

BONDS

## Expanding the US covered bonds market

BY CLAIRE SPENCER



The US covered bonds market may be in its early stages, but it is set to grow quickly. The US is loosely basing its market on the established European covered bonds market, but with a key difference: where European covered bondholders are protected by statute, US bondholders are protected by structure. This structure has been developed over the last year, and was designed to protect bondholders from issuer insolvency. This makes the covered bond structure far more suited to the current environment than mortgage backed securities. Regulators have updated the covered bonds market so that more may take advantage of it, but further developments and legislation may be required for a sustainable future.

The last few years have seen the US covered bonds market grow rapidly, and today there is an estimated \$2.75 trillion in outstanding notes. However, the market is still in its infancy, having only two depository institutions with covered bonds programs: Bank of America and Washington Mutual. Furthermore, only the former issues covered bonds in denominated US dollars. By comparison, Europe has a long history in covered bonds that can be traced as far back as 1769. Unfortunately, few of these highly experienced European covered bond issuers have offered tranches in US dollars to institutional investors.

In Europe, several jurisdictions have passed their own versions of covered bond legislation, each of which prescribes a framework for the issuance of covered bonds, notes Anna T.

Pinedo, a partner at Morrison & Foerster LLP. “Although the statutory regime in each European jurisdiction differs, all of the regimes incorporate certain core principles: the covered bonds must be secured by high quality assets, management of the cover pools must be supervised and covered bondholders are first in priority upon an issuer’s bankruptcy. Legislation in European jurisdictions provides certainty regarding the treatment of covered bonds, particularly in an insolvency scenario,” she explains. This statutory protection allows European depository institutions to easily use the covered bonds market to raise funds. However, if the covered bond fails to satisfy the terms of the legislation pertaining to special bankruptcy protection for covered bondholders, the banks holding the bonds are not entitled to preferential risk weighting by the European Central Bank (ECB). This is because these non-statutory bonds are classed as normal bank debt.

The US, on the other hand, assesses the covered bonds market on structure. Bank of America and Washington Mutual have both utilised a structure that is based on both securitisation principles and elements of European covered bond legislation. To use European terms, like UK covered bonds, US covered bonds are ‘structured covered bonds’, whereas most of their Continental European counterparts are ‘legislative covered bonds’.

### Structural developments

In the event of default, a US covered bond indi-

rectly recurses to a pool of collateral, known as a ‘cover pool’, which is kept separate from the issuer’s other assets. “Both of the depository institutions that issue covered bonds in the US utilise this structure, which evolved primarily to address uncertainty surrounding how a covered bond issued by a Federal Deposit Insurance Corporation (FDIC) insured bank would fare if the bank were to become insolvent and subject to FDIC conservatorship or receivership,” says Howard Goldwasser, a partner at Allen & Overy LLP. “That uncertainty was at the core of the structure, which entails issuing the covered bonds out of an SPV, the key assets of which are a bank issued bond secured by a bank managed, overcollateralised pool of residential mortgages, and a set of somewhat complicated swaps that are intended to mitigate losses and cashflow stoppages that might occur in an insolvency.” He adds that this structure is designed to ensure that if the originating bank were to default or become insolvent, the cover pool of mortgages could be liquidated. The resulting liquidation proceeds could then be invested by the SPV and available to pay interest and principal to investors on a scheduled – but not accelerated – basis. This is possible even though the cover pool does not directly secure the covered bonds that are held by investors.

Furthermore, it was important to guarantee that the potential acceleration of mortgage bonds would not affect holders of the covered bonds. Within the covered bond structure, it is not usual for covered bonds to accelerate unless both the issuer defaults and the collateral is unable to cover the cashflows. This is an unlikely outcome, as the ratio of covered bond to cover pool assets is tested for adequacy on a monthly basis. If the mortgage bonds default, proceeds from the cover pool are invested into guaranteed investment contracts by the covered bond indenture trustee. In turn, proceeds from these are paid to the swap provider, which return interest and principal on each series of covered bonds.

This is a highly complicated structure – too complicated according to many in the industry, not to mention costly. These detractors believe that structured covered bonds should comply with a global standard – for example, Canada based their covered bond structure on the UK’s with some success. It seems odd that the US’

should be so disparate, even at these early stages. However, many others believe that the structure is working well and that it has satisfactorily overcome the FDIC related issues from an investor and rating agency perspective.

