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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 55 – ASSET-BACKED BONDS

**Asset-backed bonds and the Implementation of Article 22(4) of the First
Directive Regarding Undertakings for Collective Investment in Transferable
Securities**

The logo for the Financial Markets Law Committee is a light blue, tilted rectangular box containing the text "Financial Markets Law Committee" in a dark blue, sans-serif font. The text is arranged in four lines, with "Financial" on the first, "Markets" on the second, "Law" on the third, and "Committee" on the fourth. The box is tilted at an angle, giving it a three-dimensional appearance.

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CONTENTS

Introduction		4
Part I	Background	5
Part II	Article 22(4) UCITS Directive	6
Part III	Implementation of Article 22(4) in other Member States	7
Part IV	Analysis of Article 22(4)	8
Part V	Article 22(4) Procedure	10
Part VI	Proposed Legislative Response	11
Annexe 1	Simplified Structural Diagram of a UK Covered Bond	15

**ASSET-BACKED BONDS AND THE IMPLEMENTATION OF ARTICLE
22(4) OF THE FIRST DIRECTIVE REGARDING UNDERTAKINGS FOR
COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES**

1. The role of the Financial Markets Law Committee (“FMLC”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
2. This paper addresses the question of how Article 22(4) of the Directive regarding Undertakings for Collective Investment in Transferable Securities (the "UCITS" Directive, 85/611/EEC) may be implemented in the UK. This question was first raised at a meeting in May 2005 with Paul Kirkman and Steve Johnson of HM Treasury and thereafter the FMLC was asked to assist the Treasury by providing this background paper. Its purpose is to give some indication as to what an implementing measure might require. The FMLC’s Working Group in this area is chaired by Simon Gleeson and the FMLC would like to register the debt of gratitude it owes to Simon and the members of the Group, listed above.
3. The FMLC is aware that there are a number of possible Government responses that could be considered in relation to the implementation of Article 22(4), including alternatives to legislation, and it understands that HM Treasury is currently considering these options from a policy perspective. Given that the remit of the FMLC does not relate to matters of public policy, this paper’s treatment of the various implementation alternatives is strictly limited to particular legal certainty issues and relevant comments are made accordingly (see Part VI).
4. However, the FMLC has been given to understand, from discussions with market participants, that there is appetite in the market for a legislative response to this issue. The FMLC would be pleased to put HM Treasury in touch with relevant market participants, in order that the views of the market on this issue can be obtained.

Part I Background

The following paragraphs set out the background to Article 22(4), the basis for obtaining the reduced risk weighting for Covered Bonds, and a proposed legislative response within the UK.

5. A number of UK credit institutions¹ have in the last few years issued securities that are intended to be treated as Covered Bonds by European investors. However, Covered Bonds issued by such UK credit institutions do not fall within the current European “definition” of a Covered Bond as set out in Article 22(4) of the “UCITS” Directive, 85/611/EEC, compared with Covered Bonds issued by relevant European issuers.
6. The reason that UK bonds are excluded is that the Article 22(4) criteria require explicit regulation of the bonds concerned under national law. No such law currently exists in the UK.
7. The advantage of Article 22(4) status is that bonds which have it are treated for some regulatory purposes as akin to government securities. Regulated investment funds are subject to more liberal investment restrictions when they invest in Covered Bonds, and banks and investment firms have a lower capital requirement. The Capital Requirements Directive (Directive Relating to the Taking Up and Pursuit of the Business of Credit Institutions, “the CRD”)² will extend and increase the benefit of the latter treatment.
8. Market participants claim that existing UK Covered Bonds have been structured to provide the same levels of legal robustness and low risk that exist in other Covered Bond markets. Thus, the chief difference between the UK Covered Bond market and other Covered Bond markets is that the UK market is not subject to express legislation.

¹ HBOS Treasury Services Limited in 2002, Northern Rock in 2003, Bradford and Bingley in 2004 and Abbey National plc in 2005. Many other UK mortgage banks have indicated that they intend to issue Covered Bonds.

² Agreed text of the European Parliament and of the Council dated 18 October 2005.

Part II Article 22(4) UCITS Directive

9. The aim of Article 22 of the UCITS Directive as a whole is to restrict exposures of regulated funds to certain types of assets - Article 22(1) provides that the baseline limit should be 5% of the regulated fund in respect of any given asset type, with national regulators given power to increase the limit to 35% in respect of government securities. The reason for this is to recognise the lower risk characteristics of government bonds. The recognition of certain types of Covered Bonds for this purpose acknowledges the lower risk characteristics of such bonds. Consequently, the effect of Article 22(4) is to recognise the fact that certain forms of Covered Bonds have sufficiently low risk characteristics as to make them eligible for similar concessionary treatment.

