

19 October 2007

Eve Engledow
Financial Stability and Risk
Room 3/19
HM Treasury
1 Horse Guards Parade
London SW1A 2HQ

Dear Ms Engledow

Proposals for a UK Recognised Covered Bonds legislative framework

We are pleased to respond to the joint HM Treasury and Financial Services Authority consultation on proposals for a UK Recognised Covered Bond regime. We are grateful for the additional time that you have extended to us to submit our response.

The IMA represents the UK-based investment management industry, therefore in terms of this consultation we approach it from the perspective of investors in the products that would be recognised under the proposed regime. Our members include independent investment managers, the asset management arms of banks and life insurers, and the managers of occupational pension schemes. Our members are responsible for the management of in excess of £3 trillion of assets. These assets are invested on behalf of clients globally. Almost all of the assets are owned by or on behalf of consumers in countries around the world. Our members undertake no proprietary trading: their entire business is conducted on behalf of others, for example through institutional funds such as pensions and life funds and through a wide range of pooled investment vehicles, including OEICs and unit trusts.

Fixed income mandates account for almost one-third of assets managed by IMA member firms. The introduction of a new legislative framework for covered bonds in the UK therefore is of considerable interest to the investment management community. Additionally, the regime proposed to be established is such that recognised covered bonds will be eligible for an extremely favourable treatment as UCITS eligible assets. So that the well placed reputation of the UCITS brand is not put at risk by the UK, the regime should only offer products of the highest quality. This will likewise act to protect the interests of consumers, in their role as investors in UCITS funds.

IMA members in general welcome the introduction of a recognised covered bond regime. If well constructed, this has the potential to add to the pool of available assets for investment, thus enhancing choice and aiding portfolio diversification.

IMA members however do have significant concerns which we highlight as follows:

- The timetable for implementation of the legislation is unworkable. Some of the outstanding issues, which we also comment on in the answers to questions, should not be settled in a rush, as they go to the heart of whether

the regime is capable of offering a high quality product. In particular, we would highlight the risks inherent in respect of insolvency arrangements in the integrated regime. We note that the City of London Law Society's Financial Law Committee has published a response on this same topic. It appears to us that it raises substantive issues which require careful consideration.

- Linked to our comment on time and quality, we point out that we have only recently become aware that the Financial Services Authority has had extensive pre-consultation over many months on the subject of this regime with the issuers, that is credit institutions. To our knowledge, this pre-consultation did not extend to any of the other stakeholders concerned with the regime, namely asset managers, UCITS managers, insurers and consumers. Because of the complexity of the issues under consideration, we strongly urge HM Treasury to ensure that all stakeholders have had adequate time to consider the proposals, and those of the Financial Services Authority, rather than permit the present imbalance of knowledge and input to influence the consultation outcome.
- We have concerns about the location of assets, which we believe is far too wide to ensure properly the quality of the regime.
- We have concerns about the range of asset types eligible to be included in the product, which we also consider to be too wide and not conducive to improving the quality of the regime.
- Lastly, we strongly oppose any extension of the current proposal to allow issuance only by those credit institutions with their registered office in the UK. We believe any such extension would act to jeopardise the quality of the regime.

We do not include with this response any answers to the questions posed by the Financial Services Authority. We will reply to those next week.

We thank HM Treasury staff for making time to see us and talk through these issues recently. We are available to discuss our response at any time.

We have copied this response also to the Financial Services Authority.

Yours sincerely

Jane Lowe
Director - Markets

Appendix

Chapter 2 Questions

1. Do you agree in the first case, subject to the other requirements of the regime, that any credit institution with its registered office in the UK should be able to issue UK Recognised Covered Bonds?

Yes, subject to our other comments on the qualitative parameters of the regime.

2. Do you agree that the location of the registered office of the issuing credit institution should be broadened if enforcement will be deliverable?

3. What are your views on possible obstacles to the integrity of the enforcement regime?

No. We strongly oppose any extension that would allow issuance other than through a credit institution with its registered office in the UK. It is important that this restriction is adhered to as we do not believe that the necessary prudential oversight can take place effectively if the Financial Services Authority is not the lead prudential regulator of the issuer. Notwithstanding cooperation agreements in place between regulators, a regulator in another jurisdiction may not always respond to the same signals as FSA, in respect of the issuer, nor prioritise the necessary support for a covered bond that FSA may have chosen to do. It raises also a prospective difficulty of enforcement against the issuer in a jurisdiction where the local regulator may have other, in their mind more pressing, concerns regarding the issuer. These consequences are a natural and unavoidable aspect of any global business, and the only credible way of resolving the tension is to ensure complete prudential oversight within the jurisdiction of the regime.

4. Do you think anything further should be added to the proposed legislative regime to impose more detailed quality requirements on the market such as the minimum level of over collateralisation or the LTV limits for mortgages?

See below answer to Questions 5, 16 and 18.

5. Do you agree with our general approach?

We agree that it is reasonable and desirable to introduce a recognised covered bond regime. However, we believe that the overriding objective must be that the new regime will be of exceptionally high quality, which as a corollary suggests some prescription or limitation in the parameters set by the regime.

