UKRCBC
Regulated Covered Bond Council

13 February 2012

Submitted via electronic submission

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Robert E. Feldman, Executive Secretary
Attention: Comments
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Securities and Exchange Commission
100 F Street NE.
Washington, DC 20549

Re Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; OCC: Docket ID OCC–2011–14; **FRB:** Docket No. R–1432 and RIN 7100 AD 82; **FDIC:** RIN 3064–AD85; **SEC:** File Number S7–41–11

On behalf of the UK Regulated Covered Bond Council (the **RCBC**), we welcome the opportunity to provide comments on the joint notice of proposed rulemaking described above (the **Proposed Rule**) as issued by the U.S. agencies addressed above (the **Agencies**). The Proposed Rule would implement Section 619 of the Dodd-Frank Act. The RCBC members are comprised of the UK Regulated Covered Bond issuers, which issuers include certain UK credit institutions with a U.S. branch. Further information with respect to the RCBC and its members is set out in Annex I.

As a starting point, we join other industry groups in expressing general concern about the broad implications and unintended consequences of the restrictions contemplated by the Proposed Rule with respect to the ability of banking entities to sponsor and invest in, and to have other relationships with, entities regarded as covered funds. We do not propose to explore these general concerns in this response letter, however, and our comments are instead focused on the effect of the Proposed Rule on UK covered bond arrangements.

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In summary, we are concerned that, as currently drafted and in the absence of clarification, the Proposed Rule may interfere with and effectively restrict aspects of existing UK covered bond structures where such transactions involve a relevant banking entity. Such an outcome is not justified and would not reflect the legislative intention behind Section 619 of the Dodd-Frank Act (i.e. to prevent banking entities from having excessive financial exposure to private equity funds and hedge funds engaged in trading and other investment activities deemed to be speculative). Moreover, such an outcome would have a negative and disproportionate effect on UK banks (in particular on their mainstream wholesale funding activities), and would give rise to potential conflicts with the legislative framework which applies to Regulated Covered Bonds in the United Kingdom.

There is no suggestion in Section 619 of the Dodd-Frank Act or in the Proposed Rule that covered bond issuance activities of non-U.S. banks are intended to be limited and/or prohibited by the restrictions contemplated therein and, as such, it seems likely that the potential implications for UK covered bonds are largely unintentional. The significance of the issues at stake, however, should not be underestimated. We note that covered bonds have proved to be an invaluable funding tool for EU credit institutions during the financial crisis. The UK Government has recently reiterated its support for the UK covered bond market and has formally confirmed that it considers covered bonds to be an important source of longer-term, more stable funding.[1] The sterling equivalent value of outstanding covered bonds issued under the UK framework has exceeded GBP100 billion (approximately USD157 billion).[2] Indeed, some GBP30 billion (USD47 billion) has been issued in the last 12 months alone, when unsecured wholesale markets have been disrupted.

It should be noted that the issues identified under the Proposed Rule in respect of UK covered bond structures would also be relevant in principle in respect of covered bond structures used in certain other EU jurisdictions (e.g. The Netherlands and Italy) and certain non-EU jurisdictions (e.g. Canada, Australia and New Zealand).

We urge the Agencies to take action in the final rules made under Section 619 of the Dodd-Frank Act to make it clear that such rules would not apply in respect of UK covered bond structures (and similar covered bond structures used in other jurisdictions). A failure to provide appropriate clarification could have significant implications for relevant UK covered bond issuers, and on the funding of real economy assets in the UK in general.

Our more detailed comments are set out below. 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 which implement the defining characteristics of covered bonds set out in Article 52(4) of the EU UCITS Directive.[3]

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1 http://cdn.hm-treasury.gov.uk/condoc_covered_bonds_summary_responses.pdf
2 For further information on the UK covered bond market, see the document linked here http://www.hm-treasury.gov.uk/d/consult_review_uk_reg_framework_covered_bond.PDF.
3 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF

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 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, 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 UK covered bond market, the UK Government introduced a special legislative framework in 2008 (which regime was reviewed and confirmed in 2011). The UK regime (which applies in respect of Regulated Covered Bond issues) provides for use of the structured model only and effectively endorses the contractual arrangements used by UK issuers prior to the introduction of the regime.

