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# COVERED BONDS IN THE US

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In this tight credit market, US banks looking for new sources of funding for their loan originations may find covered bonds a viable alternative. If proposed legislation is adopted, the statutory structure for US covered bonds would be similar to that in Europe, possibly facilitating a surge in the US covered bond market. This article examines covered bonds, including transaction structures, advantages and disadvantages of offering covered bonds, and regulatory issues.



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Covered bonds are well-established in Europe as a means of facilitating mortgage financing (see *Box, What Are Covered Bonds?*). In the US, until recently, alternative sources of mortgage funding have existed, including funding from government-sponsored entities (GSEs) like Fannie Mae and Freddie Mac, access to the Federal Home Loan Banks (FHLBs) and a thriving securitization market. These sources have limited the need for covered bonds in the US.

Recently, however, the credit crisis has caused many to question the US loan origination model. The GSEs are experiencing liquidity concerns, and costs associated with the use of FHLB funding make it an expensive alternative. Further, the securitization market has been slow to recover from the financial crisis and remains sluggish. As a result, banks must find new sources of funding for their loan originations. Covered bonds may provide them with a viable funding alternative.



## WHAT ARE...?

### 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 to both. If a covered bond is issued by a special purpose vehicle (SPV), as is the case in the US, the bondholder has recourse to both the SPV and the SPV's parent (usually a bank). If an event of default occurs, covered bondholders also have access to a pool of collateral called the cover pool (see below *The Cover Pool*) that secures the issuer's obligations to the covered bondholders. The cover pool, usually a pool of mortgage loans, remains on the parent bank's balance sheet regardless of whether an SPV is used to issue the bonds, but it is segregated from the parent bank's other assets.

This article examines:

- Transaction structures of both European and US covered bonds.
- Advantages and disadvantages of covered bonds.
- US regulatory developments, including guidance from the FDIC and Treasury Department and recent proposed legislation.

## COVERED BONDS IN EUROPE

In Europe most jurisdictions have adopted legislation that provides a statutory priority for covered bondholders to the cover pool upon the occurrence of an event of default under the covered bond indenture. As a result, European banks in countries with covered bond legislation issue covered bonds directly. No SPV is used. These transactions (frequently referred to as “legislative” covered bonds) are structured so that the institution originating the mortgage loans (or other assets) that comprise the cover pool is also the issuer of the covered bonds. For a diagram

showing this direct-issuance structure, see *Box, European (or Legislative) Covered Bonds*.

Because similar legislation does not exist in the US, holders of US covered bonds have no statutory priority claim to the cover pool upon the occurrence of an event of default under the covered bond indenture, as they do in Europe. To compensate for the absence of US legislation, issuers in the US have relied on contractually created structural arrangements to ring-fence the cover pool from unsecured creditor claims. This increases the likelihood of payment to covered bondholders upon the occurrence of an event of default under the covered bonds. These covered bonds are often referred to as “structured” covered bonds.

## STRUCTURE OF US COVERED BONDS

### OVERVIEW OF THE TWO-TIERED STRUCTURE

Unlike in European jurisdictions with covered bond legislation, at present the US covered bond structure is two-tiered (see *Box, US Covered Bonds*), with an SPV typically acting as the covered bond issuer. The two-tiered structure attempts to replicate the features of legislative covered bonds — most importantly, the ring-fencing of the cover pool to ensure priority to the collateral for the covered bondholders. This structure also facilitates perfection under the Uniform Commercial Code

of the investors' security interests in the loans comprising the cover pool, a step that is obviated in much of Europe by covered bond legislation.

In the current two-tier structure, the SPV issuer sells covered bonds, which are fixed-rate debt securities (that is, they provide investors with a fixed rate of return), to investors and then uses the proceeds to purchase either fixed or floating rate (that is, return is based on a floating rate such as LIBOR) mortgage bonds from its affiliated bank, which acts as the mortgage bond issuer. (In these transactions, there is a separate mortgage bond indenture and covered bond indenture.)

The bank-issued mortgage bonds, which are direct and unconditional obligations of the bank, serve as direct collateral for the covered bonds. The cover pool — a specific, segregated (ring-fenced) pool of mortgage loans on the bank's balance sheet (see below *The Cover Pool*) — secures the mortgage bonds, which back the covered bonds. The mortgage bonds are pledged to the mortgage bond indenture trustee, for the benefit of the covered bondholders. As a result, the cover pool ultimately, but indirectly, backs the covered bonds.

### THE COVER POOL

The cover pool usually consists of high quality assets, including residential mortgage loans, and in certain instances for issuances outside of the US, public debt or ship loans, though other assets can be used as well. As is typical in a securitization, these underlying assets are subject to various eligibility criteria. These criteria are specified either by legislation (in those jurisdictions that have covered bond legislation) or by contract (in those jurisdictions that do not have covered bond legislation). Cover pool assets must be replaced should they fail to meet these specified criteria.

In addition, throughout the term of the covered bonds, the issuer must ensure that the cover pool meets certain asset-coverage requirements, which may require the issuer to add assets to the cover pool. The bank conducts a monthly asset-coverage test to

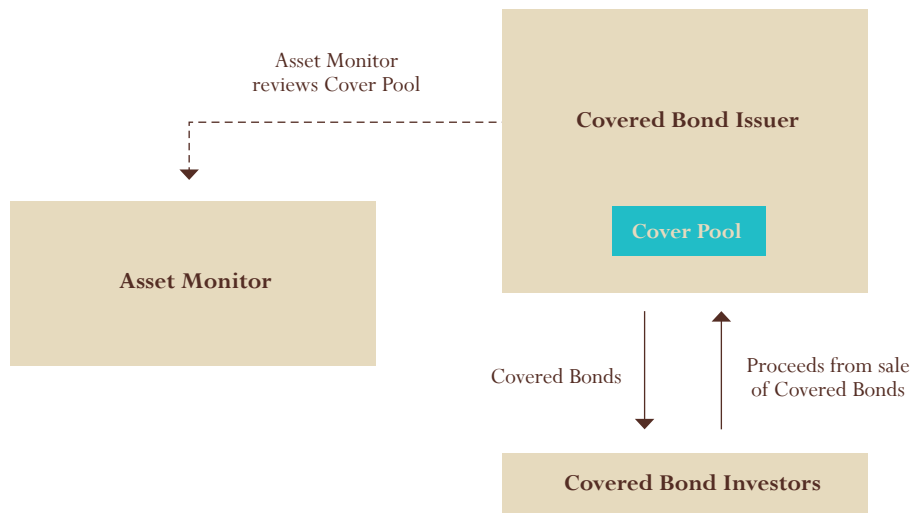
### Did you know?

Covered bonds have been used to raise capital in Europe since 1769, when the first covered bond was issued in Prussia to finance agricultural projects.

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## EUROPEAN (OR LEGISLATIVE) COVERED BONDS



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ensure that the ratio of the value of the covered bonds to that of the cover pool assets does not exceed the threshold set by the rating agencies. Further, covered bonds are structured on a strict bullet-repayment basis so that covered bondholders are not exposed to prepayment risk. If the loans in the cover pool prepay, the cover pool must be replenished to ensure the maturity profile of the pool assets matches the maturity profile of the covered bonds.

The cover pool is a dynamic pool of revolving mortgage loans, making removal and replacement of loans simple. In contrast, almost all securitizations rely on grantor trusts, which are real estate mortgage investment conduits (REMICs). A grantor trust is not empowered with the authority to exercise discretion, and a REMIC is structured as a fixed pool. As a result, there is little opportunity to vary the loans in a securitization trust. (The fixed nature of grantor trusts/REMICs has made mortgage modifications of securitized mortgages almost impossible.) However, a cover pool is a revolving pool. Month-to-month or day-to-day, the composition of the loan pool may change, with no tax or other regulatory implications.

