Lucrative knock-offs: Covered bonds in the US

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New York tourists strolling Fifth Avenue can have their pick of any number of almost genuine, authentic-looking Rolexes and Louis Vuitton bags. That these knock-offs are so popular says a great deal about consumerism in our society and also about the transcendent power of branding - luxury brands reaching Main Street, US. Buying on the cheap from a street corner vendor may provide immediate gratification or satisfy a need that might otherwise go unfulfilled. However, there also are some apparent drawbacks. Buying merchandise surreptitiously from a vendor lacks the glamour and exclusivity of a Madison Avenue shop. Then there's the ethical dilemma of supporting "fakes" that devalue intellectual property. And, finally, there are obvious limits to the verisimilitude of these knock-offs.

Many of the same observations can be made of the first generation of covered bonds in the United States. US covered bonds have many appealing features, but, of course, since we have no legislative structure for covered bonds in the US, they're not as good as the real thing. But, then again, if you can't have the real thing, a good copy may accomplish the same purpose - at least for a while. This article reviews the covered bond market, the development of synthetic covered bond structures and the unanswered questions relating to these structures.

THE COVERED BOND MARKET

Covered bonds are not the newest new thing, nor a feat of "financial engineering." In some format, covered bonds have been used in Europe, beginning with the Pfandbrief in Germany, since the 18th Century. 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. The cover pool usually consists of residential-mortgage backed securities, public debt or ship loans.

In many European jurisdictions, including France, Italy, Germany, Italy, Spain, Portugal, Sweden, Denmark, Norway and Finland, there is specific legislation prescribing a framework for the issuance of covered bonds. 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 bankruptcy event. Legislation provides certainty regarding the treatment of covered bonds, especially in an insolvency scenario.

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) against the cover pool in the event of 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 that regulators would step in if a safety and soundness issue were to arise.

By contrast, 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 cash flows. From the issuer's perspective, covered bonds remain on the issuer's balance sheet, whereas securitised assets are off-balance sheet. The assets in a securitisation may include a variety of assets of differing quality, but a cover pool references only high quality assets.

The covered bond market has grown rapidly in recent years, with an estimated US$1.7 trillion in outstanding notes. According to Dealogic, the annual rate of global issuance rose by 78% between 2001 and 2005. Many European jurisdictions have recently passed their own version of covered bond legislation, permitting European depositary institutions to tap this market in order to raise funds. Depositary institutions seeking to diversify their funding sources find that the covered bond market provides a relatively cheap (compared to securitisation) and ready funding alternative.

Covered bond investors include central banks, pension funds, insurance companies, asset managers and bank treasuries that are attracted by covered bonds' liquidity, credit ratings and covenants. Covered bonds appeal to investors seeking low risk yield-bearing products having long maturities. Almost all covered bonds are triple-A rated.

Depositary institutions in jurisdictions like the US and the UK that lack covered bonds legislation may find themselves at a competitive disadvantage in accessing the covered bonds market. In the UK, specific legislation is close to adoption. Nonetheless, UK depositary institutions began to implement securitisation techniques in order to synthetically create covered bond-like structures. In the US, depositary institutions have just started to access this market using synthetic structures that also rely on securitisation technology. These structures attempt to replicate through contractual relationships the features associated with European covered bond legislation. By and large the UK "structured" covered bonds have been popular with investors and the first initiatives by US issuers Washington Mutual and Bank of America have proven successful. These recent issuances by UK entities, which were sold to US investors, as well as the issuances by US entities offshore and in the US pursuant to securities law exemptions, have proven there also is a market in the US. Nonetheless, some disadvantages remain in the UK and the US given the lack of legislation in these jurisdictions.

EUROPEAN CENTRAL BANK TREATMENT AND RISK WEIGHTING

The European Central Bank, or ECB, classifies securities for repo purposes. Banks, which comprise a significant portion of the covered bond investor base, tend to hold covered bonds as collateral for their repo activities. For these purposes, the ECB follows the covered bond definition used in the EU's Undertakings for Collective Investment and Transferable Securities (or UCITS) directive for collective investment vehicles. In order to have an EU recognised "covered bond" regime, a country must implement the requirements of Article 22(4) of the UCITS Directive, which essentially includes covered bonds issued under statutes imposing special bankruptcy protection for covered bond holders. For repo purposes, covered bonds are discounted at 1%-7.5%, depending on maturity; bank debt is discounted at 1.5%-9%; and securitisations are discounted at 2%-12%. UK covered bonds, which are not issued pursuant to statute, are classified as bank debt by the ECB. Similarly, the WaMu covered bonds are classified as bank debt.

For bank regulatory risk weighting purposes, covered bonds will achieve a lower risk weighting only to the extent that the covered bonds are issued pursuant to statute. Covered bonds meeting the UCITS Article 22(4) criteria benefit from a 10% risk weighting, which is half of the capital charge allocated to unsecured debt from the same issuing financial entity or group. By contrast, covered bonds that are not legally based are subject to a 20% risk weighting.

THE US MARKET

One of the basic requirements 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, the protection of the cover pool assets from unsecured creditor claims is achieved by statute - through an exception to bankruptcy legislation. In the US, there is no legislative framework that prescribes the priority of the claims of the covered bond holders over the cover pool in a bankruptcy or sets 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 the context of a 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 any attempt to foreclose on a failed bank's property or to affect its rights under contract.