10. Article 22(4) of the UCITS Directive provides that

Member States may [increase the permitted exposure of UCITS to certain bonds where] these are issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

11. The aim of Article 22(4) is to identify bonds where (a) the issuer is a regulated credit institution, and (b) the bonds concerned are covered by assets which, in the event of an insolvency of the issuer, would be available to bondholders on a priority basis. In other words, the requirements which the section prescribes are that the issuer be a credit institution issuer and that the pool of assets covering the bonds be ring-fenced from the assets of the issuer on its insolvency. In principle this is the same position as would be created by a UK bond with the structure sketched out in Annexe 1.

12. As mentioned above, the CRD will supplement Article 22(4) of the UCITS Directive with further provisions relating to the precise composition of the assets which underlie Covered Bonds. However, the current text of the CRD is explicitly based on Article 22(4). Thus, after the implementation of the CRD, the criteria set out in Article 22(4) will remain the basis of classification as a Covered Bond.

Part III Implementation of Article 22(4) in other Member States

13. Bonds which qualify under Article 22(4) have certain advantages for investors making their placement in large size easier - they are treated as akin to government bonds for UCITS - and by Article 63(2) of the EU Banking Co-ordination Directive (2000/12/EC), Member States are permitted to ascribe a 10% risk weighting to securities which comply with the provisions of Article 22(4). Consequently, credit institutions which are able to issue bonds which qualify under Article 22(4) enjoy a competitive advantage in the bank funding market.

14. In most EU Member States, compliance with the requirements of Article 22(4) can only be achieved by specific legislation. The need for such legislation arises from the relative ease with which liquidators and other office holders in most EU jurisdictions can recharacterise transfers of assets and annul transactions – this may be measured, in Philip Wood’s terms, as the degree of “debtor-friendliness” of those jurisdictions³. The UK has by some way the most creditor-friendly insolvency regime in the EU. Other EU systems afford greater protection to debtors upon their insolvency, and permit liquidators and office-holders to successfully challenge creditor protection devices such as security interests and transfers of assets to third parties. Thus, in other EU countries the sort of robust creditor protections necessary to satisfy the requirements of Article 22(4) can only be created by explicit legislation. The model for such protection is the German Pfandbriefe legislation, but other EU jurisdictions have similar regimes. The fundamental issue is, as Moody’s put it, “the exclusion of those covered asset pools which continue to meet eligibility criteria and the Covered Bonds which they back from the insolvency estate of the issuer”.⁴

15. The reason that there is no UK equivalent to the Pfandbriefe legislation is that the problems that the Pfandbriefe legislation exists to solve do not arise in the UK system. In the UK, collateral coverage for the holders of Covered Bonds can be achieved through a transfer of assets to a special purpose vehicle established for the purpose. The special purpose vehicle will guarantee the obligations of the bond issuer and thus the collateral will be available to the bondholders in the event of a default by the issuer. This structure is discussed further in Annexe 1.

16. The lack of specific UK legislation on this issue, however, creates a competitive disadvantage for English credit institutions. The relevant Directives have the

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P.R. Wood, *The Law and Practice of International Finance; Principles of International Insolvency* at pp.2-4 et. seq.

combined effect that, where the problem is solved by national legislation, securities which benefit from such legislation have a concessionary capital weighting. However, where the problem does not exist and no such legislation is required to solve it, no such concessionary capital weighting is available.

Part IV Analysis of Article 22(4)

17. There are a number of elements to the requirements of Article 22(4). These can be set out as follows:-

- a. there must be bonds issued by a credit institution which has its registered office in a Member State;
- b. the credit institution must be subject by law to special public supervision designed to protect bondholders;
- c. sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds; and
- d. in the event of failure of the credit institution issuer, the assets would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest on the bonds.

18. Each of these items is considered separately below.

There must be bonds issued by a credit institution which has its registered office in a Member State

19. This requirement is self-explanatory.

The credit institution must be subject by law to special public supervision designed to protect bond-holders

20. All credit institutions are, by virtue of their status as credit institutions, subject by law to public supervision, and this public supervision is designed to protect unsecured senior creditors, a class which includes bondholders.⁵ This requirement therefore

⁴ Moody's Investor Services, European Covered Bonds: Moody's Rating and Analytical Approach, Sept. 2002.

