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An analysis of covered bonds and the US market

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This article examines the two basic models for covered bonds, together with the benefits of covered bonds for investors and issuing institutions. The prospects for the introduction of US legislation on covered bonds are analysed, along with future developments for Europe, the US and cross market.

WHAT IS A COVERED BOND?

The origins of the modern day covered bond lie in traditional German law debt securities, first issued in 1769, known as "*Pfandbriefe*". *Pfandbriefe* and covered bonds are debt instruments, issued by banks and other financial institutions and secured by a ring-fenced pool of financial assets (generally mortgage loans, public sector debt obligations or ship loans) which are used to guarantee or "cover" the principal and interest obligations owed by the issuer.

There are two basic models under which financial entities issue covered bonds:

- The integrated issuance structure, where the issuer retains certain ring-fenced collateral and directly issues the covered bonds without transferring the pool of assets to another entity (*see below, Integrated issuance architecture*).
- The segregated issuance structure, where the collateral is transferred to an affiliated entity, often a special purpose entity, other than the issuer of the covered bonds, which provides a guarantee of the covered bonds secured by security over those assets (*see below, Segregated issuance architecture*).

Recourse for the covered bond investors is determined by the model used. Under the integrated issuance architecture, primary recourse is against the issuer, with additional recourse against the ring-fenced assets of the issuer. Under the segregated issuance architecture, investors have unsecured recourse against the issuer, with additional secured recourse to a separate entity on its guarantee (*see below, Segregated issuance architecture*).

DIFFERENCES BETWEEN COVERED BONDS AND ASSET-BACKED SECURITIES

Asset-backed securities include securitisations of mortgage-backed securities such as residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS), as well as collateralised debt obligations (CDO). Covered bonds have some similarities to asset-backed securitisation bonds in that both instruments may draw upon a specified pool of collateral to meet existing payment obligations under the bonds and provide security to investors. However, fundamental differences exist. First, covered bonds are dual recourse instruments, in that investors have unlimited recourse to the issuer bank but also recourse to the pool of assets acting as collateral for the covered bonds (cover pool) in the event of the issuer bank's insolvency. By contrast, in a securitisation, since recourse to the issuing SPV is limited to the realisable assets of the issuer, a securitisation investor only has recourse to the collateral for the securitisation. Second, due to the dual recourse nature of covered bonds, liability for them will remain on the balance sheet of the bank or financial institution which issued the covered bonds and assigned the assets to the cover pool.

Covered bonds are usually issued by regulated financial institutions who are typically also the originators of the assets securing the debt. Credit risk on the assets backing the issuance of covered bonds remains on the originator's balance sheet, even if the assets securing the bonds are transferred to an affiliated entity.

In contrast, asset-backed securities often involve a "true sale" of the relevant assets to a bankruptcy-remote SPV, thereby transferring the risk associated with holding those assets (although, depending on the structure, the transferor may still retain some risk in the transferred assets). Covered bondholders are also commonly provided with a minimum level of protection by statute, including priority over the underlying assets and a minimum level of overcollateralisation for investors to rely on. Protection provided by asset-backed securitisation bonds depends entirely upon the contractual terms of the instrument and related security interests.

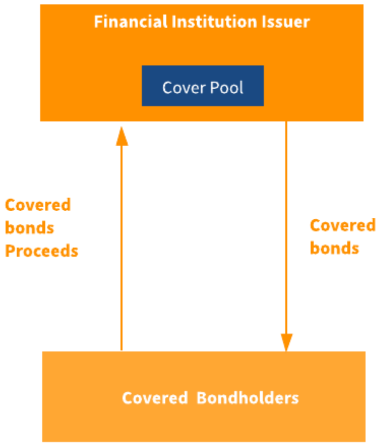
Other differences between covered bonds and asset-backed securities relate to the nature of the pool of assets included in the cover pool. In many jurisdictions, legislation prescribes the characteristics of the assets that may be included as collateral for covered bonds. Covered bonds have a dynamic pool of assets, whereby a covered bond issuer is required to "refresh" the cover pool with new, high quality assets when existing pool assets cease to meet the pool criteria. In most securitisations this refreshing of assets is generally not possible.

See *Benefits to investors*, below, for details of some of the advantages of covered bonds over other types of asset-backed securities.

INTEGRATED ISSUANCE ARCHITECTURE

To date, 27 European jurisdictions have passed covered bond legislation to ordain the insolvency remoteness and segregation of the cover pool on the issuer's balance sheet. Almost all of these frameworks utilise the integrated model. Bonds issued in these jurisdictions, commonly referred to as "legislative" covered bonds, are structured with the intention of allowing the institution originating the assets in the cover pool to issue the covered bonds directly. The legislation under which these bonds are issued governs the legal and regulatory framework, together with the rights of investors and the obligations of issuers. Under this legislation, investors are afforded a priority claim in respect of the assets in the cover pool following an event of default by the issuer, resulting in automatic segregation of the cover pool upon bankruptcy. As the regulations may vary between jurisdictions, the minimum investor protection afforded by statute will also vary (*see below, Direct issuance of covered bonds*).

