

Guidance consultation

Thematic Overview on the Regulated Covered Bond Regime

July 2012



The role of the Asset Pool Monitor

- 1.1 Following the publication of the amended Regulated Covered Bond (RCB) Regulations and Sourcebook respectively in November and December 2011, market participants requested clarification on a newly established requirement, that of the role of the asset pool monitor (APM).
- 1.2 Under regulation 17A(3), the APM shall inspect the compliance of the issuer with the requirements in regulations 16 and 17 once every twelve months and prepare an annual report on the quality of the assets in the asset pool and on the steps the issuer has taken to comply with the requirements. A copy of the report must be sent to the FSA.
- 1.3 Regulation 42 of the RCB legislative framework provides that the FSA in its capacity as supervisor of the covered bond regime can issue guidance on the operation of the Regulations themselves, the FSA's functions under the Regulations, or any other matters which the FSA thinks is desirable to give information or advice. Issuing guidance on the report of the APM more specifically is also contemplated by regulation 17A (3)(b) of the RCB Regulations.
- 1.4 The RCB Regulations provide that the FSMA obligations of consultation apply to general guidance the FSA may give. Clarification on the role of the APM constitutes guidance according to regulations 17A(3)(b) and 42 of the RCB legislation.
- 1.5 The purpose of this paper is to set out FSA's further guidance on the scope of the inspection and report of the APM and seek feedback from market participants on them.
- 1.6 While this guidance is the result of a request from the market, we believe that it will bring more consistency to existing audit reports, which currently vary a lot across RCB issuers as well as allow cross-comparisons across RCB programmes.
- 1.7 This guidance does not impose additional requirements to the RCB legislation but rather responds to an industry request and provides guidance on the scope of the asset pool monitor's inspection. Informal discussions with the largest accounting firms indicated an incremental cost arising solely

from this guidance of approximately £5,000 to £15,000 (as a result of potentially having to report more errors due to a lower level of tolerance than firms may currently use or conduct more tests). We note that this estimation does not cover the incremental costs arising from the new regulatory requirements as these have already been factored into HM Treasury's Impact Assessment, dated April 2011, through feedback received from market participants.

Regulatory requirements and FSA's interpretation of the rules

- 1.8 Asset pool monitors have a regulatory obligation to comply with the RCB Regulations in relation to the inspection of the asset pool in RCB programmes. Under regulation 17A(3), APMs have a duty to:
- “(a) inspect the compliance of the issuer with the requirements in regulations 16 and 17, and in particular—*
- (i) the extent to which the asset pool satisfies the conditions set out in regulation 17(2); and*
 - (ii) the accuracy of the records kept in relation to each asset in the asset pool, once every twelve months; and*
- (b) prepare an annual report in accordance with guidance issued by the Authority on the steps the issuer has taken to comply with regulations 16 and 17, and on the quality of the assets in the asset pool.”*
- 1.9 The report should cover the steps the issuer has taken to comply with these requirements and the quality of the assets in the asset pool. APMs are also under an obligation in regulation 17A(6) to report to the FSA in writing if it appears to the APM that the issuer has failed to comply with the requirements in regulation 17.
- 1.10 APMs are therefore expected to come to a view as to whether the respective issuer is complying with the relevant provisions of the RCB Regulations.
- 1.11 While the FSA wish to leave some flexibility to APMs and will not be prescriptive in terms of, for example, how the quality of assets should be inspected, APMs are expected to provide us with a proposal outlining how this can be achieved best. This may well be done through the consultation process on this guidance. We will reflect on the proposals made and assess whether one could be used consistently across RCB programmes.
- 1.12 While the responsibilities of the APM are set out in the RCB Regulations and Sourcebook, we reiterate some of them below as a complement to those already set out in paragraph 1.8 above.
- (a) The role and regulatory responsibilities of the asset pool monitor are set out in Regulation 17A and in our guidance in Chapter 3 of the RCB sourcebook. This includes checks to the level of OC, checks on the issuer's due diligence on the attributes of the assets, and checks that the issuer's analysis of the assets is correct. Accordingly, from 1 January 2013, asset pool monitors will be subject to certain new regulatory responsibilities and duties under the RCB regime.
 - (b) The asset pool monitor's Reports shall be undertaken on a random sample of loans statistically significant at a 99% confidence level.

