



# REAL ESTATE LAW & INDUSTRY



## REPORT

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### COVERED BONDS

*As the fog surrounding the floundering U.S. financial sector begins to clear, one possibility for righting the finance of both housing and commercial real estate is the covered bond. Until recently, the prospect of translating this common European mortgage instrument into terms cogent to the U.S. was obscured by technical, regulatory, and economic barriers. But in this article, the authors make the case that the congressional stage is set in 2011 to finally advance covered bonds as an integral part of the U.S. property finance system.*

### Covered Bonds Staged to Become Alternatives or Complements to Securitization



By ANNA T. PINEDO AND JAMES R. TANENBAUM

**A**nyone who has been in the commercial real estate business for more than two decades recalls that securitization became important as a result of a reluctance to rely solely on bank and insurance company financing. The circumstances are different now, but the

basic theme remains the same. There can never be too many sources of funding. And that is why covered bonds are receiving a great deal of attention lately. Many commentators believe that covered bonds have the potential to supplement securitization and to form part of a well-diversified liquidity management program for financial institutions and other issuers. Covered bonds also may provide investors with an asset-backed debt instrument that protects against many of the risks recently experienced with the securitization model. In this article, we examine whether covered bonds may supplement commercial mortgage-backed securities (CMBS) as a means of financing commercial real estate loan origination.

**What Is a Covered Bond?** 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 loans, but may consist of commercial mortgage loans. The assets in the cover pool are subject to strict criteria and must be replaced if they no longer satisfy that criteria. Typically, the cover pool provides for overcollateralization to preserve the value of the covered bond holders' claim in the event of the issuer's insolvency.

In some format, covered bonds have been used in Europe, beginning with the *pfandbrief* in Germany, since the 18<sup>th</sup> century. The market for these securities has been well-established and generally stable. In many European jurisdictions, including, among others, France, Italy, Germany, Italy, Spain, Portugal, Sweden, Denmark, Norway, and Finland, there is 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 issued in jurisdictions having a legislative framework are often referred to as "legislative covered bonds."

**What Are the Benefits of Covered Bonds?** 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, historically low-risk assets. The assets in a securitization may include a variety of assets of differing quality. Covered bonds usually are issued by depository institutions that are regulated entities subject to supervision by domestic banking authorities, which ensures regulators would step in if a safety and soundness issue were to arise.

By contrast, a CMBS investor only has recourse to the special purpose entity that issues the securities and to that special purpose entity's assets, which include the asset pool and its cash flows. Covered bonds remain on the issuer's balance sheet, whereas securitized assets historically have been off-balance sheet. Regulators in the U.S. have reasoned that having mortgage loans remain on an issuer's balance sheet will serve to align the interests of the mortgage originator (or covered bond issuer) more closely with those of securities holders and may lead to improved origination practices.

Covered bond investors are assured of repayment given overcollateralization and substitution requirements, as well as other protections. This is particularly reassuring to investors that suffered losses in connection with securitizations or, are at least aware of others that have done so.

For issuers, covered bonds provide a means of funding mortgage originations and provide a security that can be pledged or presented in order to obtain loans from the European Central Bank or, in the U.S. from, the Federal Reserve Board's discount window. Even if the CMBS market were to resume normal market activity, covered bonds may provide an important funding alternative. There is a deep and established European

and Asian investor base for covered bonds that is distinct from the investor base for CMBS.

The covered bond market has grown rapidly in recent years, with an estimated \$3 trillion in outstanding notes. In Europe, depository institutions seeking to diversify their funding sources find that the covered bond market provides a relatively cheap (compared to securitization) and accessible 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 with long maturities. These long maturities allow assets and liabilities to be matched over the long term.

Covered bonds typically are structured as fixed-rate instruments, with long maturities. In Europe, there traditionally has been a highly liquid market for covered bonds. Almost all covered bonds are triple-A rated. Covered bonds typically bear a higher yield than government or agency bonds and are investment-grade rated.