One particular concern for investment managers is that a failure to introduce a very high quality covered bond regime could lead to a degradation of the UCITS "brand". A consequence of the introduction of a recognised regime is that a UCITS may invest up to 25% of the fund assets in a single issuer, with up to 80% invested in the scheme overall. This is a very significant change from the current situation, which permits a UCITS, subject to overall diversification requirements, to invest up to a maximum of 5% in (unrecognised) covered bonds. The UCITS legislation was composed to introduce a European-wide product regime with substantial security of assets, and with an investment style, and diversification, suitable for the product to

be sold direct to consumers, and cross-border. UCITS eligible assets should be intrinsically conservative in their nature and of high quality. We point out also that, although a European product, in fact UCITS has world wide recognition and UCITS funds are sold heavily in jurisdictions outside the EU. Any risk of damage to the credibility of this product would provide a serious challenge to our members' business, and to the global reach of the UK-based asset management industry. In our view the quality of the regime will not be assured by allowing flexibility.

6. Do you agree with the functions we propose to give the FSA and the recognition process for issuers and their programmes?

Generally, we support a regime which delivers quality from the perspective of investors. Our members are not party to the relationship between the issuer and the regulator. We broadly agree with the functions proposed to be given to the FSA namely:

- to exercise special supervisory function to ensure the integrity of the asset pool including a power to request top-up and to approve any subsequent transfer of assets
- to recognise issuers and maintain a register
- to enforce the regime including power to remove issuer from list of UK recognised covered bonds issuers, to give directions, obtain court orders
- to provide guidance on the regime's operation

We however question the rationale of imposing fines which are ultimately paid out from the asset pool as this would effectively penalise the very category of investors which the regime is designed to protect.

We support any additional power to prevent any change to the structure of a covered bond programme if there is a risk that it would subsequently fail to meet the requirements of the regulations

7. Do you agree with the proposed time limits for the recognition process?

We cannot comment on the time required to properly consider a covered bond issuance in the context of the recognition process except to state that it should be sufficient to allow proper consideration of the issuance.

8. Do you think there should be different time limits for recognition of the covered bonds where the issuer has already been recognised?

Quite probably, subject of course to the quality of the regime not being affected.

9. Do you agree with the rationale for the enforcement provisions and the enforcement powers the FSA will have for this regime?

See our answer to question 6 above.

10. Are the types of assets permitted in the asset pool defined appropriately in Regulation 2?

No, we do not believe so. We are concerned that the current proposed definition is not satisfactory in that it may promote flexibility over quality. We note that in other

Member States the covered bond regimes include a much narrower range of allowable assets than that proposed for the UK regime. Does HM Treasury have evidence, from economic analysis, of the risks that may be brought in, especially in light of the recent sub-prime crisis?

11. Is it appropriate to widen the list of eligible property beyond the BCD list?

No. See covering letter and answer 10 above.

12. Are you satisfied that the definition of eligible property in regulation 3 has the correct balance between flexibility in eligible assets and their suitable quality?

No. See covering letter and answer 10 above.

13. Is there a better way to define the eligible property so as to provide flexibility while ensuring the quality of the assets in the pool?

We do not believe that it is possible to provide further flexibility whilst ensuring the quality of assets in the pool, nor is it desirable to seek flexibility if this does not also preserve quality. See covering letter and answer 10 above.

14. Do you think it appropriate to define the location of the eligible property backing the pool?

Yes. We believe it is essential to define the location of the eligible assets backing the pool as it operates as an integral quality control. In particular, the ability to enforce with complete certainty against the assets is a necessary part of constructing a qualitative regime.

15. Are you happy with our proposed definition of the suitable location of such assets?

No. The current proposed jurisdictions are much too wide and in our view adversely impact on the quality of the regime. The current proposal is also out of line with the covered bond regimes introduced in other parts of Europe, which are UCITS eligible. At this time we urge HM Treasury to restrict the list of jurisdictions to EEA states only, in the absence of clear support that a further extension would not impair quality.

16. Do you agree that the Regulations should adopt the "copy-out" approach with regard to capability to pay? Or do you think that for reasons of legal certainty the Treasury should include examples of different ways in which the capability test may be met?

Although we can see the benefit of allowing the Regulations to adopt a "copy-out" approach, this should only be considered as a way forward if the FSA is prepared (and able) to provide further guidance to support the Regulations. The FSA guidance should set out examples of the different ways in which the capability test may be met. If for any reason (such as the adoption of more principles based

regulation) this route is not open to FSA, then elaboration on the capability test should instead be set out in the Regulations and a “copy-out” approach should not then be followed.

17. Do you think there are other methods for assessing capability?

There may be other methods now and other methods may develop in the future. Any list should be non-exhaustive.

18. Which do you think are the most suitable methods for assessing capability?

We wish to respond on this point at a later date.

19. Do you have any comments of the ring-fencing in the Regulations and the requirements placed on the owner, issuer and liquidator?