Typically, covered bonds are overcollateralized (that is, the collateral has a market value in excess of the face amount of the covered bonds that it backs). This helps to preserve the value of the covered bondholders' claims upon the occurrence of an event of default under the covered bond indenture (and helps to obtain the desired rating for the covered bonds from the rating agencies). In European jurisdictions with covered bond legislation, the statute in each jurisdiction may specify a minimum, or base, overcollateralization level.

In a securitization, certain (senior) bondholder interests are protected through tranching of the securities offered, which creates a priority of interests and therefore a certain level of overcollateralization for the senior tranches. Covered bonds, by contrast, are not typically issued in tranches.

### PREPAYMENT AND ACCELERATION

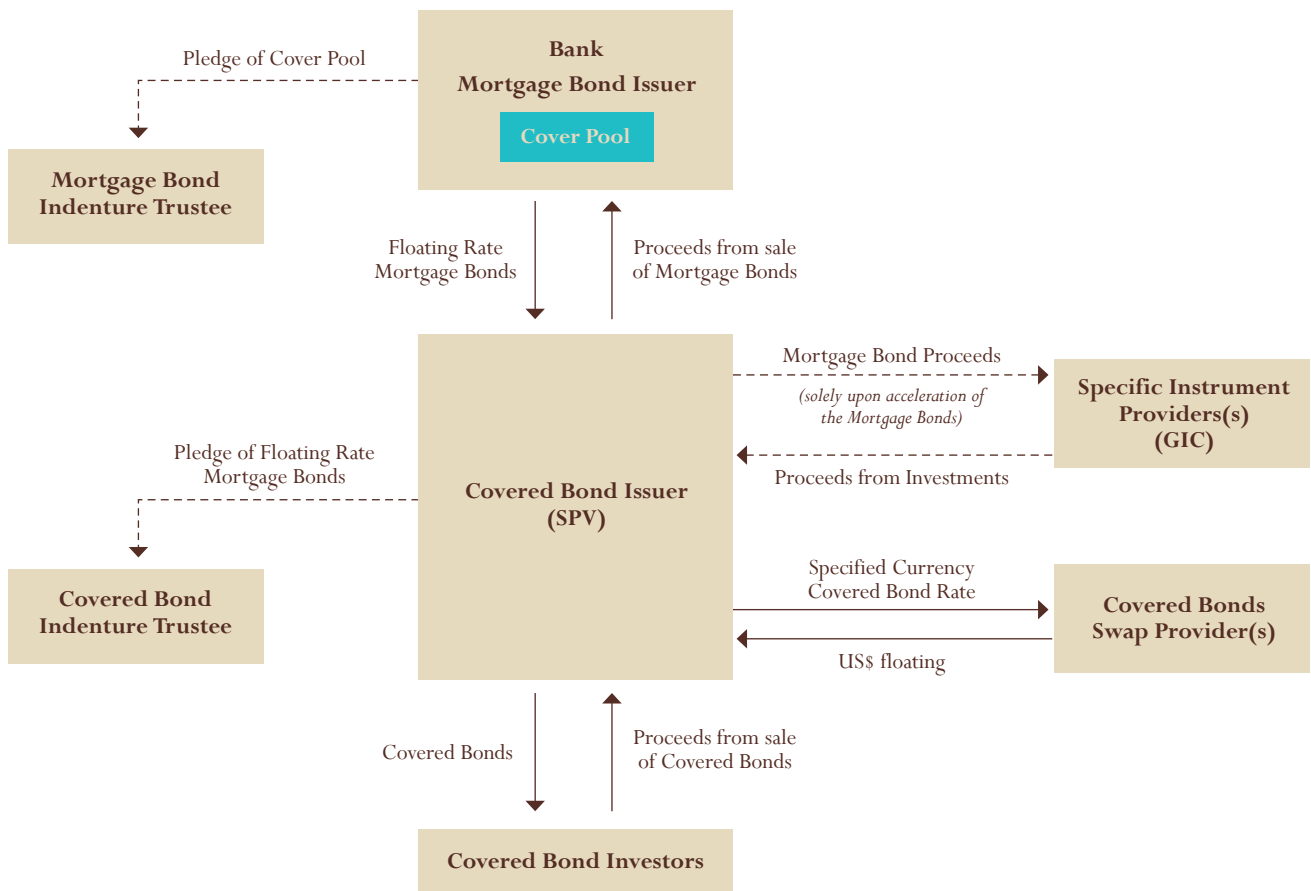
Under the current two-tiered US structure, it is important to take steps to prevent an acceleration of the underlying mortgage bonds from affecting the covered bondholders. Covered bonds do not typically accelerate unless both an event of default under the applicable indenture occurs, and

