Amist the Turmoil, Covered Bonds Bounce Back

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IF GEORGE Carlin were a regulator that had lived through the last few months, he might conclude that "securitization" should be added to his famous list of "dirty words." The subprime mortgage crisis, which began with mortgage lenders, quickly evolved into a liquidity crunch affecting virtually every market-from commercial paper to medium-term notes to financial institution stocks - even those with no subprime portfolios. This crisis unleashed the sequence of events that has now come to follow every market crisis or scandal in the U.S. Plaintiffs lawyers started filing complaints against mortgage lenders. The popular press reported on "opaque" financial structures and "mysterious" feats of financial engineering that led to questionable financial products being sold to unsuspecting investors. The SEC announced investigations into rating agency practices and securities disclosures. Legislators convened hearings to discuss potential conflicts of interest on the part of rating agencies, as well as predatory lending practices. Amidst this finger pointing and rush to judgment, it has become clear that "securitization" is under fire.

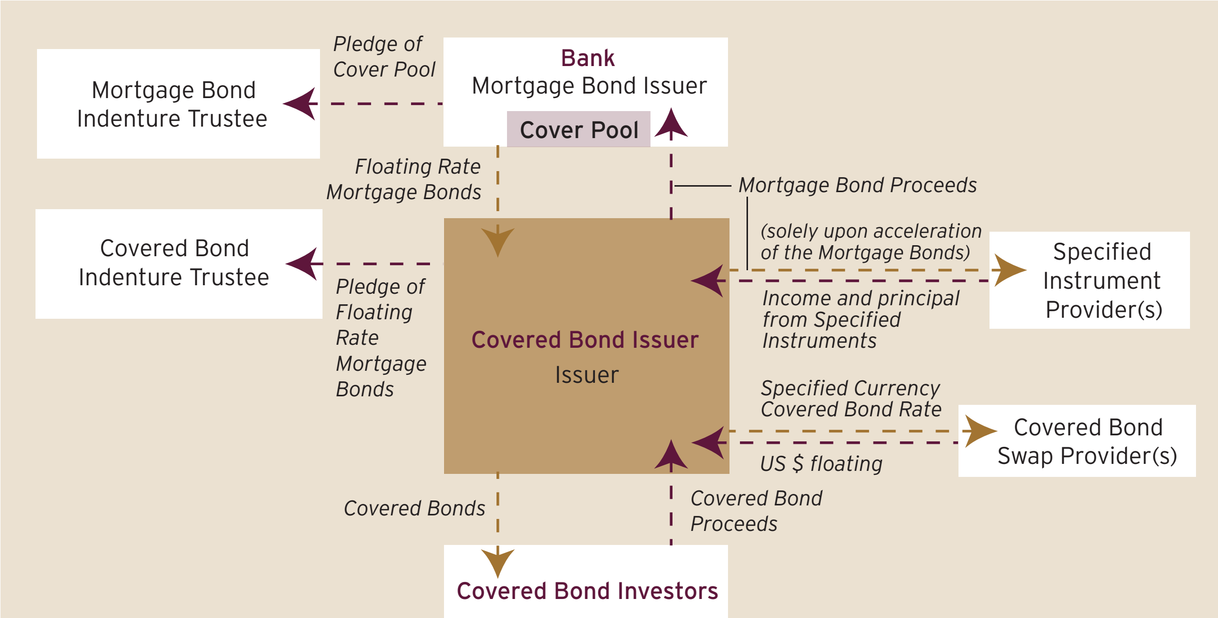
Does this sound all too familiar? We think so. Remember that in the 1990s, in the aftermath of Orange County, Procter & Gamble, the Barings blow up, and Long-Term Capital, "derivatives" became a dirty word. Following the Enron fall-out, derivatives weren't just a dirty word, they were, to quote Warren Buffett, "weapons of mass destruction." Any financial engineering that could be viewed as complex was immediately suspect. Regulators teamed up to provide guidance on "complex structured finance transactions" designed to achieve specific legal, tax, or accounting objectives. While the securitization finger pointing and head scratching proceeds apace, issuers still require liquidity, some more than ever, and financial intermediaries need to offer alternatives to securitization. It is in this context that covered bonds may be worth a close look.

Not a Securitization: Covered Bonds

Although the covered bond market was rattled by the subprime meltdown, it has recovered. Covered bonds have a number of benefits. Perhaps, first and foremost, a covered bond transaction is not a "securitization." That these transactions don't involve securitizing assets is important in this 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 (the cover pool) separate from the issuer's other assets. Typically, covered bond holders have a privileged or preferential claim (embodied in statute) against the cover pool in the event of the issuer's insolvency. 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. From the issuer's perspective, covered bonds remain on the balance sheet, whereas securitized assets are moved off balance sheet. The cover pool usually consists of high quality assets, including residential-mortgage backed securities, public debt or ship loans. The assets in a securitization may include a variety of assets of differing quality.

Covered bonds have a long and stable history, having been used in Europe since the 18th century. In many European jurisdictions, there is specific legislation that prescribes a framework for their issuance. Although the statutory regime in each 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 first in priority upon an issuer's bankruptcy. Legislation provides certainty regarding the treatment of covered bonds, especially in an insolvency scenario.

