Title: Regulated Covered Bonds Review	**Impact Assessment (IA)**
IA No:	**Date:** 16/08/2011
Lead department or agency: HM Treasury	**Stage:** Final
Other departments or agencies: Financial Services Authority	**Source of intervention:** Domestic
	Type of measure: Secondary legislation
	Contact for enquiries: coveredbondreview@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: Amber

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£220m benefit	£220m benefit	£25.6m benefit	Yes	Zero net cost

What is the problem under consideration? Why is government intervention necessary?

Covered bonds are a category of bond that can provide stable funding for banks and building societies. European regulation favours investment in covered bonds that are subject to domestic regulation. Investors value the quality and certainty enforced by regulation, and prefer stringently regulated bonds.

The UK already has covered bond regulation to allow UK covered bonds to meet European regulatory requirements. The Government and the FSA have identified a number of small improvements to the regulation to bring it closer into line with the regulation in other European countries. This will increase the appeal of UK regulated covered bonds to investors and improve lenders' access to covered bond funding.

What are the policy objectives and the intended effects?

The objective is to support UK lenders' access to stable funding from covered bonds. In particular:

- the UK's regulation should allow UK covered bonds to meet the relevant European regulatory standards;
- the regulation should promote investor confidence in UK covered bonds, by making clear the quality of UK regulated covered bonds and the strengths of the regulatory approach; and
- financial institutions' use of covered bonds should be consistent with financial stability.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

There are no viable alternatives to regulation, since European law and investors favour regulated covered bonds. The absence of regulation would reduce confidence in the UK market. These proposals are about improving existing regulation to make sure it meets its policy objectives.

The Government and the FSA propose to build on the general principles set out in the existing Regulations by introducing a small number of more prescriptive rules and codifying best practice in the market, to match the approach taken in some other countries and address certain investor concerns around quality and certainty. Since these changes largely formalise existing practice, they impose very limited costs on issuers.

Doing nothing will not address the issues raised by investors and will not increase UK lenders' access to covered bond funding. The preferred option is to proceed with the changes.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 12/2017

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** No	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: [signature] Date: 25/11/2011

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: £40m	**High:** £445m	**Best Estimate: £220m**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	**£0.5m**		**£0.4m**	**£4.3m**

Description and scale of key monetised costs by 'main affected groups'

Covered bond issuers: administrative costs of complying with Regulations. £0.5m transitional, then £0.4m per year in total across all issuers, based on legal and IT costs.

FSA: extra administrative costs of supervising covered bond issuers. £20,000 per year.

Other key non-monetised costs by 'main affected groups'

N/A

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	£0		£5m	**£45m**
High	£0		£55m	**£450m**
Best Estimate	**£0**		£25m	£225m

Description and scale of key monetised benefits by 'main affected groups'

Covered bond issuers: lower spreads on covered bonds. Total across all issuers £25m per year, based on a reduction of 0.05% in the interest rate on covered bonds demanded by investors.

Other key non-monetised benefits by 'main affected groups'

Wider society: lower cost of credit; more stable funding for banks and building societies, leading to less risk of financial disruption; fewer opportunities for regulatory arbitrage

Key assumptions/sensitivities/risks | **Discount rate (%)** 3.5%

Financial markets have displayed high volatility since the financial crisis. Any further disruption could affect the pricing of covered bonds and issuers use of them.

Future changes to bank regulation could affect the relative appeal of covered bonds to issuers and investors.

Note: Benefits rounded to nearest £5m, costs rounded to nearest £0.1m

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £0.5m	**Benefits:** £26.1m	**Net:** £25.6m saving	Yes	Zero net cost

Evidence Base

Background

Covered bonds are a category of secured bond backed by a pool of assets. The assets provide security for investors in case the issuer of the bonds fails. Covered bonds are issued by financial institutions to raise funding for lending to households and businesses. There are over £100bn of covered bonds outstanding in the UK, issued by all the major banks and a number of building societies. In the first half of 2011, issuance of covered bonds represented about 15% of the longer-term public issuance of funding by UK banks[1].

The financial crisis revealed that many banks were over-reliant on unstable, short-term funding. This over-reliance made banks very vulnerable to market disruptions. During the financial crisis in 2008, many institutions began to struggle to refinance their short-term obligations. As a result, governments and central banks across the world eventually had to step in to provide emergency funding and additional capital to prevent the failure of large, systemically important financial institutions. The ensuing disruption to the economy has imposed very large costs on UK society.

