US covered bonds: Coming soon to a financial institution near you

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Movie theatres typically announce and promote coming attractions. The US capital markets participants have their own ways of announcing and promoting what we are likely to be seeing. Recently, US Treasury Secretary Paulson, Federal Reserve Chairman Bernanke and FDIC Chairwoman Bair have made affirmative observations concerning the potential role that covered bonds might play in providing liquidity for US financial institutions. Central to their observations is the now obvious, but frequently unarticulated, fact that the current loan origination and securitisation model is broken. And it may be broken in ways that make it unlikely for it to be fixed by the normal operation of the capital markets.

By the way, this would not be the first time that this happened. After all, the current origination and securitisation model rose from the ashes of the failed model that contributed to the savings and loan crisis of the mid-1980s. In the last few months, the FDIC issued both its Interim Policy Statement on Covered Bonds and its Final Policy Statement on Covered Bonds designed to promote the issuance of US covered bonds and the development of a US covered bond market. The discussion that follows highlights the legal and structuring issues that will need to be addressed in connection with the development of a robust covered bonds market in the US.

BACKGROUND

The covered bond market in the US is in its infancy. Only two US depositary institutions have established covered bonds programmes, Washington Mutual and Bank of America, and only Bank of America has issued dollar-denominated covered bonds. By contrast, covered bonds have a long history in Europe, where they have been issued since the 18th century. In recent years, the covered bond market has grown rapidly, with an estimated US$2.75 trillion in outstanding notes. The European covered bond market has held up relatively well during the last year, at least compared to the residential mortgage-backed securities market.

Covered bonds are debt instruments that have recourse either to the issuing entity or to an affiliated group to which the issuing entity belongs, or both, and, upon an issuer default also have recourse to a pool of collateral, called the cover pool, separate from the issuer's other assets. The cover pool usually consists of high quality assets, including residential-mortgage loans, public debt or ship loans. Typically, covered bond holders have a privileged or preferential claim (embodied in statute, in Europe) against the cover pool in the event of the issuer's insolvency.

By contrast, in a securitisation, an investor only has recourse to the special purpose entity that issues the securities and to that issuer's assets, which include the asset pool and its cash flows. Covered bonds remain on the issuer's balance sheet, whereas securitised assets are off-balance sheet. Regulators in the US reason that because covered bonds remain on balance sheet, this financing structure will have the effect of encouraging lenders to maintain appropriate loan underwriting standards. Covered bonds are issued by depositary institutions that are subject to supervision by domestic banking authorities, which ensures that regulators would step in if a safety and soundness issue were to arise.

Many European jurisdictions have passed their own version of covered bond legislation, permitting European depositary institutions to tap this market in order to raise funds. In the US, depositary institutions have accessed this market using structures that rely on securitisation principles and replicate through contractual relationships the features associated with European legislation. Using European terminology, US covered bonds are "structured covered bonds," as opposed to "legislative covered bonds" (covered bonds issued pursuant to specific legislation).

CURRENT US STRUCTURE

The US structure (see Figure 1) is two-tiered – with a special purpose entity, not a bank, serving as the covered bond issuer. The covered bond issuer offers fixed rate covered bonds to investors and uses those offering proceeds to purchase floating rate mortgage bonds from the affiliated bank, which is the mortgage bond issuer. The bank-issued mortgage bonds, which are direct and unconditional obligations of the bank, serve as collateral for the covered bonds. A specific mortgage pool on the bank's balance sheet secures the bank-issued mortgage bonds and these assets ultimately back the covered bonds. The mortgage bonds remain on the bank's balance sheet and are pledged by a perfected security interest to pay the mortgage bonds. The pool is a dynamic pool of revolving mortgage loans – this means that, by comparison to a securitisation, mortgage loan substitution is relatively simple.

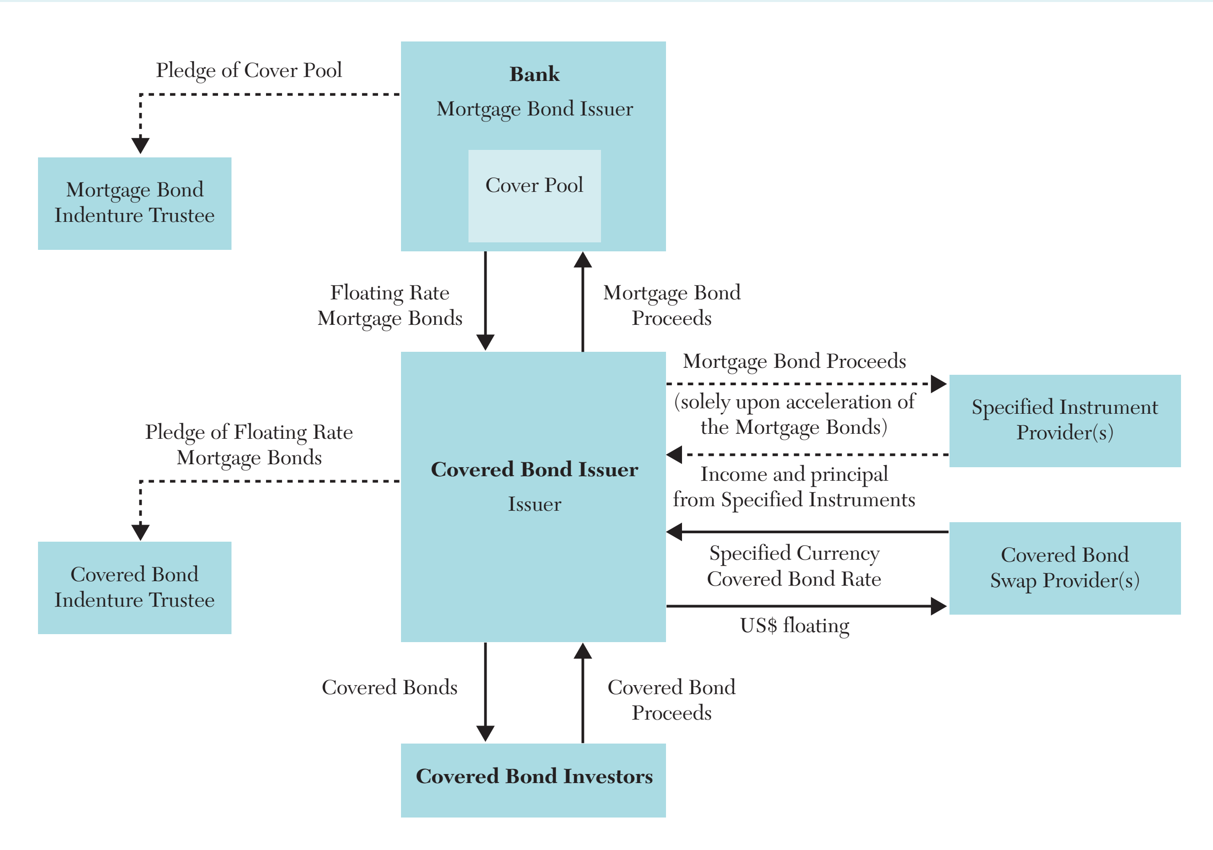
The pledged assets are segregated and a first priority preferred security interest in the cover pool is pledged to the mortgage bond indenture trustee. In this structure, an important issue is preventing the potential acceleration of mortgage bonds from affecting holders of the covered bonds. Covered bond holders do not expect an acceleration of their covered bonds unless both the issuer defaults and the collateral itself are insufficient to cover the cash flows. This result was achieved by providing that upon a mortgage bond default, proceeds from the cover pool are invested in guaranteed investment contracts, or GICs, by the indenture trustee, and proceeds from these GICs are paid to a swap provider in exchange for interest and principal due on each series of covered bonds. An asset coverage test is conducted monthly to ensure that the ratio of covered bond to cover pool assets does not exceed the rating agency threshold.

Until recently, as discussed below, the FDIC had not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario. As a result, there had been concern that upon a default by the sponsor bank in receivership, the FDIC would seek to avoid covered bond transaction documents. An amendment to US bank insolvency laws, which requires an automatic stay for as long as 90 days of any attempt to foreclose on a failed bank's property or to affect its contract rights, added to the confusion.

LEGISLATIVE COVERED BONDS

Although the statutory regime in each European jurisdiction differs, all of the regimes incorporate certain core principles: first, covered bonds must be secured by high quality assets; second, management of the cover pools must be supervised; and third, covered bond holders are

Figure 1: Current US structure



Source: Morrison & Foerster LLP

first in priority upon an issuer's bankruptcy. Legislation in European jurisdictions provides certainty regarding the treatment of covered bonds, particularly in an insolvency scenario. The basic structure for legislative covered bonds is shown in Figure 2.

