11 July 2014

Submitted via electronic submission

European Securities and Markets Authority
103 rue de Grenelle
75007 Paris, France

European Banking Authority
Tower 42, Level 18
25 Old Broad Street
London, UK EC2N 1HQ

European Insurance and Occupational Pensions Authority
Westhafenplatz 1
60327 Frankfurt am Main
Germany

Consultation paper – Draft regulatory technical standards on risk-mitigation techniques for OTC-derivatives contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (EMIR)

On behalf of the Regulated Covered Bond Council (**RCBC**), we welcome the opportunity to provide comments on the joint consultation paper described above (**Consultation Paper**) and issued by the European Supervisory Authorities (**Authorities**). In particular, we welcome the opportunity to provide comments on Question 3 of the Consultation Paper from a UK covered bond perspective. By way of background, the RCBC is made up of the UK regulated covered bond issuers. Further information with respect to the RCBC and its members is set out in Annex I.

As a starting point, we join the European Covered Bond Council (**ECBC**) in expressing our general support for the inclusion in the proposed regulatory technical standards of measures intended to take account of the nature of covered bond swaps and to address certain risks and concerns of counterparties to such swaps in connection with the coming margin requirements under EMIR. Such measures are essential to ensure the proper functioning of covered bond swaps and programmes more generally. In this regard, we note that covered bonds have been expressly recognised by the UK authorities as a valuable source of stable funding for banks and building societies,[1] and the European Commission has also recognised the importance of the product across Europe.[2]

Notwithstanding this general support for the inclusion of the proposed measures, concerns have been raised by RCBC members that such measures do not reflect UK covered bond structures and corresponding swaps in all respects and, as a result, may not operate to provide relief as intended. Moreover, comments have been raised that the proposed measures do not go far enough, in that they provide for relief from the margin posting requirements in respect of the covered bond issuer and cover pool only (so-called "one-way relief"), rather than also providing flexibility under the requirements in respect of the swap counterparty (so-called "two-way relief"). These key concerns

[1] https://www.gov.uk/government/consultations/the-uks-regulatory-framework-for-covered-bonds
[2] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014DC0168

address Third Floor North West Wing Bush House Aldwych London WC2B 4PJ
telephone +44 20 7438 8932 mobile +44 7887 825020 email chris.fielding@ukrcbc.org

are outlined in our response below, as are certain other general comments identified by RCBC members in connection with the proposals.

We urge the Authorities to take action in the final advice provided in connection with the regulatory technical standards to address the matters referred to in this response. To be clear, we consider that a lack of action in this regard could have significant implications for UK covered bond issuers, and on the funding of real economy assets in the UK in general.

We would be happy to discuss our response with you at your convenience.

Background

Covered bonds generally

Covered bonds are full recourse debt instruments typically issued by an EU credit institution that are fully secured or "covered" by a pool of high-quality on-balance sheet collateral (e.g. residential or commercial mortgage loans or public sector loans). By their nature, covered bonds are dual-recourse instruments (i.e. they offer investors recourse on the bank issuer as well as on the collateral pool). The majority of European covered bonds are issued under specific legislative frameworks that implement the defining characteristics of covered bonds set out in Article 52(4) of the EU UCITS Directive.[3]

Broadly, there are two main models used for covered bond structures in Europe – the “integrated” model (where the collateral pool continues to be owned directly by the bank issuer and is segregated by special legislation) and the structured or “segregated” model (where the pool is transferred to a special purpose vehicle and is segregated by operation of legal principles). These arrangements are regarded as achieving the same key outcome (i.e. segregation and protection of the collateral pool in favour of the bondholders and other secured creditors, including swap counterparties) and, in general, the model used by issuers will often be determined by the one provided for under the specific legislative framework which applies in the relevant jurisdiction. No distinction is drawn between covered bonds issued under these models in terms of the less restrictive investment rules and/or preferential risk weightings that are made available under European legislation in respect of certain covered bonds.

UK covered bonds

The first UK covered bonds were issued in 2003. To support further development of the market, the UK Government introduced a special legislative framework in 2008. This regime was reviewed and confirmed in 2011. The UK framework (which applies in respect of regulated covered bond issues) provides for use of the segregated model only and effectively endorses the contractual arrangements used by UK issuers prior to the introduction of the regime. As a result, all UK covered bond programmes (including those registered under the legislative framework and those which are not registered) essentially reflect the same key contractual features and protections.