New banking regulation currently being developed is designed to make banks less vulnerable to short-term market disruptions, by forcing them to raise more longer-term funding. Such funding does not need constant refinancing, and so will make banks better able to weather periods where short-term funding is less available.

Covered bonds can be one source of longer-term, more stable funding. Covered bonds last on average for around five years, and are often bought by stable investors such as pension and insurance funds that are less affected by short-term market disruptions. They proved more resilient in the financial crisis and recovered more rapidly than some other sources of funding.

Role of regulation

European regulation under the UCITS and Capital Requirements Directives favours investment in covered bonds that are subject to dedicated domestic regulatory scrutiny, by imposing lower capital requirements and higher investment limits on investors making investments in regulated bonds than other bonds. This has naturally led the investor base for covered bonds to focus largely on regulated covered bonds, and the nature of the regulation backing covered bonds has become a key component of the product.

High quality domestic regulation is therefore a necessary condition of ensuring that UK issuers have favourable access to the widest possible covered bond investor base. Without a high quality of regulation, UK covered bond issuers would not be able to compete on a level playing field in the EU market.

As a result, the Regulated Covered Bond Regulations 2008 were introduced to help UK financial institutions access covered bond funding. These Regulations provide a regulatory framework for UK covered bonds that enforces minimum standards in line with the minima in European covered bond regulation. The Regulations follow a broad, principles-based approach, which sets out high-level standards that covered bonds must meet, rather than detailed, prescriptive rules.

The Regulations have been broadly successful. Ten covered bond issuers have registered as regulated issuers, including all the major UK banks and a number of larger building societies. Issuance of covered bonds has grown rapidly since the financial crisis.

Policy objectives

In light of the background above, the introduction of the Regulations in 2008 and the ongoing regulatory approach have been driven by three objectives:

- the UK's regulation should allow UK covered bonds to meet the relevant European regulatory standards;

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[1] Source: Deutsche Bank.

- the regulation should promote investor confidence in UK covered bonds, by making clear the quality of UK covered bonds and the strengths of the regulatory approach; and
- financial institutions' use of covered bonds should be consistent with financial stability.

Problem under consideration and rationale for intervention

Market feedback on need for 'gold plating'

During December 2010, the Treasury and the FSA met with around 20 covered bond market participants to assess the effectiveness of the 2008 Regulations as part of a post-implementation review. Further feedback was received as part of the consultation process during April to July 2011, including 16 formal written responses.

Most market participants believe the UK covered bond market meets high standards. This is a result of positive practices among issuers that are driven by the high-level duties and principles set out in the Regulations.However, covered bond regulation in some other European jurisdictions takes a more prescriptive approach and imposes specific rules on covered bond issuers rather than general principles. This goes far beyond the minimum requirements of EU legislation. A more prescriptive approach is particularly evident in Germany and France, which are among the most established European covered bond markets.

Numerous market participants said they believed UK covered bonds would appeal more to investors if the Regulations took a more prescriptive approach in line with these other jurisdictions. Some investors used to investing in covered bonds subject to prescriptive rules did not believe that the UK's high-level principles could reliably deliver quality standards equivalent to those in more prescriptive jurisdictions.

Exceeding the minimum requirements of EU legislation is often regarded as unnecessary 'gold-plating'. In this case, however, so many EU Member States have exceeded the minimum requirements, and investors say they attach so much value to regulation, that not exceeding the minimum requirements appears to be putting the UK at a significant competitive disadvantage.

In effect, the absence of 'gold-plating' is more costly for the UK than its presence. Any costs that issuers might save from less regulation are more than offset by having to pay higher interest rates on their covered bonds to investors, or having less access to covered bond funding. This reduces UK lenders' access to stable, long-term funding or leads to a higher cost of funding for UK lenders, which may be passed on as a higher cost of credit for consumers and businesses. Such an outcome constitutes a regulatory failure – regulation is imposing unnecessary costs on UK society.

The following two sections discuss the evidence for this in detail.

Economic explanation of need for 'gold plating'

Despite the above market feedback, one option that has been considered would be to leave the market to find its own solution – if investors prefer prescriptive rules, issuers should meet this demand by making detailed commitments in the individual contracts governing their covered bonds.

Further investigation has suggested this option would not be effective, because it misses an important distinction between contractual commitments and statutory requirements. With a regulated product whose issuers face statutory requirements, investors can rely on the regulator to ensure the issuer complies with these requirements. With contractual commitments, an investor's recourse against an issuer who fails to comply with their commitments is to pursue the issuer through the courts to enforce the contract.

