# What are Covered Bonds and Why Should Anyone Care?

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**The authors believe that, given the current political impetus to promote lower costs of funds and greater liquidity for mortgage financing and a diversity of funding sources, there will be rapid developments in the area of covered bonds.**

Covered bonds are a form of long-term secured financing that has been used in Europe for centuries but have not previously gained popularity in the U.S. credit markets. To date, only two issuers in the United States have issued covered bonds. However, in light of the recent turmoil in the credit markets, covered bonds are being promoted as a technique to stimulate the capital markets and provide a long-term funding source for mortgage loan originators.

On July 15, 2008, a final Covered Bond Policy Statement (the ''Policy Statement'') was issued by the Federal Deposit Insurance Corporation (the ''FDIC'').[1] In addition, on July 28, 2008, the United States Department of the Treasury issued a best practices guide intended to ''encourage growth of the covered bond market in the United States.''[2] Although no specific covered bond statute exists in the United States at this time, on July 30, 2008, Congressman Scott Garrett (R-NJ) introduced covered bond legislation.[3]

## What is a Covered Bond?

A covered bond is a security issued by a bank or similar institution that provides on-balance sheet funding of assets. In general, covered bonds provide recourse to both the issuer's credit and a ''cover pool'' of high quality assets that are insulated or ''ring-fenced'' from the issuer's insolvency. As a result of the cover pool, covered bonds may receive a credit rating higher than the issuer's credit rating. Covered bonds may be issued pursuant to a specific statutory framework or on a contractual basis. A structured finance legal structure may be utilized in jurisdictions like the U.S. that lack a statutory framework, or for transactions that do not fit within an existing statutory framework.

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## Comparison of Covered Bonds and Mortgage-Backed Securities

Although both mortgage-backed securities (''MBS'') and covered bonds are potential sources of long-term funding for mortgage loans, there are several significant differences between them:

- In a typical MBS transaction, the mortgage loans are generally treated as having been sold under current U.S. accounting principles and thus removed from the sponsor's balance sheet. In a covered bond transaction, the mortgage loans securing the covered bonds remain on the sponsor's balance sheet.
- The composition of the cover pool is dynamic in that nonperforming (or prepaying) mortgage loans must be replaced with performing mortgage loans or other permitted substitution collateral. In contrast, the pool of mortgage loans underlying an MBS transaction is static and continues to back the MBS until maturity.
- Covered bonds are structured to minimize the risk of prepayment in the event of an issuer default prior to maturity of the bonds. In U.S. deals, this

is accomplished through an investment contract that covers payments on the covered bonds from default until maturity. MBS investors, in contrast, are exposed to prepayment risk, including prepayment as a result of default.

- Covered bonds provide investors with recourse to the sponsor in the event the collateral for the covered bonds is insufficient to pay the investors principal and interest owed on the covered bonds. MBS investors, on the other hand, generally do not have any recourse to the sponsor in the event of repayment of an amount less than the principal and interest owed.

## *Regulatory Hurdles to U.S. Covered Bonds*

In Europe, covered bonds are issued pursuant to statutory frameworks that exclude the cover pool from the insolvency estate of the covered bond issuer. In contrast, the lack of clear statutory or regulatory management of insolvency risks has been cited as a cause for the lack of issuance of covered bonds in the U.S. Only two U.S. issuers, Bank of America, N.A. and Washington Mutual Bank, have issued covered bonds to date. Both of these issuances predate the new regulatory guidance discussed in this article.

Insolvency risk exists in part due to the regulatory scheme applicable to potential U.S. issuers of covered bonds. For an issuer eligible to file for bankruptcy protection under the U.S. Bankruptcy Code,[4] foreclosure on the assets of the cover pool securing the covered bonds would be subject to the automatic stay provisions of the Bankruptcy Code upon the issuer's bankruptcy, and the claims on the covered bonds would be subject to resolution in the bankruptcy case. That would expose the covered bondholders to the risk of a ''cram down'' in which the covered bond obligations could be restructured.

Banks and other ''insured depository institutions'' (''IDIs''), on the other hand, are not eligible for protection under the U.S. Bankruptcy Code, but would be subject to conservatorship or receivership of the FDIC upon insolvency. The conservatorship or receivership of an IDI raises two types of insolvency risk for investors in covered bonds issued by an IDI: that the FDIC would repudiate the obligation of the IDI to perform on the covered bonds and elect to pay repudiation damages, and that during the 45 or 90 day stay on foreclosure pursuant to 12 U.S.C. § 1821(e)(13), the assets of the cover pool would be unavailable to pay the covered bonds. As conservator or receiver of an insolvent IDI, the FDIC is allowed a ''reasonable time'' to determine either to affirm or repudiate a contract of the IDI. In the event of repudiation, the FDIC would be required to pay repudiation damages.

