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Covered Bonds and U.S. Regulators

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Words such as 'I'm from the government and I am here to help...' can strike fear in the hearts of even the most courageous. Yet every now and then, these words may turn out to be accurate. For instance, recently, the Chairman of the FDIC stated that U.S. regulators were working 'on ways to help the covered bond market's development' in the United States. Senior officials at the OCC and OTS have made similar observations. In the last two months, the Secretary of the Treasury has made statements indicating his interest in seeing a covered bond market develop in the U.S. Their basic theme is that the model of 'originating and distributing' mortgages and mortgage securities exacerbated the credit crisis—formerly known as the subprime crisis. Covered bond structures require that mortgages or other assets remain on balance sheet.

Consequently, regulators reason this will have the effect of encouraging lenders to maintain appropriate loan underwriting standards. They also are well aware that the covered bond market has functioned in Europe without much drama for centuries. In fact, the market actually has held up relatively well over the last year, at a time during which investor skepticism of asset-backed and mortgage-backed securitizations has reached epic levels. So, what exactly are covered bonds and what does the FDIC say we should be doing about them?

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 both, and, upon an issuer default also have recourse to a pool of collateral, called the cover pool, separate from the issuer's other assets. The cover pool usually consists of high quality assets, including residential-mortgage backed securities, public debt or ship loans. Typically, covered bond holders have a privileged or preferential claim (embodied in statute, in Europe) against the cover pool in the event of the issuer's insolvency. By contrast, in a securitization, 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 securitized assets are off-balance sheet. 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.

The covered bond market has grown rapidly in recent years, with an estimated US$2.75 trillion in outstanding notes. Many European jurisdictions have 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 covered bonds provide a relatively cheap (compared to securitization) 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.

Depositary institutions in jurisdictions lacking covered bonds legislation may find themselves at a competitive disadvantage in accessing the covered bond market. Covered bonds that are not issued pursuant to statutes imposing special bankruptcy protection for covered bond holders are not entitled to preferential risk weighting by the European Central Bank. In the UK, where legislation was only recently adopted, depositary institutions implemented securitization techniques in order to synthetically create covered bond-like structures.

Current U.S. structure
For a chart showing current U.S. structure, click here (pdf).

The US system lags behind

In the US, depositary institutions have started accessing this market using structures that also rely on securitization principles and attempt to replicate through contractual relationships the features associated with European covered bond legislation. The U.S. structure is two-tiered — with a special purpose entity, 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 specific 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 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.

There is no specific statutory framework in the U.S. prescribing the priority of the claims of the covered bond holders over the cover pool in a bankruptcy or setting forth how covered bond holders may exercise their claims. Until recently, the FDIC had not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario and, as a result, there has been concern that upon a default by the sponsor bank in receivership, the FDIC would seek to avoid covered bond transaction documents. 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.

The FDIC Policy Statement

On April 15, 2008, the FDIC issued its Covered Bond Policy Statement, which provides guidance on the availability of expedited access (ten days) to collateral pledged for certain covered bonds in a receivership or conservatorship, after a monetary default on a bank's obligation to the covered bond obligee or after the effective date of repudiation. The Policy Statement was published as 'interim final' in order to provide immediate guidance, but with a view to possible later amendment in response to comments.

The Policy Statement is limited in scope. It defines covered bonds as recourse debt obligations of an insured depository institution with a term of greater than one year and not exceeding ten years secured directly or indirectly by perfected security interests in a pool of mortgage loans or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. The Policy Statement also only applies to covered bonds made with (1) the consent of the bank's primary federal regulator and (2) which comprise no more than four percent of the bank's total liabilities. In order to limit the risks to the Deposit Insurance Fund, the Policy Statement limits its application to 'eligible mortgages', defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income.

The FDIC as conservator or receiver will consent to a covered bond obligee's exercise of its rights to collateral if (1) the bank is, and remains, in monetary default for at least ten business days after the obligee delivers a written request to the FDIC to exercise its contractual rights or (2) the FDIC as conservator or receiver provides written notice of repudiation of a contract to the covered bond obligee and does not pay damages as a result of such repudiation within ten days after the effective date of such notice. In both cases, no involvement of the conservator or receiver is required for the covered bond obligee to exercise its rights.

The FDIC has invited comment on a number of points, including whether the Policy Statement should be limited to the current structure or open to future innovation, and if so, how any future policy should be applied to such innovative elements.

Conclusion

The FDIC Policy Statement will evoke considerable comment from capital markets participants. This is what, in large measure, it was intended to do. Questions relating to the need for covered bond legislation versus enhanced regulatory focus on facilitating covered bond issuances will take on a uniquely American flavor and, yet, will hopefully be informed by the clear need for a U.S. covered bond market that would permit depositary institutions in the U.S. to finance through covered bond issuances and compete for investor interest.