⁵ Excluding holders of subordinated bonds which are comprised in the regulatory capital of the institution.

appears redundant. However, it is clear that Article 22(4) does not apply to all bondholders, but only to the holders of the bonds to which the article applies – i.e. those bondholders who have protected recourse to certain assets in addition to their claim on the credit institution bond issuer. This requirement must therefore operate to identify certain bonds issued by the credit institution as bonds to which Article 22(4) applies.

21. In the opinion of the FMLC, the essence of this requirement is that the question of which bonds are eligible for the Article 22(4) treatment must be laid down by law, and that there must be special provisions in this law relating to the structure of the bonds. These requirements would typically be requirements as to the level of over-collateralisation and the nature of the underlying assets.

Sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds

22. The primary requirement which this provision imposes is that collateralisation must be maintained throughout the life of the bond. This requirement is clearly necessary in order to achieve the purpose of Article 22(4). The only question of interpretation which arises is the words "in conformity with the law". This cannot be a reference to law in general, since a requirement that a credit institution must not raise funds and invest them contrary to law would be unnecessary. The use of the definite article suggests that it is a specific law which is being referred to, and the best interpretation of this provision is that it refers back to the requirement mentioned in the previous sentence that there be a law by which special public supervision is imposed on the credit institution. Thus, where amounts raised through sale of bonds are invested in a way which satisfies the applicable criteria for inclusion in the Article 22 (4) list then such amounts may be said to be invested in conformity with the relevant law.

In the event of failure of the credit institution issuer, the assets would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest

23. In most continental systems, this is the major function of the relevant law, which amends the ordinary insolvency process to give bondholders priority rights over the assets concerned. In England it would not be necessary to legislate in this way, since this result can be achieved by the segregation of assets into a separate legal entity

which is bankruptcy remote from the credit institution.⁶ Nonetheless, the law probably needs to require that the assets be appropriately ring-fenced in this way.

Part V Article 22(4) Procedure

24. The mechanism for implementing the provisions of Article 22(4) is set out in the last subparagraph of that Article. This provides that

The Member States shall send the Commission a list of the aforementioned categories of bonds together with the categories of issuers authorised, in accordance with the laws and supervisory arrangements mentioned in the first subparagraph, to issue bonds complying with the criteria set out above. A notice specifying the status of the guarantees offered shall be attached to these lists. The Commission shall immediately forward that information to other Member States together with any comments which it considers appropriate, and shall make the information available to the public. Such communications may be the subject of exchanges of views within the Contact Committee in accordance with the procedures laid down in Article 53(4).

25. Article 53 establishes the Contact Committee, and sets out parameters for its operation. The most important provision of Article 53 is Article 53(2), which provides that "it shall not be the function of the Contact Committee to appraise the merits of decisions taken in individual cases by the [designated authority of any Member State]".

26. It seems to the Committee that the decision as to whether any particular Covered Bond complies with the requirements of Article 22(4) is an individual decision to be taken by the regulatory authority in the relevant Member State, and is therefore protected by Article 53(2). Consequently if the relevant Member State determines that a particular bond falls within Article 22(4), this decision may not be disputed either by the Commission or by the Contact Committee.

Part VI Proposed Legislative Response

27. It could be argued that, given the structure adopted for Covered Bonds by the market in the UK and the background UK legal framework in which this structure operates,

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Subject to a priority of payments which ensures payment of the fees and expenses of third party service providers (such as note and security trustees, paying agents and the like) and, typically, credit providers (such as liquidity facility banks and swap counterparties)

no legislative response to the opportunity created by Article 22(4) is necessary. However, although the structure of UK Covered Bonds and UK legal framework together achieve all the features required by the market (including, for example, insolvency remoteness), taking no action would effectively entail that UK Covered Bonds did not fulfil the requirements of Article 22(4). Potentially, this could lead to legal uncertainty over how UK Covered Bonds should be treated under relevant provisions of European law which contain a particular treatment, for example a concessionary capital adequacy weighting, in respect of compliant bonds. The uncertainty would exist no matter how the current market-based solution was to be implemented or developed in future, given that it could not achieve one of the requirements under Article 22(4) – that of the bonds being subject to a relevant law.