As such, all UK covered bond programmes (including those registered under the legislative framework) involve a separate special purpose vehicle (the **Asset Pool Owner**) which purchases and holds the collateral pool and guarantees payments under the covered bonds pursuant to a guarantee which is secured over the collateral pool. All UK Regulated Covered Bond issuers currently only use residential mortgages in their programmes, but the range of eligible assets under the legislative framework is much broader.

UK covered bond structures involve a number of points of connection between the bank issuer and the Asset Pool Owner. Among other things:

- the Asset Pool Owner will generally be established as a subsidiary of the bank issuer (i.e. as an English limited liability partnership in respect of which the bank issuer is a member) and with a similar name to the bank issuer;
- the bank issuer will make term advances to the Asset Pool Owner under an intercompany loan agreement, the proceeds of which advances will be used for specified purposes, including to purchase the collateral pool from the bank issuer;
- the bank issuer may repurchase certain assets from the Asset Pool Owner;
- the bank issuer may act as swap counterparty with respect to hedging transactions entered into by the Asset Pool Owner to hedge certain interest rate, currency or other risks in respect of amounts received by the Asset Pool Owner under the collateral assets; and
- the bank issuer will provide certain services to the Asset Pool Owner, including cash management services which will include investing certain amounts in authorised investments in certain circumstances.

Further detailed information on UK covered bonds is set out in Annex II.

It should also be noted that bank issuers may purchase and hold "own-name" covered bonds. Both the Bank of England and the European Central Bank permit eligible counterparties to use certain own-name covered bonds as collateral in their liquidity providing operations.

As noted above, similar covered bond structures are used in certain other EU jurisdictions (e.g. The Netherlands and Italy) and certain non-EU jurisdictions (e.g. Canada, Australia and New Zealand) (although it is not always the case that the asset pool owning entity will be established as a subsidiary of the relevant banking entity).

Key comments

As noted above, we are concerned that, as currently drafted, the Proposed Rule may interfere with and effectively restrict aspects of existing (and new) UK covered bond structures.

Asset Pool Owners should not be covered funds

Our key concerns in respect of the Proposed Rule arise primarily due to the wide definition of "covered fund" used in the Proposed Rule and the fact that it is not sufficiently clear that Asset Pool Owners used in UK covered bond structures would not fall within the definition as proposed.

We note that Section 619 of the Dodd-Frank Act prohibits banking entities (including certain non-U.S. banks) from, among other things, (a) sponsoring or acquiring or retaining an ownership interest in a "private equity fund" or a "hedge fund" (collectively referred to as "covered funds" in the Proposed Rule) (the **Ownership Restriction**) and/or (b) entering into "covered transactions" (as defined in Section 23A of the U.S. Federal Reserve Act) with any covered fund for which it serves as sponsor, investment manager or investment adviser (the **Super 23A Restriction**).

Tracking the wide definition used in Section 619 to define relevant fund entities, the Proposed Rule indicates that the term "covered fund" means any company that would be an investment company under the U.S. Investment Company Act of 1940 but for the exemptions set out in Section 3(c)(1) or Section 3(c)(7) of that Act. The Proposed Rule also seeks to further widen the covered fund definition by indicating that relevant entities will include any company that would be an issuer under the Act but for the exemptions outlined above if such issuer were (hypothetically) organised under the laws of, or offered securities to one or more residents of, the United States.

Given the wide definition of covered fund and the foreign equivalency provisions discussed above (and also taking into account discussions separate from the Volcker Rule which suggest that certain U.S. agencies may take action to revise the terms of certain other exemptions under the Investment Company Act, including the exemption set out in Section 3(c)(5)), it is not sufficiently clear that Asset Pool Owners (as providers of a guarantee) would not be regarded as an issuer within the scope of the definition.