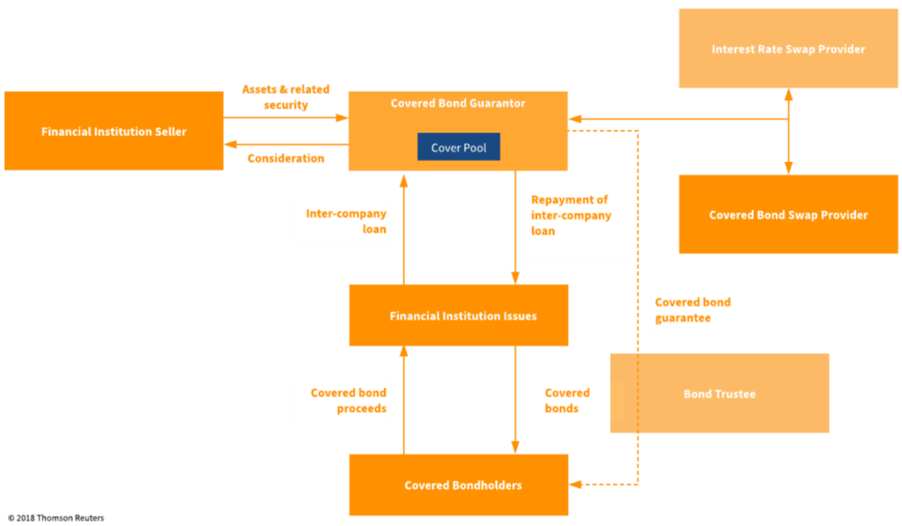
Direct issuance of covered bonds



SEGREGATED ISSUANCE ARCHITECTURE

For development of covered bonds in countries without enabling legislation which provides for such ring-fencing of the cover pool, including the US and previously Canada and the UK, it has been possible to utilise techniques developed for structuring asset securitisations as a means to provide asset segregation and issue covered bonds. As discussed above, these are known as "structured" covered bonds and have some similarity to securitisation structures. The key differentiating factor from other securitisations is the establishment of both primary recourse to the issuer and secondary recourse to a collateral pool in the event that the issuing institution becomes unable to service the debt. In other words, issuers in these jurisdictions have contractually simulated the effect of the legislation by transferring assets included in the cover pool to a bankruptcy remote SPV, thus segregating the collateral. In Canada and the UK, legislation was subsequently enacted that provides legislative recognition for this form of asset segregation for covered bond issuance (*see below, Transfer of assets included in the cover pool to a bankruptcy remote SPV*).

Transfer of assets included in the cover pool to a bankruptcy remote SPV



COVERED BOND RATINGS

Covered bonds typically achieve investment grade ratings. In part, this occurs as a result of the quality of assets that are placed into the cover pool. Investors are protected by the security that the cover pool provides, coupled with the fact that they also have primary recourse to the issuer. In addition, if there are any circumstances which result in a deterioration of the value of assets in the pool below a certain level, the issuer is obligated to replenish it with new assets in order to maintain the value of the cover pool.

However, ratings agencies do typically link a covered bond's rating to the rating of its issuer, for the reason that they believe that there are certain risks, such as commingling risks or asset-liability mismatches which are not structurally addressed. Asset-liability mismatches, for example, often arise because the underlying assets in the cover pool have longer dated maturities than the covered bonds. The covered bonds may typically have maturities of three to seven years, whereas the assets in the underlying pool will often have maturities in excess of ten years. Amortisation of the cover pool would therefore be insufficient to repay the covered bonds, resulting in a reliance on the issuer's ability to repay the covered bonds from liquidation of the assets or from other sources. As a result, Standard and Poor's, for example, will only issue an AAA rating to covered bonds where the issuer is a bank with a minimum unsecured long-term debt rating of at least BBB+ (assuming that it has met the relevant credit enhancement targets).

BENEFITS TO INVESTORS

High credit quality

The quality of assets contained in the cover pools of covered bonds is typically higher than in many asset pools that back securitisation bonds. In addition, covered bonds are also commonly issued by, or backed by assets originated by, major depository financial institutions, which are regulated entities that are subject to domestic supervision. Such involvement by regulators, both at the issuer level and in respect of enacting legislation covering statutory covered bonds, has resulted in improvements to the credit quality of covered bonds generally. As a consequence, most covered bonds are investment grade-rated.

High yield

Covered bonds are often highly regarded by investors because they produce a higher yield and provide greater diversification than many debt instruments offering a similar risk exposure (for example, sovereign or agency debt issuances).

Balance sheet investments

In contrast to more traditional asset-backed securities (where the underlying assets are removed from an originator's balance sheet), both the assets in the cover pool and the liability with respect to covered bonds will remain on an issuer's balance sheet, therefore providing it with an incentive to ensure that its asset origination procedures and standards are sufficiently robust. The result is an alignment of interests between the asset originator (whether that be the issuer in a non-SPV structure, or the asset owner in an SPV structure) and the investors. In contrast, the originate-to-sell model of originating or acquiring loans for the purpose of repackaging them into securitisation bonds, which was popular prior to the financial crisis, did not provide the same alignment of interests.

Dual recourse

As a result of the dual-recourse nature of covered bonds (described above), they may be viewed as a more palatable alternative for investors who incurred losses investing in securitised debt during the recent financial crisis.

Avoids "bail-in" risk

Upon implementation of the Bank Recovery and Resolution Directive (BRRD) in Europe, from 1 January 2016 many unsecured liabilities of financial institutions have become subject to "bail-in" requirements, which ensure that those instruments can be written off or converted into common equity, at the election of the relevant authority, upon the occurrence of a defined trigger event. In accordance with the BRRD, secured debt obligations, including covered bonds, are exempt from this treatment.

Title II of the Dodd-Frank Act is the statute for bail-in in the United States as implemented by the FDIC's "single point of entry" rule. The result under US law is only relevant to covered bond issuers organised under US law and at the moment there are none. Covered bonds of non-US issuers will be governed by the bail-in laws of their home jurisdictions, not US law.

Protected maturity/bullet-pay

Covered bonds are usually structured to provide for the principal to be repaid in a single payment on the maturity date (often referred to as a hard bullet structure), while only the interest element is paid during the life of the bonds. Some covered bond offerings are structured to provide for an extension of the maturity date for up to one year if the issuing institution is insolvent in order to provide sufficient time to realise proceeds from the cover pool to meet the principal payment obligation on the bonds (a soft bullet structure).