- (c) We request to be notified by issuers when the asset pool monitor is replaced, with details of the substitute and reason for the change.
- (d) The issuer must provide a copy of the asset pool monitor's report to the FSA when it sends the annual confirmation of compliance required by this section to the FSA. As a result, we expect the APM work to be conducted in line with the timeframe for submitting the attestation (i.e. there should not be a large delay from the inspection and the provision of the report to the FSA).
- (e) As required under Regulation 17A of the RCB Regulations, if it appears to the asset pool monitor that the issuer has failed to comply with the requirements set out in Regulation 17 (or, on the insolvency of the issuer, the compliance of the owner with Regulation 24) of the RCB Regulations, or has not provided all relevant information or explanations, the asset pool monitor must report that to the FSA in writing as soon as possible.

1.13 Following discussions with market participants, we believe it would be helpful to clarify our interpretation of a number of requirements set out in the RCB Regulations and the relevant guidance in Chapter 3 of the RCB Sourcebook as well as some observations on market practice. These include:

- (a) The asset pool monitor must inspect compliance with Regulations 16, 17 and (if relevant) 24 on an annual basis, even if the asset pool has not materially changed over the past year.
- (b) While the asset pool monitor's inspection is expected to be conducted on an Agreed Upon Procedures basis as per current market practice, we expect the report to cover more than just a list of errors (or 'exceptions') found as a result of the tests conducted. APMs have yet the duty to inspect the issuers' compliance with the relevant regulations (whether or not they are part of the scope of an AUP audit) and report to the FSA on the outcome of it.
- (c) The AUP inspection should exclusively apply to the pool of assets acting as security in the regulated covered bond programme at the time the audit sample is being randomly selected.
- (d) We note that the Regulations provide for the issuer to appoint 'an' asset pool monitor for each asset pool (Regulation 17A (1)). We believe that the work required for the annual confirmation is very much linked to that of the APM report which is the reason why the APM report must be submitted along with the annual confirmation of compliance. As a result, we expect that only one APM be appointed for each RCB programme.
- (e) For the avoidance of doubt, we note that the Asset Coverage Test, Over-collateralisation Test and Interest Coverage Test fall under the responsibilities of the APM, as set out in Regulation 17.
- (f) As per Regulation 17A, the person appointed as asset pool monitor must (a) be eligible for appointment as a statutory auditor of the issuer under Part 42 of the Companies Act 2006; and (b) not be disqualified from acting as a statutory auditor of the issuer by section 1214 of that Act (independence requirement). As a result, we expect that the independent APM be a third party auditor fulfilling these requirements. Provided these are met, we do not object the APM being the current third party auditor of the RCB issuer.

- (g) While we will not be imposing one specific sampling methodology, we expect asset pool monitors to identify in their report the methodology they are using and explain why they believe it is appropriate.
- (h) Market practice would suggest that an engagement letter be produced between issuers and APMs. Issuers should consider whether a document formally describing the role of the asset pool monitor may be beneficial for the programme and/or whether prospectuses and relevant transaction documents should be updated (as it should be the case for the other new regulatory requirements).
- (i) The introduction of the role of the asset pool monitor provides additional scrutiny to the oversight of regulated covered bond programmes and should not be seen as a substitute to the role of the Compliance and/or Internal Audit functions.

