

Looking to Europe

The US needs covered bond rules. Following Europe's lead would make them cheaper to sell and remove the need for an issuing series trust

Covered bonds are relatively unique: an investor has recourse to the issuing bank, but if the bank is insolvent payments continue to be made on the bond through maturity from the collateral pool securing the bond. In 2006 and 2007 two US banks, Washington Mutual and Bank of America became the first US banks to enter the market. But in the absence of an enabling covered bonds statute in the US, a quasi-securitisation structure was used, which proved to be increasingly expensive for issuers. As a result, there is now an active effort underway to adopt federal legislation to enable covered bonds.

Such legislation would have several benefits for US banks as issuers of covered bonds: (1) it would remove a good deal of unnecessary expense to the issuer of issuing covered bonds; (2) it would improve the secondary market for covered bonds of US issuers; (3) it would level the playing field for US banks relative to their European counterparts; and (4) it would improve the pricing of US covered bonds.

Remove unnecessary expense

Under European statutory covered bond schemes, a covered bond is issued directly by a bank and is secured by a pool of collateral (the cover pool). All series of covered bonds are secured by the same cover pool. Because the assets in the cover pool are still owned by the issuing bank, it must carry the required regulatory capital for the assets and maintain reserves for expected losses on the assets.

In the event of the insolvency of the issuing bank, the cover pool is set aside and held for the benefit of the holders of the covered bonds. Collections and proceeds from sale of the cover pool assets are used to make payments on the outstanding covered bonds through the stated maturity of the covered bonds. The cover pool is protected from other creditors of the bank until the holders of the covered bonds have been paid in full.

But in the US, because there is no covered bond statute, a quasi-securitisation structure

is used to achieve the key feature of a covered bond – continuation of payments on the bond after the insolvency of the issuing bank. First, the issuing bank issues a mortgage-backed bond pursuant to an indenture to a Delaware series trust. The mortgage-backed bond is secured by a pool of mortgage loans owned by the bank. All of the mortgage-backed bonds issued by the issuing bank are secured by the same pool of mortgage loans and the mortgage-backed bonds are cross defaulted with each other.

Second, the trust issues a covered bond to investors, securing the covered bond by the mortgage-backed bond the trust obtained from the issuing bank. Each series of covered bonds is issued by a separate series of the series trust and is secured by a related series of mortgage-backed bonds. For US income tax purposes, each series of the trust is treated as a separate grantor trust.

The trustee of the series trust is the holder of the related mortgage-backed bond for the benefit of the series trust. Accordingly, the indenture trustee under the indenture acts for the benefit of the trustee of the series trust in carrying out its duties under the indenture.

In the event of the insolvency of the issuing bank, unlike in Europe, the mortgage loans securing the mortgage-backed bond cannot be set aside for the benefit of the trustee of the series trust as the secured creditor. Instead, in the US, two statutes determine what happens to the collateral pool. First, the Uniform Commercial Code, which governs the rights of secured creditors, requires a secured creditor to liquidate the collateral securing the obligation to it and to return any excess proceeds to the debtor. Only with the consent of the debtor and the agreement of other creditors could a secured creditor take the collateral in lieu of payment of the obligation. Because cover pools would normally have significant over-collateralisation in them there is no prospect of obtaining the cover pool.

Second, the Federal Deposit Insurance Act, which applies to banks upon insolvency instead of the Bankruptcy Code, appoints

the Federal Deposit Insurance Corporation as receiver or conservator of the failed bank. Upon its appointment as receiver or conservator, the FDIC has essentially three options regarding the obligations of the bank, including a covered bond: (1) it can affirm the obligation, thereby agreeing to perform the obligation or transfer the obligation to another bank that will perform the obligation; (2) it can repudiate the obligation and pay the holder of the obligation "actual direct compensatory damages", which generally includes accrued interest only through the date of the appointment of the FDIC; or (3) it can take no action, which will eventually lead to a payment default under the obligation for failure to pay interest or principal when due, thus invoking the rights of secured creditors to seize and liquidate collateral to pay off the obligation. A valid security interest in bank collateral is recognised under the FDIA. The FDIC determines to repudiate, it is required to repudiate within a reasonable period after its appointment.

In 2006, the FDIA was amended to provide that no foreclosure or other action against the assets of an insolvent bank is permitted without the consent of the FDIC for a period of 90 days after appointment of the FDIC as receiver (as conservator). Accordingly, US covered bond structures need to provide from other sources interest on the mortgage-backed bond for 90 days after the appointment of the FDIC plus the estimated additional time it would take to liquidate to collateral pool, typically at least 60 days.

So unlike a European covered bond program, a US program must obtain from third parties (usually swap counterparties) and pay for 150 days or more of interest on each mortgage-backed bond issued by the program. To put this into perspective, the amount of missing interest that would need to be covered would be almost \$42 million or more on a \$2 billion covered bond series, assuming a 5% coupon.

Although the FDIC released its Covered Bond Policy Statement in April 2008 to provide some relief from the 90-day stay, the statement did not provide relief from the FDIA limitation on interest accruing on a bank obligation only through the date of appointment of the FDIC. So even with the benefit of the Covered Bond Policy Statement a covered bond program needs to provide for 100 days or more of missing interest. In the example discussed above the missing interest would be approximately \$28 million or more for each series of bonds issued.