Pursuing a breach of contract through the courts can involve delays, legal fees, and uncertainty about outcomes for an investor. Regulatory enforcement requires far less individual investor engagement and, given the regulator's considerable powers, tends to involve less uncertainty as to whether enforcement will be successful.

This means that, in general, where an investor can choose between a covered bond subject to certain statutory requirements and an otherwise identical product subject to equivalent contractual commitments, it would be rational to prefer the additional certainty and enforceability in the product that is subject to statutory requirements.

Market feedback from investors suggests the distinction between contractual commitments and statutory requirements is particularly pertinent to the covered bond market for two reasons.

Firstly, investors face a broad choice of covered bonds from different countries and will compare the approach in the UK Regulations with the covered bond regulations in other jurisdictions. Many other jurisdictions, including the long-established covered bond markets in Germany and France, take a much more prescriptive approach than the UK, as illustrated in Table 3.A of the consultation document.

Secondly, covered bonds are typically low-yielding products, and so it is not cost-effective for most investors in them to conduct detailed analysis on the contractual structure of individual bonds. Instead, investors often assess covered bonds with reference to the general standards prevailing in the covered bond market of a particular country, by reference to the country's covered bond regulation. The lack of prescriptive rules in the UK Regulations may therefore negatively affect investors' assessments of the UK market.

Quantitative evidence on cost of not gold plating

The importance of regulation as a factor in investors' perceptions of UK covered bonds can be expressed in terms of the impact it has on the price of covered bonds. Other things being equal, one would expect investors who are concerned about the lower level of prescription in UK covered bonds to demand a higher return when they buy the bonds. This would be reflected in the spread[2] on UK covered bonds being higher than on covered bonds from countries with more prescriptive regulatory regimes.

In July 2011, the spread on UK covered bonds relative to risk-free rates was around 90bps (basis points, i.e. units of 0.01%). The spread on German covered bonds, which are based on a more prescriptive regulatory framework, was around 25bps. The spread on Swedish covered bonds was around 40bps and on French covered bonds around 60bps[3]. This means investors demand around 50bps extra return on UK covered bonds relative to those from competing jurisdictions.

Many factors come into the choice between covered bonds from different jurisdictions, and in practice there is never a choice between identical bonds that differ only in terms of being subject to statutory or contractual rules. When choosing between different bonds, investors' perceptions of the strength of the underlying housing market in a particular jurisdiction, the strength of covered bond issuers, the track record and history of covered bonds in that jurisdiction, and the extent of state support for covered bonds may be a more material factor than the nature of the covered bond regulation.

However, analysis by the Bank of International Settlements (BIS) of the spreads on covered bonds from different jurisdictions found that, after controlling for several such factors, there was a residual difference between spreads in different jurisdictions that could be due to perceptions of the regulatory regime[4]. While the BIS analysis was inconclusive on the precise impact of the regulatory regime, investor feedback supports the view that the less prescriptive UK regulation of covered bonds is a factor in the much higher spreads on UK covered bonds.

Economic consequences of regulatory failure

Changes to address the regulatory failure could reduce the spreads on covered bonds. The spread on a covered bond reflects a transfer of risks and rewards between agents in a financial market. In the first instance, lower spreads would reduce costs for covered bond issuers at the expense of reducing returns for covered bond investors. There is therefore no necessary connection between higher spreads on covered bonds and an economic cost to UK society. In this case, however, there is strong evidence that higher spreads do represent a welfare loss, to the extent that they arise from a regulatory failure.

As explained above, many market participants have stated that they believe the underlying quality of UK covered bonds is high in comparison to international peers. To the extent that this is true, those investors who demand higher spreads on UK covered bonds are doing so partly on the basis of the regulatory framework – due to the greater uncertainty and lower enforceability that arises from the need for investors to rely on contractual commitments or market practice rather than statutory requirements.

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[2] The spread on a bond is an indication of how much of a return on their investment investors demand if they are to buy the bond. Higher spreads tend to imply bonds are riskier or less attractive.

[3] Source: JP Morgan. Average secondary market spread vs asset swap curve for covered bonds with maturities of 3-5 years, July 2011.

[4] *The covered bond market - BIS Quarterly Review*, part 4, September 2007, http://www.bis.org/publ/qtrpdf/r_qt0709f.pdf.

