established in July 2003 under general law and contract without special public supervision, as defined in the Undertakings for Collective Investments in Transferable Securities Directive.

In March 2008 specific UK covered bond legislation (Regulated Covered Bond Regulations 2008) was implemented by HM Treasury and the Financial Services Authority, the UK regulator (FSA). Following this the UK covered bond market comprises both Regulated Covered Bond programmes (RCB) and structured (unregulated) covered bond programmes.

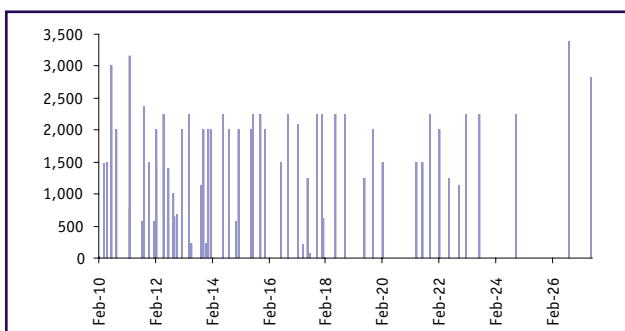
To achieve UK RCB status, a covered bond programme must undergo a rigorous, independent and comprehensive risk review by the FSA. As special supervisor of covered bond programmes, we wish to facilitate a robust RCB market in the UK. The FSA also continues to monitor programmes once they are admitted to the RCB register to ensure their quality is maintained and to preserve investor confidence in the UK RCB market's reputation.

RCBs benefit investors with:

- higher prudential investment limits under UCITS (increasing the concentration investment limits on bonds issued by the same entity to 25% (from 5% of total assets invested);
- higher investment thresholds for insurers (up to 40% of assets in RCBs compared with 5% in structured (unregulated) covered bonds); and
- lower riskweights under the Banking Consolidation Directive (EU implementation document of Basel II).

## Term structure of UK Regulated Covered Bond Market (€ millions)

Total of €105.5bn—equivalent as at Dec 09



## Regulated Covered Bond Issuers (as at September, 2010)

Abbey National Treasury Services plc  
Barclays Bank plc  
Bank of Scotland plc  
HSBC Bank plc  
Leeds Building Society  
Lloyds TSB Bank plc  
Nationwide Building Society  
Royal Bank of Scotland  
Yorkshire Building Society

## What does the FSA review when admitting a covered bond programme to the register?

The FSA conducts a rigorous on-site and desk-based review of an issuer and programme applying for regulated status.

This review, which is independent of any other analysis (e.g. credit rating agency analysis), assesses the:

- appropriateness of the issuer's oversight and governance framework. The FSA conducts an onsite visit to assess the competency of senior management to manage effectively risks inherent in the programme;
- appropriateness of systems, controls, policies and procedures in relation to risk management, underwriting, arrears and valuation, as well as compliance with UK RCB Regulations;
- proficiency of cash management and servicing functions, which are reviewed during an on-site visit;
- quality of eligible assets in meet cover pool requirements (considering borrower history, income verification, LTV ratios, income multipliers, arrears, seasoning, loan purpose, property types and terms of the loans);
- ability of the assets in the cover pool to mitigate the risk of asset-liability mismatches, the credit risk of assets, and other market value risks, concentration risks, currency risks, basis risks and counterparty risks;
- assets on the issuer's balance sheet available to be substituted in to meet cover pool requirements;
- ability of the programme to make timely payment on bonds. This is assessed separately by both the issuer and the FSA, through two independent cashflow models of the programme under various FSA-agreed stressed scenarios;

- legal structure's compliance with the UK RCB Regulations (for example, to ensure the programme's remoteness from issuer insolvency). The FSA also reviews the relevant legal documents to inform our risk assessment (such as offering circulars, final terms, swaps and cash management agreements);
- existence of procedures for identification and rectification of any potential breaches (including contractual triggers and appointment of replacement counterparties); and
- independent legal and audit opinion on the compliance of the issuer and programme with RCB Regulations (including a true sale opinion).

## How does the FSA monitor Regulated Covered Bonds?

Once an issuer is on the RCB register, the FSA's dedicated RCB Team and FSA Risk Specialists continue to:

- ensure sufficient assets in the cover pool to mitigate risk of non-timely bond payments;
- provide independent assurance that in advance of further issuance a regulated programme's asset pool would continue to make timely payments on all bonds under FSA credit and cashflow modelling;
- monitor the impact of significant changes in asset-liability profiles of the programmes (through modelling cashflows under FSA stressed scenarios);
- receive and analyse line by line and pool performance data;
- review any proposed material changes to the programme's contractual terms to ensure the risk of non-timely bond payments does not increase; and
- maintain a public register of regulated programmes.

If an RCB issuer or RCB programme breaches any of the UK RCB Regulations, the FSA has the power to either direct correction of the breach (including by the transfer of additional assets into the cover pool), impose financial penalties, or otherwise de-register or wind-up the programme.

## What must issuers do to keep the RCB programmes on the RCB register?

Once an issuer and programme is on the register they must continue to model the programme's credit and cashflows on a quarterly basis and confirm to us that the asset pool is capable of making timely bond-payments. The cashflows must be stressed under levels commensurate with FSA-agreed benchmark stresses. Whether directed by the FSA, or to maintain sufficient assets, the issuer must be able to transfer assets to the cover pool on a timely basis.

The issuer must record the assets transferred by way of true sale to the LLP to ensure the bankruptcy remoteness of the LLP's collateralised guarantee.

## FSA cashflow modelling

When modelling the cashflows of regulated programmes we stress the following variables:

- default rate (including shape/curve);
- loss severity (including shape/curve);
- time to recovery;
- refinancing sale price of assets;
- prepayment rate (including shape/curve);
- survival or fall-away of the interest rate swap and currency swap;
- base rate (including shape/curve);
- libor margin over base rate (including shape/curve);
- SVR versus Libor;
- GIC rate/margin; and
- servicing/expense rate.

We incorporate into our cashflow modelling the:

- actual assets (asset type, amortization characteristics, interest cashflow drivers);
- outstanding liabilities (currency, redemption profile, and coupon characteristics); and
- structural features (swap terms, reserve funds, extension period optionality and minimum yield requirements).

Separately, the issuer must provide information to the FSA at appropriate intervals to ensure we can review the programmes efficiently, such as:

- notification of any proposed material change to the contractual terms that may affect compliance with the UK RCB Regulations;
- quarterly cover pool performance data (including LTV ratios, arrears, seasoning, borrower history, income verification and geography);
- quarterly loan pool data tapes and updated program documentation to enable credit and cashflow stress-testing under the FSA's separate asset capability model;
- annual confirmation from senior management that the programmes are in compliance with the UK RCB Regulations;
- annual independent legal and audit opinions on continued compliance with RCB Regulations; and
- quarterly confirmation of the asset pool's capability to make timely payments on the bonds.

## For further information, please contact:

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**RCB Register**  
[http://www.fsa.gov.uk/Pages/Register/rcb\\_register/index.shtml](http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml)