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A Separate Piece

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The pieces are actually falling into place. At this rate, 2008 may well be remembered as (among other things) the year the U.S. covered bond market got its start. Let's take a look at some of the pieces. A wide range of U.S. capital markets participants are now on record supporting the proposition that covered bonds could be an important financing instrumentality during this unprecedented period of market volatility and liquidity challenges. The FDIC has provided considerable regulatory certainty through its Final Policy Statement on Covered Bonds. The U.S. Treasury's recently published Best Practices have provided something of a roadmap, or at least a departure point, for structuring the initial U.S. residential mortgage covered bond transactions. SIFMA is at work developing approaches that will foster a liquid and active secondary market. So what's left? Only one more separate piece. The SEC could make a useful contribution if it were to come forward with guidance on a few points.

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 mortgages, 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. The cover pool provides for over-collateralization to preserve the value of the covered bond holders' claim.

Prior to the release of the FDIC Final Policy Statement, the U.S. covered bond structure that had evolved was a two-tiered structure—with a special purpose entity, not a bank, serving as the covered bond issuer. In the two-tier structure, 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 special purpose entity. This structured covered bond approach relied on contractual arrangements and well-established UCC principles to replicate the preferential claim, in bankruptcy, of covered bond holders. This structure also relies upon having a specified investment contract, usually in the form of a guaranteed investment contract, or GIC, in place to avert an acceleration of the covered bonds following a mortgage bond default. Upon a mortgage bond default, the cover pool proceeds are invested in the GIC and proceeds from the GIC are paid to a swap provider in exchange for interest and principal due on the related series of covered bonds.

To date, covered bonds issued by U.S. depositary institutions have been issued outside of the U.S. pursuant to Regulation S and within the U.S. to qualified institutional buyers (QIBs) in reliance on the 144A exemption from registration requirements. The FDIC Final Policy Statement and the Treasury Best Practices both contemplate issuances through special purpose vehicles, as well as direct issuance structures, through which the covered bonds would be offered by the bank issuer. Similarly, both contemplate the possibility of registered covered bond transactions, as well as issuances of covered bonds in reliance on available securities exemptions.

Given the clarity provided by the FDIC Policy Statement, we anticipate that potential issuers will consider a single-tier, or direct issuance, approach. If that were the case, one could envision continuing to offer covered bonds in private placements to accredited investors, as well as issuances to QIBs, or issuances offshore. However, for issuers that are banks, the Section 3(a)(2) exemption from registration for bank-issued securities may well be available and may provide greater flexibility. Issuers should consider whether the relevant specified instruments, which may be either deposit agreements or GICs, would themselves be "securities" or bank deposits or investment agreements (in other words, not "securities") or, in the case of the GICs, insurance contracts that are otherwise exempt from registration under the Securities Act. The analysis would be somewhat more complex if one were to use a two-tier structure, with a bank affiliated special purpose entity issuer. For quite some time, the SEC has declined to issue no-action letter guidance on the Section 3(a)(2) exemption. However, given the public policy objective of promoting a covered bond market in the U.S., and the straightforward nature of a bank-issued covered bond transaction, guidance on the availability of the exemption for bank-issued covered bonds would be helpful.

If an issuer sought to register a covered bond transaction with the two-tiered structure, that too presents interesting questions. In the current two-tiered structure, one would have to consider whether the special purpose entity issuer would be eligible to use a short-form registration statement on Form S-3. Availability of short-form registration for the SPE issuer may be limited going forward if the proposed NRSRO related amendments to Form S-3 that were released for comment by the SEC in July were to be approved. Those amendments would require that a SPE issuer use a long-form (S-1) registration statement until the registrant had offered $1 billion of registered covered bonds. In addition, those proposed amendments, which were one of several proposed rule changes intended to address the ratings related problems in the residential mortgage-backed securities area, also would limit the potential offerees for covered bonds. The proposed rules would require that such securities be offered only in $250,000 denominations and only to QIBs. Extensive comments were submitted by market participants to the SEC in response to these proposed rules; however, commentators did not take into account that one of the financial products that is believed to be a partial solution for the mortgage market may, in fact, get caught up in the regulatory response to the NRSROs.

The Treasury Best Practices included recommendations regarding the disclosure that a covered bond issuer should make available to investors at the time of issuance and on a monthly basis thereafter. The information that the Treasury suggested be included in a disclosure document seems largely consistent with the information that would be required in connection with a registered asset-backed securities offering to which the disclosure requirements of Regulation AB would be applicable. However, covered bonds would not squarely fall under Regulation AB as it is currently written. Regulation AB, with very limited exceptions, requires that there be a discrete or unmanaged pool; whereas, the cover pool requires active management. This, of course, also raises other securities questions, but, sticking with Regulation AB, if one were to consider many of the comments raised when Regulation AB was being considered, it also would seem that covered bonds should not be considered subject to Regulation AB. It would seem sensible in connection with considering the potential application of the proposed Form S-3 eligibility changes to consider changes to Regulation AB that might address covered bonds.

At this writing, it is not clear whether the SEC will adopt regulation, or publish guidance, relating to covered bonds. If this last piece were to fall into place, it would supplement the useful initiatives that have already been undertaken and, very possibly, accelerate the speed at which the U.S. covered bond market will develop.

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