Our guidance

- 1.14 In relation to the tests to be carried out as part of the asset pool monitor's inspection of the accuracy of records, we have outlined in Appendix 1 what we expect in terms of content of the tests and tolerance levels.
- 1.15 It is our understanding that the tests outlined in Appendix 1 are already performed by audit firms, although not in all programmes and with slight nuances from one programme to another. The purpose of having one set of tests and tolerance levels is to bring more consistency and allow cross-comparison across RCB programmes.
- 1.16 **Question 1:** Do you have any comments on Appendix 1?
- 1.17 In relation to the content of the asset pool monitor report, we expect it to cover:
 - a. A description of the analysis of the pool audit being conducted.
 - b. A description of the method used (including sampling methodology) and procedures that have been followed throughout the APM's inspection.
 - c. A description of the pool sample and population used in the AUP.
 - d. A description of the scope of the AUP work.
 - e. A summary of the finding which, with regard to the accuracy of records, may cover the elements set out in Appendix 2.
 - f. An assessment of the steps taken by the relevant issuer to comply with Regulations 16 and 17, and on the quality of the assets in the asset pool (Reg. 17A (3) (b)).
 - g. The asset pool monitor's conclusion as to the compliance of the issuer with Regulations 16 and 17 (Reg. 17A(3)(b) and Reg. 17A(6) if relevant – though note under regulation 17A(6) if it appears to the asset pool monitor the issuer has failed to comply with the requirements set out in Regulation 17, or that the issuer has not provided it with all the information and explanations, the asset pool monitor must report that to the FSA in writing as soon as possible).

1.18 **Question 2:** Do you have any comments on paragraph 1.17?

How to respond to the consultation

- 1.19 Written responses to this consultation are requested by **COB 14 September 2012**. Please ensure that responses are received by the closing date. We cannot guarantee that responses received after this date will be considered.
- 1.20 Responses can be sent by email to rcb@fsa.gov.uk or posted to:

Covered Bonds Team
Capital Markets
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

There is no need to submit a response by post if you are also submitting an email response.

- 1.21 When responding, please state whether you are doing so as an individual or on behalf of an organisation. It is helpful if you include your contact details with your response, in case there is a need to seek further detail on any issues you raise.

Appendix 1: List of tests for accuracy of records (residential mortgage assets)

Note: The tests set out below are based on the assumption that cover pools are made of residential mortgages, as it is currently the case in RCB programmes. These may be revisited at a later stage should cover pools' composition change.

Key: Where the underlying document is not found for a specific test then record an exception.

Test	Category	Specific sub-tests	Tolerance level ¹
1	Name	The borrower(s)' first name (or initials) and surname agrees to the following: a) Mortgage offer letter b) Certificate of Title (COT) or Report on Title (ROT) c) Mortgage application form.	Will tolerate immaterial spelling mistakes such as reversal of initials or reversal of names.
2	Address	Check that the property address and postcode are confirmed to be in England, Scotland, Wales or Northern Ireland and agree on all of the following with no exception for spelling. a) Mortgage offer letter b) Certificate of Title (COT) or Report on Title (ROT) c) Application form d) Valuation report, where available	New build properties by their nature could be subject to postcode changes. In such circumstances confirm an out-code rather than a full postcode.
3	Term	Latest agreed term of the loan agrees to the latest mortgage offer	None
4	Amount advanced	Latest amount advanced agrees to the latest offer documents	None
5	Mortgage balance	Mortgage balance on the AUP extraction file equals the balance on the mortgage loan processing system at the cut-off date	£500
6	Completion date	Completion date agrees to date on the Certificate of Title (COT) or Report on Title (ROT)	+/- 1 working day

¹ Rounding errors and spelling mistakes which are of immaterial significance to the correctness of the data should not be counted as 'exception'. To avoid doubt, the following example should not be considered as a spelling mistake:
Address in record: '1 high street' ; Exact address: '1A high street' (or vice versa).