Using more prescriptive regulation to reduce this uncertainty and increase enforceability would reduce spreads for issuers by removing uncertainty for investors. Issuers would benefit to the extent that spreads are lower without them having to make any major changes to their covered bond programmes. The net effect on investors is zero – since the pricing of covered bonds is determined in a competitive market, the cost to the investor of accepting a lower spread on the covered bond will be equal to the benefit of the greater certainty the investor derives from the more prescriptive rules. Overall, there is therefore a gain to society. The extent of that gain will depend on how lower costs for issuers contribute to overall social welfare. The extent of the gain is discussed further in the section on Benefits below.

Summary

In conclusion, these arguments suggest that there is scope to make changes to the Regulations that would produce a welfare gain for the UK. The general direction of these changes would be to introduce more prescriptive requirements into the Regulations, in line with the practice in competing jurisdictions and in excess of the minimum EU standards.

Policy options

In discussions with market participants, the Treasury and the FSA investigated which specific issues underlie the general market perception that the UK regulatory framework may not be sufficiently prescriptive compared to international peers. Through this process, the Government and FSA have identified a set of areas, discussed below, where issuer and investor feedback has suggested that regulatory change will improve outcomes in the UK covered bond market. Feedback from the consultation has reinforced the case for these proposals, subject to a number of small changes mentioned below.

Excluding securitisations as eligible assets

The Regulations set out which assets are eligible for inclusion in covered bond asset pools. They currently allow securitisations of residential and commercial mortgages to be included in covered bond asset pools, as well as 'raw' mortgages. This is in line with the relevant provisions of the European Banking Consolidation Directive. However, many other jurisdictions take a stricter approach than the Directive and do not allow securitisations to be included[5]. This is because many investors regard covered bonds backed by securitisations as a more complex and less transparent product.

No UK regulated covered bond programmes currently contain securitisations, and no issuer has ever applied to the FSA to use them. Despite this, market feedback suggests that investors look to the Regulations that allow securitisations to be included and adjust their assessment of UK covered bonds accordingly. This constitutes a failure in the Regulations – issuers are unable to credibly communicate their intentions and the nature of their product to investors.

This means that aligning the Regulations with the practice in other countries by removing the option to include securitisations in covered bond asset pools will remove uncertainty for investors and improve perceptions of the quality of UK covered bonds, while imposing no costs on issuers. Investors responding to the consultation strongly supported this proposal.

The Government and FSA have considered whether adding additional conditions in the Regulations relating to the inclusion of securitisations could address the problems above without excluding securitisations completely, as some issuers have said they would like to retain the flexibility to potentially use securitisations in future. However, such conditions would need to ensure securitisations were only included if they were sufficiently simple that they did not complicate the assessment of the quality of a covered bond. Given the intrinsic complexity of securitisation, this is not a realistic option.

Beyond reducing uncertainty for investors, there are benefits to broader financial stability from excluding securitisations. While there is a favourable regulatory treatment for covered bonds under the UCITS and Capital Requirements directives, the treatment of securitisations is much less favourable. If securitisations could be included in covered bond asset pools, this would represent an opening for regulatory arbitrage – market participants could evade the tighter regulatory requirements placed on securitisations by repackaging them into covered bonds. Since the tighter regulatory requirements have been introduced to correct failures that contributed to the financial crisis, evasion of these requirements could substantially increase risk in the financial system.

Single asset type pools

The Regulations currently allow a range of asset types to be included in a covered bond asset pool, including residential mortgages, commercial mortgages, and public sector loans. The risk characteristics of these assets types are very different. Since the assets in a covered bond programme need to be replenished over time, some investors have remarked that with broad eligibility criteria they are concerned that over time the mix of assets in a covered bond programme could change from less risky to more risky assets. These investors will factor this risk into their assessment of the quality of a covered bond, which could raise the spread on the bond.

[5] For example, Germany, Ireland, and Spain.

Some other jurisdictions make it a requirement in their regulation that issuers maintain asset pools with only a single type of asset in them[6]. In these countries, different asset types must be placed in separate pools. In comparison with such jurisdictions, some investors have said that in the UK there are insufficient protections against a change of asset quality, even in cases where an issuer states they will not change the type of assets over time.

No UK covered bond issuer currently includes or has expressed an interest in including any assets other than residential mortgages in their programme. The risk of a change in asset types perceived by investors therefore represents a regulatory failure, since the Regulations appear to be preventing issuers from credibly communicating their intention not to change asset types to investors.