The other risk is that due to the operation of the stay on foreclosure referred to above, the cover pool cannot be liquidated, without FDIC consent, sooner than 45 days upon an FDIC conservatorship or 90 days upon an FDIC receivership. Therefore, if the FDIC fails to make interest payments on covered bonds during the stay period, covered bondholders would not be able to realize on the assets in the cover pool without the consent of the FDIC. Even if the stay period expires, the FDIC only permits foreclosure if it is a self-help remedy that does not require involvement of the FDIC. Otherwise, the FDIC may require any realization upon the assets in the cover pool be effected through the FDIC claims process, resulting in a potentially significant delay in restitution to covered bondholders.

To help ensure that the covered bonds remain outstanding to maturity after a repudiation or liquidation of the cover pool, U.S. covered bonds issued to date have been structured to include an investment contract such as a guaranteed investment contract, deposit agreement or similar instrument (a ''specified investment contract'') purchased from a third party. The structure can be summarized as follows: an IDI issues full recourse mortgage bonds secured by residential mortgage loans to a special purpose vehicle (an ''SPV''), typically a Delaware statutory trust. The SPV issues covered bonds in the same principal amount to investors. The covered bonds issued by the SPV are secured by the mortgage bonds issued by the IDI. The SPV enters into the specified investment contract, which provides for the investment of repudiation or liquidation proceeds in order to provide for payments on the covered bonds to be made as scheduled until their maturity date. The SPV also enters into one or more swap agreements to cover certain mismatches between the rate, amount, currencies and/or timing of payments on the SPV's assets and the covered bonds. The IDI would be responsible for the cost of obtaining and maintaining the specified investment contract, any swap agreement and any other liquidity arrangements needed to ensure continued payment on the covered bonds if the FDIC fails to continue making payments on the covered bonds following the IDI's insolvency.

## *What Does the FDIC Policy Statement Do?*

The Policy Statement was intended to clarify the treatment of covered bonds upon the insolvency of the issuer, and to reduce the costs associated with the additional liquidity required by such structures.

The Policy Statement provides that if the FDIC elects to repudiate an IDI's contractual obligations with respect to a covered bond, the repudiation damages are ''limited to'' par plus accrued interest to the date of appointment of the FDIC. However, in the ''Background'' portion of the Policy Statement, the FDIC states that if the FDIC repudiates the covered bonds or defaults in a payment, ''the par value of the covered bonds plus interest accrued to the date of appointment of the FDIC *would be paid in full up to the value of the collateral*.'' The FDIC states that if the value of the assets in the cover pool exceeds par plus accrued interest to the date of the FDIC's appointment as receiver or conservator, the FDIC would recover the excess, and if the value of the assets in the cover pool is less than par plus accrued interest to the date of the FDIC's appointment as receiver or conservator, the shortfall amount would constitute an unsecured claim against the IDI. The Policy Statement does not specify the collateral valuation date for purposes of calculating repudiation damages.

The Policy Statement also addresses some of the timing issues created by the FDIC's automatic stay. Under the Policy Statement the FDIC consents to the exercise of contractual rights, including liquidation of the assets in the cover pool, during the automatic stay period if either (i) at any time after the FDIC is appointed as receiver or conservator, there is a monetary default to a covered bondholder (*i.e.*, the SPV) that remains in default for 10 business days after actual delivery of a written request to the FDIC to exercise contractual rights, or (ii) the FDIC as conservator or receiver provides a written notice of repudiation to a covered bondholder and fails to pay repudiation damages within 10 business days after effective date of the notice.

## Under What Conditions Does the Policy Statement Apply?

The Policy Statement applies to all covered bonds that are:

(i) recourse debt with a term of more than one, but not more than 30, years,

(ii) secured directly or indirectly by perfected security interests under applicable federal and state law on assets owned and held by the IDI (which assets must consist of ''eligible mortgages'' (as described below), AAA-rated MBS secured by ''eligible mortgages'' that constitute not more than 10 percent of the cover pool, and cash or treasury or agency securities, which may be substituted for the initial assets in the cover pool as necessary to prudently manage the cover pool),

(iii) made with the consent of the IDI's primary regulator, and

(iv) within a four percent issuance limit (*i.e.,* the aggregate total covered bond obligations of the IDI do not exceed four percent of such IDI's total liabilities (as set forth in its call reports)).

