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Covered bonds: changes and challenges for the UK market

Clifford Chance's Peter Voisey and Will Sutton outline the regulatory changes affecting the UK covered bond market, but remain optimistic that clarity and certainty will emerge.

The first half of 2013 has undoubtedly been slow in the UK covered bond market. Issuance levels are well down from their equivalent in 2012 and 2011. Nevertheless, the regulatory and macro-economic landscape that impacts the UK covered bond market has not stood still, indeed far from it. It remains to be seen how the UK covered bond market will develop in the face of these changes. This article will analyse some of the challenges that the UK market faces, and will also consider some other recent market developments.

Recent initiatives

ECBC covered bond label

The ECBC covered bond label was established with the aim of improving the standards and transparency of the European covered bond market, and one of its stated goals has been positioning the covered bond asset class with respect to "upcoming regulatory challenges". The regulations and challenges are numerous, and the ECBC has not been silent in the face of them.

Each European issuer of regulated covered bonds may apply for the covered bond label and will go through a self-certification process. Each issuer is required to pay a registration fee and then supply ongoing information to the ECBC website regarding their programme and the issuances under it.

The label also recommends detailed transparency items to be included at a national level on the relevant issuer's website. To date, the number of applications for the label by UK issuers has been relatively low compared with some other jurisdictions. This may in part be explained by the fact that UK issuers already disclose their transaction documents and loan-level data (the latter being a key part of the ECBC's push for greater transparency in the covered bond market) on the Bank of England website. For UK issuers, supplying this data in yet another, slightly different format may be less appealing given the repetitiveness of the exercise and the additional expense involved.

Key highlights

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- **ECBC covered bond label**
- **RCB amendments**
- **Funding for lending scheme impact**
- **Basel III and the LCR**
- **New asset classes?**

Amendments to RCB Regulations

A recent development in the UK market was the amendments to the UK RCB Regulations, which came into force at the beginning of this year. Although their market impact may be limited, it is worth considering them here briefly, not only because of their practical impact but also because of the wider question of what the amendments demonstrate about the regulation of the UK covered bond market and the thoughts of the UK regulators.

The amendments include a fixed minimum overcollateralisation and interest coverage requirement; the supply of loan level data; the requirement to appoint an asset pool monitor to provide an annual report to the FCA; and the single- or multi-asset class election. Whilst, ultimately, none of these requirements will have alarmed any UK issuers, they will have increased both the cost and the administrative burden on them.

The reporting requirements in particular can be seen as part of a general push for greater transparency in the covered bond market, something that the covered bond label initiative seeks to promote on a European level. The amendments can also be seen as a demonstration that the FCA remains a robust and hands-on regulator of the UK covered bond market. As to whether the benefits in terms of investor comfort outweigh the increased administrative burden on UK issuers remains to be seen.

"There can be little doubt about the detrimental effect of the Bank of England's Funding for Lending Scheme…has had on issuance levels"

Funding for Lending

There can be little doubt about the detrimental effect that the Bank of England's Funding for Lending Scheme (FLS), with the access to low-cost funding that it provides, has had on issuance levels in the UK covered bond and RMBS market. Clearly, drawing a direct correlation between the FLS and the declining levels of UK covered bond issuance is difficult: in an environment where banks are deleveraging and with the significant market concern over the impact of forthcoming regulations (discussed below), linking the issuance decline directly to a single government scheme is questionable.

Nevertheless, the Bank of England has recently noted a significant drop in covered bond issuance by both UK and European lenders. Although the Bank did not link this directly to the FLS, it did comment that the relatively low level of issuance over the review period was due to a number of factors, and expressly mentioned the FLS. In the short term at least, the impact of the FLS will continue to be felt by the UK covered bond market given the April announcement by the Bank of England that the FLS would be extended to allow drawdown until January 30 2015.

There can also be little doubt, however, that prior to the FLS the UK covered bond and RMBS markets were re-establishing themselves. For the issuers, these markets were beginning to provide new, stable, economic funding; for investors, access to much-needed, high-quality paper. If the effect of the FLS has been to stop this re-establishment in its tracks, the FLS has got a great deal of work to do to convince that this constitutes acceptable collateral damage in the long-term.

Forthcoming European regulations

On a European level, there is still a focus on the vast array of regulations affecting financial institutions and insurance companies that are being proposed, debated and consulted on. These include, among others, the forthcoming CRDIV proposals (in particular the Liquidity Coverage Ratio, LCR), the bail in proposals, a financial transaction tax, a regulation on asset encumbrance, CRA3, Solvency II and EMIR.

Certain of these, such as the Solvency II (if enacted) and the LCR confer favourable regulatory treatment on covered bonds and thus have the potential to boost the covered bond market, but at the moment, uncertainty reigns to its detriment. In addition to the uncertainty, some of the regulations seem to be in active conflict with others, in particular regarding their impact on the covered bond market.

Chief among these is the threat that ultimately these regulations will not sit consistently alongside one another and will end up imposing repetitive (but slightly inconsistent) disclosure and transparency requirements and will increase the regulatory and administrative burden on issuers. Other areas of uncertainly for covered bonds include their regulatory treatment as well as the ECB eligibility criteria (the recent amendments to which may be seen as the ECB signalling a desire to rebalance high-quality securitisations (in particular RMBS) with covered bonds).

As such, the impending regulations represent a major challenge to the market and some of the key concerns are discussed below.

