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Covered bonds in the UK have been issued through a combination of structured finance techniques and statutory provisions following the implementation of specific UK covered bond legislation in March 2008 by HM Treasury and the Financial Services Authority. The first UK covered bonds were issued in 2003 prior to the implementation of the dedicated covered bond regulatory framework, with the market growing steadily until Q3 2007. Although structured covered bonds issued by UK entities are recognised as secure products in their own right, in February 2008 HM Treasury and the Financial Services Authority implemented a specific UK covered bond legislation. The Regulated Covered Bonds Regulations 2008 (the "Regulations") overlaid the existing common law and contractual structures, providing the necessary underpinning for UCITS Article 52(4) (formerly UCITS Article 22(4)) compliance and thereby providing the benefits of higher prudential investment limits, higher investment thresholds for insurers and lower risk weights under the BCD.

Under the Regulations, the FSA is designated as the special public supervisor for regulated covered bond issuers, with its stated objectives being to ensure a robust regulated covered bond market in the UK, and to ensure that quality is maintained to preserve investor confidence in the UK regulated covered bond market's reputation. There are currently 11 regulated covered bond issuers in the UK, which are required to undergo a "rigorous, independent and comprehensive" risk review by the FSA in order to achieve regulated status and are subject to detailed ongoing supervision and monitoring. The UK market also comprises some unregulated covered bond programmes; however we confine this summary to the principal features of Regulated Covered Bonds as we expect that the market will be dominated by regulated covered bond issuance going forward.

UK REGULATED COVERED BONDS

I. FRAMEWORK

The UK Regulations came into force on 6 March 2008. Under the Regulations, in order to attain "regulated status" there are two broad sets of requirements the issuers need to comply with –those relating to issuers and those relating to the covered bonds. Issuers are permitted (but are not required) to submit their covered bond programmes to the UK Financial Services Authority (the FSA) for recognition. The application process is comprehensive, as described in Section VI below. Those issuers and covered bonds that meet all of the criteria set out in the Regulations are added to the register of Regulated Covered Bonds maintained by the FSA.¹ The Regulations only apply to those covered bonds which have been admitted to the register. As at July 2011 these issuers are: Abbey National Treasury Services plc, Barclays Bank plc, Bank of Scotland plc (residential mortgage programme), Clydesdale Bank plc, Coventry Building Society, HSBC Bank plc, Leeds Building Society, Lloyds TSB Bank Plc, Nationwide Building Society, Royal Bank of Scotland plc and Yorkshire Building Society.

¹ The register may be found at http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml

Regulated Covered Bonds are subject to special public supervision by the FSA. The FSA is required to have regard to “the need to preserve investor confidence in, and the desirability of maintaining the good reputation of, the Regulated Covered Bond sector in the United Kingdom ...” in the exercise of its functions under the Regulations. Regulated Covered Bonds comply with the requirements of Article 52(4) of the EU Directive on Undertakings for Collective Investment in Transferable Securities (the UCITS Directive). At time of writing, all Regulated Covered Bonds also comply with the definition of covered bonds set out in the EU Capital Requirements Directive (Directive 2006/48/EC, referred to as the CRD).

Certain elements of the Regulated Covered Bond structure are governed by contract: for example, the cover assets are ring-fenced by means of a “true sale” to a special purpose entity and several cover pool collateral sufficiency tests are set out in the programme documents. However, the FSA has a veto over material amendments to the contracts and broad powers to enforce its provisions. In addition, the priority of claims against the cover pool in a winding up scenario is as set out in the Regulations – no counterparty may have any claim against the cover pool in priority to bondholders, regardless of what is set out in the contracts.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. It must also have a registered office in the UK and meet certain additional requirements set by the FSA. The Regulations do not place any additional restrictions on the business activities of the issuer beyond those set out in existing financial institution regulations.