Taking into account the intention behind Section 619, this is not an appropriate outcome and such a result has the potential to create significant issues for the UK covered bond market given the wide restrictions contemplated by the Volcker Rule. In particular, in the absence of clarification, certain common points of connection between the bank issuer and the Asset Pool Owner outlined above may be prohibited. Moreover, such an outcome may result in certain arrangements which are expressly permitted (and indeed required) by the UK covered bond legislative framework (including the use of Asset Pool Owners in general) being restricted under the Volcker Rule, effectively putting relevant issuers in a position of being subject to conflicting laws. From a policy perspective, it would seem appropriate for the UK authorities to regulate the structure to be used in the context of UK Regulated Covered Bond transactions (as they have done), but the rationale for the application of a conflicting U.S. law in this regard is unclear.

There is no suggestion in Section 619 of the Dodd-Frank Act or in the Proposed Rule that covered bond issuance activities of non-U.S. banks are intended to be limited and/or prohibited by the restrictions contemplated therein and, as such, it seems likely that the potential implications for UK covered bonds are largely unintentional. Any uncertainty with respect to the position is cause for significant concern, however, and must be addressed to ensure that issues do not arise.

We note that U.S. Congress specifically sought to avoid restricting the ability of banking entities to engage in securitisation activities under Section 619 by including an express provision that nothing therein was to be "construed to limit or restrict the ability of banking entities or nonbank financial companies … to sell or securitise loans in a manner otherwise permitted by law". In principle, given the extraterritorial reach of the Proposed Rule, we consider the policy reasons which justified the provision of this protection for securitisation as a funding source should also justify the provision of protection for other essential bank funding sources used in other jurisdictions, such as covered bonds. We suspect that specific protections were not built into Section 619 for covered bonds because it was assumed that such arrangements would not be affected (possibly on the assumption that only integrated model structures are used), or possibly as a result of the lack of a developed U.S. covered bond market (meaning that Congress may not have focused on covered bonds). In any event, as noted above, a lack of certainty as to the position of UK covered bond structures would have a negative and disproportionate effect on UK banks and possibly on the wider UK economy and, as such, must be addressed.

Our members urge the Agencies to take action in the final rules made under Section 619 of the Dodd-Frank Act to make it clear that relevant covered funds (for the purposes of both the Ownership Restriction and the Super 23A Restriction) would not include Asset Pool Owners used in UK covered bond structures. We consider that this could be achieved by clarification of the proposed covered fund definition to more specifically identify those entities intended to be within scope (i.e. hedge funds and private equity funds) and by provision for an express exemption for covered bond vehicles. We consider that the case for taking such action is clearly made.

Asset Pool Owners should not be banking entities

As Asset Pool Owners may be subsidiaries of relevant banking entities, it is also necessary for a clear exemption to be provided for such vehicles from the definition of "banking entity". In the absence of this clarification, the activities of Asset Pool Owners may be restricted to the extent that such activities may be construed to fall within the widely cast proprietary trading restriction and/or within the range of restricted activities and transactions vis-à-vis covered funds.

From a policy perspective and given the legislative intention underpinning the Volcker Rule, Asset Pool Owners should not be regarded as banking entities for the purpose of the Rule. It would appear likely that the potential implications in this regard are largely unintentional. However, once again, a lack of certainty as to the position of vehicles used in UK covered bond structures would have a negative and disproportionate effect on UK banks. On this basis, we urge the Agencies to make the position of Asset Pool Owners clear on this front as well by providing for an express exemption from the banking entity definition for such entities.

As noted above, covered bonds have proved to be an invaluable funding tool for EU credit institutions during the financial crisis and the sterling equivalent value of outstanding covered bonds issued under the UK framework has exceeded GBP100 billion (approximately USD157 billion).[4] Any uncertainty with respect to the position of covered bond structures under the Volcker Rule should be avoided and we strongly urge the Agencies to provide the clarifications described herein.

Thank you once again for the opportunity to comment on the issues raised in the Proposed Rule. Should you have any questions or require any additional information regarding any of the comments set out above (including with respect to the requested exemption and how this could be drafted to properly exempt relevant vehicles), please do not hesitate to get in touch with the undersigned.