Low risk of acceleration

Covered bonds are designed to continue paying scheduled principal and interest on the covered bonds using cash flows from the cover pool if the issuer becomes insolvent. In addition, overcollateralisation and substitution requirements for defaulted assets provide additional protections to investors. The risk of acceleration of a covered bond is therefore low, unless there is a breach of certain predetermined conditions relating to the cover pool. By contrast, most structured finance transactions are designed to unwind following a default on the payment of the senior classes of securities or loss or deterioration of credit enhancement for those securities. In such cases, the trustee will be required to enforce the security granted over the underlying assets. This exposes the bondholders to what is known as reinvestment risk: the risk that the proceeds received from any acceleration/security enforcement cannot be redeployed for the remaining scheduled maturity of the bonds at the same rate of return.

Issuance regulated by statute

In the case of statutory covered bonds, the rights of bondholders and the quality of collateral are uniform across the relevant jurisdiction, despite issuance by many institutions. This simplifies an investor's analysis of covered bonds from that jurisdiction, since the rights in collateral in the cover pool and the minimum quality parameters for the collateral need only be analysed once.

Preferential rating for liquidity requirements

Covered bonds can obtain a Level 2A classification as high quality liquid assets for the purpose of the Basel III liquidity coverage ratio, with a haircut of 15% from their market value. Such assets are consequently able to account for up to 40% of a financial entity's required stock of liquid assets, which makes them more attractive to banks that are subject to the liquidity coverage ratio. Currently, of the various types of securitisation bonds, only those which are backed by certain types of low loan-to-value residential mortgage loans, and rated AA or higher, may be counted as high quality liquid assets for this purpose. Even then they are subject to a 25% haircut and as Level 2B assets, can only constitute up to 15% of the required stock of liquid assets.

In Europe covered bonds can now be included as Level 1 high quality liquid assets for the purpose of the liquidity coverage ratio under CRD IV, which implements the Basel II reforms in the EU. CRD IV is the name given collectively to EU Regulation 575/2013 (CCR) and Directive 2013/36/EU (CRD). Through delegated regulations (Regulation 2015/61, which came into force on 6 February 2015), the European Commission opted to provide extensive recognition of covered bonds in the LCR, on the basis of empirical analysis by the European Banking Authority (EBA). This confirmed excellent performance by the top rated covered bonds during the period of analysis. As a consequence, the European Commission has allowed the inclusion of covered bonds meeting certain eligibility criteria in Level 1, up to a cap of 70% and with a minimum haircut of 7%. Likewise, they have also allowed the inclusion of covered bonds (meeting less stringent criteria) in Level 2A, up to a cap of 40% with a minimum haircut of 15%, and in Level 2B, up to a cap of 15% with a minimum haircut of 30%.

In the US, the final rule for implementing a liquidity coverage ratio excludes covered bonds from the definition of high quality liquid assets. In fact, all financial institution obligations are excluded from the definition of high quality liquid assets on the grounds that such assets could "experience wrong-way risk and could become less liquid during periods of stress" (see the adopting release at 79 FR 61440 at 61450). This exclusion of covered bonds may also reflect the small relative size of the covered bond market in the US. Hopefully, as the US market continues to grow, this exclusion will be eliminated.

Undertakings for Collective Investment in Transferable Securities (UCITS) Article 52(4) compliant

Credit institutions issuing European debt securities often strive to ensure compliance with Article 52(4) of the Directive 2009/65/EC on undertakings for collective investment in transferable securities (UCITS) (UCITS IV Directive). This is primarily because funds and other collective investment schemes subject to this Directive are able to invest up to 25% of their assets in Article 52(4) compliant covered bonds (as opposed to just 5% for non-Article 52(4) compliant covered bonds). Such covered bonds also attract a preferential risk weighting under the CRD IV, making them a more attractive investment for banks and other institutions subject to that Directive.

In order to be Article 52(4) compliant, a credit institution must meet all the requirements detailed in that Article. This poses an obstacle for structured covered bonds, which are governed by contract, as one of the conditions to be met is that the covered bonds being issued must be subject by law to special public supervision designed to protect bondholders. In the UK, the Regulated Covered Bond Regulations 2008 (the Regulations) were enacted in order to provide for such special supervision and therefore ensure that structured covered bonds issued in the UK could compete with legislative covered bonds issued in continental Europe. The Regulations allow for UK covered bonds to be Article 52(4) compliant while following the segregated issuance model. However, once the UK leaves the EU (pursuant to the Brexit referendum in 2016), absent any special agreement, UK covered bonds will cease to be Article 52(4) compliant.

Note that the European Banking Authority published a report (*EBA Report on Covered Bonds*) in 2016. Among other things, the report recommends the development of a new covered bond directive to provide a definition of covered bonds as an instrument recognised by EU financial regulation, effectively replacing all the existing covered-bond-related provisions in the UCITS Directive (*Article 52(4)*).

Investor friendly

No complex tranching. Securitisation techniques often require complex tranching and structuring in order to ensure that some of the bonds are able to achieve sufficiently high credit ratings. This is because the lower-rated series of securities need to absorb losses first, in effect reducing the losses required to be absorbed by the higher-rated tranches. The result is that investors must spend time and money analysing complex cash flows. In the case of covered bonds, complicated tranching techniques are not required to obtain high credit ratings, resulting in a more simple and transparent structure. Such bonds' high credit ratings are attained instead as a result of (amongst other things) the quality of the collateral in the pool and the level of overcollateralisation, and the fact that investors have primary recourse to the issuing institution and then recourse to the segregated pool in the event that things go wrong (*see above, Covered bond ratings*).

No negative convexity (prepayment) risk. As stated above, there is limited prepayment risk with respect to covered bonds, which risk can often reduce expected returns on other similar types of securities. Securities issued through a securitisation vehicle, for example, will often be structured so as to ensure repayment at a specified future date, subject to principal prepayments being within an expected range. In the event that principal prepayments are received with respect to the underlying assets at a higher than expected rate, there is a risk that such principal amounts would be "passed through" to the bondholders, generating an early redemption of the securities. With covered bonds, as assets pay down, the asset pool is refreshed by the issuer with new assets.