the collateral is insufficient to cover the principal and interest payments due and owing on the covered bonds. Most mortgage bonds, however, can be accelerated under certain circumstances.

To protect against these risks, at issuance, the issuer also enters into a guaranteed investment contract (GIC) or similar agreement. So, if an event of a default occurs under the mortgage bonds (often the precursor to acceleration), the covered bond indenture trustee, on behalf of the covered bondholders, deposits all payments from the loans in the cover pool and related proceeds with the GIC provider (or similar party) for investment with, or by, financially sound counterparties. This maximizes the likelihood that uninterrupted payments are made on the covered bonds through maturity despite the underlying mortgage bond default.

If an event of default under the covered bonds occurs, the mortgage bond indenture trustee (usually the same entity as the covered bond trustee) liquidates the cover pool. The liquidation proceeds are then invested under the GIC and the proceeds of the investment are used to make all payments due on the covered bonds through maturity.

## US COVERED BONDS



## ADVANTAGES AND DISADVANTAGES OF COVERED BONDS

### DUAL-RECOURSE OBLIGATION

In a securitization, an investor only has recourse to the SPV that issues the securities and to that SPV's assets, which include the underlying asset pool and the cash flows it generates, but not to the SPV's sponsor, often a large financial institution. In contrast, covered bonds are dual-recourse obligations, with recourse to the issuer-affiliated bank (assuming the bonds are issued by an SPV), as well as to the SPV issuer, and, upon the occurrence of an event of default under the applicable indenture, recourse to the cover pool.

### ON BALANCE SHEET

Covered bonds remain on the bank's balance sheet, whether or not an SPV is used as the issuer. This aligns the interests of the mortgage originator (the issuer in non-SPV issuance or the parent of the issuer where an SPV is used) more closely with those of the covered bondholders. This encourages responsibility in the mortgage origination practices used to originate the mortgage loans in the cover pool, which ensures a higher quality cover pool.

In a securitization, the underlying collateral pool is typically "sold" to an SPV subsidiary issuer and held off of the balance sheet of the affiliated bank. Some market participants and industry professionals have commented that the absence of common

interests among originators, issuers and investors facilitated questionable mortgage lending practices that contributed to the recent financial crisis.

### HIGH QUALITY ASSETS

The cover pool in a covered bond offering consists of high quality assets. In a securitization, assets of varying quality could comprise the securitized asset pool.

### NO PREPAYMENT

Covered bondholders are not subject to prepayment risk, which can reduce expected returns on mortgage-related bonds. Bonds issued in a securitization, though structured to be repaid at a future point in time, may be repaid early if principal repayments are received on the underlying mortgage

portfolio (for example, as a result of mortgage prepayments or refinancing) and “passed through” to the bondholders.

### FUNDING ALTERNATIVE

Covered bonds provide a means of funding mortgage originations and provide investors with a security that is eligible collateral that may be used to secure advances from the Federal Reserve. Even if the securitization market were to re-emerge, covered bonds could provide an important funding alternative.

## US REGULATORY DEVELOPMENTS

Both the Federal Deposit Insurance Corporation (FDIC) and US Treasury Department have issued guidance intended to promote covered bond issuances in the US — an important step toward the development of a healthy US covered bond market.