In particular, all UK covered bond programmes (including those registered under the legislative framework and those not registered) involve a separate special purpose vehicle (**Asset Pool Owner**) that purchases and holds the collateral pool and guarantees payments under the covered bonds pursuant to a guarantee which is secured over the collateral pool. Annex II includes a basic overview of the UK structure. A similar structure is used in certain other EU jurisdictions (e.g. the Netherlands and Italy).

[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF

UK covered bond swaps

The Asset Pool Owner will typically enter into swap transactions to hedge certain interest rate and/or currency risks in respect of amounts received by it in connection with the collateral pool assets. The counterparty to these swap transactions may be the issuing bank or building society, or a third party entity.

Provisions will typically be included in the contractual arrangements (driven by rating agency criteria) to require the counterparty to be sufficiently highly rated. In the event such counterparty (or any guarantor) is downgraded below a specified level, the swap agreement will require the counterparty to take certain remedial measures, which may include providing collateral for its obligations under the swap, arranging for its obligations to be transferred to an entity with ratings as required by the relevant rating agency, procuring another entity with the requisite ratings to become co-obligor or guarantor in respect of its obligations under the swap, or taking such other action (as confirmed by the relevant rating agency) as will result in the rating of the covered bonds then outstanding being maintained at, or restored to, the level it was at immediately prior to such ratings downgrade. A failure to take such steps will allow the Asset Pool Owner to terminate the swap.

While many of the provisions described above have their origins in rating agency criteria, it should be noted that similar features are also found in many unrated arrangements due to the risk mitigation features which they provide for the swap counterparty.

It should also be noted that the swap counterparty will have the benefit of the security provided by the Asset Pool Owner and will generally be entitled to receive payments on a relatively senior basis under the contractual priority of payment provisions which apply in respect of distributions made by the Asset Pool Owner (other than in respect of certain termination payments related to an event of default in respect of the swap counterparty).

Key comments

General support for adjusted treatment for covered bond swaps

As stated above, we support the inclusion in the proposed regulatory technical standards of measures intended to take account of the nature of covered bond swaps and to address the risks and concerns of counterparties to such swaps in connection with the coming margin requirements under EMIR.

In particular, we support the inclusion in the regulatory technical standards of measures which disapply the requirement to post initial and variation margin from the perspective of the cover pool (such pool being represented by the Asset Pool Owner in UK structures), along the lines contemplated by Article 3 GEN of the proposed regulatory technical standards. That said, we consider that certain clarifications are required to the proposals to properly accommodate UK structures and arrangements, which arrangements function to provide swap counterparties with a substantially equivalent level of protection as that which exists under more traditional covered bond regimes.

In addition, we consider that provision should be made for relief for swap counterparties to covered bond swaps in the context of rated arrangements (i.e. for “two way relief”). RCBC members consider that rated (and many unrated) arrangements already benefit from sufficient and appropriate protection through operation of certain common contractual provisions which provide for remedial measures in the event of a relevant swap counterparty downgrade, which measures may require the posting of collateral in certain circumstances and replacement of the swap counterparty in others.

Certain proposed conditions do not clearly reflect UK covered bond swaps; required clarifications

Article 3 GEN of the proposed regulatory technical standards requires the satisfaction of certain conditions in order for covered bond issuers and cover pools to benefit from an adjusted treatment under the initial and variation margin requirements. For largely technical reasons, not all of these conditions are clearly satisfied in the context of UK covered bond swaps, notwithstanding that such swap arrangements are substantially compliant with the stated policy intention of providing relief for programmes which "ensure the derivative counterparty a certain level of protection as an alternative to the exchange of collateral". As a general matter, we note that it would be very difficult to make changes to existing UK programmes to clearly satisfy the current drafting of the proposed conditions, notwithstanding that such programmes reflect the stated policy intention.

We urge the Authorities to ensure that sufficient flexibility is provided under the conditions to accommodate not only more traditional "integrated model" covered bond structures, but also "segregated" arrangements (such as the UK model) which involve materially equivalent protective features. We consider each of the proposed conditions below in turn.

