



Update on the FSA's Approach to Covered Bond Issuance and Asset Encumbrance

On 23 October 2008, the Financial Services Authority (the "FSA") published a letter written to the British Bankers' Association (the "BBA"), setting out a change of approach with respect to the FSA's monitoring of covered bond issuance and asset encumbrance (the "2008 Letter").

Previous Position

On 4 August 2005, in order to develop a consistent approach to assessing the materiality of a bank's covered bond issuance (in the light of potential risks to depositor's interests) and, accordingly, to establish suitable prudential limits, the FSA published initial guidance in a letter written to the BBA (the "2005 Letter").

The FSA's approach was based on two threshold levels:

- a "monitoring" threshold where the bank's issuance reaches 4% of total assets (the "First Threshold"); and
- an upper benchmark where the bank's issuance reaches 20% of its total assets (the "Benchmark").

Banks with a total cumulative covered bond issuance below the First Threshold were under no obligation to inform the FSA of any new issuances. As soon as the First Threshold was passed, however, the FSA's policy required that firms inform the FSA, triggering a case-by-case evaluation process to determine the potential of any additional material risk to depositors.

Two key factors were considered during an evaluation:

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

At low levels of issuance, it was envisaged that the benefits of increased funding and liquidity would outweigh any increased threats to the claims of depositors. However, as a bank approached the Benchmark, the possibility of it being asked to raise additional capital under Pillar 2 of the Capital Requirements Directive increased. Once the Benchmark was reached, it was extremely likely that additional capital would be required.

Current Position

The 2008 Letter advised the BBA that, with immediate effect, the FSA required firms to participate in advance discussion of all plans for covered bond issuance or any other significant new asset encumbrance. Such requirement superseded the approach and quantitative requirements set out in the 2005 Letter.

The need for these discussions reflects recent changes in market conditions, and the fact that banks are increasingly using balance sheet assets to increase liquidity. As such, following a case-by-case assessment, “supervisory outcomes” are a possibility, including an additional Pillar II capital charge, a cap on covered bond issuance, and/or a limit on the term of issuance.

The FSA set out a list of the factors in the 2008 Letter which will be considered when looking at a bank’s proposals regarding covered bond issuance or any other new asset encumbrance:

- the volume of encumbered assets as a proportion of the bank’s total assets, and the level of over-collateralisation;
- the bank’s current and long-term funding plan;
- the potential causes and subsequent effects of a credit rating downgrade that might be suffered by the bank;
- the bank’s ability to maintain a covered bond or other programme given the bank’s contractual obligation to maintain asset levels in the programme;
- the level of senior management and involvement, 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 bank.

Going forward, the FSA makes clear that it intends to produce a clear prudential framework which adequately reflects the potential risks to unsecured creditors, and which is likely to lead to capital charges that adequately reflect such risks. It expects that such prudential framework would be the subject of a standard FSA consultation process.

Contacts

Peter Green
+44 20 7920 4013
pgreen@mofocom

Jeremy Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofocom

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofocom.

© 2008 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.