### FDIC POLICY STATEMENT

On July 15, 2008, the FDIC issued its Final Policy Statement on covered bonds. The FDIC intended for the Final Policy Statement to clarify for investors how the FDIC would respond if it were appointed conservator or receiver of a depository institution that had issued covered bonds, either itself or through an affiliate SPV. The Final Policy Statement “define[s] the circumstances and the specific covered bonds transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral”.

### The FDIC’s Role in a Bank Failure

One of the primary concerns of covered bond investors, especially in today’s financial climate, is the insolvency or failure of the bank involved in the covered bond issuance. In a securitization, assets are “sold” to the issuing SPV, which is designed to stand alone and to withstand an insolvency of its parent bank. Covered bonds lack this structural independence and are, by design, inextricably linked to the affiliated bank.

Generally, in the event of the failure of a US depository institution, the FDIC is appointed as the receiver or conservator of the bank. In such a scenario, it is not clear how the

FDIC would treat the covered bond program of a failed bank. Under federal law, the FDIC may take several actions with respect to covered bonds, including:

- Assumption of the obligations on the covered bonds, and transfer of the cover pool and the covered bond obligations to an assuming bank.
- Repudiation of the obligations on the covered bonds and payment to the bondholders of “actual, direct compensatory damages” determined as of the date of its appointment as conservator or receiver.
- No action, which would result in a payment default on the covered bonds and foreclosure on, and liquidation of, the mortgage loans in the cover pool by the mortgage bond indenture trustee.

Investors and the market had been concerned that the FDIC would seek to repudiate the covered bond transaction documents of a failed bank of which it has been appointed receiver or conservator. However, the Final Policy Statement provides clarity on several matters relating to covered bonds in the US, including this issue.

### Expedited FDIC Consent

The Final Policy Statement confirms that the FDIC, when acting as conservator or receiver of a bank that has been involved in a covered bond issuance, will consent to a covered bondholder’s exercise of its rights to the cover pool if either:

- The bank is, and remains, in default with respect to any payment due on a covered bond that it or an affiliate has issued for at least ten business days after a covered bondholder delivers a written request to the FDIC to exercise its rights to the collateral under the terms of the securities; or
- The FDIC, as conservator or receiver of the bank that has been involved in the issuance of a covered bond, provides written notice to the covered bond obligee of repudiation of a contract related to the covered bond issuance and does not pay damages as a result of this repudiation within ten days after the effective date of the notice.

The Final Policy Statement eased covered bond investor concerns about how long it would take to access collateral if a bank that has been involved in a covered bond issuance enters into FDIC receivership. The Final Policy Statement makes it clear that covered bonds would not be subject to the 90-day automatic stay provisions of the Federal Deposit Insurance Act.

### Actual Compensatory Damages

The Final Policy Statement also provides needed guidance from the FDIC on the actual compensatory damages the FDIC will pay when acting as conservator or receiver of a bank involved in a covered bond issuance. In its Policy Statement, the FDIC outlines its three options:

- Continue to perform on the covered bonds;
- Pay off the covered bonds in cash up to the value of the cover pool (it is not clear, but is assumed that the FDIC would then take possession of the loans in the cover pool); or
- Allow liquidation of the cover pool to pay off the covered bonds.

Under the first scenario, payments on the covered bonds would be made as scheduled. In the other two instances, the FDIC would pay covered bondholders the outstanding principal amount plus accrued and unpaid interest on the covered bonds, up to the value of the cover pool on the date of the FDIC’s appointment as conservator or receiver. If there is excess collateral remaining in the cover pool after these payments are made, the FDIC would retain the surplus. If the collateral is insufficient, the FDIC would limit the amount of secured claims up to the value of the cover pool (it is not clear, but is assumed, that, in this case, all of the covered bondholders would take a pro rata haircut).

### Collateral Limitations

The Final Policy Statement places strict limits on the collateral eligible for inclusion in the cover pool. Only “eligible mortgages” (defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate

## COVERED BONDS VERSUS SECURITIZATIONS

The chart below summarizes the principal differences between covered bonds and securitizations.