Derivative is not terminated in case of default of the covered bond issuer – the rationale for the inclusion of this condition is unclear given that provision for the continuation of the swap in the case of the insolvency of the covered bond issuer primarily serves to protect the covered bondholders in a scenario where the cover pool is held by the issuer (as is acknowledged in footnote 7 on page 60 of the Consultation Paper), rather than serving to meaningfully protect the swap counterparty. In keeping with this, we consider that the condition is not necessary to ensure sufficient protection for swap counterparties and, as such, should be removed from Article 3 GEN. If (notwithstanding our comments) the condition is retained, RCBC members consider that it is essential that certain clarifications are made. In particular, while footnote 7 suggests that the reference to "default" in the condition is intended to capture insolvency events only, this is not clear based on the current drafting and a wider reference to other types of defaults (such as non-performance related events) would essentially rule out most covered bond swaps. In addition, we note that the condition assumes that the cover pool holding entity entering into the swap is the covered bond issuer and that, as a result, there is a risk that an insolvency event in respect of the issuer may result in the termination of the swap on the cover pool side. This does not reflect UK covered bond structures where, as described above, the cover pool is held by a separate entity (the Asset Pool Owner) and it is this entity (rather than the issuer) which enters into the swaps on the cover pool side, meaning that the same concerns with respect to the continuation of the swap in the event of the insolvency of the (separate) covered bond issuer do not arise. We are also concerned that the condition could be read to restrict swaps which terminate upon the insolvency of the swap counterparty to the cover pool where that swap counterparty is the covered bond issuer, as may be relevant once again in a UK covered bond swap context given the separation of the issuer from the Asset Pool Owner. Unless addressed, these assumptions within the current drafting may operate to effectively restrict the availability of the relief in respect of UK covered bond swaps – notwithstanding that such swaps involve sufficient protection for swap counterparties.
Proposal: We consider that this condition should be removed as it does not clearly reflect the driving principle of Article 3 GEN of ensuring sufficient protection for swap counterparties to cover pools. If the condition is retained, then our more technical comments noted above could be addressed by amending the wording as follows – "if the covered bond issuer is the holder of the cover pool, then the derivative is not terminated in the case of an insolvency or analogous event of default in respect of the covered bond issuer".

Derivative counterparty ranks at least pari passu with the covered bondholders – we assume that this condition is intended to ensure in general that the swap counterparty benefits from a sufficiently senior claim with respect to the cover pool assets in an acceleration scenario when the likelihood of recovery in respect of the general claim against the covered bond issuer may be reduced. In this regard, we note that certain covered bond regimes (including the UK framework) are principles-based and do not specify the ranking of creditors, including swap counterparties, in all circumstances.[4] As a result, the contractual arrangements must also be taken into account. In this regard, we note that the swap counterparty will be a secured creditor with respect to the Asset Pool Owner and will be required to accede to the terms of the security documents, thereby ensuring its general senior ranking under the contractual payment waterfall provisions which apply with respect to distributions made by the Asset Pool Owner from amounts received in respect of the cover pool assets. However, there are two technical points to note with respect to this ranking. First, given that UK covered bond structures involve in general payments to bondholders being made by the covered bond issuer and payments to swap counterparties being made by the Asset Pool Owner in a pre-acceleration scenario, it is difficult to point to the relative ranking of payments as between covered bondholders and swap counterparties in these circumstances and it would be extremely challenging to revisit this aspect of UK programmes if changes were required. However, as noted above, we assume that the key concern behind the proposed condition relates to the relative ranking in a *post-acceleration scenario* (given the importance of the ranking of distribution of recoveries in respect of the cover pool in this scenario), and we urge the Authorities to make this clear to ensure that compliance confirmation may also be provided in the context of segregated covered bond structures (including the UK framework). Second, it should be noted that it is common in UK covered bond swaps for certain termination payments arising as a result of an event of default in respect of the swap counterparty to be subordinated to certain other payments (including payments to covered bondholders) in both a pre- and post-acceleration scenario. Given the limited nature of such termination payments and their connection to the fault or failure of the swap counterparty, we consider that these payments should be carved-out of the condition. Such a carve-out is not inconsistent with the policy intention of ensuring that the swap counterparty benefits from sufficient protection, as other payments owed to the swap counterparty will in general rank at least *pari passu* with payments to covered bondholders and this will be the case without exception in a post-acceleration scenario.