Regulated Covered Bonds are direct, unconditional obligations of the issuer; however, investors also have a priority claim over a pool of cover assets in the event of the insolvency of or default by the issuer. The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to a special purpose entity (referred to in the Regulations as the “owner”), which guarantees the issuer’s obligations under the covered bonds. All transactions to date have used a limited liability partnership (LLP) for this purpose. The purchase price paid by the LLP for the cover assets is either cash (funded by an inter-company loan from the issuer) or a partnership interest in the LLP. The transfer of mortgages to the LLP is by way of equitable assignment; however, the mortgage borrowers must be notified of the assignment (which perfects legal title in favour of the LLP) following the occurrence of certain trigger events, such as the downgrade of the issuer below investment grade (if the issuer is a bank) or an issuer insolvency event (if the issuer is a building society).

The LLP guarantees the issuer’s obligations in respect of the covered bonds and provides security over the cover assets to a security trustee on behalf of the investors. If there is a call on the guarantee (see Section VII below), the LLP will use the cash flows from the cover pool (eg, payments of interest and principal from the mortgage borrowers, after taking account of any swap payments) to service the covered bonds. If these cash flows are insufficient, the LLP is permitted to sell cover assets, subject to meeting certain tests to ensure equality of treatment of bondholders.

III. COVER ASSETS

The Regulations allow those assets which are listed in Annex VI, Part 1, Section 12, Paragraph 68 a) to f) of the CRD to be permitted in the cover pool, subject to the following restrictions:

- > deposits and other exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) are not permitted; and

- > in order to ensure transparency to the end investor, RMBS and CMBS are only allowed in the cover pool if: (i) the underlying mortgages were originated or acquired by the issuer or one of its affiliates; (ii) they are rated AAA; and (iii) in the case of mortgages originated by an affiliate, the affiliate is a credit institution with a registered office in the UK.

The Regulations also allow certain assets which are not permitted under the CRD: loans to registered social landlords and loans to public-private partnerships (subject in each case to certain restrictions).

The Regulations require cover assets to be of high quality, and the FSA is permitted to reject any application for Regulated status if it believes that the quality of the proposed assets will be detrimental to the interests of investors in Regulated Covered Bonds or the good reputation of the Regulated Covered Bonds sector in the United Kingdom.

Cover assets must be situated in EEA states, Switzerland, the US, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man. If an issuer includes non-UK assets in its cover pool, it must get confirmation that the laws of the relevant jurisdiction would not adversely affect the rights of the LLP or the security trustee.

In all of the programmes that have to date been registered, the cover pools consist of assets with narrower eligibility criteria than those allowed under the Regulations, and comprise only UK residential mortgages and the substitution assets described below. Mortgage LTV criteria are as described in Section IV below.

Substitution assets can be included in the cover pool. In most programmes their aggregate value can make up to 10% of cover assets, although HSBC has explicitly linked its substitution asset limits to those set out in the CRD and the Regulations (whichever is more strict). In all programmes, substitution assets are limited to short-term investments in sterling, namely bank deposits and debt securities with a minimum rating of double-A minus or P-1/A-1+/F1+, triple-A rated RMBS and government debt, in each case subject to the restrictions described above.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are valued using UK mortgage market accepted practice. A surveyor is often used, although other methods (such as desktop valuations) are also accepted depending on the issuer's underwriting criteria. Residential property values are indexed to either the Halifax or Nationwide real estate price index, each of which reports quarterly on a region-by-region basis. Price decreases are fully reflected in the revaluation, while in the case of price increases a haircut (15% in all programmes) is applied.

The LTV limit for mortgages varies across the different programmes (see Figure 1), but in all existing programmes it is below the 80% level for residential mortgages stipulated by the CRD and the Regulations. It is important to note that loans above the LTV limit are included in the pool, but the amount of the loan which exceeds the LTV limit is excluded from the Asset Coverage Test (see Section V below). Loans which are in arrears are either repurchased by the issuer or subject to specific haircuts (see Figure 1).

V. ASSET - LIABILITY MANAGEMENT

The Regulations do not prescribe a minimum level of overcollateralisation (OC). Instead, they require the cover pool to be capable of covering all claims attaching to the bonds at all relevant times. The minimum OC level for any programme is considered by the FSA on a case-by-case basis, taking into ac-

count the quality of the cover assets, risk-mitigation measures, such as swaps and downgrade triggers, asset-liability mismatches, and so on. The FSA has the power to order the issuer to transfer additional assets to its cover pool if it believes the collateral in the pool is insufficient.

