The Not So New New Thing—Covered Bonds

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Covered bonds have been getting a great deal of press as of late. The basic theme is that covered bonds may present an interesting new source of liquidity for US financial institutions and other entities that originate mortgages and, perhaps, other receivables as well. The popular press also has been reflecting investor concern regarding whether innovation, financially complex new products, or financial engineering may have been to blame for the current credit crisis. While a fear of the new or the unknown may be a predictable response to such a persistent market downturn, such a reaction might deter financial intermediaries from considering interesting alternatives. Happily, covered bonds are not all that new—just new to the US. Whether a robust US covered bond market develops will be determined in the not too distant future. But, for now, a helpful starting point might include a discussion of this time-tested financing alternative.

What are Covered Bonds?

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 (the cover pool) separate from the issuer’s other assets. The cover pool usually consists of residential mortgage-backed securities, 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. The assets in the cover pool are subject to strict criteria and must be replaced if they do not satisfy that criteria. Typically, the cover pool provides for over-collateralization to preserve the value of the covered bond holders’ claim in the event of the issuer’s insolvency.

The covered bond market has grown rapidly in recent years, as many more European jurisdictions have passed covered bond legislation. Depositary institutions seeking to diversify their funding sources find that covered bonds provide a relatively cheap (compared to securitization) and ready funding alternative. Meanwhile, depositary institutions in jurisdictions like the US that lack covered bonds legislation may have previously found themselves at a competitive disadvantage in accessing this market. 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. In the United Kingdom, specific legislation was recently adopted, but prior to the legislation, UK depositary institutions had implemented securitization techniques in order to synthetically create covered bond-like structures. In the US, depositary institutions already have started accessing this market using structures that also rely on securitization prin-
principles. By and large, the UK “structured” covered bonds have been popular with investors and the first initiatives by US issuers Washington Mutual and Bank of America have proven successful. These issuances by UK entities, which were sold to US investors—as well as the issuances by US entities offshore and in the US pursuant to securities law exemptions—have proven there is a market for these securities in the US.

The US market seems likely to develop quickly as recent market disruptions have severely limited the ability of depositary institutions to securitize their loan portfolios. With access to alternative loan-buyers like Fannie Mae, Freddie Mac and other government-sponsored enterprises (GSEs) constrained, the US Treasury Department believes that covered bonds represent a “potential additional source of financing that could reduce borrowing costs for homeowners, improve liquidity in the residential mortgage market, and help depositary institutions strengthen their balance sheets by diversifying their funding sources.” Treasury further believes that covered bonds “present an alternative source of funding for institutions that can complement other sources of financing for a wide range of high-quality assets.”

Covered Bonds in the United States

In the US, depositary institutions have started accessing this market using structures that also rely on securitization principles and attempt to replicate through contractual relationships the features associated with European covered bond legislation. The US structure that has been used to date (see the diagram below) is two-tiered—with a special purpose vehicle (SPV) not a bank, serving as the covered bond issuer. The covered bond issuer offers fixed rate covered bonds to investors. The covered bond issuer 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—one that is protected from claims by other parties—to pay the mortgage bonds. The cover pool is a dynamic pool of revolving mortgage loans.
Instead of using the residential mortgage loans in the cover pool as direct collateral for the covered bonds, the bank issues and sells the mortgage bonds to the SPV that is the covered bond issuer. 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 the covered bond holders. Covered bond holders do not expect an acceleration of their covered bonds unless both the issuer defaults and the collateral itself is unable to cover the cash flows. This result was achieved by providing that upon a mortgage bond default, the cover pool proceeds are invested in guaranteed investment contracts (GICs) by the covered bond 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 is no more than the threshold set by the rating agencies.