The Government proposes to address this by introducing an option in the Regulations for issuers to formally declare their covered bond programme as a 'single asset type' programme. Issuers would still be able to retain their current flexibility to mix and change asset types according to the contractual terms of their programmes by declaring their programme as a 'mixed asset type' programme.

This proposal will impose no change and hence no costs on issuers who wish to continue with their current, potentially more flexible arrangements. Issuers who choose to declare their programmes as single asset type would only do so if they believed this would be benefit them by removing uncertainty for their investors. Overall, this proposal is therefore expected to lead to a net benefit for issuers. It was supported by all investors and almost all issuers during the consultation.

The Government and the FSA considered removing the option for mixing asset types altogether, which would bring the UK fully into line with some other jurisdictions. The Government and the FSA have rejected this option because it is unnecessary to go this far to address the problem identified. Mixing asset types may in future meet the needs of some issuers and investors, so removing this option from the Regulations may unnecessarily constrain the potential for innovation and growth in the covered bond market.

Investor reporting

One contributor to the financial crisis was a lack of transparency about the characteristics of financial products and financial institutions' exposures to them. This lack of transparency led to a mispricing of risk, especially an under-pricing of risk in the run-up to the crisis.

UK covered bonds benefit from high levels of transparency, such as detailed reporting about the quality of covered bond asset pools and disclosure of legal documentation. This transparency, however, is not driven by any feature of the Regulations and is instead a result of market practice. The lack of regulation in this area means the format of disclosure is not consistent across all issuers, increasing the barriers to comparing and evaluating the relevant data for investors. A lack of regulation also means investors may not have as much confidence in the quality of this disclosure or recognise it as a key feature of UK covered bonds as if the disclosure was enforced by regulatory requirements

The Government proposes to amend the Regulations to give the FSA the power to direct publication of information. The FSA will use this to ensure consistent reporting and disclosure for UK covered bonds. A better informed market will benefit from more efficient pricing, which will benefit issuers with high quality covered bonds. Both issuers and investors responding to the consultation agreed that high, consistent transparency standards would be a positive step.

The specific investor reporting requirements to be imposed are a matter for the FSA, and there have been extensive discussions between issuers and the FSA in developing these, as discussed in detail in the FSA's Regulated Covered Bond Sourcebook (Amendment No 2) Instrument 2011. To minimise costs to issuers, the FSA is building on existing forms and processes in developing the proposed reporting standards. The proposed standards are similar to the standards developed by the Bank of England with which almost all issuers have indicated that they are already planning to comply. Overall, this means the proposal is likely to impose only minimal additional administrative costs on most issuers. The scale of costs is discussed below.

[6] For example, Germany, Ireland and Spain.

Fixed minimum overcollateralisation

Overcollateralisation is the degree to which the balances outstanding on the assets in a covered bond asset pool exceed the balances outstanding on the bonds. It provides protection to investors by ensuring the asset pool can suffer a certain threshold of losses but still be able to secure repayment of the bonds if the issuer fails, and is a key factor in determining the quality of a covered bond.

Overcollateralisation levels in all covered bond markets are driven by rating agency requirements, investor preferences, issuers' operational decisions, and regulatory requirements. In the UK, the regulatory component of overcollateralisation levels is determined by FSA stress testing. This assesses the performance of each individual covered bond programme against a range of possible adverse scenarios to determine the required level of overcollateralisation.

Some other jurisdictions take a different approach and impose a statutory fixed minimum level of overcollateralisation that issuers must meet[7]. In practice, overcollateralisation in these countries is, like in the UK, far higher than the typical fixed minimum levels used, and is driven by rating agency requirements and investor preferences. A fixed minimum level is, however, more transparent and readily understood by investors than a variable level. Some investors have commented that the absence of a minimum in the UK introduces a degree of uncertainty and makes the UK regime harder to compare with other jurisdictions.

The Government proposes to introduce a requirement in the Regulations that issuers must maintain a fixed minimum level of overcollateralisation in covered bond asset pools. Almost all consultation respondents agreed with this proposal, and suggested setting the fixed level at between 2% and 25%. The Government and the FSA have chosen 8%, which is comparable with the levels in other jurisdictions, and well below the current levels of overcollateralisation in the UK. This means the new requirement will have no material impact on issuers, but will bring benefits through reducing investor uncertainty.

Asset Pool Monitor

UK covered bonds benefit from a high degree of external scrutiny, including an annual external audit of the programme. As with numerous other features of positive UK market practice, however, the external audit is not currently a statutory requirement in the Regulations and so, for the reasons described above, not all investors are aware that it takes place and they do not give issuers full credit for the added confidence that external scrutiny of programmes should bring.