100% skin-in-the-game. In recent years securitisation vehicles or asset originators have been required to retain a certain amount of credit risk on the underlying assets (or "skin-in-the-game") via the Dodd-Frank Act in the US and CRD IV in Europe. This requirement is intended to align, to some extent, the interests of issuers/originators with investors. However, such measures only require an issuer to retain a minimum 5% of the loan issuance value of a securitisation, whereas the on-balance-sheet nature of a covered bond ensures that the issuer retains 100% skin-in-the-game at all times.

BENEFITS TO ISSUING INSTITUTIONS

Very large liquid market

The global demand for covered bonds is substantial and has generally held up well in recent years, despite the onset of the financial crisis (estimated by the European Covered Bond Council in 2017 to be worth USD3 trillion (*ECBC Fact Book, 2017*). While a significant proportion of the market is concentrated in a relatively small number of countries (in particular, Germany, France, Denmark, Spain and the UK), the demand for high quality, low cost funding is increasingly resulting in the opening of new markets in countries such as Australia, Turkey, Canada and Singapore.

Extended Weighted Average Maturity (WAM) of bank debt

Typical maturities for covered bonds tend to be around three to seven years (although they can extend up to 15 years), allowing issuing institutions to extend the weighted average maturity of their liabilities. During the financial crisis many institutions found the weighted average maturity of their liabilities shortening sharply as creditors preferred investing in shorter maturities. In the US, the weighted average maturity of bank liabilities traditionally was about seven years, but during the financial crisis the weighted maturity was reduced to about three-and-a-half years, increasing exposure to refinancing risk. Covered bonds can be helpful in rebuilding or maintaining longer weighted average maturities.

Greater flexibility with respect to collateral

During the financial crisis, many mortgage loan borrowers who encountered difficulties in meeting their payment schedules found that their lenders were unable to accommodate them with an adjusted payment schedule because the lenders had sold their loans into securitisations. Servicers of loans in securitisations have limited ability to change the terms of a loan. As a consequence, many loans defaulted that might have been kept current if an adjusted payment arrangement could have been made available to the borrower.

Covered bond financing does not have this failing. The lender retains ownership of the mortgage loans. The lender may remove loans from a cover pool and substitute other loans, giving the lender the ability to work out a loan with a borrower who is in difficulty and possibly avoid default and foreclosure.

Exempt from clearing requirements under EMIR

The European Market Infrastructure Regulation (EU) No 648/2012 (EMIR) provides (amongst other things) that certain in-scope counterparties trading over the counter (OTC) derivatives will be required to centrally clear any trades determined to be subject to a clearing requirement. Relevant technical standards provide that (subject to certain conditions being satisfied) derivatives used in the context of covered bond issuances are not subject to a clearing requirement.

LIMITATIONS

While it is clear that there are numerous benefits associated with covered bonds (*see above, Benefits to investors* and *Benefits to issuing institutions*), there are also a number of limitations that may prove restrictive for both issuers and investors. Issuers, for example, may prefer to remove the underlying assets from their balance sheet, and to transfer the risk of default to investors. This may assist in respect of compliance with any applicable balance sheet encumbrance limits imposed by local regulators, and may free up regulatory capital that would otherwise need to be maintained in respect of the transferred assets. Covered bonds also offer limited customisation of interest rate payments, as most are structured to provide a fixed rate bullet repayment.

ENCUMBRANCE CONCERNS

There has been a continued growing concern among regulators about the levels of encumbrance of assets by banks issuing covered bonds. Some of the concern appears misplaced as it relates to apparently very high overcollateralisation levels in some European covered bond programmes that result not from legal requirements, but rather from the structure of the issuer as a specially created covered bond issuer all of whose assets are available to support its covered bonds. In other cases, heavy reliance on covered bond issuance by some banks, particularly at a time of difficult senior debt markets, has worried regulators. The regulators have been concerned that the encumbrance represented by cover pools can significantly reduce the availability of quality assets to support depositors and that the preference provided for covered bond holders in effect subordinates depositors.

At the same time, changing rating agency requirements have led to downgrades and higher overcollateralisation levels for some issuers and, as a result of the Euro crisis and the difficulty at times of issuing senior debt, banks have been more reliant on covered bonds.

In some countries, there are limits on the percentage of bank assets that can be encumbered by covered bonds: Canada, for example, has a 4% limit; the UK started with a 4% monitoring limit (above which regulatory notification was required) and a "soft" upper threshold of 20%. However, such limits have now been replaced in the UK by determination on a case-by-case basis. Australia and New Zealand each have an 8% limit. Similar concerns have been raised by the Federal Deposit Insurance Corporation about the proposed US covered bond legislation and a 4% limit has been discussed.

There are generally no such limits on securitisations, which tends as a policy matter to encourage securitisation over covered bonds. The wisdom of this policy choice may be questionable.

US MARKET

While there were some occasional sales of covered bonds into the US before the financial crisis, 2010 saw the first really significant sales of covered bonds into the US with about USD30 billion of sales by non-US banks. 2011 and 2012 saw continued growth in the market as Canadian and European banks increased their use of the market and Australian and New Zealand banks appeared for the first time. Issuance was approximately USD40 billion in 2011 and USD50 billion in 2012. At the end of 2012, there was more than US$100 billion in covered bonds outstanding from USD issuance. All of these offerings (other than those of the Royal Bank of Canada and Bank of Nova Scotia) have been made as private placements relying on Rule 144A.

2012 saw significant growth in the number of foreign banks accessing the US dollar market as the market continued to provide attractive financing opportunities for European banks, with about USD50 billion of private placements into the market. The year also saw the first US Securities and Exchange Commission (SEC)-registered covered bond offering when Royal Bank of Canada came to market with a USD2.5 billion offering in September that was very well received and brought many new investors into the market.

SEC-registered covered bonds have a number of advantages over privately placed bonds. Importantly, SEC-registered covered bonds are eligible for the major bond indices, such as the Barclays Aggregate Index, which is expected to result in a much more liquid secondary market. Also, SEC-registered covered bonds are eligible for the TRACE reporting system, which significantly improves the transparency of covered bond pricing for investors.