There is no specific statutory framework in the US prescribing the priority of the claims of the covered bond holders over the cover pool in a bankruptcy or setting forth how covered bond holders may exercise their claims. Until recently, the Federal Deposit Insurance Corp. (FDIC) had not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario and, as a result, there had been concern that upon a default by the sponsor bank in receivership, the FDIC would seek to void covered bond transaction documents. An amendment to the 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 rights under contract, had added to the confusion. In light of recent regulatory actions, which have provided certainty on several issues, we anticipate the issuance structure for US covered bonds is likely to change to a direct issuance approach.

**Certainty for the U.S. Covered Bond Market**

On July 15, the FDIC issued its Final Policy Statement on covered bonds. “The FDIC noted that the Policy Statement ‘define[s] the circumstances and the specific covered bonds transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral.’ The Policy Statement provided needed clarity and certainty about the issuance of covered bonds in the US and reflects the FDIC’s desire to facilitate the development of the covered bond market. On July 28, the Treasury Department announced the publication of a Best Practices guide for US covered bonds, intended to further promote covered bond issuances. These are important steps forward for the US covered bond market.

**FDIC Policy Statement**

The Final Policy Statement confirms that the FDIC, as conservator or receiver, will consent to a covered bond holder’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 holder to exercise its rights.

**Scope**—The Policy Statement defines covered bonds as recourse debt obligations of an insured depositary institution with a term of greater than one year and not exceeding 30 years, secured directly or indirectly by perfected security interests in a pool of mortgage loans, or—not exceeding 10% of the collateral—by AAA-rated mortgage bonds. The Policy Statement permits the substitution of cash, US Treasury and agency securities as cover pool collateral. However, the FDIC declined to expand the assets that may be included in the cover pool, believing that many assets the FDIC considered are subject to substantial volatility, while others would not specifically support
additional “liquidity for well-underwritten residential mortgages.” The Policy Statement limits its application to “eligible mortgages,” which are defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate based on documented income. The FDIC urges issuers to disclose the loan-to-value (LTV) for mortgages in the cover pool. The Policy Statement applies only to covered bonds made (1) with the consent of the bank’s primary federal regulator; and (2) which comprise no more than 4% of the bank’s total liabilities.

Compensatory Damages—The Policy Statement provides a definitive statement on the actual compensatory damages that the FDIC will pay when acting as conservator or receiver. The FDIC noted that it 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 covered bonds holders 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. If there is excess collateral, the FDIC will retain the excess for distribution under the Federal Deposit Insurance Act (FDIA) and if there is not enough collateral, it will limit the amount of secured claims up to the collateral value. These statements eliminate the risk that investors may lose a portion of their principal.

Flexibility—The FDIC noted that there is nothing in the Policy Statement requiring the use of an SPV to issue covered bonds. Rather, the FDIC will use its “well-defined standards to determine whether to treat such entities as separate from” the depository institution. The determination as to whether an SPV is a separate entity will be based on specific facts and circumstances. We anticipate that new issuers will look to a direct issuance structure for covered bonds in order to benefit from favorable securities law exemptions.

Treasury Best Practices


Cover Pool—In addition to the requirements set forth in the Policy Statement, the Best Practices recommend that collateral have a maximum LTV of 80% at the time of inclusion in order to be eligible for the cover pool. No single Metro Statistical Area should make up more than 20% of the cover pool, and negative amortization mortgages should not be included. Mortgages in the cover pool should be first-lien only. The Best Practices recommend that an issuer maintain an over-collateralization of at least 5% of the outstanding principal amount of the covered bonds at all times. For purposes of calculating this figure, only the 80% portion of the LTV will be credited.

Payments—The Best Practices recommend that at the time of issuance, the covered bond issuer enter into one or more swap agreements to: (1) provide scheduled interest payments in case the issuer becomes insolvent; and (2) mitigate timing mismatches between interest payments and interest income, if applicable. This is consistent with the US covered bond issuance structure discussed above. If a covered bond is denominated in a currency other than US dollars, the Best Practices recommend the issuer enter into a currency swap at the time of issuance. The Best Practices also recommend that an issuer enter into a Specified Investment Contract—a deposit agreement, a GIC, or other arrangement whereby the proceeds of the cover pool are invested with, or by, one or more financially sound counterparties. The Specified Investment Contract should pay ongoing scheduled interest and principal payments after a default or repudiation by the FDIC, so long as the Specified Investment provider receives proceeds from the cover pool at least equal to the par value of the covered bonds.
Disclosure—The issuer should make available to investors descriptive information about the cover pool at the time of issuance (when the investment decision is made) and on a monthly basis thereafter. If more than 10% of the cover pool is substituted within any month, or more than 20% within any quarter, the issuer should provide investors with updated information on the cover pool. The issuer must perform a monthly asset coverage test on the cover pool to ensure collateral quality and required over-collateralization levels, and for necessary substitutions. Asset coverage test results should be made available to investors. If the asset coverage test is breached, the issuer has one month to correct the breach. If not corrected, the trustee may terminate the covered bond program and principal and accrued interest will be returned to investors. In addition, the depository institution and the SPV (if one is used) should disclose any other information that an investor might view as material to its investment decision. The information that the Best Practices suggests be included in a disclosure document is consistent with the information that would be disclosed for a registered asset-backed securities offering to which the disclosure requirements of Regulation AB (promulgated pursuant to the Securities Act) would be applicable.

Additional recommendations—The Best Practices specifically contemplate covered bond issuance either through a newly created, bankruptcy-remote SPV or directly by the depository institution and/or a wholly-owned subsidiary. Under the direct issuance approach, the issuing institution designates a pool of residential mortgages that constitute the cover pool. The Best Practices also specify that covered bonds may be issued either as registered securities or pursuant to an exemption from the registration requirements of the Securities Act. We anticipate that if banks were to use a direct issuance structure, covered bonds might be eligible for the exemption from registration provided by Section 3(a)(2) under the Securities Act for “bank securities.”

Proposed New legislation

On July 30, US House Representative Scott Garrett of New Jersey introduced H.R. 6659, the

Equal Treatment of Covered Bonds Act. This proposed legislation would codify the treatment of covered bonds, providing a statutory framework for their issuance. The proposed bill would make a covered bond a “qualified financial contract” under the FDIA. This would result in there being virtually no delay for covered bond holders to exercise their rights after the FDIC’s appointment as conservator or receiver for a depository institution that issued covered bonds. The proposed legislation goes a step further than the FDIC Policy Statement and the Treasury Best Practices with respect to compensatory damages. The legislation states that actual compensatory damages payable by the FDIC when acting as conservator or receiver will include the outstanding principal and interest on the covered bonds, the cost of a GIC and other costs (including reasonable attorney’s fees) relating to the exercise of any right, power or remedy under the covered bonds. The proposed legislation also provides for an expanded cover pool, defining a covered bond as a “nondeposit recourse debt obligation of an insured depository institution, with a term to maturity of at least 1 year, which is secured by specifically identified assets which are performing in accordance with the terms of the contracts which created the assets.” This would open the door to using other assets, such as credit card receivables, home equity lines of credit, commercial mortgage loans and public sector loans, as collateral in a cover pool.

Benefits Associated with Covered Bonds

Covered bonds have a number of benefits that are likely to render them an attractive funding choice for mortgage originators, as well as investors. In a securitization, an investor only has recourse to the SPV that issues the securities and to that SPV’s assets, which include the asset pool and its cash flows. Because covered bonds are dual recourse (recourse to the issuing entity and, upon a default, recourse to the cover pool), covered bond investors would be assured of repayment given over-collateralization and substitution requirements, as well as other protections. Of course, this is reassuring to investors that may have suf-
fered losses in connection with securitizations. While covered bonds still represent an interest in residential mortgage securities, the covered bond market in Europe has demonstrated a resiliency during the credit crisis that suggests that investors may view these securities as more akin to corporate debt or, at least, as a hybrid.

From the issuer’s perspective, covered bonds remain on balance sheet, whereas securitized assets are off-balance sheet. Regulators believe that having mortgage loans remain on an issuer’s balance sheet will serve to align the interests of the mortgage originator (covered bond issuer) more closely with those of securities holders and may lead to improved mortgage origination practices. In a covered bond transaction, the cover pool usually consists of high quality assets; whereas, the assets in a securitization may include a variety of assets of differing quality. Covered bonds are issued by depository institutions that are regulated entities subject to supervision by domestic banking authorities, which also ensures that regulators would step in if a safety and soundness issue were to arise. For issuers, covered bonds provide a means of funding mortgage originations and provide a security that can be pledged or presented in order to obtain loans from the Fed window. Even if the securitization market were to reopen, covered bonds will provide an important funding alternative to public or private label or agency securitizations.

The chart below summarizes the principal differences between a covered bond and a securitization.

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<th><strong>Covered Bonds</strong></th>
<th><strong>Securitization</strong></th>
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<tbody>
<tr>
<td><strong>Accounting</strong></td>
<td>On-balance sheet</td>
<td>Off-balance sheet</td>
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<tr>
<td><strong>Recourse</strong></td>
<td>Direct or indirect recourse to the originator</td>
<td>Limited recourse</td>
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<td>Upon originator default, collateral used to repay bonds</td>
<td>Bankruptcy remote SPV</td>
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<td></td>
<td>Issuer is not limited by business or financial covenants</td>
<td>Cash flows from assets repay the bonds</td>
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<td>Exposure to parent company management risks</td>
<td>Servicer risk, prepayment risk and credit risk</td>
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<tr>
<td><strong>Liquidity</strong></td>
<td>High degree of homogeneity, liquidity</td>
<td>Heterogeneous structures, lower liquidity</td>
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<td></td>
<td>Limited spread volatility</td>
<td>Limited spread volatility</td>
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<td></td>
<td>Bankruptcy segregated from issuer, preferential claim</td>
<td>Bankruptcy remote from issuer</td>
</tr>
<tr>
<td><strong>Ratings</strong></td>
<td>Greater linking of bond ratings to parent company</td>
<td>No linking of bond ratings to parent company</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td>Open-ended vehicle whose collateral pool can evolve over time with strict collateral qualifying criteria; overcollateralization required</td>
<td>Open or closed-ended pools with strict collateral qualifying criteria</td>
</tr>
<tr>
<td><strong>Investors</strong></td>
<td>Large number of eligible investors</td>
<td>Large investor base that typically invests in ABS paper</td>
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<td></td>
<td>Taps non-securitization investors (liquidity investors)</td>
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<td></td>
<td>Limited overlay with senior unsecured investor base</td>
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Conclusion

In due course, the breadth and depth of the US covered bonds market will be ascertainable. It may not ultimately live up to some of the hyperbole that holds that it may replace securitization in the US. In fact, over time, it probably will not. Yet, based on the long and stable presence that covered bonds have had in European capital markets, the competitive pressures facing depository institutions and the installed investor base for covered bonds, it is quite likely that covered bonds will have a significant place in the US capital markets and exist alongside other funding and capital raising alternatives.

NOTES
5. For more information regarding bank insolvency regulations, see Federal Deposit Insurance Act § 11, 12 U.S.C. 1821.
8. For additional information regarding the FDIC Policy Statement, see our client alerts, which can be found at http://www.mofo.com/docs/pdf/CoveredBondsUSRegulator.pdf and http://www.mofo.com/docs/pdf/Client_ALERT_FDIC.pdf.
9. For additional information regarding the Treasury Best Practices, see our client alert, which can be found at http://www.mofo.com/news/updates/files/080729TreasuryAnnounces.pdf.
10. For a copy of the bill see http://thomas.loc.gov/home/gpoxmlc110/h6659_ih.xml.