28. A helpful modification of the pure market-based response might be the development of a self regulatory code in relation to Covered Bonds. In order to address the identified deficiency – from the perspective of the Directive – of the market-based approach (i.e. that the bonds are not subject to a relevant law), it might be enough were such a code to be subject to legislative backing. For example, a Covered Bond issuers' association might produce a code and legislation might confirm that the insolvency protections necessary under the European legislation are applicable to bonds issued under such a code. However, this approach could again give rise to legal uncertainty, both in relation to its consistency with Article 22(4) and in the development and management of such a code and its interaction with existing law.
29. Another possible approach would be for the FSA to make rules regulating the issue of Covered Bonds pursuant to section 138 of the Financial Services and Markets Act 2000. However, there are two residual legal certainty concerns which are relevant in this context:
 - a. First, such rules have the status of delegated legislation and arguably would not satisfy the requirements of the Directive that Covered Bonds be regulated by "laws". It has been suggested by some (continental European) institutions that only primary legislation is appropriate for this purpose; and
 - b. Second, FSA rules alone do not have the effect of protecting Covered Bondholders in the event of the insolvency of the issuer of the bonds, since the FSA does not have statutory authority to affect the conduct of insolvencies. The FSA can make rules mandating the use of structures which

will have the effect of protecting assets in the event of insolvency, but again it has been suggested that laws must have the direct effect of protecting bondholders in order to satisfy the UCITS requirement.

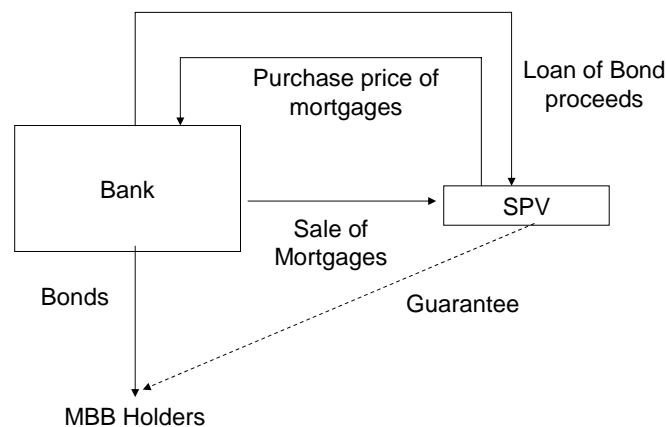
30. In light of the issues highlighted above, it may be that HM Treasury takes the view that the only way to achieve a resolution of the issue without raising issues of legal (un)certainty is to develop a legislative response as outlined below.
31. On the basis that it is thought necessary to address the issue identified through legislation, comments are set out below detailing how such an approach could be formulated.
32. The test set out in the Directive requires Covered Bonds to be backed by investments made in conformity with the law, and indicates broadly the structure of such law. For the purposes of implementation in the UK, the Committee considers that an appropriate statutory instrument might have roughly the following structure:-
 - a. The FSA is to establish and maintain a register of Covered Bonds issued by UK credit institutions.
 - b. A UK credit institution may submit an application to the FSA for registration of a bond issued by it as a Covered Bond. Such application must specify the level of cover to be provided for the bond, and the nature of the assets which will compose the pool.
 - c. Conditions for registration shall include, *inter alia*, that:
 - i. during the life of the Covered Bond, it is covered at least 100% by “eligible assets” (as defined either by the FSA or in legislation. We would expect the types of assets capable of being used to be restricted to the classes identified in the CRD.)
 - ii. the FSA is satisfied that the criteria set out in Article 22(4) are satisfied through the receipt of relevant certifications from the issuing credit institution regarding the terms of the Covered Bond to be issued; and
 - iii. such other conditions as the FSA shall determine from time to time.

- d. Provision should be made in respect of the audit and reporting mechanisms to be put in place to ensure that at all material times the cover pool is equal to either the minimum requirement or the amount specified in the application.
 - e. Effect of breach/removal of Covered Bonds from the register to be at the discretion of the FSA.
 - f. Powers for FSA to intervene in respect of any breach of the cover provisions.
 - g. The segregation of the bonds on insolvency of the bond issuer to be affirmed (although such affirmation should permit challenges based on fraud or collusive transactions).
33. The general view of the Committee is that such an order could be made under section 426 of the Financial Services and Markets Act 2000. Since the purpose of that Act as set out in the preamble is "to make provision about the regulation of financial services and markets", the proposed order satisfies the test set out in section 426(1) as being a supplemental order made "for the general purposes... of this Act."
34. This is a very general sketch of the major features of the legislation required. The Committee would be very happy to provide a further, more detailed set of the issues which fall to be considered in respect of any such legislation, should the Treasury consider that exercise to be helpful.