For the purposes of the Policy Statement, ''eligible mortgages'' are defined as performing first-lien loans secured by one-to-four family residential property, underwritten at the fully-indexed rate (defined as the index rate prevailing at origination plus the margin to be added after the expiration of any introductory interest rate), in reliance upon documented income, and which comply with existing supervisory guidance.[5]

## What Issues Did the Policy Statement Fail to Resolve?

The Policy Statement did not adopt the requests made in comment letters to include as part of the repudiation damages the cost of purchasing a specified investment contract or a swap agreement. The Policy Statement also does not fully address the risk of loss or delay of interest payments after FDIC appointment. Since repudiation damages do not include accrued interest from the date of appointment of the FDIC to the date of default on the bonds, the issuer must purchase a swap agreement to cover the cash flow shortfall for this gap period. In addition, timing of access to the cover pool and its liquidation could create further shortfalls, absent other sources of funds such as a swap agreement. Timing issues could arise if the payment date default does not occur until some time after the FDIC's appointment, in which case access to the cover pool, even under the accelerated time frame permitted under the Policy Statement, will be delayed until after the payment default occurs. Even after bondholders have the right to liquidate the cover pool, liquidation could take several months, and because the covered bonds may have one or more payment dates for which the assets of the cover pool are not available to make the payments due on such payment date, the swap agreement will be the sole source of payment on the covered bonds during this gap period.

The Policy Statement did not adopt requests made in comment letters to permit immediate foreclosure or to include liquidation expenses in repudiation damages, nor did the Policy Statement provide for foreclosure upon a non-monetary default, including failure to satisfy any overcollateralization test. The FDIC also declined to broaden the Policy Statement to permit a broader array of eligible assets of the type commonly securing European covered bonds (such as commercial mortgage loans) to be included in a cover pool.

## What is the Treasury Department's ''Best Practices for Residential Covered Bonds''?

On July 28, 2008, the U.S. Department of the Treasury issued a best practices guide intended to ''encourage growth of the covered bond market in the U.S.''[6] The best practices are intended as a complement to the Policy Statement and to bring increased clarity and homogeneity to the U.S. market by providing a ''standardized model . . . in the absence of dedicated legislation.'' However, the best practices ''should not constrain the market in the future,'' as Treasury expects the market to evolve.

The best practices address only covered bonds backed by residential mortgages. A ''Best Practices Template'' (described below) incorporates many terms of the Policy Statement, including a four percent issuance limit, the requirement of regulator consent, term requirements, collateral requirements (except as described below), and a discussion of insolvency procedures. In addition, Treasury states market participants should independently review the Policy Statement ''to ensure conformity with all provisions.''

Treasury states that upon an issuer's request to its primary federal regulator for consent to issue covered bonds, as required by the Policy Statement, the regulator will make a determination based on that regulator's policies and procedures. ''Only well-capitalized institutions should issue covered bonds.'' The Treasury Statement contains a definition of covered bonds that differs (but does not apparently conflict with) the Policy Statement definition. The template states documentation must conform to it ''throughout the life of the program, not only at the time of issuance.''

## *What are the Requirements of the Treasury's Best Practices Template?*

The Best Practices Template applies to covered bond issuances by an SPV in a two-tier program or by an IDI and/or its wholly owned subsidiary in a ''direct issuance structure.'' The SPV structure may be collateralized by mortgage bonds from more than one institution. The issuer must designate an independent trustee to represent the interests of covered bondholders and enforce investors' rights in the cover pool.

The Best Practices Template requires the terms of the covered bonds conform to the requirements of the Policy Statement. In addition, the Best Practice Template also includes the following additional requirements:

- interest on the covered bonds that accrues at a fixed or floating rate;
- if covered bonds are issued in a different currency than the cover pool, the issuer must employ a currency swap;
- the issuer must enter into a specified investment contract with one or more financially sound counterparties, which should require payment of ongoing scheduled interest and principal after payment default by the issuer so long as proceeds from the liquidation of the cover pool are at least equal to the par value of the covered bonds;
- covered bondholders must have a perfected, first priority security interest in the cover pool assets, and those assets may not be encumbered by any other lien;
- the mortgage loans included in the cover pool must meet the requirements of the Policy Statement, but the cover pool may not include MBS, as is permitted by the Policy Statement (cash or treasury or agency securities are permitted to the same extent as they are permitted by the Policy Statement);
- the issuer must clearly identify the cover pool's assets, liabilities and security pledge on its books and records; and
- in the event of a default, losses must be allocated pro rata across covered bond issuances that utilize a common cover pool, irrespective of maturity.