7	Valuation amount	Valuation amount in the extraction file agrees to latest valuation conducted according to the issuer's underwriting policy. For buy-to-let mortgage loans, confirm that the valuation report included a valuer's opinion on suitability for buy to let and/or likely rental income.	None
8	Valuation date	Valuation date in the extraction file agrees to the date on the latest valuation report and should be confirmed to be within one year of completion date.	+/- 1 working day. If the valuation requirement at origination was waived, then record an exception and describe its nature.
9	Signatures	The following documents had been signed: a) Mortgage offer letter b) Certificate of Title (COT) or Report on Title (ROT) c) Application form d) Valuation report, where available e) Deed	None
10	Arrears	Aggregate arrears data in the extraction file reconciles the figures shown in the primary system of record at cut-off date.	£100 Where arrears are quoted as 'number of months in arrears', this field should be determined and validated by dividing the total amount of overdue payments by the monthly repayment amount.
11	Income	Applicants' income in the extraction file matches the figure stated in the application form as well as the underlying evidence of income (such as payslips or tax returns) where income verification is carried out.	None
12	Loan characteristics	The loan characteristics (e.g. fixed, variable, tracker) agrees to latest offer or supporting documentation	None

13	Property tenure and type	Property tenure (freehold, leasehold, etc) and type (detached, flat etc) agrees to valuation report or land registry.	None
14	Maturity date	Original maturity date of each mortgage on the primary system of record reconciles to latest offer document.	None
15	Repayment type	Repayment type (repayment/ interest only etc.) matches the latest offer document or supporting documentation.	None
16	Employment status	Employment status of the borrower agrees to the application form	None
17	Flag	Mortgage loan in the primary system of record (or primary medium where loans are being flagged) is correctly being flagged as being used solely for the purpose of the covered bond pool	None
18	Interest rate	Interest rate, interest rate type, interest rate index and interest rate margin agrees with the latest offer document.	None
19	Reversionary date	Reversionary date in the primary system of record agrees with the latest offer letter	None
20	Year of Birth	Year of birth of the borrower(s) on the application form agrees with the application form.	None
21	Loan purpose	The purpose of the loan (owner occupied, buy to let etc) in the primary system of record confirms to the application form or any other supporting documentation.	None
22	Account number	The account number agrees with the primary system of record.	None
23	Credit score	The credit score recorded must agree with the primary system of record.	None

Appendix 2: Template for asset pool monitor findings with respect to accuracy of records (residential mortgage assets)

Cover pool information

RCB programme	
APM	
Total number of loans in cover pool	
Number of audited loans	
Cover pool cut-off date	
Date of AUP	

Aggregate Findings

	Test 1	Test 2	Test 3	Test 4	Test 5	Test 6	Test 7	Test 8	Test 9	Test 10	Test 11	Test 12	Test 13	Test 14	Test 15	Test 16	Test 17	Test 18	Test 19			Test 28	
Number of data																							
Number of exceptions found																							
Error statistic calculated																							

Loan-level Findings: Nber of exceptions found on loans

Data Sample ID	Loan Account ID	Total Nber of exceptions found on loan	Test 1	Test 2	Test 3	Test 4	Test 5	Test 6	Test 7	Test 8	Test 9	Test 10	Test 11	Test 12	Test 13	Test 14	Test 15	Test 16	Test 17	Test 18	Test 19			Test 28
1																								
2																								
3																								
.																								
.																								
.																								

Guidance on Completion

- Replace test [?] headings with actual names of tests
- In loan-level findings, flag instances where exceptions have been found and provide reason why the data audited was interpreted as exception. Note that if the inclusion of commentary on exceptions results in awkward presentation in terms of format, option available to provide the commentary under separate appendix (see below).
- This template should form part of the APM report.

Appendix: Exceptions Commentary

Data Sample ID	Loan Account ID	Test No	Data in file	Actual Data in data tape	Exception Description	Management Representation of exception (incl. why error occurred)
1						
2						
3						
.						
.						
.						