From the issuer's perspective, issuing covered bonds in the US has several advantages. US banks are not presently issuing covered bonds, as there is no enabling statute in the US for US banks to rely on and the structure used previously for structured covered bonds by US banks is not currently economically viable. Foreign banks, on the other hand, have found the US market attractive because it allows them to diversify their funding base by attracting new investors in a new and growing market. Assuming the cost of issuing in US dollars and converting to their home currency is manageable, the ability to broaden their investor base will generally reduce their funding costs.

Two additional Canadian banks, Bank of Nova Scotia and Bank of Montreal, obtained approval from the SEC to file registered covered bond programmes.

As in prior years, for US issuers the hope in 2018 is that this is the magic year for covered bond legislation in the US. There is a ready and growing US investor base for covered bonds created by Canadian and European issuers, a well-established investor base in Europe and Asia and a funding alternative that may be attractive, since changes to the capital rules, the accounting rules and risk retention requirements have made off-balance sheet securitisations more difficult. Moreover, the legislation as previously proposed could provide much improved access to the capital markets for smaller, regional banks, particularly for funding of commercial mortgage loans and for funding state and municipal debt, as well as residential mortgage loans. The recovery of the US housing market and the proposed wind-down of Fannie Mae and Freddie Mac, together with other factors, may create a positive environment for adoption of covered bond legislation.

However, the prospects for covered bond legislation in the United States appear to be tied to the resolution of Fannie Mae and Freddie Mac and there seems to be no impetus to deal with any change to the two agencies. Ms. Sandra Thompson, Deputy Director of the Federal Housing Finance Agency, which is the regulator of and the conservator for Fannie Mae and Freddie Mac, spoke about the prospects for reform of the two government sponsored enterprises (GSEs) at the Euromoney/ECBC North America Covered Bond Forum in April 2018. She stated that the two GSEs currently finance about 90% of new residential mortgage loans in the United States and she saw little likelihood of any change in the conservator status of the GSEs in the near term or any change in the dominating role they are playing in housing finance. Any change to the GSEs is likely to be divisive and politically difficult. In the current environment, none of the major banks in the United States has indicated any interest in covered bonds or other alternatives to financing through the GSEs. Without the backing of the major banks, the prospects for the passage of covered bond legislation is bleak.

TYPES OF ASSETS USED IN THE US AND RECENT TRANSACTIONS

Those non-US issuers that have issued covered bonds in the US all have existing covered bond programmes, and the covered bonds issued in the US have the benefit of the same cover pool that benefits covered bonds sold into Europe. No non-US issuer has established a separate programme for issuance into the US. Accordingly, the assets that are eligible for the cover pool are those assets defined by the covered bond statutes in the issuing bank's home jurisdiction. To date, the cover pool assets related to US dollar issuances have been predominantly residential mortgage loans, with a few issuers using public sector covered bonds.

Canadian banks through 2012 used residential mortgage loans insured by CMHC. The sole exception was Royal Bank of Canada, which used only uninsured mortgage loans. With the adoption of covered bond legislation in Canada, CMHC-insured mortgage loans may no longer be used in covered bond programmes to support new issuances of covered bonds. Canadian banks may continue to add insured mortgage loans to their existing covered bond programmes as needed to satisfy the applicable asset coverage test, but have had to establish new covered bond programmes using uninsured mortgage loans in order to issue a new series of covered bonds.

As noted above, US banks are not issuing covered bonds at present. In 2006 and 2007, two US banks issued structured covered bonds utilising securitisation techniques to create a bond with features like a classic covered bond. In the aftermath of the financial crisis, that structure is too expensive to use for the issuance of covered bonds and it is unlikely that a US bank will issue covered bonds in the absence of covered bond legislation in the US. The legislation that was proposed in 2011 and 2013 would permit a variety of eligible assets:

- Residential mortgage loans.
- Commercial mortgage loans.
- Municipal or state obligations.
- Auto loans or leases.
- Student loans.
- Revolving credit receivables.
- Loans made or guaranteed by the Small Business Administration of the United States.
- Any asset designated by the covered bond regulator in consultation with the issuer's primary federal financial regulator.

However, it should be noted that only one asset type can be used in a cover pool. Use of a second asset type by an issuer would require the establishment of a separate covered bond programme.

PROSPECTS FOR US LEGISLATION AND PROBABLE FEATURES OF A STATUTE

Covered bond legislation was first introduced in the US Congress in 2008 by Representative Scott Garrett (R-NJ), who was a member of the Financial Services Committee in the House of Representatives. Representative Garrett introduced further legislation in 2009, 2010 and 2011. The legislation introduced in 2011 (H.R. 940) was assigned to both the Financial Services Committee and the House Ways and Means Committee, which considered the bill's impact on tax revenue.

Following committee hearings, the Financial Services Committee approved H.R. 940, with some amendments, by a strongly bi-partisan vote of 44-7 in June 2011. The Ways and Means Committee, however, continued to review the legislation and, as a result, the legislation could not be voted on by the full House of Representatives while the Ways and Means Committee continued its deliberation of the bill.

A bill similar to H.R. 940 (S.1835) was introduced in the US Senate in September 2011 by a bi-partisan group of Senators, but no hearings were held.

As a presidential election year, 2012 was an unlikely year for the passage of anything other than essential legislation. This proved to be the case with covered bond legislation when no action was taken in either house of Congress other than an abortive attempt to tack on covered bond legislation to the JOBS Act in the Senate. This attempt could not pass muster under the Senate's procedural requirements for amendments to a bill.

2013 saw the convening of a new session Congress. All unfinished legislation of the old Congress had to be reintroduced in the new

Congress. Accordingly, a new version of covered bond legislation needed to be introduced in the House of Representatives and considered by the Financial Services Committee and the Ways and Means Committee. Similarly, a new covered bond bill had to be introduced in the Senate.