	Covered Bonds	Securitizations
<b>Accounting</b>	On balance sheet.	Off balance sheet.
<b>Recourse/ Exposure</b>	<p>Direct or, in the case of a two-tier structure, indirect recourse to the originator of the cover pool assets. Issuer is typically originating bank.</p> <p>Upon originator default, cover pool used to repay bonds.</p> <p>Issuer not limited by business or financial covenants.</p> <p>No prepayment risk (covered bonds have a fixed time to maturity).</p> <p>Exposure to parent company management risks.</p>	<p>Recourse only to the assets of the issuer.</p> <p>Issuer is bankruptcy-remote securitization trust special purpose vehicle (SPV).</p> <p>Cash flows from issuer assets repay the bonds.</p> <p>Prepayment risk (for example, if mortgage loans are prepaid early, then the time to maturity will be shorter).</p> <p>Credit risk.</p> <p>Servicer risk (servicer must perform its duties under the pooling and servicing agreement).</p>
<b>Liquidity</b>	High degree of homogeneity, liquidity.	Heterogeneous structures, lower liquidity.
<b>Ratings</b>	Greater linking of bond ratings to parent company creditworthiness.	No linking of bond ratings to parent company creditworthiness.
<b>Assets</b>	<p>Open-ended vehicle whose collateral pool evolves over time with strict collateral qualifying criteria.</p> <p>Overcollateralization required.</p>	Generally closed-ended pools, structured, for US tax purposes, as a grantor trust that qualifies as a REMIC, with strict collateral qualifying criteria (collateral pool is typically "static").
<b>Investors</b>	<p>Large number of eligible investors.</p> <p>Non-securitization investors (liquidity investors).</p> <p>Limited overlay with senior unsecured bond investors.</p>	Large investor base that typically invests in asset backed securities.

>> For a review of current market practices, search [Trends in Securitization](#) on our website.

based on documented income) may be used. The FDIC permits cash, US Treasury and agency securities (backed by Fannie Mae, Freddie Mac or Ginnie Mae) to be substituted for the mortgages in the cover pool.

In the Final Policy Statement, the FDIC declined to expand the assets acceptable for inclusion in the cover pool, believing that many assets (including second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt and student loans) would be subject to substantial volatility while others would be unsuitable for covered bonds.

The implications of these collateral guidelines, however, are not yet clear. Because there have been no covered bond defaults

in the US, it is not clear if a failure of an issuer and its affiliate bank to adhere to these guidelines means that the FDIC, if appointed receiver of the bank, would not guarantee that it will honor the covered bond documents and program. This would appear to be the only way for the FDIC to promote adherence to the Policy Statement collateral guidelines.

### Direct Issuance

The FDIC also noted that nothing in the Final Policy Statement requires issuers to use an SPV to issue covered bonds. However, if an SPV is used, the FDIC will use its "well-defined standards to determine whether to treat such entities as separate from" the failed depository institution. The implications of this statement, though, are unclear.

### US TREASURY BEST PRACTICES

On July 28, 2008, the Treasury Department announced the publication of its Best Practices for US covered bonds. While they are not binding, the Treasury Department's Best Practices suggest a standard framework for US covered bond issuances. Best Practices are intended to work in conjunction with the FDIC's Final Policy Statement.

In addition to the requirements set out in the FDIC's Final Policy Statement, the Treasury Department's Best Practices recommend that:

- Mortgage loans in the cover pool have a maximum loan-to-value ratio (LTV) of 80% at the time of inclusion in the cover pool.
- No single Metro Statistical Area (a large population nucleus, identified

by the US Bureau of the Census and available on its website) should account for more than 20% of the cover pool.

- Negative amortization mortgages should not be included in the cover pool.
- All mortgages in the cover pool should be first-lien only.
- Covered bond issuers should maintain overcollateralization levels of at least 5% of the outstanding principal amount of the covered bonds at all times, counting only the 80% portion of the collateral backing each loan in the cover pool used in calculating the LTV ratios.