COMPETITIVE DISADVANTAGES

Covered bonds that are not issued pursuant to statutes imposing special bankruptcy protection for covered bond holders are not entitled to preferential risk weighting by the European Central Bank, or ECB. Banks, which comprise a significant portion of the covered bond investor base, tend to hold covered bonds as collateral for their repo activities. For these purposes, the ECB follows the covered bond definition used in the EU's Undertakings for Collective Investment and Transferable Securities (or UCITS) directive for collective investment vehicles.

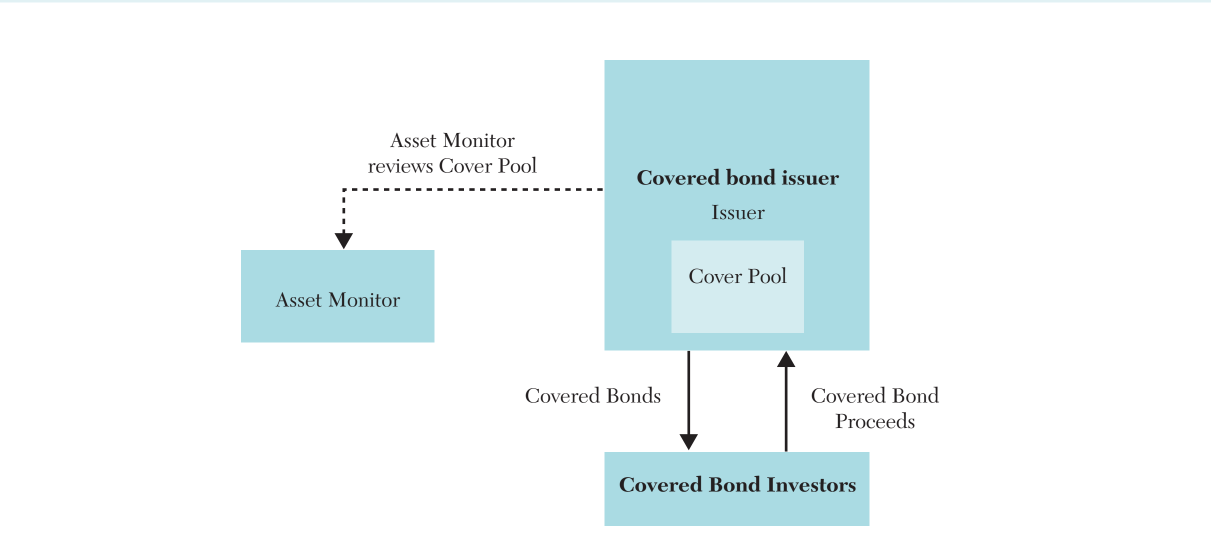
In order to have an EU recognised "covered bond" regime, a country must implement the requirements of Article 22(4) of the UCITS directive, which essentially includes covered bonds issued under statutes imposing special bankruptcy protection for covered bond holders. For repo purposes, covered bonds are discounted at 1%-7.5%, depending on maturity; bank debt is discounted at 1.5%-9%; and securitisations are discounted at 2%-12%. Structured covered bonds, including UK covered bonds (issued prior to recent legislation) and the covered bonds that have been issued by US depositary institutions, which are not issued pursuant to statute, are classified as bank debt by the ECB.

For bank regulatory risk weighting purposes, covered bonds will achieve a lower risk weighting only to the extent that the covered bonds are issued pursuant to statute. The Capital Requirements Directive (CRD), which effects the changes prescribed by the Basel II framework, requires European credit institutions to hold a certain amount of eligible capital depending on the risk weighting of their assets. Covered bonds meeting the UCITS Article 22(4) criteria benefit from a 10% risk weighting, which is half of the capital charge allocated to unsecured debt from the same issuing financial entity or group. By contrast, covered bonds that are not legally based are subject to a 20% risk weighting.

FDIC INTERIM POLICY STATEMENT

Regulators in the US are keenly aware that investors have become sceptical of any structure that involves "securitising," or moving assets off balance sheet into a special purpose entity. As noted above, covered bonds have a number of benefits over securitisation: first, covered bonds may allow depositary institutions to raise funds for continued mortgage origination; whereas the securitisation market may not come

Figure 2: Basic structure for legislative covered bonds



Source: Morrison & Foerster LLP

back for a while; transaction costs for covered bonds may be lower; there is less investor risk associated with covered bonds so investor confidence in mortgage related assets may be restored; there are fewer restrictions on modifying or replacing assets; and the covered bonds structure may prevent the moral hazard of dissociation of underwriting risk of loans from banks to investors.