Covered bond legislation was included in H.R. 2767, a GSE reform bill, in the House of Representatives in 2013. These provisions tracked very closely the provisions of H.R. 940. However, this was a bitterly partisan bill due to the GSE provisions and it was approved by the Financial Services Committee on a strictly partisan, party-line vote. The bill was not taken up by the full House for a vote. It continued to be a live bill in the House for the rest of that session of Congress.

A very different GSE reform bill introduced in the Senate (S.1217) did not contain covered bond provisions. While it was reported that S.1217 was likely to be the template of an eventual GSE reform bill, it did not appear that any GSE reform bill was likely to pass Congress in 2014. Accordingly, if covered bond legislation was to be adopted in 2014, it would have had to have been taken up separately, which was unlikely given the many higher priority items on the legislative agenda, or included in another bill that is likely to achieve passage. There was no indication that either of the alternatives was being pursued.

The prospects for eventual adoption of a covered bond bill are good, despite the uncertainty about the timing. The best prospects for passage of covered bond legislation would occur if the bill was attached to an important piece of other legislation. On its own, a covered bond bill is subject to being crowded off the legislative agenda by more urgent bills. A covered bond bill would address a relatively narrow need, although certainly anything that assists housing finance in the US would be likely to get attention. While in the past Bank of America supported covered bond legislation, none of the major money centre banks to date has pressed Congress for adoption of a covered bond statute. Their attention has been focused instead on the many challenges arising under provisions of the Dodd-Frank Act affecting banks and in dealing with the deluge of litigation following the financial crisis. In the early years after the financial crisis, with the expansive funding limits provided by Fannie Mae and Freddie Mac, Federal Deposit Insurance Corporation (FDIC) insurance coverage for deposit accounts of any size attracting large corporate deposits to banks, and a severely depressed residential real estate market, there was no funding pressure on banks in connection with their mortgage loan origination.

In 2014 and 2015, many of these considerations were changing favourably for covered bond legislation, improving the prospects for passage. The residential real estate market began improving in the spring of 2012 and that development continued to gather force in 2013. This resulted in increased mortgage loan origination for 2015 and, in particular, increased origination of loans that exceeded the funding limits of Fannie Mae and Freddie Mac. Although the tapering of the QE III programme by the Federal Reserve was expected to result in higher interest rates and a corresponding decline in mortgage loan borrowing, interest rates continued to hover around historic lows. The overall effect on mortgage loan borrowing was therefore still positive.

With the recovery of the housing market, the process of shrinking the presence of Fannie Mae and Freddie Mac in the US housing market began. Their portfolios of mortgage loans are being reduced and the limits on the size of loans they can guarantee will at some point be reduced. What other actions will be taken with respect to the two agencies as a result of their conservatorship and the large losses they imposed on the government remains to be seen. Whatever the result, it seems unlikely that the government will continue to guarantee more than 90% of newly originated mortgage loans as it did through Fannie Mae, Freddie Mac, the Federal Housing Administration and the Veterans Administration in the aftermath of the financial crisis if the political paralysis can be resolved. This will compel banks to look elsewhere to fund some of their mortgage loan production. To date, however, banks generally continue to remain cash rich and to satisfy any funding requirements through the sale of loans to Fannie Mae and Freddie Mac.

Despite the deep divide in the Congress between Democrats and Republications, on some issues there will be common agreement. Covered bond legislation could well be one of those rare areas of agreement. The actions in the House and the Senate in 2011 on covered bonds suggest that covered bond legislation could have strong bi-partisan support.

Moreover, the election of 2017 has produced Republican majorities in both Houses of Congress. With Republicans in control of the White House and both Houses, it is much more likely that any legislation that passes one House will be taken up in a timely manner by the other House.

Also, the irony of the rapidly developing covered bond market in the US is not lost on the Congress. The fact that US investors are financing mortgage loans in foreign jurisdictions through their purchase of covered bonds issued by non-US banks, at a time when US banks cannot issue bonds to the same investor base, is increasingly drawing attention. Every sale of covered bonds into the US by non-US banks increases the likelihood that Congress will act to adopt a covered bond statute so that US banks can access the same investor base.

The approval of two registration statements for covered bonds programmes by the SEC created a similar irony. A US government agency approved covered bond issuance to US investors by a non-US bank, but US banks were unable to take advantage of it without the passage of legislation. When the SEC issued a no-action letter permitting RBC to file its registration statement, Senator Kay Hagan (D-NC), a member of the Senate Committee on Banking, Housing and Urban Development, stated that: "The growing acceptance of covered bonds among US regulators is a positive development. Unfortunately, until a legislative framework for covered bonds is in place in the US, our economy, US lenders and their customers will be unable to benefit from the low cost funding that covered bonds provide. This is all the more reason for the Congress to act swiftly to pass legislation to authorise this mainstream capital markets product."

The probable features of a US covered bond statute are suggested by H.R. 940 and H.R. 2767. It is likely that any new covered bond bill will contain most of the covered bond features of H.R. 940 and H.R. 2767.

Under those bills, eligible assets in a cover pool for covered bonds were defined as:

- First lien residential mortgage loans.
- Commercial mortgage loans.
- Loans to or securities of states or municipalities.
- Auto loans or leases.
- Student loans.
- Credit or charge card receivables.
- Loan made or guaranteed by the Small Business Administration.
- Any asset designated by the Secretary of the Treasury in consultation with the covered bond regulators.

"Substitute assets" were defined as:

- Cash.
- Any direct obligation of the US government or obligations guaranteed by the US government.
- Any direct obligation of a US government sponsored enterprise of the highest credit quality, or any obligation of the highest credit quality that is guaranteed by such enterprise.

- Overnight federal funds.
- Any other substitute asset designated by the Secretary of the Treasury in consultation with the covered bond regulators.

Eligible issuers were defined under H.R. 940 as:

- Any FDIC insured depository institution or subsidiary.
- A bank or savings and loan holding company or subsidiary.
- Any non-bank financial company supervised by the Federal Reserve and any subsidiary.
- An entity sponsored by an eligible issuer for pooled issuance.

