

Financial Services Authority

IMS

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Dear Ian

Covered bond issuance

I am writing to highlight to you and your members the FSA's interest in recent developments in the UK covered bond market, and to give an indication of the likely supervisory response to a bank's issuance of covered bonds.

Background

As you will be aware, the covered bond market in the UK has recently developed significantly: three major UK banks (HBOS, Northern Rock and Bradford & Bingley) have issued covered bonds in the past 12 months. We recognise the fact that covered bond issuance offers potential funding advantages for banks, including easier access to international capital markets, broadening a bank's investor base and a relatively low cost of funding. However, owing to the structural features of covered bond issues, we believe them to have the potential to pose additional risk to depositors. This risk arises because such structures require a ring-fenced pool of eligible mortgage assets of a certain quality to back the bonds. As a result of the preferential claim of covered bondholders on the mortgage assets used to secure the bonds, a smaller, and potentially lower quality, pool of assets would be available than would otherwise be the case to meet the claims of depositors. There is also a gearing effect, in terms of the arrears rate of the remainder of the mortgage portfolio.

Prudential policy approach

We have considered some possible policy responses for dealing with this additional risk, and have decided at this juncture to focus upon the materiality of issuance. Is a bank's issuance of covered bonds became material, we would reflect the additional risk in our assessment of a bank's Individual Capital Ratio ('ICR'), as we would with other material risks. The corollary of this is that we would view a certain level of issuance as immaterial. We do not propose to prescribe a single hard limit defining the materiality threshold for covered bond issuance, as this would vary from firm to firm, according to the size of its mortgage book and total balance sheet. However, the greater the level of issuance, and the greater the proportion of mortgage assets as a proportion of total assets, the greater the weight we would place on covered bond issuance as a factor in the ICR assessment.

In practice, supervisors will discuss on a case-by-case basis with covered bond issuers regulated by the FSA the materiality of the firm's covered bond issuance. The FSA has been content for current issuers to issue bonds equating to around 4% of total assets. However, a firm should not rely on this percentage being considered immaterial for it.

It is important also to note that material issuance would not automatically result in a mechanical increase in a bank's ICR, rather it would be one of the factors that supervisors would consider in determining an ICR. This is consistent with our approach of using the ICR regime to capture material additional risks that are not captured by the current solvency regime. Once the new Capital Requirements Directive is implemented, we would expect this risk to be fall within the Pillar 2 regime.

Further work

It should be noted that the approach outlined above is an interim policy response: the FSA's Wholesale and Prudential Policy Division plans to give further consideration to the optimal prudential mechanism for capturing the risks inherent in covered bond transactions. As part of this process, we will consider whether or not, and at what juncture, it would be appropriate to provide general guidance on this issue via our Handbook. Any such general guidance would, of course, be subject to formal consultation with the industry.

If you would like to discuss this issue in greater detail, then please feel free to contact me or Diane Hilleard (020 7066 1622). If your members would like to discuss the prudential treatment of proposed covered bond issues, they should contact their FSA supervisor directly.

Yours sincerely



Paul Sharma
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Prudential and Accounting Risks