Issuers must also carry out a dynamic Asset Coverage Test (ACT) on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the principal balance of the mortgages in the cover pool (after applying the haircuts listed below) to equal or exceed the principal amount of covered bonds then outstanding. The following haircuts are applied:

- > The issuer only gets credit for mortgages up to the indexed LTV limit specified in the programme documents (see Section IV above) or the asset percentage of the mortgages, whichever is lower.² The LTV limit for performing mortgages is between 60-75%; for non-performing mortgages (i.e., greater than three months in arrears) it is between 0% and 40%, depending on the programme. The asset percentage is determined from time to time by the rating agencies, subject to a 'base', or maximum, asset percentage set out in the programme documents. Figure 1 below sets out the LTV limits, maximum asset percentage and current asset percentage (and the minimum levels of OC that these imply) for each Regulated Covered Bond programme.
- > Additional haircuts are applied to mitigate set-off risk, redraw risk on flexible mortgages, and potential negative carry.

The issuer is required to rectify any breach of the ACT within a specified timeframe by transferring additional cover assets to the LLP. If the breach is not rectified within the allowed remedy period, the trustee will serve a notice to pay on the LLP. This will require the LLP to pay interest and principal on the covered bonds as originally scheduled under the guarantee, as described further in Section VII below.

The issuer may also become liable to enforcement action by the FSA. An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VII below). It is designed to ensure that the cover pool will be sufficient to enable the LLP to make payments under the covered bonds on their originally scheduled payment dates as required under the guarantee. The amortisation test is similar to the ACT, but requires a lower level of OC to reflect the fact that the cover pool is being wound down. If the test is failed, the covered bonds will accelerate against the LLP, as described further in Section VII below. The LLP is required under the programme documents to enter into swaps with suitably-rated counterparties at the time each covered bond is issued to fully hedge any mismatches between the currencies and interest rates of the bonds and the cover assets. In addition, downgrade triggers for swap counterparties, the pre-maturity test, the ACT, maturity extension rules and the amortisation test all ensure cash flow adequacy.

Most UK covered bond transactions have a soft-bullet maturity. Following the service of a notice to pay, the legal final maturity may be extended, typically by 12 months, in order to allow the realisation of the cover assets.³ It is important to note that the issuer does not have the option to extend the bond's

² For example: Let us assume a cover pool which contains two loans. Each loan has a principal balance of £80 and is secured by a property worth £100. If the ACT applies an LTV cap of 75% and an asset percentage of 90%, the issuer will get credit for £144 of loans: applying the LTV cap would allow £150 (maximum 75% LTV for each loan); but the asset percentage allows a lower amount (£160 × 90% = £144) and therefore governs.

³ Some programmes also allow the issue of bonds which become pass-through (i.e. principal repayments by mortgage borrowers are passed along to the covered bondholders) if the issuer fails to repay the bond on its scheduled maturity date; however, no bonds in this format have been publicly issued.

maturity; failure by the issuer to repay the bond in full on the originally-scheduled maturity date would result in an issuer event of default.

In some programmes, a **pre-maturity test** is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency.⁴ If, in a specified period before a maturity date (6-12 months, depending on the issuer and the rating agency), the issuer's ratings fall below certain specified triggers (typically A-1+ / P-1 / F1+), the pre-maturity test requires the LLP to cash-collateralise its potential obligations under the guarantee. The LLP can raise this cash through contributions from the issuer or by selling randomly-selected loans.

All Regulated Covered Bond programmes include a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support the transaction, including the swap counterparties and cash managers, and independent audits of the cash manager's calculations are undertaken on a regular basis.

If the issuer's short-term ratings are downgraded below A-1+ (S&P), P-1 (Moody's) or F1+ (Fitch), the LLP is required to establish and maintain, from the income it receives from the cover assets, a reserve fund in an amount sufficient to meet at least the next interest payment on each series of covered bonds (following revisions to Fitch counterparty criteria, it is expected that this requirement will become three months interest on a rolling basis going forward for many programmes). This amount is retained in a GIC account. If a notice to pay is delivered, the LLP can use the reserve fund to meet its obligations under the guarantee.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

An applicant under the Regulations must be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. Issuers must satisfy the FSA that their programmes comply with the criteria set out in the Regulations and provide, among other things:

- > details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements and ratings triggers;
- > details concerning asset and liability management, audit and controls;
- > arrangements for the replacement of key counterparties;
- > cover pool data; and
- > legal and audit opinions.