Under H.R. 940 and H.R. 2767, "covered bonds" had to be full recourse obligations of an eligible issuer, secured by a cover pool of eligible assets and issued under a registered covered bond programme. A "covered bond programme" had to be approved by and registered with the applicable covered bond regulator. One or more series or tranches could be issued under a covered bond programme and the issuer could have more than one covered bond programme, but only one type of eligible asset could be used in each covered bond programme. If an issuer wished to fund both commercial mortgage loans and residential mortgage loans, for example, it would be required to establish two covered bond programmes.

Upon the insolvency of a covered bond issuer, there could be two results under the legislation, depending on whether the FDIC was receiver or conservator for the issuer. If the FDIC was the receiver or conservator under applicable laws, while it continued to pay the covered bonds the FDIC would have one year after the insolvency of the institution to find another institution to assume the obligations under the covered bonds and to take the cover pool. In the event that the FDIC was unable to find an assuming institution within the one-year period, the cover pool would be separated from the estate of the failed institution and administered as a separate estate to pay the covered bonds in accordance with their terms.

For those issuers for which the FDIC was not the receiver under applicable law, upon the insolvency of the institution the cover pool would be separated immediately from the estate of the failed institution and administered as a separate estate to pay the covered bonds in accordance with their terms.

Upon default of the issuer prior to insolvency, whether by failure to pay the bonds as required by their terms or by breach of any covenant, including the asset coverage test, the cover pool would be separated immediately from the estate of the defaulting institution and administered as a separate estate to pay the covered bonds in accordance with their terms. The creation of a separate estate would occur immediately regardless of whether the FDIC would be the appropriate receiver if the issuer were insolvent.

The "covered bond regulator" under H.R. 940 and H.R. 2767 would be the issuer's appropriate federal banking regulator, and if the issuer had no federal banking regulator, the Secretary of the Treasury.

PROSPECTS FOR THE FUTURE

Europe

While the outlook for the banking system in general remains uncertain in Europe, due to various uncertainties including the impact of Brexit, key elections (including France, Germany and the UK) and the perceived weakness of parts of the European banking sector, including Italy, covered bond issuances have remained fairly stable in recent years. The general expectation is that gross covered bond issuance in Europe in 2018 is expected to increase over 2017 to around EUR175 billion (*DBRS 2017 Outlook for European Structured Finance and Covered Bonds Survey Results 2018*). Despite the political uncertainties highlighted above, analysts on the whole believe that the credit quality of covered bonds will remain stable in 2018 as European economies continue to recover and unemployment levels fall (*DBRS European Structure Finance Outlook 2018*). Among the regulatory factors favouring covered bonds in Europe is an exemption for covered bonds from the bail-in provisions under the BRRD and the inclusion of certain covered bonds as Level 1 high quality liquid assets for the purposes of the liquidity coverage ratio under CRD IV and the exemption of covered bond swaps from the clearing requirement under EMIR.

Since October 2014, the European Central Bank has engaged in a covered bond purchase programme, intended to stimulate the Euro economy by easing lending conditions. The programme was initially intended to run for at least two years and is believed to have boosted total issuance by around EUR60 billion per year or so, thereby contributing to a reduction in refinancing risk. While a tapering of the programme has been forecast, continued economic and financial uncertainties in Europe suggest that the programme may continue into 2019.

Further to the EU Commission's Capital Markets Union (CMU) initiative, in September 2015, the EU Commission launched a consultation to assess the merits of a potential harmonised EU covered bond framework. In April 2017, the Commission published its Final Report. The consultation document considered that such framework could either be achieved through the voluntary convergence of covered bond legislation through non-legislative co-ordination measures or, alternatively, EU legislation providing a regulatory framework in respect of covered bonds including harmonisation as to issuance structures, licensing, segregation of assets in the cover pool, eligibility requirements for cover pool assets, hedging and other risk mitigation requirements and coverage requirements and administration and supervision of the cover pool following segregation of the cover pool assets. The Final Report concludes that the benefits of harmonising legislation clearly outweigh the costs.

The United States

The picture for covered bonds in the United States is obscured by history and politics.

Federal support for financing residential mortgage loans began in the 1930s with the creation of the Federal Home Loan Banks to provide financing for the savings and loan industry and the establishment of Fannie Mae. These programmes were designed to channel funding to areas of the country where deposits were scarce as a result of the Great Depression in order to support home building. In 1970, Freddie Mac was established to provide competition to Fannie Mae to improve mortgage rates. Thus reliance on government funding for mortgage loans in the United States is almost 100 years old.

Early in the 1980s the private sector RMBS emerged, modelled after Fannie and Freddie mortgage-backed securities. At its peak in 2006, annual issuance of private RMBS was nearly USD1.3 trillion and total RMBS outstanding in 2007 was more than USD2.7 trillion, challenging the federal financing system for primacy.

Against this backdrop covered bonds emerged in the United States in 2006 when Washington Mutual issued the first covered bonds by a US bank, followed by Bank of America in 2007. These offerings were very well received and priced attractively. Covered bonds were endorsed by Treasury Secretary Paulson in 2008 and at his urging the four biggest banks committed to begin covered bond programmes. These commitments were subsumed by the enveloping financial crisis.

Canadian banks began issuing covered bonds in 2007 in Europe. In 2010, Canadian and European banks began issuing covered bonds into the United States. Issuance levels for covered bonds in the United States peaked in 2012 and have ebbed and flowed since then. Canadian and European covered bond issuers turn to the US dollar market primarily when the cross-currency funding costs are favourable and occasionally when US funding needs arise. Canadian banks have consistently been about 50% of covered bond issuance activity in the United States.