As mentioned in our letter, we have considerable concerns about the ring-fencing in the Regulations in relation to the integrated model. Further legal analysis is required in relation to the integrated model and it is not possible to do this within the tight timescales within which the new legislation is required to be implemented. In these circumstances, the integrated model option needs to be removed and, perhaps, re-introduced after due consideration.

20. Do you think that the protected period in regulation 25 (10) is the correct length?

Yes, subject to a discretion to extend such protected period as currently set out in regulation 25(2).

21. Do you agree that service providers can be paid as an expense of the winding up?

Yes. The issue of priority as between bond holders and service providers will be set out in the agreements. We understand that certain claims need to be paid in priority to the claims of the covered bond holders. Therefore regulation 28(2) needs to be re-considered to allow the contractual provisions to take effect.

22. Do you agree with our analysis of the set-off position?

23. Do you think we should put the set-off position beyond doubt?

We note that the analysis has been criticised by the City of London Law Society's Financial Law Committee. We point out that over-collateralisation will not cure the flaw in set-off provisions. We would be happy to discuss this with you in more detail.

Additionally, we are concerned that the validity of a claim by one pool for misapplication of assets against another pool lacks clarity under the proposed regulations. We understand that this may be an issue even under the Channel Island regimes.

PROPOSAL FOR A UK RECOGNISED COVERED BONDS LEGISLATIVE FRAMEWORK – INVESTMENT MANAGEMENT ASSOCIATION RESPONSES TO CHAPTER 3 QUESTIONS

The responses to the Financial Services Authority questions are in addition to the Investment Management Association's response to the HM Treasury questions, submitted to HM Treasury on 19 October 2007, and should be read together.

The IMA points out that the FSA has not included investor protection in its regulatory impact test. This is a significant and problematic omission for investment managers and their clients.

24. Do you agree with having a separate specialist sourcebook? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees with the FSA's proposal to have a separate specialist sourcebook. It will be much easier to track the requirements of the regime if the relevant material is held in one place.

25. Do you agree with the proposed approach of an issuer declaration at recognition? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees that under principles based regulation the focus is correctly on senior management responsibilities and that the issuer should formally declare compliance with the regulations at recognition. Regarding recognition of "categories of bonds", rather than each individual bond, the IMA would urge the FSA to put some mechanism in place to ensure that the individual bonds in the programme were homogenous and that investors therefore understood that the bonds in a particular programme would deliver what was expected.

26. Do you agree with the proposed approach of a professional adviser declaration at recognition? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees that independent verification of compliance with the regulations at recognition of the bond programme is desirable. We do however understand that there may be capacity and resource issues which might not allow the industry to deliver such verification. In addition, we would query the definition of "suitably qualified".

27. Do you agree with the proposed approach to the Register? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees that the proposed register of issuers and their issuing programmes be published on the FSA web-site. It would be helpful also if FSA published ISIN numbers in relation to each bond issuance.

28. Do you agree with the proposed approach to notifications? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

29. Do you agree with the proposed approach of an annual issuer declaration? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees that an annual issuer declaration of compliance with the requirement to provide relevant information to the regulator is desirable.

30. Do you agree with the proposed approach of an annual professional adviser declaration? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees, but see Q26.

31. Do you agree with the proposed approach to reporting? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees that exception based reporting is the correct approach. This is in line with the overall principles-based approach. We would anticipate that the FSA would also routinely look at the detail of bond issuance programmes as part of its programme of firm supervision, and potentially on a themed basis.

32. Do you agree with the proposed approach not to set out in detail guidance on 'capability'? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA believes that capability can be demonstrated in different ways. However, these should be equally robust. Whilst detailed guidance in legislation would be difficult to devise and prospectively too prescriptive, we believe that FSA could, and should, provide guidance in the form of a series of examples of the different ways in which the capability test may be met.

33. Is the purpose of requiring there to be a bondholder representative function clear? If not please describe what further explanation is necessary.

This is clear.

34. Do you agree with the proposed approach to skilled persons' reports? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

We have no comment to make on the proposed approach at this time.

35. Do you agree with the proposal to recover the costs of the Regime through a combination of recognition and ongoing fees payable by solvent issuers rather than owners? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA agrees that only issuers should pay for the cost of introducing and implementing the regime through recognition fees and an on-going annual fee.

36. Do you agree with the proposal that any financial penalties received in one financial year should be distributed to issuers as a deduction from their ongoing fees in the following year? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

We have no comment to make on this proposal at this time.

37. Do you agree with the proposal to charge an administrative fee of £250 for failure to submit reports on time? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

The IMA believes this looks reasonable.

38. Do you agree with the proposed approach to directions? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

39. Do you agree with the proposed approach on penalties? If not please describe what you think should be done differently and explain why including an assessment of the costs and benefits.

40. While Pillar 2 does not form part of the Regulations or the Regime it is an important consideration for many covered bond issuers and investors. Ahead of the work planned on Pillar 2 and the encumbrance of assets do you have any comments?

We have no comment to make at this time.