This makes it suitable for investors seeking low risk yield bearing products with long maturities. These include central banks, pension funds, insurance companies, asset managers and bank treasuries that are attracted by covered bonds' liquidity, credit ratings and covenants. Evidently, covered bonds are more suited to the current climate than securitisation, explains Ms Pinedo. "In a securitisation, 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 cashflows. From the issuer's perspective, covered bonds remain on the issuer's balance sheet, whereas securitised assets are off-balance sheet. Covered bonds are issued by depository institutions that are regulated entities subject to supervision by domestic banking authorities, which ensures that regulators would step in if a safety and soundness issue were to arise," she notes. This makes covered bonds more transparent than securitisations – an attractive option for investors who are shying away from engineered and opaque financial structures.

**Legal and regulatory developments**

The changes in the market since the subprime crisis have inspired the FDIC and the Treasury Department to consider their options to expand and develop the US covered bonds market. While there are no legislative developments in the pipeline, the FDIC has been particularly active, and in April 2008 produced an interim covered bond statement to clarify how the covered bonds of a FDIC insured bank would fare if the bank became insolvent. Mr Goldwasser suggests that there may be more than one reason for this activity. "Problems in the US mortgage market

have nudged the regulators to look more closely – in a very positive way – at covered bonds. Since the mortgage pool that supports a covered bond remains on a bank's balance sheet, more covered bond issuances and fewer RMBS issuances, they have noted, would discourage some of the more casual mortgage underwriting practices facilitated by the originate to sell practices of some mortgage originators who relied heavily on securitisation to fund their mortgage origination businesses," he notes.

Banks can use covered bonds to quickly boost their dwindling liquidity levels without opening themselves up to greater risk and mortgage lenders can use them as a source of long term funding. Furthermore, encouraging the expansion of the covered bonds market may be better for the market as a whole. The model of 'originating and distributing' mortgages and mortgage securities exacerbated the credit crisis. Covered bond structures, on the other hand, require that mortgages or other assets remain on-balance sheet. Regulators believe that the covered bond structure will encourage lenders to maintain higher underwriting standards, and are keen to work on further developments. They have examined the market in Europe, where the covered bonds market has worked consistently well, and have recognised the recent resilience of the US covered bonds market compared to the mortgage backed securities market.

The FDIC's interim covered bond statement is a step in the right direction, but is quite limited in scope in its current form. "It defines covered bonds as recourse debt obligations of an insured depository institution with a term of greater than one year and not exceeding 10 years secured by directly or indirectly by perfected security interests in a pool of mortgage loans or, not exceeding 10 percent of the collateral, by AAA rated mortgage bonds," explains Ms Pinedo. "The policy statement only applies to covered bonds

made with the consent of the bank's primary federal regulator and which comprise no more than 4 percent of the bank's total liabilities. Furthermore, the policy statement limits its application to eligible mortgages, defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income," she says. She adds that the bank must remain in monetary default for 10 days before a covered bondholder can exercise their rights to collateral. The guidelines are new so it is too soon to tell how helpful they have been in this form, but the FDIC has invited comment for any amendments required.

Mr Goldwasser believes that a clear covered bonds market would be highly beneficial to the US. "Obviously, it would introduce greater liquidity and additional funding sources to US banks and other mortgage lenders at a time when both are needed. At the same time, it would help promote sounder fundamentals and greater transparency in mortgage underwriting practices and bank balance sheet management – just what the doctor ordered in the wake of the originate to sell practices that exacerbated the subprime mess," he says.

The US covered bonds market seems to be poised for significant growth, and the structures used by its two participating depository institutions are designed to protect bondholders from the shockwaves of issuer insolvency. These are positive steps for those who have worked hard to develop the covered bonds market to attract risk averse investors and bring liquidity back to the banks. However, sustainability may depend on achieving a global standard for covered bonds. This is unlikely unless the US implements a regulatory framework to bring it in line with the long established European market. Although this may be off the cards for now, the benefits of legislated covered bonds in a tight environment could be the catalyst for regulatory action. ■



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Anna T. Pinedo has concentrated her practice on securities and derivatives. She represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other structured products. Ms. Pinedo works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution

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