The issuer is responsible for monthly cover pool monitoring; however, the ACT calculation is checked by an independent auditor on an annual basis. The FSA must be notified by the issuer of any breaches of the ACT, may also require the issuer to provide such additional information about the cover pool as it considers fit and also is required to be notified prior to each new issuance. Finally, rating agencies are heavily involved in the programme and need to re-affirm the ratings of the programme as a condition to each issuance.

⁴ Within the Barclays Bank, Bank of Scotland, HSBC and Nationwide programmes, only covered bonds which are issued as "hard bullet Covered Bonds" are subject to the prematurity test. The programmes also allow for the issue of bonds with a 12 month maturity extension.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being transferred to a special purpose entity (referred to as the “owner” in the Regulations), which guarantees the issuer’s obligations under the covered bonds. All transactions to date have used an LLP for this purpose. All cover pool hedges are entered into directly by the LLP.

The Regulations require that the cover assets be recorded on a register maintained by or on behalf of the issuer and the LLP. The register must be available for inspection by the FSA. The issuer is responsible for ensuring that all cover assets meet the relevant eligibility criteria set out in the Regulations and, if applicable, any additional criteria set out in the programme documents.

The LLP becomes obligated to pay the covered bondholders under the guarantee upon delivery by the bond trustee of a notice to pay following the occurrence of an issuer event of default or other trigger event. The events which can trigger a notice to pay typically include:

- > Failure by the issuer or any group guarantors to pay any interest or principal on the covered bonds when due;
- > Bankruptcy or similar proceedings involving the issuer or any group guarantors;
- > Failure to rectify any breach of the asset coverage test; and
- > Failure to rectify any breach of the pre-maturity test (if applicable).

The delivery of a notice to pay does not accelerate payments by the LLP. To the extent that an issuer event of default has occurred, the bond trustee may commence proceedings against the issuer and any group guarantors on an unsecured basis on behalf of the covered bondholders. Nevertheless, for so long as an LLP acceleration event has not occurred (as described below), the LLP will only be required to make the originally scheduled payments of interest and principal on the covered bonds.

LLP acceleration events typically include:

- > The LLP fails to pay any interest or principal when due under the guarantee;
- > Bankruptcy or similar proceedings are commenced involving the LLP; and
- > After delivery of a notice to pay, the LLP breaches the “amortisation test”.

The occurrence of an LLP acceleration event causes the acceleration of payments by the LLP to covered bondholders and the redemption of the bonds at the relevant early redemption amount.

The LLP is reliant on the proceeds derived from the cover assets to make payments under the guarantee. Under the Regulations, in a winding up scenario, no claims against the cover assets can rank ahead of the claims of the Regulated Covered Bondholders. In addition to the secured claim against the cover pool, investors continue to have an unsecured claim against the issuer and any group guarantors for the amounts due under the covered bonds.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The list of eligible assets under the Regulations is in some respects narrower than that set out in the CRD. Residential mortgage backed securities, for example, are severely restricted. However, certain assets which are excluded from the CRD – such as loans to UK housing associations – are permitted in the cover pool under

the Regulations. Therefore, some Regulated Covered Bonds may not qualify for preferential risk weightings in the hands of regulated investors. To date, however, all Regulated Covered Bonds are CRD compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions.