**How Is a Covered Bond Different From CMBS?** In a securitization, the sponsor or a depositor pools together loans, and sells these to a special purpose vehicle, which is generally organized as a trust. This sale to the special purpose vehicle is referred to as a "true sale." The trust then issues and sells securities (publicly or privately) to investors. The financial intermediary underwrites the offering of the securitization trust securities to investors. The return on the securities depends upon the performance of the underlying loans. Essentially, these are "pass through securities." Pass-through securities are structured to provide that a portion of the payments on the underlying loans are passed through to the holders of the CMBS. Interest payments on the underlying loans are used to pay interest on the CMBS. Principal payments on the underlying loans are used to pay down the principal on the CMBS. The trust is structured as a bankruptcy-remote vehicle. CMBS investors depend on the payments on the underlying loans and do not have recourse to the original mortgage lender or to the depositor in the event of payment defaults. CMBS investors are subject to all of the risks relating to the mortgage loans, including the risk of a prepayment on an underlying mortgage loan (which reduces the term of the mortgage-backed security) and the risk of a payment default (which reduces the payments on the mortgage-backed security). A CMBS investor, then, holds a security that, depending on prepayments, mature earlier than expected. This differs from a covered bond, which has a fixed maturity date. In addition, a CMBS investor will bear the losses associated with underlying mortgage loan payment defaults; whereas, an investor in a covered bond is not exposed to such losses.

Typically in a CMBS transaction, there will be a variety of tranches of securities offered to investors, with each tranche having different payment features and a different payment priority or seniority. In a covered bond transaction, there is only a single tranche of covered bonds issued, so an investor does not have to analyze priority/subordination issues. Covered bonds should be appealing given the current predilection for simpler structures, and for greater transparency. Moreover, given their simplicity, rating agencies are able to

analyze and rate covered bonds without the need for complex models that may have embedded assumptions.

The securitization trust is not intended to be an “active” entity that exercises any discretion. Consequently, securitization transactions are “hardwired” so that the trust essentially is a static pool of mortgages. This is distinguished from a covered bond structure, in which the cover pool is a dynamic pool. A covered bond issuer may move loans in and out of the cover pool. Under certain circumstances, the covered bond issuer is obligated to substitute mortgage loans into the cover pool.

A securitization trust that initially qualifies as a Real Estate Mortgage Investment Conduit (REMIC) may lose its qualification if a sufficiently large portion of its mortgages are “significantly modified.” Modifications to the mortgages would be seen as indicative of active management rather than passive investment. Only certain limited modifications are permitted.

**Differences Between Covered Bonds and Securitization.** The chart below summarizes the principal differences between a covered bond and CMBS.

	Covered Bonds	CMBS
<b>Accounting</b>	<ul style="list-style-type: none"> <li>■ On-balance sheet</li> </ul>	<ul style="list-style-type: none"> <li>■ Off-balance sheet<sup>1</sup></li> </ul>
<b>Recourse</b>	<ul style="list-style-type: none"> <li>■ Direct or indirect recourse to the originator</li> <li>■ Upon originator default, collateral used to repay bonds</li> <li>■ Issuer is not limited by business or financial covenants</li> <li>■ Exposure to parent company management risks</li> </ul>	<ul style="list-style-type: none"> <li>■ Limited recourse</li> <li>■ Bankruptcy remote SPV</li> <li>■ Cash flows from assets repay the bonds</li> <li>■ Servicer risk, prepayment risk and credit risk</li> </ul>
<b>Liquidity</b>	<ul style="list-style-type: none"> <li>■ High degree of homogeneity, liquidity</li> <li>■ Limited spread volatility</li> <li>■ Bankruptcy segregated from issuer, preferential claim</li> </ul>	<ul style="list-style-type: none"> <li>■ Heterogeneous structures, lower liquidity</li> <li>■ Limited spread volatility</li> <li>■ Bankruptcy remote from issuer</li> </ul>
<b>Ratings</b>	<ul style="list-style-type: none"> <li>■ Greater linking of bond ratings to parent company</li> </ul>	<ul style="list-style-type: none"> <li>■ No linking of bond ratings to parent company</li> </ul>
<b>Assets</b>	<ul style="list-style-type: none"> <li>■ Open-ended vehicle whose collateral pool can evolve over time with strict collateral qualifying criteria; over-collateralization required</li> </ul>	<ul style="list-style-type: none"> <li>■ Open or closed-ended pools with strict collateral qualifying criteria</li> </ul>
<b>Investors</b>	<ul style="list-style-type: none"> <li>■ Large number of eligible investors</li> <li>■ Taps non-securitization investors (liquidity investors)</li> <li>■ Limited overlay with senior unsecured investor base</li> </ul>	<ul style="list-style-type: none"> <li>■ Large investor base that typically invests in ABS paper</li> </ul>