Proposal: Our comments with respect to this condition could be addressed by amending it as follows – "following acceleration of the covered bonds, the derivative counterparty ranks at least pari-passu with the covered bondholders other than in respect of payments due to the derivative counterparty where an event of default has occurred in respect of that derivative counterparty or an additional termination event has occurred following a failure by the swap counterparty to comply with the requirements of the ratings downgrade provisions set out in the relevant swap agreement".

Derivative is registered in the cover pool of the covered bond programme in accordance with national covered bond legislation and is used only for hedging purposes – we note that the draft impact assessment section of the Consultation Paper suggests that this condition has been included to ensure that the counterparty benefits from the appropriate segregation of the assets in the cover pool. As noted above, under UK covered bond structures, segregation of the cover pool is achieved through the cover pool being held by the (separate) Asset Pool Owner and this is the entity which enters into the swaps. As a result, unlike covered bond arrangements based on an integrated structure (where the cover pool continues to be owned by the bank and is segregated by operation of statutory provisions), there is no need in the

4 In a security enforcement scenario and/or in the context of the owner being wound up, the UK covered bond regulations provide that the claims of the bondholders and certain service providers and counterparties rank in priority to all other creditors and as between themselves, such claims may rank equally, but the claims of the service providers and swap counterparties may not rank in priority to bondholder claims. The UK regulations also provide that the claims of certain service providers and swap counterparties may be paid as an expense by the receiver or insolvency officeholder and such expenses rank above all other claims, including bondholder claims with respect to certain amounts.

context of UK arrangements for the swap to be identified as forming part of the cover pool via a formal registration process. In this regard, we note that the recent report published by the European Banking Authority (**EBA**) entitled "EU Covered Bond Frameworks and Capital Treatment" (**EBA Covered Bonds Report**) expressly acknowledges in the context of considering segregation of cover pool assets that this may be achieved "either by registration of the cover pool assets into a cover register or by transfer of the cover assets to a special purpose vehicle". Accordingly, the UK covered bond statutory framework does not require a formal cover pool register to be maintained and instead requires the covered bond issuer to make arrangements with the Asset Pool Owner so that a record is kept of each asset in the asset pool (including the corresponding swap agreements). The asset pool notification forms required to be submitted to the competent authority in respect of UK regulated programmes also provide for the filing of certain swap information. Moreover, as noted above, swap counterparties will be required to accede to the terms of the security documents and, as a result, they will have the benefit of the security provided by the Asset Pool Owner in respect of the cover pool. On this basis, we consider that this condition should be adjusted in circumstances where the cover pool is held by a separate entity such that formal registration of the derivative in the cover pool is not required. In addition, with respect to the proposed requirement that the derivative is used only for hedging purposes, clarification should be provided that this should be interpreted in accordance with Article 10(3) of EMIR and, in particular, the criteria set out in Article 10 of Regulation (EU) No 149/2013 with respect to establishing which derivative contracts are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the relevant entity.

Proposal: Our comments with respect to this condition could be addressed by amending it as follows – "the derivative is registered in the cover pool of the covered bond programme in accordance with national covered bond legislation or is entered into by a cover pool entity which is separate from the covered bond issuer". We would also suggest that the hedging purposes point is addressed by a separate condition which would read as follows – "the derivative is used only for hedging purposes, which shall be interpreted in a manner consistent with the principles to be applied under Article 10(3) of Regulation (EU) No. 648/2012".

Netting set does not include derivatives unrelated to the covered bond programme – given that UK covered bond swap arrangements will be documented separately and that such swaps are entered into with the Asset Pool Owner, this proposed condition is not expected to present any issues. As a result, members have not raised any comments on this condition.