Chris Fielding, Executive Director
UK Regulated Covered Bond Council

CC: Christian Moor, European Banking Association
CC: Anna Simons, UK Financial Services Authority
CC: Eleanor Riley, HM Treasury

[4] For further information on the UK covered bond market, see the document linked here http://www.hm-treasury.gov.uk/d/consult_review_uk_reg_framework_covered_bond.PDF.

ANNEX I

The UK 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:

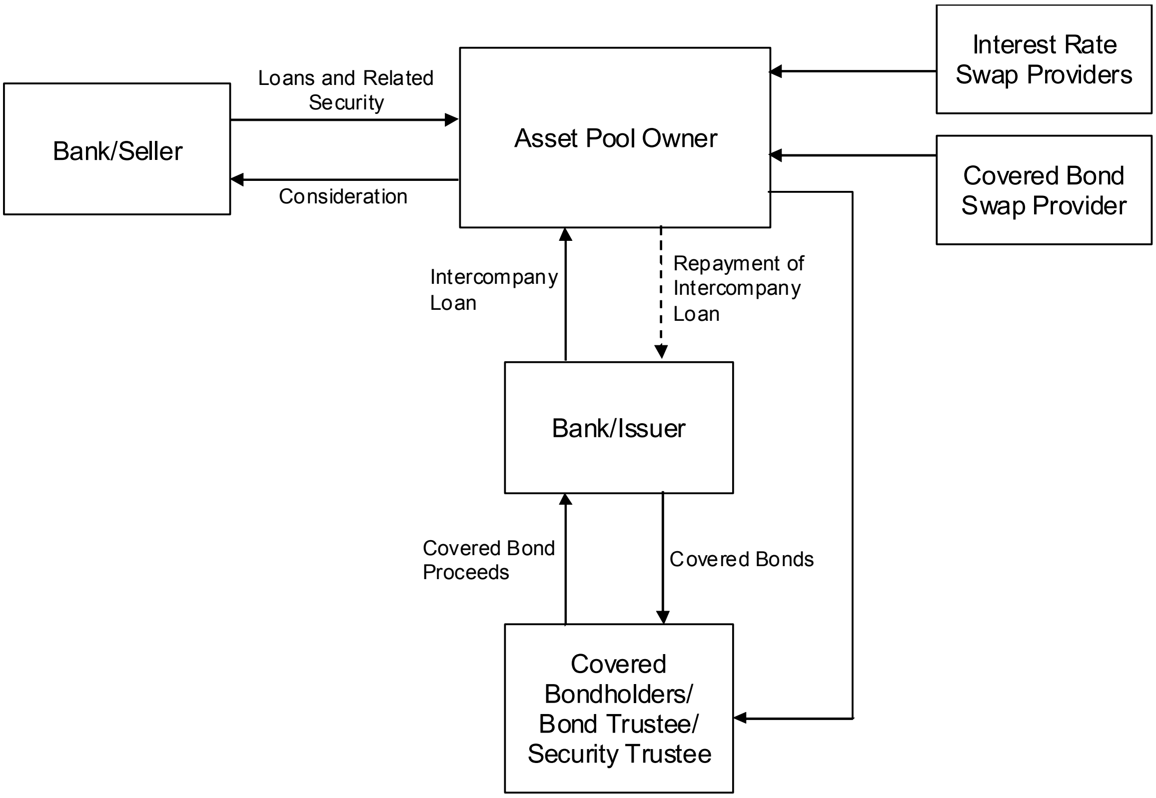
- to promote the UK Regulated Covered Bond product;
- to collect, produce and disseminate information and analysis relevant to UK Regulated Covered Bonds;
- to promote best practice and, to the extent possible, common standards in investor reporting, modelling asset capability and other similar areas; 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 include:

- Abbey National Treasury Services plc
- Bank of Scotland plc
- Barclays Bank plc
- Coventry Building Society
- Clydesdale Bank plc
- HSBC Bank plc
- Leeds Building Society
- Lloyds TSB Bank plc
- Nationwide Building Society
- The 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 mortgage 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 mortgage loans 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 mortgage 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 mortgage loans and the substitution assets (calculated on an adjusted basis to take account of any delinquent mortgage 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.