<sup>1</sup> As we discuss below, the accounting treatment for securitizations has changed and more securitizations will be consolidated or brought “on balance sheet.”

Historically, one of the benefits of securitization is that it permitted originators to move mortgage loans “off balance sheet” and thereby effectively “recycle” capital and obtain greater leverage. Securitizers now must contend with new accounting pronouncements (Statement of Financial Accounting Standards [FAS] 166/167) which require that the obligations of securitization trusts be moved back on balance sheet. In addition, following financial regulatory reform, securitizers will be required to retain an unhedged interest in securitization trusts. These and other regulatory changes, including those relating to capital brought about by the Basel III framework, will result in a different cost structure for securitizations going forward.

**How Have Covered Bonds Developed in the U.S.?** One of the basic requirements for covered bonds is either 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 United States, there is still 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. As a result, U.S. depository institutions started accessing this market using structures that rely on securitization principles and attempt to replicate through contractual relationships the features associated with European covered bond legislation. These are referred to as contractual covered bonds or structured covered bonds.

The U.S. structure that has been used to date is two-tiered—with a special purpose vehicle, or SPV, not a bank—serving as the covered bond issuer. The covered bond issuer offers fixed-rate covered bonds to investors. The covered bond issuer uses those offering proceeds 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 mortgage loans in the cover pool as direct col-

lateral 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 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 (GICs) 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.

**Disadvantages Associated With Contractual Covered Bonds.** By and large, contractual covered bonds have been popular with investors; however, these structures have certain embedded additional costs, and result in certain other funding disadvantages.

The European Central Bank (ECB) classifies securities for repo purposes. Banks, which make up 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 European Union's Undertakings for Collective Investment and Transferable Securities (UCITS) directive for collective investment vehicles. In order to have an EU-recognized "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 percent to 7.5 percent, depending on maturity; bank debt is discounted at 1.5 percent to 9 percent; and securitizations are discounted at 2 percent to 12 percent. Those United Kingdom covered bonds, which were not issued pursuant to statute (prior to adoption of legislation), were classified as bank debt by the ECB. Similarly, U.S. 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 percent 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 percent risk weighting. The European Union's Capital Requirements Directive, which implements the Basel II regulatory capital framework, also makes it more attractive for banks to invest in legislative covered bonds.

Moreover, in the two-tiered U.S. structure described above, there is embedded expense as a result of the various ancillary arrangements, such as the GIC and the swap agreements, which are necessary in order to replicate the legislative structure. In addition, the complex-

ity of the current structure is off-putting to potential investors.

**Current Status of U.S. Covered Bond Legislation.** Until relatively recently, the Federal Deposit Insurance Corporation (FDIC) had not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario. As a result, there had been concern that upon a default by the sponsor bank in receivership, the FDIC would seek to avoid (or would repudiate) covered bond obligations. An amendment to the bank insolvency laws, which 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, added to the confusion. In 2007, development of the nascent U.S. covered bond market was put on hold as the financial crisis unfolded. In 2008, regulatory efforts to encourage development of the covered bonds market, including the FDIC's Final Policy Statement on Covered Bonds and the U.S. Treasury's Best Practices for Residential Covered Bonds, were well received. However, these efforts did not prove to be sufficient to launch a U.S. covered bond market both because the efforts did not allay investor concerns regarding the treatment of covered bonds upon the insolvency of an issuing bank, and because most prospective covered bond issuers were unable to act given the extreme dislocation of the capital and credit markets.

