

NEWS

FINANCE: COVERING YOUR ASSETS

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US and UK financiers have hitherto made little use of covered bonds, but the strength of security they offer means they may help to restore liquidity to the stricken mortgage markets, as Jeremy Jennings-Mares and Peter Green explain

Covered bonds have been widely used in continental Europe for centuries, yet completely ignored in the UK and the US until a few years ago. British and American interest in them has recently heightened, with many seeing covered bonds as a possible means of breathing new life into the mortgage financing market.

Each of the continental European countries has its own particular covered bond structure, for instance, Pfandbriefe (the oldest type of covered bonds) in Germany and Cédulas in Spain.

The essential feature shared by all the variations is that an investor in such an instrument possesses not only a debt claim against the issuer, but also a security interest in a pool of 'cover assets' that places it in a priority position if the issuer becomes insolvent.

A typical secured bond creates a security interest that can be enforced over the insolvent company's assets in priority to most (but not all) other creditors.

However, a covered bond is structured so that the cover assets are segregated from other assets of the issuer and therefore do

not have to be administered or liquidated as part of the overall assets of the issuer in any insolvency proceedings. In fact, they are treated as separately available only to covered bondholders and other parties ancillary to the covered bond issuance.

In most jurisdictions, specific legislation is necessary to achieve the desired segregation of assets in an insolvency situation.

This has been enacted in most of the continental European jurisdictions that have a developed covered bond market. Other countries, such as the UK, the US and Canada, instead achieve this effect by the traditional structured finance technique of inserting a special purpose vehicle so as to separate the ownership of the covered assets from the issuer of the covered bonds — often referred to as 'structured covered bonds.'

Such preferential insolvency treatment, together with strict criteria laid down as to the quality and value of assets forming the cover pool, has allowed covered bonds to achieve high credit ratings. Covered bonds are now

seen as the highest grade of corporate 'on-balance sheet' bonds.

There are several asset classes that can typically form the cover pool, but the most common type of asset financed by covered bonds has historically been mortgage-backed loans. It is no surprise, therefore, that covered bonds are now regarded by regulators and politicians in the UK, the US and Canada as having the ability to fill a large part of the funding requirements of banks and building societies in the liquidity-constrained markets.



In the UK, the recent enactment of the Regulated Covered Bonds Regulations 2008 has opened the way for UK covered bonds to compete for investors' attention on an equal basis with continental European covered bonds. This has been achieved by complying with a key provision of the European Union (EU) Directive on Undertakings for Collective Investment in Transferable Securities (UCITS). Where covered bonds meet the criteria set out in article 22(4), European investment funds, for example, are allowed to invest a greater proportion of their assets in such covered bonds issued by a single issuer. Such compliance also allows EU banks that invest in these bonds to assign them with a lower risk weighting when determining their capital adequacy requirements.

Structured covered bonds issued by UK issuers since 2003 satisfied three of the four UCITS 22(4) criteria, namely: the issuer has its registered office in a European Economic Area member state, the cover assets are capable of covering all obligations under the covered bonds and the bond holders have priority claims over the cover assets. However, the one missing criterion was that UK covered bonds were not previously "subject by law to special public supervision designed to protect bondholders". Now, UK covered bond programmes and issuers may become registered under the 2008 regulations, whereupon the Financial Services Authority is given extensive supervisory and enforcement powers in respect of these regulated covered bonds, including the ability to require a cover pool to be topped up and, if necessary, to remove an issuer from the register.

One of the driving forces behind the UK's recent covered bond legislation has been the Government's desire to find ways of allowing UK mortgage lenders to obtain long-term fixed rate funding, so that they, in turn, could offer homeowners long-term fixed rate mortgages. However, events of the last year have led to the almost complete paralysis of the mortgage-backed structured finance market, at least for the origination of new mortgage loans. Hence the reason that covered bonds — which are 'on-balance sheet' as regards the issuer group and backed by high-quality assets — seem set to play an even greater role in the current economic environment than originally envisaged.

Participants in the US are similarly enthusiastic about the prospects of covered bonds, although for slightly different reasons. Like the UK (until the 2008 regulations), the US covered bonds issued to date have not had the benefit of any specific covered bonds legislation. Instead they have used traditional structured finance techniques to separate ownership of the cover

assets from the issuer and to give covered bondholders a priority security interest over the assets.

Only two US issuers have so far issued covered bonds, although this looks certain to change in the near future. The major obstacle so far in the US has not been compliance with UCITS 22(4), since this does not apply to US issuers, but instead the uncertainty as to how covered bonds would be treated in an insolvency of a bank issuer. The most important unanswered question was whether the Federal Deposit Insurance Corporation (FDIC) in the US would impose an automatic stay of enforcement on proceedings by covered bondholders in the case of the issuer's insolvency, as it is able to do in the case of other creditors of an insolvent bank.

After considerable political and market pressure, the FDIC has clarified the preferential insolvency treatment of covered bondholders (at least for covered bonds up to a certain percentage of the bank's total liabilities, which are backed by a certain type and quality of mortgage loan). The US Treasury is now promoting the increased use of covered bonds by US institutions. In particular, it has issued a statement of Covered Bond Best Practices, with the aim that the practices of US-covered bond participants will maintain the perception of covered bonds as a high-quality product, backed by high-quality assets.

One of the most attractive features of covered bonds to US regulators is the fact that they are an 'on-balance sheet' way of funding new mortgage loan originations. Some criticism of certain US mortgage loan originators in recent years has stemmed from a perceived relaxation of their loan origination standards, where the loans were being originated to be distributed in the structured finance markets, rather than to be held by the originator. This explains why US regulators and politicians are particularly keen on funding methods wherein the originator retains exposure to the underlying loans. Probably with justification, they feel that the loan origination procedures are likely to be more robust.

In the UK and the US there remain limits on the proportion of a bank's assets that can be used in a covered bond asset pool and also minimum quality criteria that must be satisfied. Given these limitations, and given that a certain level of off-balance sheet funding will always be desirable for banks, covered bonds are never going to be a total replacement for securitisation. However, they do represent a useful additional tool for mortgage lenders, especially in this credit-crunch era.

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