Eligible mortgage loans for the purposes of the Best Practices Template must be current when added to the cover pool, and any mortgage loans that become more than 60-days past due must be replaced. The maximum loan-to-value ratio (''LTV'') for any mortgage loan at time of inclusion in the cover pool is 80 percent and no single Metro Statistical Area may make up more than 20 percent of the cover pool. Negative amortization mortgage loans are ineligible.

The Best Practices Template also includes the following additional requirements:

- the issuer must maintain an overcollateralization value at all times of at least five percent, tested monthly;
- the issuer must designate an independent asset monitor to periodically determine compliance with the overcollateralization test;
- the issuer must update the LTV of the mortgage loans in the cover pool quarterly using a nationally recognized, regional housing price index or comparable measurement;
- only the 80 percent portion of the updated LTV will be credited if the mortgage loan has an updated LTV of over 80 percent; and
- if the overcollateralization test is breached, the issuer has one month to cure, and if the breach remains after that time, the trustee may terminate the covered bond program and principal and accrued interest will be required to be paid to the covered bondholders.

Although covered bonds may be issued as registered securities or may be exempt under securities laws, the Best Practices Template requires the following specific disclosures to investors:

- material financial information on the IDI and, if applicable, any SPV;
- descriptive information on the cover pool must be made available to investors at the time the investors make their investment decision and monthly thereafter;
- updated disclosure on the cover pool if more than 10 percent of cover pool is substituted in any month or more than 20 percent in any quarter; and
- the results of any overcollateralization test and any reviews by the asset monitor must be made available to investors.

## *What are Key Rating Agency Concerns in Rating U.S. Covered Bonds?*

The rating agencies have each issued different statements on how they analyze covered bonds. Moody's and S&P used a dual approach that looks to both the issuer's credit and the cover pool, and therefore partially links covered bond ratings to the rating of the IDI. Fitch examins the continuity between the IDI and cover pool in determining the degree of rating independence. Fitch's continuity analysis is based on segregation from bankruptcy estate, alternative management of cover assets, liquidity gaps between cover pool and bonds and dedicated covered bonds oversight.

### *Proposed Legislation; Future Developments*

Both the Policy Statement and the Best Practices Template note that future developments in the marketplace may create new structures for covered bond transactions not presently contemplated, and that additional actions may be taken in response to such changes in the marketplace. In addition, the U.S. Congress may intervene and pass legislation addressing some of the issues raised by the Policy Statement. Congressman Scott Garrett (R-NJ) introduced a covered bond legislation bill on July 30, 2008.[7] This bill provides (i) that repudiation damages must include, in addition to par plus interest accrued to the date of the FDIC appointment, the cost of purchasing a specified investment contract providing for scheduled payments to be made until maturity, and enforcement costs, (ii) that a covered bond would constitute a ''qualified financial contract'' and thus would not be subject to the automatic stay or a 10 business day waiting period imposed by the Policy Statement, and collateral liquidation of the cover pool would be permitted for all defaults (*i.e.*, payment or nonpayment), and (iii) an expansion of the scope of assets eligible for inclusion in the cover pool. It is uncertain whether the bill will ever become law, or if it becomes law, that the provisions of the law will be similar to the provisions of the bill.

Given the current political impetus to promote lower costs of funds and greater liquidity for mortgage financing and a diversity of funding sources, we anticipate rapid developments in the area of covered bonds. It therefore is important to monitor legislative and regulatory actions, as well as industry practice with respect to covered bonds.

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[1] Available at http:/www.FDIC.gov/news/news/press/2008/pr08060a.html.

[2] http://www.ustreas.gov/press/releases/hp1102.html.

[3] http://thomas.loc.gov/cgi-bin/query/z?c1 10:H.R.6659: In addition to providing the text of the bill, this hyperlink provides links to Congressional Record references to this bill and permits you to track the status of this bill.

[4] The United States Bankruptcy Reform Act of 1978, as amended. 11 U.S.C.A. § 101 et seq.

[5] Specifically, the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, the Interagency Guidance on Subprime Mortgage Lending, July 10, 2007 and such additional guidance applicable at the time of loan origination.

[6] http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf.

[7] http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.6659: In addition to providing the text of the bill, this hyperlink provides links to Congressional Record references to this bill and permits you to track the status of this bill.