> FIGURE 1: OVERVIEW – REGULATED UK COVERED BOND PROGRAMMES*

	Abbey National	Barclays Bank	Bank of Scotland	Coventry BS	HSBC	Leeds BS	Lloyds TSB Bank	Nation-wide BS	Royal Bank of Scotland	Yorkshire BS
Pro-gramme volume in EUR bn	25	35	60	7	25	7	15	45	15	7.5
LTV cap	75%	75%	60%	75%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Halifax	Nation-wide	Halifax	Halifax	Halifax	Nation-wide	Halifax	Avg. of Halifax & Nation-wide
Maximum asset percentage applied in ACT	91.00%	94.00%	92.50%	90.00%	92.50%	93.5%	93.00%	93.00%	90.00%	93.50%
Minimum OC	109.90%	106.38%	108.10%	111.11%	108.10%	106.95%	107.53%	107.53%	111.11%	106.95%
Current asset percentage applied in ACT	76.7%	77.3%	70.0%	Not disclosed	78.2%	75.6%	79.9%	84.5%	79.1%	78.0%
Current OC	105.0%**	130.5%	113.6%	108.0%**	116.4%	107.5%	144.3%	118.00%	111.50%	143.4%
In arrears accounting (over three months)	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurchase	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurch.	No recognition	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurchase	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurch.	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurch.	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurch.	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurch.	75% in case in arrears = <3M, 40% in case in arrears >3M	Max. 40% if LTV ≤ 75%, max 25% if LTV > 75% or repurch.
"Hard bullet" possible	Yes; pre-maturity test	Yes; pre-maturity test	Yes; pre-maturity test	No	Yes; pre-maturity test	No; 12-month maturity extension	Yes; pre-maturity test	Yes; pre-maturity test	Yes; pre-maturity test	No; 12-month maturity extension
Asset monitor	Deloitte LLP	PWC	KPMG	E&Y	KPMG	Deloitte LLP	PWC	PWC	Deloitte LLP	KPMG

Source: Barclays Capital

* Issuers of Jumbo UK Regulated Covered Bonds

** The minimum OC is calculated excluding other items from the Asset Coverage Tests as these differ between the programmes. These other items, such as adjustments for set-off for savings balances and negative carry, are the reason why the current over-collateralisation in some programmes is

less than the minimum over-collateralisation based on the Asset Percentage. If these items are excluded the current over-collateralisation is higher.

Note: Clydesdale Building Society is also a regulated covered bond issuer but currently they do not have any regulated covered bonds outstanding.

D. RECENT DEVELOPMENTS

(i) Review of the UK's Regulatory Framework for Covered Bonds

In April 2011, HMT and the FSA launched a joint review of the UK regulatory framework for covered bonds⁵, with the aims of the review being to ensure that the Regulations continue to support the UK covered bond market, promotion of investor understanding of the UK's regulated covered bond regime, and consultation on a small number of proposed amendments to the existing legislation. The deadline for responses to the consultation was 1 July 2011, with any subsequent amendments not expected to be implemented until the end of 2012.

Going forward, we expect the majority of new issuance to be as regulated covered bonds, as we believe that investors will take more confidence from the additional layers of supervision.

(ii) Bank of England Transparency Initiatives

UK covered bond programmes already benefit from the provision of relatively detailed investor reporting compared to other covered bond jurisdictions. This is in part due to regulated issuers needing to produce detailed reporting to the FSA as special public supervisor, although traditionally the UK market has conformed since inception to a relatively high standard of investor reporting. Notwithstanding this, following its market notice in November 2010⁶ the Bank of England has revised its eligibility criteria for the inclusion of covered bonds in its market operations including (amongst others) the provision of loan level data, publication of transaction documentation, transaction summaries and standardised investor reporting. It should be noted that these requirements are not mandatory for issuance however it is expected that some of the UK issuers will move toward the new requirements in due course.

E. DEVELOPMENT OF THE MARKET

The current outstanding volume of publicly and privately placed UK regulated covered bonds (excluding self-retained issuances) amounts to EUR 97.86 billion (equivalent) as of July 2011. The first half of 2011 saw a record issuance of EUR-, USD- and GBP-denominated covered bonds from UK covered bond issuers. As at July 2011, a total of EUR 20.2 bn equivalent of publicly and privately placed covered bonds have been issued, which already surpasses last year's total supply. Furthermore, this sets a record in the first half of the year for issuance in the UK market since its inception in 2003.

This year has also seen increased supply of GBP-denominated covered bonds. Compared to last year, when only a single GBP-denominated covered bond of £0.3bn was issued, this year has seen a total of £6.0bn of GBP-denominated covered bonds issued by UK banks and building societies. Having said that, the UK market is still dominated by EUR-denominated covered bonds which at EUR80.2bn equivalent represent 82% of total outstanding covered bonds.