The main challenges ahead

Basel III and the LCR

The LCR is to be introduced as part of the suite of regulatory proposals from the Basel committee (to be implemented by member states in the European Union through CRD IV). Basel III proposes that covered bonds with credit ratings of at least AA- are to be treated as Level 2A high quality liquid assets (HQLA), thereby attracting a 40% holding limit and a 15% haircut.

This is not yet settled, however. The European Banking Association (the EBA) has launched a consultation process on the treatment of liquid assets under the LCR, the outcome of which may determine whether covered bonds will ultimately be afforded Level 1 status (the preserve of sovereign debt and cash as things stand), and thereby obtain the 60% holding limit. The outcome of this consultation process is therefore hugely significant for the covered bond market, but uncertainty continues in the market while the consultation continues.

In this context, it is also worth mentioning the financial transaction tax, which as proposed will apply to secondary trading in securities, such as covered bonds. This is an example of two proposed regulations seemingly at odds with each other, at least as far as covered bonds are concerned. If one of the aims of the LCR has been to categorise certain assets as high quality liquid assets, it seems counterproductive to at the same time introduce a measure that will significantly hamper the liquidity of these assets.

Recognising the impact to covered bonds, the ECBC has duly called for all LCR-eligible assets to be exempt from this tax, pointing out the inconsistency of with one proposal encouraging the holding of highly liquid assets and, with another, hampering that liquidity. It remains to be seen how the regulators will respond.

Asset encumbrance

"Some of the regulations seem to be in active conflict with others"

Asset encumbrance is an increasing concern for regulators, and a recent consultation paper issued by EBA has highlighted the potential risks, in particular in relation to the potential structural subordination of unsecured creditors and depositors. The EBA proposes to introduce ongoing reporting on asset encumbrance, with the ultimate aim of this being part of the national law of each member state.

It is certainly true that increased levels of asset encumbrance in Europe have coincided with the popularity of covered bonds as an asset class and, with their overcollateralization levels and their relatively long-term nature, covered bonds have attracted particular scrutiny. However, it is also true that other types of secured funding, in particular repo funding, have also been responsible, and many feel the focus placed on covered bonds to be unjustified. Furthermore, to some extent, increased asset encumbrance is inevitable as unsecured funding becomes more subject to bail in provisions and investors demand respite from this regulatory move in the form of secured funding. It is yet another example of different regulatory initiatives causing unforeseen tension with one another – we might call this the law of unintended regulatory consequences.

Indeed, in Europe between 2005 and 2011, asset encumbrance increased significantly in all sample countries except Germany, and the strongest correlation was between increased levels of asset encumbrance and countries with problematic public finances, such as Greece, Spain, Ireland, Portugal and Italy, which had the highest levels of repo funding with the ECB.

The upshot of these and other proposed regulations is that the market does not yet know where it stands with the regulators, and what the ultimate impact to the asset class will be. At the very least, it is to be hoped that greater clarity and consistency will emerge in the coming months.

New developments

On a more positive note, there are a couple of possible areas of expansion for the UK covered bond market that are actively being explored. These are SME covered bonds and renewable energy, or green, covered bonds.

SME Covered Bonds

In the UK, as in the rest of Europe, there is political focus on SME lending. In Europe this has had an active impact on the covered bond market thanks to the Commerzbank SME covered bond transaction in February. Some comments have been raised over the use of the term covered bond in a jurisdiction that is not used to giving labels to transactions involving such a structure (true sale) with such assets (SME loans). In the UK, where covered bond transactions all employ the true sale structure, there was perhaps less of a problem from a structural perspective in identifying the Commerzbank transaction as a bona fide covered bond (and in April 2013 the ECB may be said to have endorsed that view by elevating the Commerzbank transaction from liquidity category 4 to category 3 in its liquidity framework). Regardless of the semantics, there is no doubt that the Commerzbank transaction has helped to raise awareness on how covered bonds may be used to increase SME funding given the economic and political desirability of achieving this goal, and this is true of the UK as well.

Green covered bonds

Green covered bonds are seen as a potentially vital means of encouraging investment in the renewable energy market. In December last year, a Renewable Energy Covered Bonds Roundtable met in London to discuss the possibility of developing renewable energy, or green covered bonds. Green covered bonds are seen as a potentially vital means of encouraging investment in the renewable energy market, as part of a transition to a lowcarbon economy. Green covered bonds could work by either structuring covered bond programmes which are collateralised by renewable energy assets, or by using the existing residential mortgage framework but using so-called green residential mortgages as collateral.

Several challenges remain before either of these options become viable. In relation to both, existing covered bond legislation (assuming regulated status was sought after) would need to be amended to include the assets and (in the case of the green mortgage option) ensure that national bank lenders are incentivised to originate green covered bonds to their domestic market. For covered bonds structured using renewable energy assets, structuring and credit analysis problems may arise, given there is no great performance history of such assets, and these assets are likely to lack the homogeneity of, say, residential mortgages. Covered bonds backed by green mortgages may have more traction, at least in the short term, because they could be structured around a portion of a mortgage that constituted a portion of the borrowings that were applied to finance any green investment in the property.

Covered bonds: the resilient asset class

Challenging times remain for the UK covered bond market, indeed for the covered bond market as a whole, but it is hoped that greater clarity and certainty in the forthcoming regulations will emerge. Covered bonds have been one of the most resilient asset classes in the recent global downturn, and there is no reason to suggest that that will not continue to be the case, both on a national, European, and global level.

Covered bonds remain the ultimate safe haven. There remains some way to go before we emerge from the danger zone and until we do covered bonds will remain a key funding tool for banks and a vital asset class for investors desperate for some high quality paper.

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