The ramifications of the restrictions

imposed by the UCC and the FDIA are wide-ranging.

The structure exposes the holder of a US covered bond to market risk related to liquidation of the collateral securing the related mortgage-backed bond. Liquidation of the entire collateral pool at the time of insolvency of the issuing bank is likely to result in a fire sale of the collateral and achieve poor pricing. The rating agencies have countered this risk by increasing over-collateralisation levels significantly as the rating of the issuing bank declines. In the case of Washington Mutual, the over-collateralisation levels exceeded 40% just prior to its receivership.

The covered bond series trust will receive cash in the amount of the outstanding principal of the mortgage-backed bond plus interest accrued through the date of appointment of the FDIC. This cash must be invested upon receipt and the interest earned on the investment will be used to pay the swap counterparties. For this purpose, a standby investment is entered into with an investment provider at the time of and in the amount of the issuance of a series of covered bonds. These standby investments tend to be expensive and to provide a relatively low yield. The difference between the yield on the investment and the interest due on the covered bonds is borne by the swap providers. As a result, the swap providers are covering both the missing interest and the yield differential, which makes the swaps very off-market and very expensive. The swap providers bear the cost of the yield differential through the stated maturity of the covered bonds, which could be a long time on a covered bond originally issued with a fifteen or twenty year maturity.

However, most of the expenditure for additional costs in the US structure is unnecessary. The FDIC will tell you privately that it is very unlikely to permit a liquidation of the collateral because of the risk of a fire sale. It is economically more efficient for the FDIC to affirm the mortgage-backed bond and transfer the obligation on the bond and the collateral to an assuming bank and avoid the losses that would result from a fire sale. This is exactly what occurred when the FDIC took control of Washington Mutual: the obligation on the mortgage-backed bond and the collateral were transferred to JPMorgan. The windfall to the holders of the covered bonds was that the rating of bonds was immediately reinstated at AAA. The result was that the standby investment and the credit enhancement provisions of the swaps that were so expensive were unused.

But the uncertainty about what the FDIC will do in the event of the insolvency of an

issuing bank requires that those expensive features be added to the structure just in case they are needed. And one result is that the story to investors describing the covered bonds is quite complicated – lots of elements in the structure and numerous counterparties that add their own risk to the structure. This complexity increases the coupon the bank must pay to investors on the covered bonds because on a relative basis covered bonds issued by European banks are simpler to understand and have fewer risks associated with them.

Why legislate?

Much of the added cost in US covered bond programs relative to European programs could be eliminated with legislation similar to European legislation. In Europe, the insolvency of an issuing bank leads to the separation of the cover pool from the estate of the bank and the administration of the cover pool to make payments when due on the covered bonds. In effect, upon insolvency the obligation on the covered bonds is treated like a virtual securitisation of the cover pool.

This would have several benefits to US covered bonds. First, it would allow covered bonds to be issued directly by a bank and eliminate the need for and expense of establishing an issuing series trust. Second, it would eliminate the need to sell the collateral in fire sale at the time of the insolvency of the issuing bank, perhaps the worst possible time to sell the collateral. Third, this would eliminate the need for a standby investment and for the swaps to cover the yield differential on the investment, thereby eliminating third party credit risk. And fourth, investors would be presented with a much simpler investment and, accordingly, should demand a lower coupon.

Improvement in the secondary market

US covered bonds are currently offered in private placements in the US and under Regulation S outside the country. With legislation, US banks could issue covered bonds directly, without using an issuing trust, and therefore could rely on the Section 3(a)(2) exemption under the Securities Act of 1933 for bank issued securities. This would permit monthly investor reports on the cover pool and outstanding covered bonds to be publicly available not only to investors but also to the analyst community, which should build a much wider investor base for covered bonds. Direct issuance by banks would also allow covered bonds to be carried in corporate bond indexes, another factor that should help expand the investor base. The

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combined effect should lead to a deeper and more liquid secondary market for covered bonds of US issuers.

European banks are capable of issuing covered bonds in the United States and in Europe using the more efficient European structures. Canadian Imperial Bank of Commerce, for example, just recently closed an offering of covered bonds in the US. Because the issuance and funding costs for covered bonds of European banks are lower than the costs for US banks, European banks are able to fund themselves more efficiently in the US capital markets than US banks can. Legislation in the US would lead to a more level playing field and would permit US banks to fund themselves more competitively.

Improve the pricing

The complicated structure currently used by US banks to issue covered bonds results in investors demanding a higher yield than is paid by European bank issuers. Legislation could provide a simpler structure and the simpler structure is likely to be more attractive to investors. This should reduce or eliminate the premium charged to US banks for their covered bonds.

Legislation could significantly reduce the cost of issuing covered bonds and improved access to the covered bond market would make US banks more competitive with European banks. A legislative solution is relatively simple and would provide alternative funding for residential mortgage loans and other consumer assets while avoiding any of the concerns related to the recent financial crisis. With covered bonds, for example, the issuer continues to own the assets in the cover pool throughout the life of the financing, so it is not an originate to sell business model. And the bank would have significant skin-in-the-game since it would own 100% of the assets in the cover pool.

By Jerry Marlatt of Morrison & Foerster