### Disclosure

The Treasury Department also recommends in its Best Practices that covered bond issuers:

- Make available to investors detailed information about the cover pool at the time of issuance (or when the investment decision is made) and on a monthly basis thereafter. If the issuer replaces more than 10% of the cover pool in a month or more than 20% in a quarter, the issuer should provide updated descriptions to the investors.
- Provide to investors the results of the monthly asset-coverage tests they perform.
- Disclose any other information that an investor might view as material to its investment decision.

The information that the Treasury Department suggests be included in a disclosure document is consistent with the information that would be disclosed for a registered asset-backed securities (ABS) offering to which the disclosure requirements of Regulation AB of the Securities Act of 1933, as amended (the Securities Act), would be applicable.

### Additional Treasury Department Recommendations

The Best Practices also clarify that covered bonds may be issued either as registered securities or under an exemption from the registration requirements of the Securities Act. It is anticipated that, if banks were to

use a direct-issuance structure (no SPV), covered bonds would be eligible for the exemption from registration provided by Section 3(a)(2) of the Securities Act for “bank securities”.

### PROPOSED LEGISLATION

As noted, there is no specific statutory framework in the US prescribing the priority of the claims of the covered bondholders to the cover pool upon the occurrence of an event of default under a US covered bond indenture. In addition, there is no framework setting out how US covered bondholders can exercise their claims to the collateral.

Proposed legislation that would promote the development of a robust covered bond market in the US has been introduced in the House of Representatives. A copy of the legislation is available at the US House of Representatives website ([house.gov](http://house.gov)).

As currently proposed, the legislation would:

- Separate the cover pool from the issuing bank in the event of the issuing bank’s failure.
- Designate the Treasury Department as the trustee, for the benefit of the covered bondholders, of the separated cover pool.
- Establish the authority of the separate cover pool to borrow on a secured basis from the Federal Financing Bank in order to obtain liquidity to continue to permit required payments on the covered bonds to be made, and avoid disposing of the cover pool.
- Permit a residual interest in the cover pool to be issued to the FDIC or other receiver, which would receive all excess value in the cover pool after payments are made in full on the covered bonds.
- Permit a broad array of assets to be considered eligible for a cover pool.

Eligible cover pool assets would include residential mortgage loans, home equity loans, commercial mortgage loans, student loans, auto loans, credit card receivables, municipal and state obligations and small business loans. An issuer of covered bonds might establish one or more covered bond

programs for different asset classes. Once created, an issuer would be required to designate the cover pool applicable to each of its covered bond programs.

The proposed legislation also clarifies that covered bonds offered and sold to the public by a bank or an operating subsidiary of a bank would be “exempt securities” under the Securities Act, and would not be subject to securities law registration requirements.

### READY TO EMERGE?

As of mid-November 2009, there were approximately EUR170 billion of covered bond issuances for the year. No covered bond has ever defaulted in the 200-year history of the European market. To date, however, only one US issuer has ever issued a covered bond denominated in US dollars, Bank of America in 2007. There has been only one other covered bond issuance in the US, issued in euros by Washington Mutual, now a part of JPMorgan Chase, in late 2006.

A strong US covered bond market would bolster liquidity and lower borrowing costs in the US housing market. If the legislation is adopted, it would result in a statutory structure for covered bonds issued by US depository institutions that would be similar to the framework that exists in Europe. A transition to a direct-issuance structure in the US would also be facilitated if proposed US covered bond legislation were to be adopted.

It remains a possibility that the negative public sentiment surrounding securitization could affect the perception of covered bonds. If so, legislators could view facilitating covered bond issuance as a low priority, which may leave covered bonds below the radar in the US for the foreseeable future. However, the public and legislators may recognize that covered bonds offer an alternative to securitization that could address some of its shortcomings, including the lack of transparency and mortgage-origination issues. If so, and if the proposed legislation is passed in 2010, the covered bond market may emerge as a viable alternative or supplement to securitization.

*Article photos by Tooga/Digital Vision/Getty Images.*