Some other jurisdictions include a formal requirement in their regulation for an 'asset pool monitor' or related role, which performs a similar function to an external auditor[8]. The lack of such a requirement in the UK Regulations, despite market practice that would meet this requirement, may be putting UK issuers at a disadvantage compared with competitors from other jurisdictions.

The Government proposes to address this by adding a requirement to the Regulations for issuers to appoint a formal Asset Pool Monitor, with a remit that is very similar to that of existing auditors. This will make the presence of external scrutiny of UK covered bond programmes more apparent to investors without imposing major changes on issuers. Investors responding to the consultation welcomed this proposal, and some argued the Government should go further and mandate publication of the Asset Pool Monitor's report to further reassure investors.

However, issuers commented that formalising and expanding the role of auditors could increase costs for issuers. It is not the Government's intention to increase costs unnecessarily, and in response to consultation the Government and FSA have both amended the drafting of the monitor's duties to minimise burdens. Nevertheless, some issuers have said auditors may regard conducting a review in line with a statutory requirement as increasing their potential liability in case of error compared with one conducted under contract, and so could try to increase their fees even if the content of the audit is unchanged. The effect of such an increase is discussed below.

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[7] For example, Germany, France, Ireland and Spain.

[8] For example, France, Germany and Ireland.

Overall costs and benefits

Benefits

The key direct benefits from these proposals are in the form of removing uncertainty among investors about the quality of UK covered bonds, especially when comparing UK covered bonds with covered bonds from other jurisdictions. As set out above, a significant reduction in uncertainty will manifest itself in the form of lowering the spreads on UK covered bonds. For the reasons given above, this represents an overall welfare gain by reducing costs for issuers without any net welfare impact on investors.

Lower costs for issuers could lead to higher profits, or be passed on to firms and individuals in the form of a lower cost of credit for those who borrow from issuers. The overall impact of a lower cost of credit on society is very hard to quantify. It could lead, for example, to the financing of a greater number of productive investment opportunities, which could boost economic output by an amount greater than the immediate monetary reduction in credit costs. However, due to the difficulty of estimating such effects and the very small scale of any possible reduction in the overall cost of credit for the economy, this Impact Assessment assesses only the immediate monetary gains to issuers from a reduction in spreads.

Investors and issuers both commented that it was not possible to attribute individual spread reductions to the individual measures, only to the set of measures as a whole. This is because the regulation of covered bonds in any one jurisdiction is seen as a package. Individual measures contribute by raising perceptions of the overall quality or transparency of regulation. As discussed above, there is considerable evidence that each measure *qualitatively* raises transparency and addresses investor concerns, but it has not proved possible to translate this into *quantitative* impacts. Instead, some investors indicated spread reductions from the overall package could be in the region of 10 – 20bps, though many commented this was hard to predict given the current volatility in financial markets.

Another way of quantifying the impact is to look to the Bank of International Settlements analysis of covered bond spreads discussed above, which found that the residual component in spread differences that could be attributable to perceptions of the regulatory regime was +/- 8ps, at a time in 2005/6 when the widest difference in spreads between different jurisdictions was around 20bps. This means the residual accounted for the majority of the difference in spreads. Spread differences across products in all financial markets have increased since the financial crisis, and as discussed above, the difference between UK covered bond spreads and those of European competitors is now over 50bps.

A conservative estimate of the reduction in spreads due to the measures proposed could therefore be 5bps, which is below investor estimates and represents a reduction of only 10% in the current difference between UK and other countries' covered bond spreads. The outstanding volume of UK covered bonds is around £100bn. If the collective impact of the measures above was to reduce the spread on UK covered bonds by 5bps, in the steady state this would represent a saving to UK issuers collectively of £50m annually (£100bn x 0.05%).

In practice these savings will build up slowly over time, as existing bonds on fixed interest rates are refinanced. As a conservative assumption, if a tenth of bonds are refinanced every year (compared to average maturities of five years), and there is no net growth in the overall volume of outstanding covered bonds (despite the recent increase in issuance), this represents an NPV benefit of £220m (rounded) to UK issuers over the next ten years. This is the discounted sum of £5m in the first year (£100bn x (1/10) x 0.05%), £10m in the second year (£100bn x (2/10) x 0.05%) and so on, for 10 years.

A reduction of 5bps in spreads is the central assumption. The table below illustrates the potential benefits from a lower reduction in spreads (1bps) and a higher reduction in spreads (10bps).

