Covered bonds are debt instruments that have recourse either to the issuing entity or to an affiliated group to which the entity belongs, or both, and upon an issuer’s default, also have recourse to a pool of collateral (the cover pool) that is separate from the issuer’s other assets. Covered bonds are an established capital raising and investment vehicle in Europe, where they have been used since the 18th century.

Issuers and investors have found that covered bonds have significant benefits. Covered bond holders have dual recourse with a claim against the issuer, and also a privileged or preferential claim (embodied in statute, in Europe, at least) against the cover pool upon the issuer’s insolvency. Covered bonds are secured by high quality, low risk assets. Covered bonds are issued by depositary institutions that are regulated entities subject to supervision by domestic banking authorities, which ensures regulators would step in if a safety and soundness issue were to arise. By contrast, in a securitization, 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. From the issuer’s perspective, covered bonds remain on the issuer’s balance sheet, whereas securitized assets are off-balance sheet. The assets in a securitization may include a variety of assets of differing quality, but a cover pool references only high quality assets. Covered bond investors include central banks, pension funds, insurance companies, asset managers and bank treasuries that are attracted by covered bonds’ liquidity, ratings and covenants.

The challenge for U.S. issuers, bankers and their lawyers was clear. Unlike their European counterparts who can work within a specific statutory framework that governs the issuance of covered bonds, there is no such regulation or guidance in the U.S. Specifically, there is no framework that prescribes the priority of the claims of covered bond holders over a cover pool in a bankruptcy or that sets forth how holders may exercise their claims. The FDIC has not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario. In order for U.S. issuers to sell, and U.S. investors to buy, covered bonds, a structure had to be created using a series of contractual obligations that synthetically replicated a popular European covered bond structure (illustrated below) that ring fences assets. We worked with our client, a U.S.

Covered bonds are hardly a substitute for off-balance sheet financing; they do not involve securitizing assets. Yet during this time of uncertainty and securitization market unrest, our U.S. depositary institution clients are giving covered bonds a very close look.