The onset of the financial crisis in 2007 is attributed to the development of lax underwriting standards for residential mortgage loans and the securitisation of near prime mortgage loans both in the federal systems and in the private RMBS market. The relaxation of underwriting standards was led by Congress seeking to expand home ownership. The private sector RMBS market disappeared in the crisis and Fannie Mae and Freddie Mac were taken into conservatorship by the federal government. Washington Mutual, the largest savings and loan in the United States, was taken into receivership by the FDIC and liquidated. Even though they were in conservatorship, the government expanded Fannie Mae's and Freddie Mac's authority to finance mortgage loans in an attempt to support the housing market. Today, the two federal programmes are still in conservatorship and private RMBS is still struggling to recover. Fannie Mae and Freddie Mac provide nearly 95% of mortgage loan financing in the United States.

Housing advocates see Fannie Mae and Freddie Mac as critical federal programmes for directing support to lower income families trying to purchase a home. There is a concern that without expansive federal programmes many lower income families would be shut out of the housing market and never have the opportunity to make the transition to the middle class. There is also a concern that without a strong RMBS market if Fannie and Freddie have their authority reduced there may be nothing to fill the void, causing significant problems in the housing market.

Across the aisle and the political spectrum are the conservative voices asking why the United States is the only country in the world that requires such extensive government support for private housing. What is unique, they ask, in the United States that precludes private financial markets from financing private housing? After all, they point out, numerous other countries have levels of home ownership comparable to the United States without extensive government support. Moreover, these two entities created significant systemic risk in the financial crisis – it was necessary for the government to inject almost USD200 billion to sustain them. Critics of Fannie and Freddie urge significant reform to avoid future risk to the government.

And that sets the stage for the political battle over resolving the conservatorship of Fannie and Freddie. The gulf between the two sides appears unbridgeable and so the two agencies sit in suspended existence, neither government agencies backed by the full faith and credit of the United States nor private sector entitles generating profits for shareholders. Today the profits from Fannie and Freddie are swept into the Treasury and the stockholders of Fannie and Freddie scramble for legal arguments to force the government to release at least some of the profits to the stockholders. With Fannie and Freddie providing 95% of mortgage loan financing, mortgage loan originators are content to rely on the agencies for funding at prices unobtainable in the private market. No other funding source is necessary with the continued expansive funding authority of the two agencies.

As for covered bonds, Bank of America has not issued a covered bond since 2008 and Washington Mutual vanished in the crisis. No other US bank has sought to issue covered bonds. In today's climate it is likely that the structured covered bond programmes established by Washington Mutual and Bank of America would not find favour in the market – too expensive and too cumbersome. It appears that US banks will not turn to covered bonds for funding without enabling legislation and while Fannie and Freddie proceed with such expansive authority.

However, any contemplation of mortgage loan funding legislation raises the question of the appropriate design of a housing finance system and the role of the government in that system. Fannie and Freddie are the elephant in the room that can't be ignored – if housing finance is going to be addressed there has to be a resolution of Fannie and Freddie. Thus covered bonds and Fannie and Freddie are inextricably linked – no covered bond legislation until there is a solution for Fannie and Freddie.

On 21 June 2018, the President of the United States released a reform and reorganisation plan entitled "Delivering Government Solutions in the 21st Century". This plan includes a proposal to convert Fannie Mae and Freddie Mac into private sector entities, to provide an express government guarantee of mortgage loans to Fannie, Freddie and other qualifying entities, and to restructure financial support for low and moderate income family mortgage loans into the Department of Housing and Urban Development. It is too early to tell what the prospects are for the President's plan, but if it results in legislation then perhaps we will finally see movement on covered bond legislation.

Cross market

Future prospects for cross-market issuance from Europe into the US or the US into Europe look pretty one-sided at the moment. Without a US statute it is unlikely that US banks will issue covered bonds in the US or in Europe. US banks would issue into Europe if US covered bond legislation were passed, although you would expect the US banks will focus first on the US market before venturing into Europe, so the prospects for US bank issuance into Europe for 2018 are likely to be pretty remote.

High cross-currency swap costs discouraged issuance into the US in 2014. Issuance into the US in 2015 was better as swaps costs improved. Once again, in 2018 the year began with unfavourable cross-currency swap cost and meagre covered bond issuance in the United States. Only if cross-currency swap costs become favourable should we see the resumption of growth in the issuance of covered bonds by European and Canadian banks into the US.

The hallmark issuance of SEC-registered covered bonds into the US by Royal Bank of Canada brought new investors into the market and enjoyed enviable pricing. The Bank of Nova Scotia and Royal Bank both issued SEC-registered covered bonds as late as 2016. This performance was thought likely to induce other Canadian banks to follow, and that it would not be a surprise to see possibly three or four of the Canadian banks issuing SEC-registered covered bonds in the US. This issuance of SEC-registered covered bonds was seen to continue a transformation of the US covered bonds into the main stream of the capital markets. While the sale of SEC-registered covered bonds would free up capacity for covered bonds sold in private placement under Rule 144A, the SEC-registered product was expected to begin to dominate the market.

The high hopes for SEC-registered covered bonds were dashed, however, by the SEC. Although covered bonds are not asset-backed securities, the SEC staff took the position that covered bond prospectuses should include the same degree of loan level disclosure as new SEC rules require of RMBS offerings.

The expected cost and effort to adopt such disclosure, in the view of the Canadian banks, was seen to substantially exceed the funding benefits of SEC-registered offerings. As a result, the Canadian banks have abandoned the SEC-registered market and are accessing the US market solely through Rule 144A offerings.

There is every reason to expect European, Australian and New Zealand banks to continue to access the US dollar market. The US investor base continues to provide important diversification, particularly for the European issuers. European banks have constituted about 50% of the US covered bond market over the past eight years, with the Canadian issuers providing the balance. The level of issuance by European banks in 2018 will depend on the extent of inexpensive funding provided by central banks, such as the ECB and the Bank of England, the availability of the senior debt market, the impact of TLAC funding requirements, the impact of Brexit and other political events in Europe and, of course, the overall economic vitality of the eurozone. The current environment suggests that European banks will continue to provide about 50% of 2018 issuance in the US covered bond market.

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