ANNEXE 1

Simplified Structural Diagram of a UK Covered Bond

UK MBB



1. A new special purpose vehicle (**SPV**) is established. It may or may not be a subsidiary of the Bank (as defined by section 736 of the Companies Act 1985). To date, all SPVs have been established as limited liability partnerships (under the Limited Liability Partnerships Act 2000), with the relevant issuing Bank being a member of that partnership.
2. The Covered Bond is issued by a UK credit institution (the **Bank**).
3. The Bank applies the proceeds of the Covered Bond issue to make a loan to the SPV.
4. The SPV applies the proceeds of the loan from the Bank towards the purchase price of a portfolio of mortgage assets from the Bank.
5. The aggregate outstanding principal balance of the mortgage assets sold to the SPV by the Bank is greater than the aggregate principal amount outstanding of the Covered Bonds and hence the loan made to the SPV. This difference constitutes the “over-collateralisation” in the mortgage pool sold to the SPV. The amount of over-

collateralisation in a mortgage portfolio held by an SPV is driven by the quality of the mortgage portfolio and the desired ratings of the Covered Bonds. All Covered Bonds issued by UK credit institutions to date have been rated AAA/Aaa by the three main rating agencies (Standard & Poor's, Moody's and Fitch) and the level of over-collateralisation has been between approximately 8% and 11%.

6. The over-collateralisation is "paid for" by the SPV by the capital (or "membership") interest of the Bank in the SPV. The Bank is also entitled to deferred consideration from the excess revenue receipts in the SPV.
7. The sale of the mortgage assets to the SPV is structured as a "true sale" – i.e. once sold to the SPV, neither a creditor, administrator or liquidator would be able successfully to claim the transferred assets back. A transfer of title under a transaction whose terms satisfy an arm's length test cannot be reversed unless the transaction is effected as a deliberate fraud on creditors or is otherwise a transparent attempt to define a particular transaction as something which it clearly is not⁷ (a "sham"). The English courts have taken a strong view on shams, and have consistently held that transactions should not be recharacterised or reversed without evidence of an intent to disguise (*Welsh Development Agency v Export Finance Co* [1990] BCC 393). Although the courts have recently assumed greater powers to recharacterise transactions (*MacNiven v Westmoreland Investments Ltd* [2001] STC 237), the founding principle of this jurisdiction has remained that transactions entered into in good faith to achieve a particular end should retain the legal form given to them, and should not be subject to challenge, unless they embody an attempt to avoid the intention of the legislator.
8. In consideration of the loan from the Bank, the SPV grants a guarantee in favour of the trustee for the Covered Bondholders, in respect of the Bank's obligations under the Covered Bonds. This guarantee is secured over all the assets of the SPV.
9. In the event that the Bank defaults in respect of its obligations under the Covered Bonds, then notice to pay will be served on the SPV, and the SPV will be obliged to make payments of scheduled interest and scheduled principal under the Covered Bonds to the Covered Bondholders. These payments will be funded from the moneys received by the SPV from time to time on the mortgage assets, and from the sale of those mortgage assets. The Covered Bondholders accordingly have a priority claim

⁷ For example describing an employee as self-employed in order to avoid paying NICs.

on the assets of the SPV to meet the payment obligations under the Covered Bonds issued by the Bank.

10. During the life of the Covered Bond, the SPV is obliged to maintain the pool of mortgage assets in an amount that will cover the claims of Covered Bondholders. Asset coverage is tested on a monthly basis. The SPV uses principal receipts on the Covered Bonds to acquire more mortgage assets or other eligible assets from the Bank, and the Bank is expected to sell mortgage assets to the SPV on a continuing basis, to ensure that there is sufficient asset coverage.
11. The assets of the SPV are administered by the Bank (for so long as it is not in default).
12. The SPV covenants not to carry on any business other than as generally permitted by the documents. This will limit its other potential creditors and accordingly ensure that it is “bankruptcy remote”.
13. There is no consolidation under UK law, which means that in principle the administration or liquidation of the Bank will not in any way cause the administration or liquidation of the SPV.

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ⁱ Sally Dewar took no part in discussions surrounding the issues raised in this paper.

ⁱⁱ Clive Maxwell took no part in discussions surrounding the issues raised in this paper.