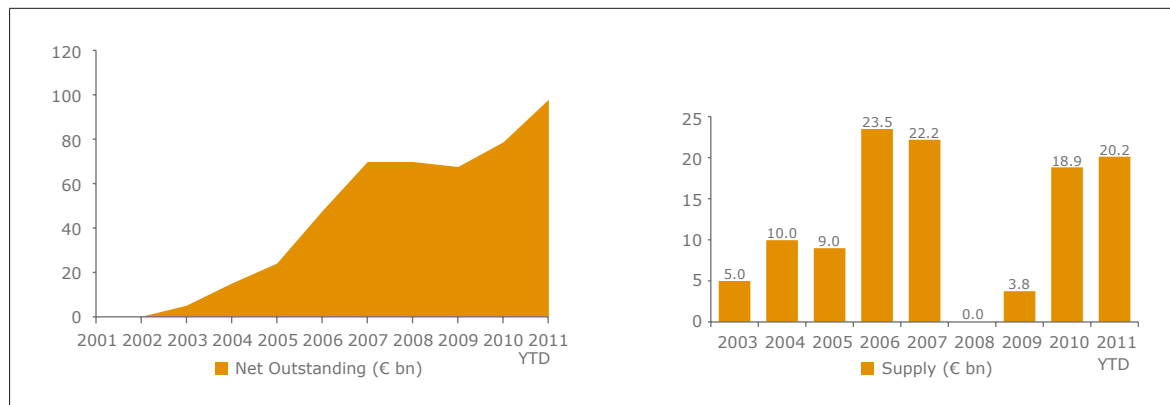
Figure 2 and 3 show the development of total outstanding of UK regulated covered bonds and annual supply of UK covered bonds (publicly and privately placed, excluding self-retained issuances). Figures 4

5 Please see http://www.hm-treasury.gov.uk/consult_covered_bond_review.htm for further details on the UK's Regulatory Framework for covered Bonds.

6 Please see <http://www.bankofengland.co.uk/markets/marketnotice101130abs.pdf> for further details the Bank of England Transparency Initiatives

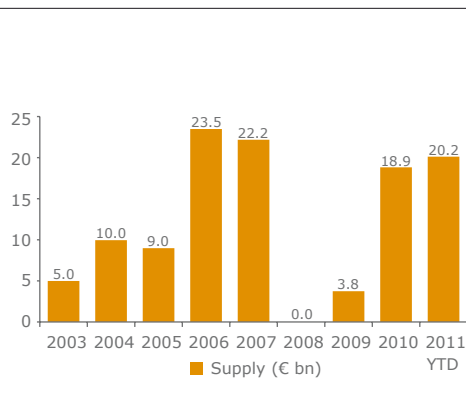
and 5 show the market share (as measured by covered bonds outstanding) per issuer and the currency distribution for outstanding issuances.

> FIGURE 2: DEVELOPMENT OF OUTSTANDING VOLUME AND AVERAGE SIZE (EUR BN)



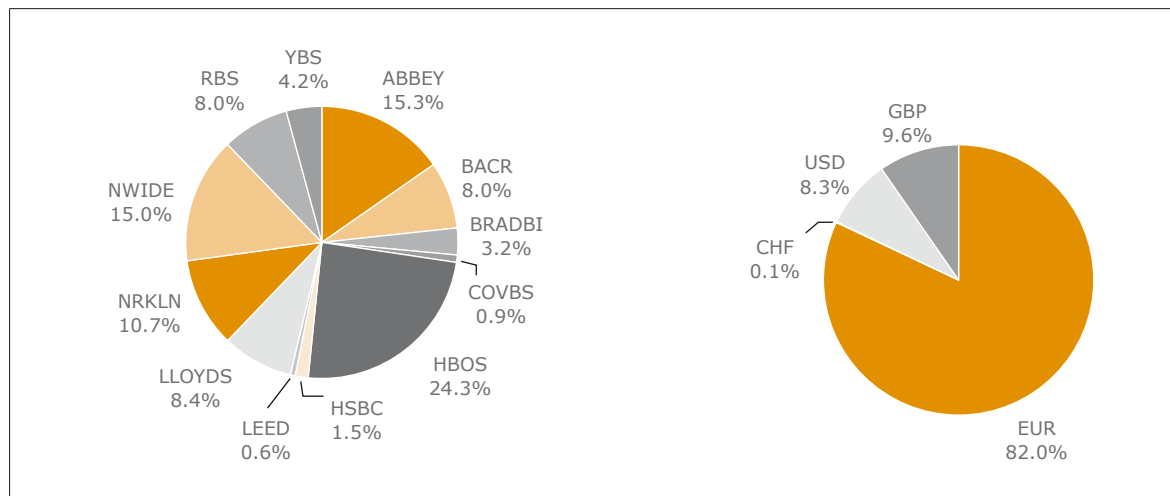
Source: Barclays Capital

> FIGURE 3: ANNUAL SUPPLY (EUR BN)



