

Covered Bonds – Will Insurance Companies Follow Banks?

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Covered bonds, a time-tested technique for capital-raising, have been utilized by credit institutions in Germany for over two centuries.

The instruments also have been popular in a number of other European jurisdictions in light of legislation providing investors in such structures with

the **Federal Home Loan Bank** to finance their mortgage lending.

In addition, unfavorable statutory automatic stay and repudiation provisions applicable in the event of a bank receivership had, until recently, discouraged interest in the U.S.

To date, two U.S. issuers, **Washington Mutual** and **Bank of America**, have established covered bond programs that replicate, through contractual relationships, the features associated with European covered bond legislation.

The recent credit crisis and the ensuing effect on government sponsored entity financing sources, however, have seriously affected the availability of residential property-based financings. Recent pronouncements by the **Federal Deposit Insurance Corp.** clarifying the rights of investors in the event of a bank issuer's insolvency have already led to the announcement of at least four more banks contemplating the issuance of covered bonds.

Given current market conditions and uncertainty as to how government guarantees of bank paper will function, no activity is expected to occur until early 2009.

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, on an issuer default, also have recourse to a dynamic pool of collateral (cover pool) separate from the issuer's other assets. Because of the recourse structure, covered bonds typically obtain higher ratings than traditional securitized notes and are able to carry lower

interest rates. Although covered bonds have generally been limited to residential mortgage loans, public debt or ship loans, in principle, many high quality securitized asset classes held by insurance companies could be considered as candidates for covered bond treatment.

Insurance companies have undertaken asset securitizations for disparate reasons — to monetize illiquid assets, to capitalize prepaid acquisition expenses, to reduce capital requirements, to facilitate balance sheet adjustments or to finance corporate reorganizations such as demutualizations or acquisitions. Such transactions have included embedded value transactions for an entire block of insurance business, both closed block and open block, monetization of reinsurance recoverables, policy loans, commercial mortgages, agent receivables or holdings of illiquid privately placed bonds, and vital and life settlement securitizations.

In the current capital markets environment, insurance companies are subject to the same capital and surplus pressures as are banks. Concerns over collateralized debt obligations and other arcane structured instruments seen as precipitating the credit crisis have also effectively shut down the securitization market. Insurance companies, however, do not generally have access to either the Federal Reserve Discount window or certain programs available under the *Emergency Economic Stabilization Act of 2008*. On the other hand, unlike banks and other credit institutions, insurance companies are not subject to the same

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preferential treatment in the event of the bankruptcy of the issuer.

Absent legislation in jurisdictions such as in the U.K., where legislation was only recently adopted, institutions instead adapted standard securitization techniques to synthetically create covered bond-like structures.

Until the recent credit crisis, covered bonds have proven to be one of the more reliable and cost-efficient methods for European banks to raise funds.

With such developments, the market has grown rapidly in recent years, with an estimated U.S. \$2.75 trillion in outstanding notes.

Investors for these long-term low-risk instruments include central banks, pension funds, insurance companies, asset managers and bank treasuries that are attracted by the liquidity, credit ratings, and covenants offered by the instruments.

In contrast, U.S. banks and credit institutions in the mortgage industry have traditionally had access to cheaper funding from **Fannie Mae**, **Freddie Mac** and

statutory automatic stay and repudiation provisions as are insolvent banks.

Moreover, the covered bond structure may serve to overcome other issues inherent in certain asset classes, such as ramp-up risk or origination risk for life settlement policies, now often addressed by synthetics. Thus insurance companies may be logical candidates to consider the issuance of covered bonds as an alternate means of capital raising or of monetizing assets.

What is the structure of covered bonds? Under the so-called “integrated” structure, where the asset owner and the issuer are the same entity, the asset owner issues bonds secured by a specified pool (the cover pool) of the asset owner’s assets. Legislation, if available, generally specifies the types of qualifying cover pool assets and the segregated nature of those assets. The assets are generally of a sufficiently high quality to ensure a high credit rating for the bonds, usually ‘AAA.’ Covered bond holders have a privileged or preferential claim (by statute or contract) against the cover pool in the event of the issuer’s insolvency.

The U.S. bank-structure has so far been two-tiered, with a special purpose entity, not the sponsoring bank, serving as the covered bond issuer. The covered bond issuer offers fixed-rate covered bonds and applies the offering proceeds to purchase floating-rate mortgage bonds from the affiliated sponsoring bank. The bank issues mortgage bonds which are direct and unconditional obligations of the bank, to serve as collateral for the covered bonds. A specific pool of mortgage loans on the bank’s balance sheet secures the bank-issued mortgage bonds, and the pool ultimately secures the covered bonds. The pool is pledged by a perfected security interest to pay the covered bonds.

Of primary concern for the covered bond investors is the avoidance of any ac-

celeration of the mortgage bonds except when, in the event of an issuer default, the collateral is insufficient to cover the cash flows. In order to provide for this, in the event of a covered bond default, the covered bond indenture trustee is required to use proceeds from the cover pool to acquire guaranteed investment contracts or other comparable agreements to fund a swap.

In turn, the swap provides for payment of principal and interest payments due on the covered bonds. As additional protection for investors, a monthly asset coverage test is conducted to ensure that the ratio of covered bonds to cover pool assets is no more than the threshold set by the rating agencies.