Summary of benefits from possible spread reductions	
Spread reduction	**NPV benefit (10 years)**
1bps	£50m
5bps – central assumption	£220m
10bps	£450m

The measures above will also reduce systemic risk in the financial system, through encouraging issuers to make use of longer-term, more stable funding through covered bonds, eliminating opportunities for regulatory arbitrage, and improving the functioning of markets through greater transparency. These benefits are difficult to quantify, but given the very large costs that the financial crisis has imposed on society, these are noted as important non-monetised benefits from the proposals.

Costs

The sources of potential costs to issuers have been discussed above in the context of each measure, and are in most cases negligible. The FSA sent a survey to all existing issuers to inform quantitative estimates of costs. Out of the 10 issuers, 4 responded. Two issuers provided further information as part of the consultation process, and the FSA also sought further views from audit firms in relation to the asset pool monitor proposal (see below).

Transitional costs

The key transitional costs of the proposals will be in the form of administrative costs for issuers in implementing the changes, for example as a result of changing legal documentation or amending IT systems. Most issuers' estimates of the incremental costs were minimal, since the changes involved were minor, could be integrated in an existing programme of routine changes, or (in the case of IT systems) are already taking place to meet existing requirements such as those set out by the Bank of England.

The only area where major transitional costs were reported was in relation to one issuer that indicated they did not intend to comply with the existing Bank of England reporting requirements with which the FSA is aligning its proposed requirements. The transitional costs given by issuers during consultation for IT procurement required to comply with the Bank's existing requirements ranged from around £100,000-£300,000 but with one estimate of over £900,000. As part of the consultation process the FSA has worked closely with issuers to assess the costs of this proposal and minimise the burdens involve by amending the format of the proposed reporting requirements. Given these adjustments, the FSA believes the figure of £300,000 is most appropriate to use as the transitional cost for the one issuer not already planning to comply with the Bank's reporting requirements.

The impact assessment also assumes a transitional cost of £20,000 in total per issuer to cover the cost of legal advice to make changes to documentation, based on the standard fees charges by law firms for small legal changes. This has been reduced from £10,000 per proposal (i.e. £50,000 in total) in the initial consultation, based on discussions that suggest there will be significant synergies in the cost of making the whole package of changes as a single set rather than as five individual changes.

Ongoing costs

Ongoing costs may arise from complying with the new investor reporting requirements and from any increase in the cost of external audits by the Asset Pool Monitor. The proposals to exclude securitisations, to allow single asset class pools, and to impose a minimum level of overcollateralisation do not impose any ongoing costs on issuers, since they do not mandate any change in existing or intended practice.

In relation to investor reporting, since the requirements will be based on existing forms and processes, issuers expected that at most a small amount of additional staff time would be required, of the order of a few hours a month. To be conservative, this impact assessment uses a cost of £10,000 of staff time per issuer per year, or 40% of an FTE costing £25,000 per year. To reflect the fact that one issuer has said they are not already planning to comply with the Bank of England's requirements, the Impact Assessment adds additional annual costs of £30,000, reflecting the median annual cost of meeting the Bank's requirements given by issuers, equivalent to 1.2 FTEs.

In relation to the Asset Pool Monitor, issuers have said auditors may increase their fees to reflect the additional costs of undertaking a statutory rather than contractual duty. The consultation estimated a doubling of auditors' fees from the existing £30,000 to £60,000 a year. Some consultation feedback argued that cost increases could be higher than this. In response to this feedback, the FSA has amended its requirements. Given these changes, it now expects an increase of only £15,000 a year, but to be conservative the impact assessment retains the original £30,000 increase.

The costs are summarised below. They have been scaled to the current population of 10 issuers.

Summary of costs to issuers		
Proposal	**Transitional costs**	**Ongoing annual costs**
Excluding securitisations	£0.2m in total for the package	£0
Single asset class pools		£0
Minimum overcollateralisation		£0
Cover pool monitor		£0.3m
Investor reporting	£0.3m	£0.1m
Total	**£0.5m**	**£0.4m**
NPV cost (10 years)	**£4.1m**	

No administrative costs for investors are expected, since the Regulations do not place any direct requirements on them. Some investors commented in consultation that there could be small additional costs in processing more extensive reporting from issuers due to the new investor report requirements, but others said the costs would be minimal and absorbed into existing spend on processing data. In any case, there is no obligation on investors to process the additional information, and one would expect that they would only do so if they believed the benefits of a greater understanding of covered bonds outweighed the administrative costs.