Covered bond programme meets the requirements of Article 129 of Regulation (EU) No 574/2013 – while it is not clear, we assume that this condition is intended to ensure that the relevant programme demonstrates certain key features consistent with the nature of covered bonds. However, as drafted, by referring only to programmes which satisfy the requirements of Article 129 of the Capital Requirements Regulation (**CRR**), this condition is too restrictive and will mean that the exemption is only available in respect of covered bonds backed by the specific asset types referred to in that article. While such asset type limitations are appropriate for the purposes of preferential risk weight treatment (which is what Article 129 is intended to determine), these limitations are not necessary or appropriate for the purposes of the proposed relief for covered bond swaps. In particular, we consider that this condition should *also* recognise bonds which comply with the key features referred to in Article 52(4) of the UCITS Directive (Directive 2009/65EC). This approach is consistent with the objective of ensuring sufficient counterparty protection is provided as the features referred to in Article 52(4) require the cover pool assets to be capable of covering covered bondholder claims. Moreover, this approach of referring to both Article 129 of the CRR and Article 52(4) of the UCITS Directive has been used in other EU legislative contexts where it is intended to identify high-quality covered bond arrangements, e.g. in the provisions relating to liquid assets for the purposes of the Liquidity Coverage Ratio in Article 416(2)(a) of the

CRR, and the importance of the principles referred to in Article 52(4) is clearly acknowledged in the recent EBA Covered Bonds Report. We also consider that it would be appropriate to disapply the requirement under Article 52(4) which refers to special public supervision as there are covered bond programmes in existence which, although not regulated, are consistent with the other key covered bond features identified in Article 52(4) and, as such, provide similar protection to swap counterparties as is provided under regulated programmes. As an aside, we assume that the reference in the condition to "Regulation (EU) No *574*/2013" should be a reference to "Regulation (EU) No *575*/2013".

Proposal: Our comments with respect to this condition could be addressed by amending and clarifying it as follows – "the covered bonds issued under the programme are bonds as referred to in Article 52(4) of Directive 2009/65/EC (disregarding the requirement that such bonds are subject to special public supervision) or which meet the requirements for the treatment set out in Article 129(4) or (5) of Regulation (EU) No. 575/2013".

Covered bond programme is subject to a legal collateralisation requirement of at least 102% - it is not clear whether the reference to "legal" here is intended to capture both statutory requirements applicable under national covered bond laws and contractual provisions that operate to establish an over-collateralisation requirement. In our view, both types of requirements are legal in nature and should be acceptable for the purposes of the exemption, as neither would equate to "voluntary over-collateralisation" which could be unilaterally reduced as described in footnote 9 on page 60 of the Consultation Paper. We further note that we have assumed that this condition is focused on the total principal amounts outstanding in respect of the cover pool assets as compared to the total principal amounts outstanding in relation to the issued covered bonds (rather than an interest coverage requirement).

Proposal: Our comments with respect to this condition could be addressed by amending and clarifying it as follows – "the covered bond programme is subject to a legal collateralisation requirement (arising through operation of statutory and/or contractual provisions) of at least 102%".

Question 3 of the Consultation Paper seeks feedback on whether the proposed relief for covered bond swaps set out in Article 3 GEN adequately addresses the risks and concerns of counterparties to derivatives in cover pools and asks whether the proposed requirements should be further tightened. To be clear, RCBC members are of the view that the conditions are sufficiently robust as drafted and should be amended as described above in order to ensure the full range of relevant covered bond swap arrangements may be eligible for the relief as a threshold matter. It would be problematic if the exemption was only available in practice in respect of swaps used in more traditional "integrated" covered bond structures notwithstanding that substantially equivalent protections exist in the context of other covered bond swaps, such as those used in connection with UK structures.

Case for two-way relief; appropriate protections for the Asset Pool Owner already provided by operation of rating agency criteria

As noted above, the covered bond swaps will typically involve risk mitigation measures (driven by rating agency criteria) designed to protect the Asset Pool Owner from the credit risk of the swap counterparty. These measures will typically require the counterparty to take certain remedial action in the event of its rating being downgraded beyond a specified level, which action may include providing collateral for its obligations under the swap, arranging for its obligations to be transferred to an entity with ratings as required by the relevant rating agency, procuring another entity with the requisite ratings to become co-obligor or guarantor in respect of its obligations under the swap, or taking such other action (as confirmed by the relevant rating agency) as will result in the rating of the covered bonds then outstanding being maintained at, or restored to, the level it was at immediately prior to such ratings downgrade.