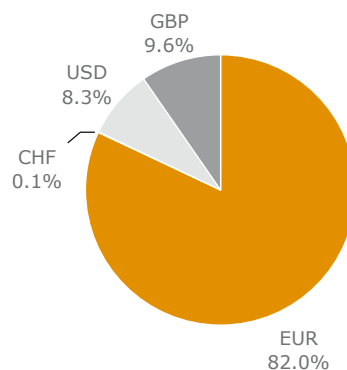
Source: Barclays Capital

> FIGURE 4: MARKET SHARE, JULY 2011



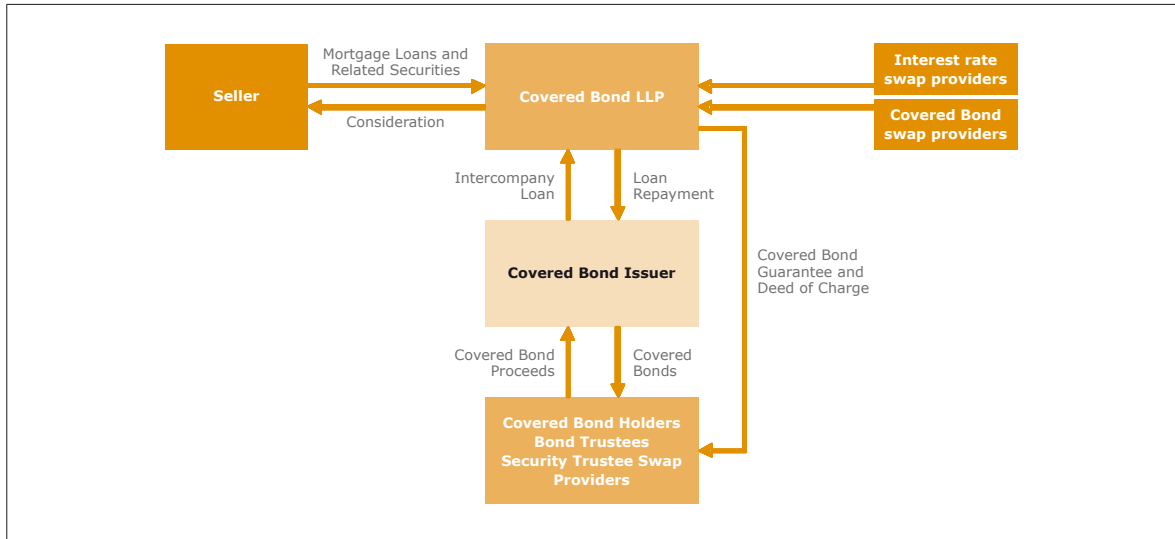
Source: Barclays Capital

> FIGURE 5: CURRENCY DISTRIBUTION OF OUTSTANDING ISSUANCES (EUR BN)