Since July 2008, there have been various legislative proposals that would codify the treatment of covered bonds and provide a statutory framework for their issuance. The bills were introduced by Reps. Scott Garrett (R-N.J.) and Paul Kanjorski (D-Pa.). This proposed legislation, which had been considered as an amendment to the financial regulatory reform legislation (The Dodd-Frank Act), was not approved by the House-Senate conference committee and not incorporated as part of the final regulatory reform legislation. However, a version of covered bond legislation was repropounded in the fall and will likely be considered by Congress early in 2011.

The most recent iteration of the legislation (H.R. 5823) would create a statutory structure for covered bonds issued by U.S. institutions similar to the structure used in the European covered bond market. The key elements of the legislation are: (1) a requirement that an independent asset monitor be appointed and that an asset coverage test be satisfied, (2) separation of the cover pool from the issuer in the event of the insolvency or default of an issuer or transfer of the cover pool and the obligation on the covered bonds to an assuming bank in the event of the insolvency of an issuing bank, and (3) designation of a covered bond regulator as the trustee of the separated cover pool to act for the benefit of the covered bondholders.

The legislation sets forth a procedure for separating and transferring a cover pool in the event that the issuer has failed or defaulted on its covered bonds. If the FDIC is not appointed as a receiver, the cover pool is separated immediately from the estate of the issuer. This may be the case for a non-bank issuer or for a bank issuer that has defaulted prior to the appointment of the FDIC as receiver. If the FDIC is appointed as conservator or receiver of a failed institution prior to a default on the covered bonds, the bill provides a period during which the FDIC may transfer the cover pool and the covered bond obligations to an assuming institution.

In the past, this has been a successful approach. For example, after the failure of Washington Mutual, which had issued covered bonds, the covered bond program was transferred to JPMorgan Chase. However, if the cover pool and the covered bonds are not transferred to an assuming institution within the requisite period, the cover pool will be separated from the estate of the failed institution and treated as a separate estate. In other words, the covered bonds will not be accelerated and will remain outstanding. Once a separate estate is established, the covered bond regulator is appointed as the trustee, and the covered bond regulator has the authority to appoint and supervise a servicer and administrator.

The covered bond regulator has the power to require the issuer or the conservator, receiver, liquidator, or bankruptcy court to turn over all the books and records relating to the cover pool and continue servicing the cover pool for 120 days, subject in the event of an insolvency to any right of repudiation or rejection by the FDIC. The failure of the FDIC to continue to make payments on the covered bonds during this period would automatically lead to the creation of a separate estate by separation of the cover pool from the estate of the failed bank. The new bill now additionally provides that a repudiation by the FDIC would also lead to the creation of a separate estate. If the cover pool is separated from the estate of the issuer, the legislation provides for the creation of a residual interest in the cover pool for the benefit of the issuer or the FDIC or third party as

receiver. Any remaining value in the cover pool after payment in full of the covered bonds will belong to the issuer or the FDIC or third party as receiver.

The legislation defines “eligible issuers” of covered bonds as any insured depository institution or subsidiary thereof, any bank holding company, any savings and loan holding company, any entity sponsored by one or more eligible issuers, or any nonbank financial company approved by its “primary financial regulatory agency and the covered bond regulator.” Eligible assets include: residential mortgage loans, home equity loans, commercial mortgage loans, student loans, auto loans, credit card receivables, municipal and state obligations, small business loans, and any other asset class designated by the covered bond regulator. Loan assets would be eligible assets only if they are not more than 60 days delinquent.

The proposed legislation may be further revised before it is finally considered by Congress in the new session.

**Conclusion.** Amidst the current uncertainty concerning how commercial real estate will be financed in the United States, new ideas should be welcome. Whether covered bonds will emerge as a supplement to existing funding approaches, or as a vibrant alternative to them remains to be seen. What is in plain sight already is that any new approach that presents the possibility of providing funding to the industry deserves a very close look.