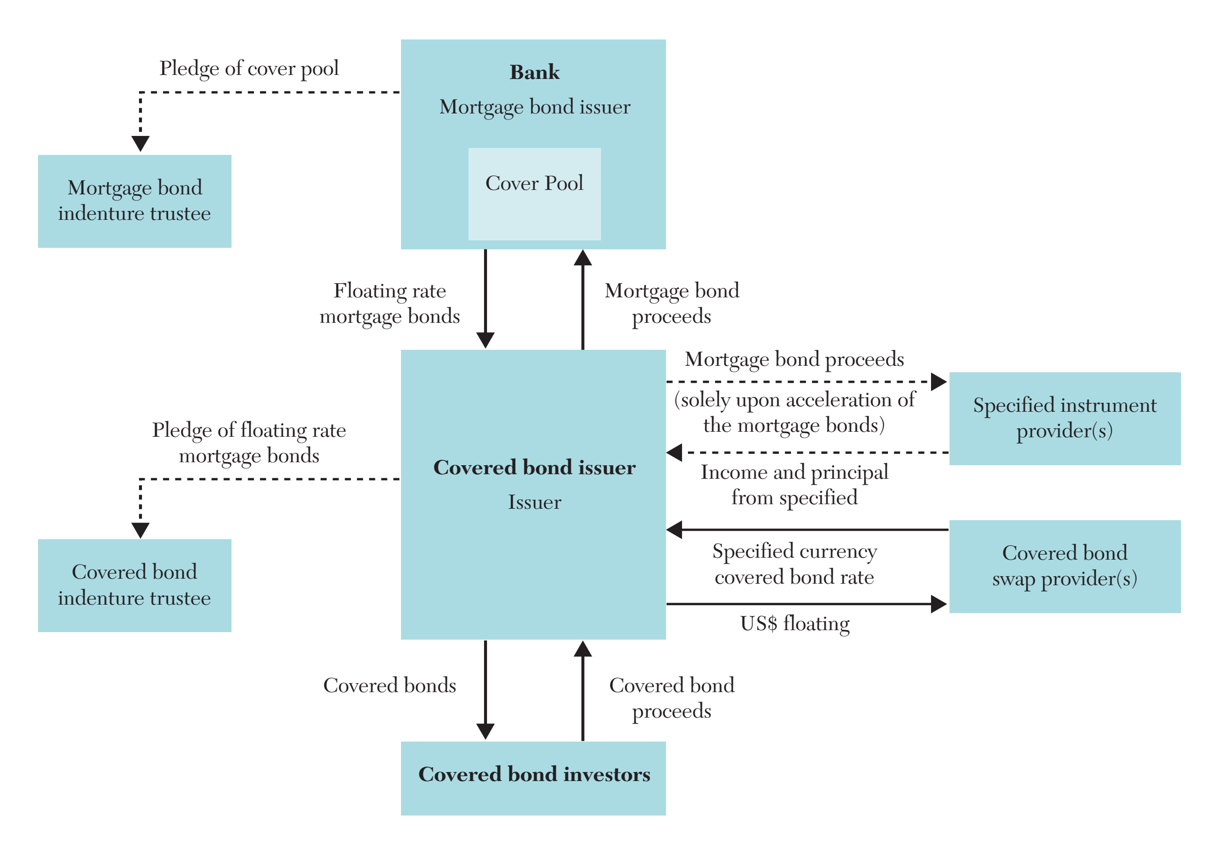
To date, two US issuers, Washington Mutual and Bank of America, have established covered bond programmes. Both programmes use a similar structure derived largely from securitisation techniques, as well as from the UK structured covered bond experience. The structure is illustrated in Figure 1.

The US 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 US 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

Figure 1: US covered bond structure



Source: Morrison & Foerster

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 is unable to 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.

In evaluating the US covered bond issuances, ratings agencies have noted that they consider the following factors:

- the effective segregation of the cover assets from the claims of other creditors of the issuer;
- the immunity of excess overcollateralisation against the claims of other creditors of the issuer;
- bankruptcy-remoteness of the collateral posted by privileged swap counterparties;
- provisions against the risk that the pool's cash flows could be commingled with other revenues of the insolvent issuer and might not reach the covered bond investors; and
- protection against borrowers' attempts to set off their debt against any receivable they have against the issuer.

CONCLUSION

There is no reason for euphemisms. The issuance of covered bonds by US issuers and the sale by UK issuers of covered bonds to US investors are the result of knocking off, and restructuring, already well accepted European covered bonds. This has opened up potentially deep new markets for covered bonds. In light of growing investor concern about other asset classes (notably, sub-prime), these initiatives could not be coming at a more interesting time.

Although the timing may be ideal, several challenges remain to be addressed in the US before the US investor base for covered bonds can increase significantly. While the US covered bond structure is attractive and works well, it does not benefit, as do European covered bonds, from a statutory framework. This results in certain limitations that can be overcome only by obtaining authoritative guidance from the FDIC. This guidance might encompass the treatment of covered bonds in a receivership scenario, an acknowledgement that a cover pool can be revolving, dynamic and comprised of a variety of financial assets (other than just mortgage loans), and the process through which a covered bond holder could realise on the cover pool in the event of a receivership. Also, to date, the covered bonds that have been sold to US investors have not been registered with the SEC, but, instead, have relied on securities law exemptions. If covered bonds are to reach the broadest possible investor base, product structurers will have to develop a US-registered covered bond programme. In the meantime, it is clear that US investor interest for this product, which has been a mainstay in the European capital markets, has been piqued.

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