Covered bonds differ in a number of significant ways from securitization transactions and should be viewed as a funding alternative for issuers. Principally: the cover pool remains on balance sheet for the sponsor entity; the pool is a dynamic, managed pool rather than the static pool more typical of securitizations; there are fewer restrictions on modifying or replacing cover assets; bond investors retain recourse to the sponsor; the ratings of the covered bonds is linked more closely to that of the sponsor; the guaranteed investment contract functions in place of a third-party wrap; transaction costs may be reduced; and, the bonds may be of interest to non-securitization investors. By contrast, in a securitization, an investor has recourse only to the special purpose entity that issues the securities and to that issuer’s assets, which include the asset pool and its cash flows.

In July 2008, the **U.S. Department of Treasury** announced the publication of a *Best Practices* guide, intended to promote covered bond issuances for the U.S. residential mortgage market. Although not applicable by their terms to non-banks or to underlying assets other than residential mortgage loans, the standards enumer-

ated in the *Best Practices* suggest a road map for covered bond structures undertaken by other entities such as insurance companies utilizing other asset classes. The standards include the following:

* Provision for one or more swap agreements: (i) to provide scheduled interest payments in case the issuer becomes insolvent and (ii) to mitigate timing mismatches between interest payments and interest income, if applicable.

* Execution by the covered bond issuer of a deposit agreement, a guaranteed investment contract, or other arrangement (a Specified Investment), whereby the proceeds of the cover pool assets are invested with one or by one or more financially sound counterparties to fund the bank-up swap.

* Provision of adequate descriptive information about the cover pool at the time of issuance 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 is to provide updated information on the cover pool to investors.

* Application of a monthly asset coverage test on the cover pool to ensure collateral quality and the proper level of overcollateralization, and for necessary substitutions. The results of each asset coverage test is to be made available to investors.

* The typical covered bond transaction provides that the same cover pool may collateralize a series of covered bond issuances. Upon an issuer default, any losses must be allocated *pro rata* across all cover bond issuances that are supported by the same cover pool.

* Provision of minimum nominal overcollateralization of 5%.

Although, as indicated above, the *Best Practices* provisions do not apply to non-bank sponsors, it is unclear whether

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ment agreements from old manager to new provides such a permanent alternative but generally requires CLO noteholder consent, which may be costly if not impossible to obtain. Therefore, we predict the third structure, corporate M&A, will have a boost in popularity in 2009 and we expect to see a variety of new creative merger and equity purchase transactions.

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rated class would be unaffected. Even by month 12, the 'AAA' class would not be downgraded, although its Rating Outlook would have been changed to Negative from Stable.

Potential Mitigating Actions:

Credit cards are revolving, rather than amortizing, financial instruments and

Conclusion

Notwithstanding the above challenges, MM CLOs continue to perform relatively well, particularly compared other types of CLOs and CDOs. In 2008, there were a few downgrades of MM CLOs, yet most deals continue to avoid downgrade and make timely payments of interest and principal. While any predictions for 2009 are inherently uncertain given the present volatility, it seems fairly certain that loan defaults will continue to rise in

are more dynamic than other consumer assets. To accommodate this collateral characteristic, trusts are structured such that the receivables and accounts are continuously replenished. If a credit issue occurs, the issuer may have flexibility to improve trust performance through various actions, including the execution of a large addition of better performing accounts. However, this is contingent on the existence of a large number of unsecured, high credit quality accounts on

2009 before leveling off, with new MM CLO issuance volume staying at very low levels and most activity in the MM space to come from restructuring of existing CLOs and warehouses and collateral manager M&A. However, once loan default levels peak and begin to subside — most likely towards the end of 2009 — investors will trickle back into the market and new warehouse activity, followed by CLO issuance, will likely pick up toward the end of 2009 and early 2010.

the balance sheet.

In addition, credit card issuers have historically possessed a significant ability to change terms of the credit card lending agreement to preserve their profit margins. In addition to risk mitigation activities such as credit line decreases, risk-based pricing initiatives are fluid and widely used in the industry. A byproduct of this flexibility is a fairly consistent level of excess spread over the past few years.

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rating agencies, or investors, will require some or all of these practices to be adopted by other issuers.

Structuring of insurance company covered bond issuances will also need to reflect applicable rating agency methodologies. Because investors enjoy full recourse to the sponsoring institution, **Fitch Ratings**, for example, applies the rating of the sponsor as a floor for the rating of the covered bonds. Second, in the event of an issuer default, any discontinuity in the transition from the issuer to the cover pool as the source of payment on the bonds, including due to asset segregation mechanisms, regulatory impairments or protections, availability of substitute liquid assets and substitutability of servicer are among

the factors that Fitch considers. Stress testing of the sufficiency of the overcollateralization will also be a significant factor in the rating process.

Finally, the unique regulatory scheme applicable to insurance companies will need to be examined as well as the nature of the pool assets. The accounting treatment for the pledged cover pool assets will need to be taken into account, for the effect on admitted assets and for risk-based capital purposes. Applicable regulatory requirements will need to be considered, including use of a wholly-owned, rather than an unaffiliated, special purpose entity to allow a "parental" guarantee by the sponsoring insurance company, and required inter-affiliate filings and approvals under applicable insurance holding company statutes will need to be made. Insurance-related asset classes may be less

familiar to covered bond investors and modeling, hedging, mortality-related cash flow patterns and disclosure issues may arise, depending upon the class of assets. Other factors particular to the insurance market may present issues, such as persistency, or changes in cost of insurance or dividend declarations. In sum, deviations from bank covered bonds will require analysis and an educational effort for investors.

As is always the case with the introduction of new capital markets instruments, a great many questions will need to be resolved in connection with the issuance of insurance covered bonds. But the well-developed precedential bank covered bond market and the advantages that a covered bond instrument may afford to insurance companies in the current economic environment may justify this further examination.