While Recital 24 to EMIR refers to the alternative protection given to swap counterparties in the context of covered bond swaps and does not refer to the protections typically provided to covered bond issuers and cover pools via the operation of rating agency criteria, we do not consider that this should be interpreted as meaning that two-way relief may not be provided by the Authorities. In this regard, we note that Article 11(3) refers only to "the timely, accurate and appropriately segregated exchange of collateral" and Article 11(15)(a) clearly leaves it to the Authorities to specify what is appropriate for these purposes, with Recital 24 merely providing one example of the adjustments to be made. We further note that there is nothing in the text of EMIR which prescribes that the only way to satisfy the risk mitigation requirements referred to in Article 11(3) is by the exchange of liquid collateral on a daily basis by reference to the mark-to-market value and associated volatility of transactions.

Although the rating agency requirements do not require collateral posting on "day one", in certain respects such requirements are more likely by their nature to achieve meaningful protection for the Asset Pool Owner. For example, in certain circumstances, the downgraded counterparty may be required to find a replacement for itself, which is helpful to the Asset Pool Owner, particularly given its special purpose nature.

On the basis of the foregoing, RCBC members consider that two-way relief should be provided and no further requirements should be applied in respect of UK covered bond swaps, from the perspective of the Asset Pool Owner or the swap counterparty.

Third party collateral provider alternative proposals; practical constraints

We note that the impact assessment section of the Consultation Paper refers to an alternative "collateral provider" proposal (referred to as the "market-based solution" in Question 3), whereby, as we understand it, a third party service provider would be engaged to provide the required collateral on the covered bond issuer/cover pool's behalf to the swap counterparty in exchange for a fee. Aspects of the proposal are unclear. While we appreciate the work undertaken by the Authorities to consider and seek feedback on other potential solutions to the challenges presented for covered bond swaps under the margin requirements, we have significant concerns with the practical feasibility of the alternative proposal.

In particular, concerns have been raised that the use of such an arrangement would introduce a new source of potential counterparty risk into structures (as the collateral provider could default). Moreover, such an arrangement would likely give rise to significant new costs for transactions, as third parties are unlikely to perform such a role without adequate compensation, and it is expected that this would result in much higher costs, which costs are likely to result in higher costs for underlying consumers. That said, in the absence of full details with respect to the proposed alternative structure, and with respect to the capital and accounting rules which would apply to such a structure, it is not possible for RCBC members to quantify the full costs of such an arrangement and/or the feasibility of a third party being prepared to take on this role.

As a result of the foregoing, RCBC members are unable to confirm that the proposed market-based solution would present an adequate and feasible alternative for covered bond swaps which do not meet the conditions in proposed Article 3 GEN and, based on the limited information available, there is a sense that it would not. Moreover, given the protections already present in UK covered bond swaps, it is not clear what meaningful additional protection would come with use of the solution. That said, in the absence of other solutions (including more flexible relief as described above), it would be preferable for this option to remain available in the event that it can be made to work in some contexts.

Other general points and comments

Certain other points referred to within the Consultation Paper are potentially significant in the context of UK covered bond swaps and more generally. In this regard, RCBC members wish to confirm their support for comments raised by certain other industry groups in their responses to the Consultation Paper and these points are described below.

- *Intragroup exemption* – as noted above, in UK arrangements, the covered bond issuer may act as swap counterparty in respect of swaps entered into by the Asset Pool Owner, meaning that in certain circumstances the intragroup exemption may be relevant and the parties may seek to rely on this. However, various provisions included in the Consultation Paper with respect to the intragroup exemption (including proposed Article 3 IGT on relevant practical and legal impediments) are not sufficiently clear as drafted and further clarification is necessary in order to provide sufficient certainty with respect to the exemption. In this regard, RCBC members endorse the comments made on the intragroup exemption in the consultation response from the International Swaps and Derivatives Association (**ISDA**) and in the consultation response from the Association of Financial Markets in Europe (**AFME**).

- *Calculation of group thresholds for initial margin requirements* – it is our understanding that, based on the proposals in the Consultation Paper, it would be necessary for relevant groups with a covered bond issuer or cover pool entity to include covered bond swaps when calculating the group thresholds for non-centrally cleared derivatives under proposed Article 1 FP, notwithstanding satisfaction of the conditions in Article 3 GEN and the fact that such swaps would only be used for hedging purposes, meaning that the risk across the financial group should not be increased by such swaps. As is acknowledged in Recital 16 to EMIR, due to the nature of covered bond swaps, it will not be possible in general for these arrangements to be cleared. Accordingly, as drafted, Article 1 FP would appear to operate in a disproportionately onerous manner for groups including a covered bond issuer or cover pool entity. To address this issue, RCBC members consider that covered bond swaps that satisfy the conditions in Article 3 GEN should be carved out of the calculations under Article 1 FP and, in this regard, we endorse the comments made in the consultation response from the ECBC.