The covered bond market has grown rapidly in recent years, as many more European jurisdictions have passed their own version of 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 U.S. and the U.K. that lack covered bonds legislation may find themselves at a competitive disadvantage in accessing the covered bond 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 U.K., specific legislation is close to adoption. Nonetheless, U.K. depositary institutions began to implement securitization techniques in order to synthetically create covered bond-like structures. In the U.S., depositary institutions have started accessing this market using structures that also rely on securitization principles. These structures attempt to replicate through contractual relationships the features associated with European covered bond legislation. By and large the U.K. "structured" covered bonds have been popular with investors and the first initiatives by U.S. issuers Washington Mutual and Bank of America have proven successful. These recent issuances by U.K. entities, which were sold to U.S. investors, as well as the issuances by U.S. entities offshore and in the U.S. pursuant to securities law exemptions, have proven there also is a market in the U.S. Nonetheless, some disadvantages remain in the U.K. and the U.S. given the lack of covered bond legislation.



Source: Fitch

The U.S. Market

A basic requirement for covered bonds is a statutory or a contractual framework that ring fences the cover pool from unsecured creditor claims and directs payment to covered bond holders. In Europe, protection of the cover pool assets from unsecured creditor claims is achieved by statute-through an exception to bankruptcy legislation. In the U.S., there is no legislative framework 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. The FDIC has not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario. There is concern that upon a default by the sponsor bank in receivership, the FDIC would seek to avoid covered bond transaction documents. A recent amendment to the bank insolvency laws created further confusion. The amendment requires an automatic stay for as long as 90 days of

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Eat Here

* Delectable dining abounds in O-Town

At the mention of the word "Orlando," what is the first thing that comes to mind? Walt Disney? SeaWorld? Cape Canaveral? In a city best known for its tourist attractions and theme parks, it's not surprising that people's thoughts jump first to "Mickey Mouse" and not necessarily to "fabulous dining." Be careful, however, not to underestimate the Orlando dining scene. As a magnet city for theme-park-hungry families, die-hard golfers, and tons of convention and conference attendees, Orlando keeps its visitors fed and fed well. Several of the area's restaurants are operated by some of the most talked about chefs in the country, including Emeril Lagasse, Todd English and Roy Yamaguchi. And the many extravagant and impressive resorts of Orlando have continuously topped the charts when it comes to offering their guests exquisite dining venues.

Conference host **Grande Lakes Orlando** dishes up a mass of culinary experiences as varied and vast as the property itself. At **Norman's** (407-393-4333), richly hued rose and tan walls, set off by sleek marble floors, make for an inspired eating experience. Chef Norman Van Aken's exceptional cuisine is a fusion of Latin and Caribbean recipes with traditional European technique best experienced through the signature four-course tasting menu with wine pairings. **Primo** (407-393-4444) is contemporary Italian fare at its finest. Chef Melissa Kelly places emphasis on the freshest of local ingredients to create dazzling and imaginative recipes. The menu is alive with handmade pastas, fresh seafood options, and organic produce. For a perfectly grilled steak complemented by a glass of fine American wine, look no further than **The Vineyard Grill** (407-393-4154). Or pay a visit to American brasserie, **Citron** (407-393-4622) to nosh on colorful and fashionable food fare including a new twist on egg salad complete with egg brioche and applewood smoked bacon, chicken pot pie, or steak frites. Find a light bite and inspirational sunset or take afternoon tea at the **Lobby Lounge**. With live evening entertainment Tuesday through Saturday, the Lounge is also the perfect spot to meet for a cocktail and take in the breath-taking garden, lake, and golf course views.

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At the beginning of 2007, AOL CityGuide Orlando ranked the city's top resort dining, and **Emeril's Tchoup Chop** (Universal Orlando's Royal Pacific Resort, 6300 Hollywood Way; 407-503-2467) garnered the top spot. Its tiki bar décor, complete with bamboo, waterfalls and sculpted gardens serves as the perfect backdrop for the bold Polynesian and Asian-inspired cuisine. Excite your palate with menu options including mussels in a thai chili lemongrass broth, Peking style duck with cashew rice, and a curry clay fish pot. Then soothe it with a creamy coconut crème brûlée for dessert. Coming in second, the **Yachtsman's Steakhouse**

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any attempt to foreclose on a failed bank's property or to affect its rights under contract.

To date, two U.S. issuers, Washington Mutual and Bank of America, have established covered bond programs. Both use a similar structure (see graph, page 4).

The U.S. structure is two-tiered-with a special purpose entity that is not a bank serving as the covered bond issuer. The covered bond issuer offers euro-denominated fixed-rate covered bonds to investors. The covered bond issuer uses those offering proceeds, which are converted into U.S. dollars, 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 specified 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.

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 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 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 can't 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 by the covered bond indenture trustee, and proceeds from these guaranteed investment contracts 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.

Conclusion

Covered bonds are hardly a substitute for off-balance-sheet financing. Yet, during this time of uncertainty and market unrest, covered bonds are likely to get a close look from a fair number of potential U.S. issuers. ●