There may be costs to the FSA from additional staff time in monitoring issuers' compliance with the new requirements. The FSA estimates these costs will be equivalent to at most one fifth of a full-time equivalent staff member. Taking into account all the costs associated with employing staff, the FSA estimates this represents a cost of £20,000 annually (20% of an FTE costing £100,000 per year), or £0.2m on an NPV basis.

Risks and assumptions

A key risk to the assessment of the benefits from these proposals is the potential for disruption to financial markets. Disruption may lead to a change in investors' or issuers' appetite for issuing or buying covered bonds, which could lead to a change in the size of the covered bond market or the nature of the covered bonds issued.

There is less uncertainty in the assessment of costs, since these are largely administrative and so less sensitive to broader changes in financial markets. The assessment of costs has been informed by a survey of issuers and subsequent discussions during consultation, in which they may have made simplifying assumptions. Unexpected changes in the costs of IT systems or in legal fees, for example, could affect these assumptions.

A third risk affecting both the costs and benefits arises from the ongoing development of financial regulation in Europe and internationally in the wake of the financial crisis. Were there to be major changes to the regulatory approach to covered bonds, the nature of these changes could affect the costs and benefits of these proposals.

Summary and implementation plan

Following the consultation, the Government has decided to proceed with the proposals, subject to a number of small changes to improve legal drafting and minimise unnecessary costs. The FSA has also decided to proceed with its own associated regulatory changes subject to similar amendments.

The Regulations will shortly be laid before Parliament, and if approved would come into force from 2013. The FSA will put its proposed regulatory changes to its Board, to come into force at the same time.

No change in existing enforcement arrangements is required.

Wider impacts

Equality

The proposals relate solely to financial instruments traded between financial institutions in wholesale markets. They are not expected to have any impact on equality.

Competition

The proposals are not expected to have an impact on competition. While the increase in costs to issuers of covered bonds may in theory raise barriers to entry in the market for issuing covered bonds, the additional costs involved are immaterial in comparison to the already high costs of developing the necessary IT systems and legal arrangements to issue covered bonds.

Small firms

No impact on small firms is expected, for two reasons.

Firstly, the minimum size of issuance of covered bonds in the market is in the hundreds of millions of pounds, given investors' preference for large issues that provide greater liquidity. Such a scale of issuance is very unlikely to be achievable for a small firm, and no small firms currently issue covered bonds.

Secondly, only firms that apply to the FSA to become regulated issuers of covered bonds are subject to the Regulations. This means that should a firm decide they wish to issue covered bonds but want to exempt themselves from the burden of regulation, they can readily do so by not registering with the FSA as an issuer of regulated covered bonds. A number of firms have issued unregulated covered bonds, and there is no barrier to them continuing to do so.

Justice

No justice impact is expected. The proposals do not involve the creation of any new offences. The only proposal where there is a potential for offences to be committed is the proposal to introduce an Asset Pool Monitor. In line with existing provisions of the Regulations, which bring the provision of information about covered bonds to the FSA into the scope of the existing offence of 'misleading the Authority' in section 398 of the Financial Services and Markets Act 2000, the draft Regulations treat the provision of information to the Asset Pool Monitor as information provided to the FSA. It is not expected this will lead to any material increase in offences under section 398.

Human rights

The proposals relate solely to financial instruments traded between financial institutions in wholesale markets. They are not expected to interfere with human rights.

Annex 1: Post Implementation Review (PIR) Plan

Basis of the review: A duty for the Treasury to review the Regulations by the end of 2017 is set out in the draft Regulations.
Review objective: To assess whether the Regulations continue to meet their policy objectives, as described above, and whether those objectives remain appropriate.
Review approach and rationale: The review is expected to follow the same approach as this current review, which has been informed by detailed feedback from market participants.
Baseline: The baseline position is the current UK market for covered bonds in 2011. Broader developments in financial markets and future regulatory changes could affect this baseline, and so these will need to be taken into account in the review.
Success criteria: Success criteria include positive market feedback about the quality of UK covered bonds and their regulation compared to the standards in other jurisdictions. This may be accompanied by a reduction in covered bond spreads in the UK compared to those in other countries. Success criteria also include positive feedback from issuers on their ability to access covered bond funding.
Monitoring information arrangements: The FSA supervises all UK regulated covered bond programmes, and collects data and conducts analysis on an ongoing basis.
Reasons for not planning a review: N/A