- *Existing transactions* – it is our understanding based on certain provisions included in the Consultation Paper (including proposed Recital 18 and the explanatory note on pages 24 and 25) that the Authorities intend the margin requirements to only apply to transactions entered into from the date of entry into force of the regulatory technical standards. To remove any possible doubt in this regard, however, it would be helpful if this was also expressly referred to in an operative provision of the regulatory technical standards. In addition, we consider that it should be clarified that where an existing transaction is amended after it has been entered into, such amendment should not constitute entry into a new transaction for the purposes of determining the application of the requirements. Lastly, we also consider that where an existing transaction is novated as required under, and in accordance with, the terms of the original transaction, such novated arrangement should also be regarded as an existing transaction. RCBC members endorse the comments made on the application of the requirements to future transactions only in the consultation response from AFME.

- *Third country entities* – based on the proposals included in the Consultation Paper, the margin requirements would be implemented such that certain differences would apply as between EU and non-EU counterparties. While the proposal not to permit reliance on the NFC- exemption in the case of a non-EU entity is unlikely to be relevant from a UK covered bond swap perspective (as Asset Pool Owners will be established in the UK and their swap counterparties will not be potential NFC- entities in general), certain other potential differences in treatment could be relevant. In this regard, we note that the proposals do not clearly permit a non-EU counterparty to rely on the EUR 50 million or EUR 8 billion thresholds. While we assume that this is unintentional, clarification should be provided that such a counterparty may rely on these thresholds in order to avoid confusion. In principle, RCBC members consider that the provisions should operate in the same way as between EU and non-EU counterparties. In this regard, RCBC members endorse the comments made on scope and thresholds in the response from ISDA.

Thank you once again for the opportunity to comment on the issues raised in the Consultation Paper. Should you have any questions, or require any additional information regarding any of the comments set out above, please do not hesitate to get in touch with the undersigned.

Chris Fielding, Executive Director
Regulated Covered Bond Council

CC: Christian Moor, European Banking Authority
CC: Stephanie Tetu, Financial Conduct Authority
CC: Johnny Elliott, HM Treasury

ANNEX I

The Regulated Covered Bond Council (**RCBC**) was formed in 2009. The purpose of the RCBC is to represent UK regulated covered bond issuers in discussions with regulators, legislators, rating agencies and other trade bodies.

The objectives of the RCBC are:

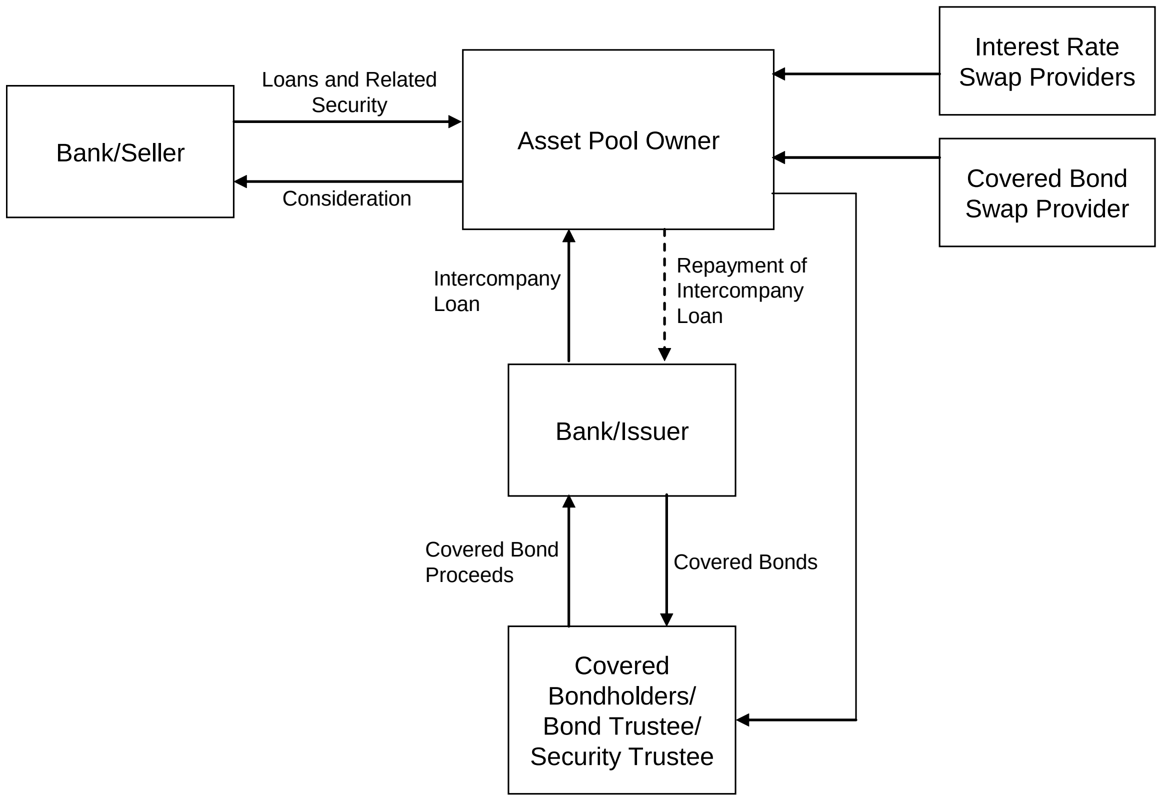
- to promote the UK regulated covered bond product;
- to collect, produce and disseminate information and analysis relevant to UK regulated covered bonds;
- to promote best practice and, to the extent possible, common standards in investor reporting, modelling asset capability and other similar areas; and
- to foster relationships and synergies and to campaign for RCBC interests with other industry members (legal counsels, investment banks, trustee and corporate services providers) and other national or multi-jurisdictional industry associates.

The RCBC members are:

- Abbey National Treasury Services plc
- Bank of Scotland plc
- Barclays Bank plc
- Co-operative Bank plc
- Coventry Building Society
- Clydesdale Bank plc
- HSBC Bank plc
- Leeds Building Society
- Lloyds Bank plc
- Nationwide Building Society
- Royal Bank of Scotland plc
- Yorkshire Building Society

ANNEX II

Structure diagram



Structure overview

- The UK structure involves a UK bank or building society either directly, or through a subsidiary, issuing covered bonds through a medium term note programme. The covered bonds constitute direct, unsecured and unconditional obligations of the issuer.

- The issuer will lend the proceeds of the covered bonds to a special purpose vehicle, established as a UK limited liability partnership and which is a subsidiary of the issuer – i.e. the Asset Pool Owner.

- The Asset Pool Owner will in turn use the proceeds of such loan to purchase loans from the issuer (or an affiliate of the issuer) or to refinance an existing series of covered bonds.

- The loan made by the issuer to the Asset Pool Owner will not be repaid unless and until such time as the related series of covered bonds has been discharged in full.

- The Asset Pool Owner will guarantee the obligations of the issuer under the covered bonds. The Asset Pool Owner's obligations under the guarantee will be secured by its interest in the cover pool (including the loans, their related security and certain substitution assets) and any other assets of the Asset Pool Owner.

- In the event that the issuer fails to meet its obligations under the covered bonds, although the trustee will accelerate the claims as against the Issuer, the assets (including the cover pool) of the Asset Pool Owner will be utilised to ensure the covered bonds are serviced to their original maturity. It is only on the occurrence of an event of default with respect to the Asset Pool Owner that the covered bonds are accelerated, resulting in the liquidation of the assets.

- As with all covered bonds, the UK structures utilise an asset coverage test designed to ensure that the loans and other substitution assets comprised in the cover pool, taking into account certain discounts to the principal balance of the loans (such as a maximum loan to value ratio and deductions for delinquencies and set-off risk), will be sufficient to service the covered bonds to their designated maturity.

- In the event that the Asset Pool Owner is required to make payments to the covered bondholders under the guarantee, an additional test (an amortisation test) is intended to ensure that the principal balance of the loans and the substitution assets (calculated on an adjusted basis to take account of any delinquent loans and the weighted average term to maturity of the then outstanding covered bonds) is at least equal to the outstanding principal balance of the covered bonds.