In an effort to encourage the growth of the market, on April 15, 2008 the FDIC issued its Covered Bond Policy Statement as "interim final" in order to provide immediate guidance, but with a view to possible later amendment in response to comments. The Interim Policy Statement clarified the FDIC's views regarding the status of covered bonds in the event of a bank issuer's insolvency. The FDIC as conservator or receiver will consent to a covered bond obligee's exercise of its rights to collateral if (1) the bank is, and remains, in monetary default for at least 10 business days after the obligee delivers a written request to the FDIC to exercise its contractual rights or (2) the FDIC as conservator or receiver provides written notice of repudiation of a contract to the covered bond obligee and does not pay damages as a result of such repudiation within 10 days after the effective date of such notice. In both cases, no involvement of the conservator or receiver is required for the covered bond obligee to exercise its rights. The FDIC statement also acknowledges that the cover pool may constitute a revolving pool.

The Interim Policy Statement defined covered bonds as recourse debt obligations of an insured depository institution with a term of greater than one year and not exceeding ten years secured directly or indirectly by perfected security interests in a pool of mortgage loans or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. The Policy Statement also only applies to covered bonds made with (1) the consent of the bank's primary federal regulator and (2) which comprise no more than four percent of the bank's total liabilities. In order to limit the risks to the Deposit Insurance Fund, the Policy Statement limits its application to "eligible mortgages," defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income. On the whole, market participants thought the Interim Policy Statement was a very useful first step, but might have gone farther in clarifying the FDIC's position.

FDIC FINAL POLICY STATEMENT

On July 15, 2008, the FDIC issued its Final Policy Statement on Covered Bonds, seeking to provide the market with the clarity it was looking for.

Comments on the Interim Policy Statement stressed the need for the FDIC to provide a definitive statement regarding the actual compensatory damages the FDIC will pay holders of covered bonds if it were acting as conservator or receiver. The Policy Statement confirmed that the FDIC will indeed pay as actual compensatory damages the outstanding principal amount plus accrued and unpaid interest. With respect to covered bonds, the FDIC has three options when acting as conservator or receiver for an FDIC-insured institution: (1) continue to perform on the covered bonds, (2) pay off the covered bonds in cash up to the value of the pledged collateral, or (3) allow liquidation of the pledged collateral to pay off the covered bonds.

Under scenario 1, payments on the covered bonds would be made as scheduled. Scenarios 2 and 3 would be triggered if the FDIC were to repudiate the transaction or if a monetary default were to occur. In both cases, the FDIC will pay to holders of covered bonds the outstanding principal amount plus accrued and unpaid interest on the covered bonds to the date of the FDIC's appointment as conservator or receiver, up to the value of the cover pool (the collateral). If there is excess collateral, the FDIC will retain the excess for distribution under the FDIA and if there is not enough collateral, it will limit the amount of secured claims up to the collateral value. These affirmative statements provide certainty to investors and eliminate the risk that investors may lose a portion of their principal.

Though some market participants had suggested that the FDIC expand the definition of eligible mortgage (including changing the criteria for such mortgages to an LTV, delinquency and negative amortization assessment), the FDIC determined that its interest in efficient regulation of FDIC-insured institutions, as well as the initial development of a resilient covered bond market that can provide reliable liquidity for well-underwritten mortgages, supported retention of the collateral limitations specified in the Interim Policy Statement. The FDIC will instead urge issuers to disclose LTV for mortgages in the cover pool.

The FDIC further clarified that the Policy Statement permits the substitution of cash as cover pool collateral. However, the FDIC declined to further expand the assets, believing that many of the assets suggested (second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt and student loans) are subject to substantial volatility, while others would not specifically support additional "liquidity for well-underwritten residential mortgages." Responding to requests from market participants, the FDIC increased the term limit for covered bonds from 10 to 30 years.

MOVING FORWARD IN 2008

The FDIC has provided the market with some much needed certainty and clarity. And it has left open the door for future revisions to the Policy Statement, noting that as the US covered bond market develops, future modifications or amendments may be considered. In particular, the FDIC indicated that it may reconsider the limits placed on the composition of cover pools and change the limitation on issuances as the market develops. While some hoped that the Final Policy Statement might have gone farther, it is clear that a robust US covered bond market is a large step closer to reality. It looks to us as if this coming attraction is likely to arrive soon and be successful at the box office.

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