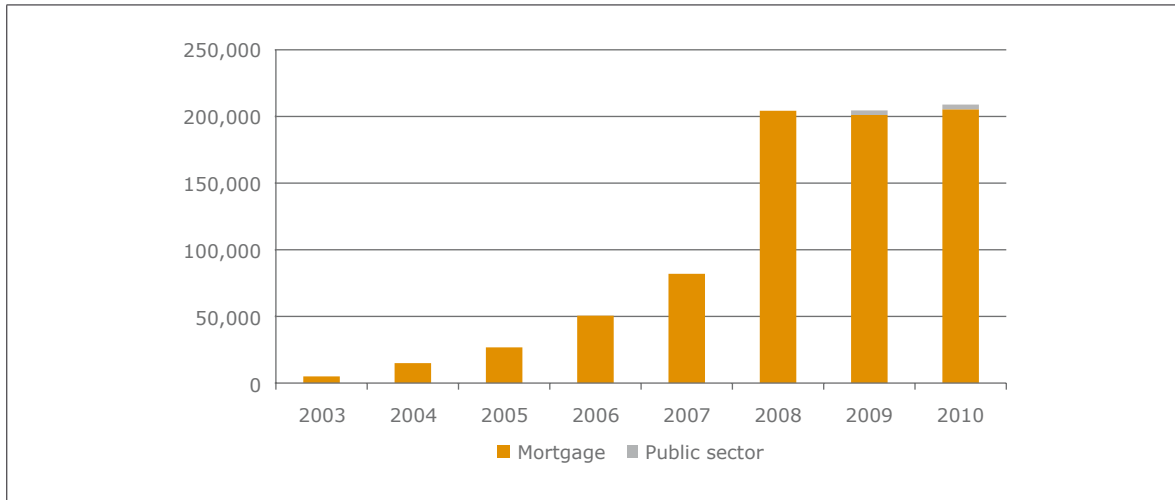
Source: Barclays Capital

> FIGURE 6: GENERIC UK COVERED BOND PROGRAMME STRUCTURE



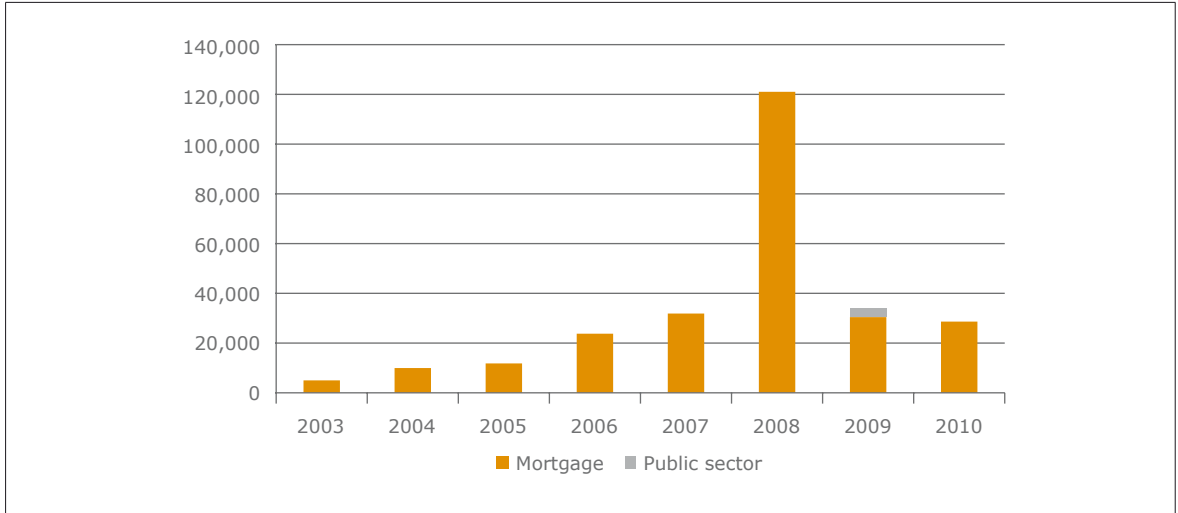
Source: Barclays Capital

> FIGURE 7: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 8: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: As of July 2011, currently 22 covered bond issuers in the United Kingdom: Abbey National; Anglo Irish Bank London Corporation; Bank of Ireland (UK); Bank of Scotland Plc (HBOS Treasury Service); Barclays Bank Plc; Bradford & Bingley; Britannia Building Society; Clydesdale Bank plc; Co-operative Bank Plc; Coventry Building Society; HSBC Bank plc; Leeds Building Society; Lloyds TSB Bank plc; Nationwide Building Society; Newcastle Building Society; Northern Rock; Norwich & Peterborough Building Society; Princes Building Society; Royal Bank of Scotland; Skipton Building Society; and Yorkshire Building Society.

An updated list of regulated issuers is available from the FSA: http://www.fsa.gov.uk/Pages/Register/rcb_register/index.shtml