Bridging the Gap

Regulatory moves in the U.K. and U.S. seek to close the gap with Europe on covered bonds

By Jeremy Jennings-Mares and Peter Green

RECENT REGULATORY ACTION on both sides of the Atlantic to promote covered bonds comes not a moment too soon, as mortgage lenders in the U.K. and the U.S. struggle to find liquidity in the structured finance markets. The U.K. and the U.S. covered bond markets lag a long way behind those in continental Europe, and a major reason for this has been their lack of specific covered bonds legislation, as well as their heavier reliance on securitization.

Typically, covered bonds legislation in continental Europe governs the type and value of assets that can be used to secure the bonds, how the pool of assets can be applied and, most importantly, provides that the covered bondholders' claims against the pool of cover assets rank ahead of claims of other creditors and insolvency officials. By comparison, the U.K. and the U.S., in the absence of specific legislation, have instead applied conventional structured finance techniques to create structures providing bondholder protection broadly equivalent to the 'legislative covered bonds' in continental Europe.

Compliance for the U.K.

In the U.K., these 'structured covered bonds' typically involve a credit institution issuing the covered bonds and transferring the assets in the cover pool, usually residential mortgage loans, to a special purpose vehicle (SPV), which then guarantees the issuer's obligations to the covered bondholders and secures that guarantee with a charge over the asset pool. Over-collateralization usually will be built into the structure, the amount of which will depend on the credit quality of the issuer and the assets and desired rating of the covered bonds.

Since the SPV does not carry on any activities except those ancillary to the particular issue of covered bonds, it does not incur any obligations to creditors other than the parties directly connected with that particular issue. The transfer of assets to the SPV is structured as a 'true sale,' in that no creditor or liquidator of the issuer is able to claim back the assets from the SPV. Consequently, the covered bondholders have assurance that there will be no competing creditors of the issuer or the SPV for the rights to the pool of assets, even in the event of the issuer's insolvency.

Despite the robust bondholder protection afforded by such a structure, structured covered bonds have been much less popular with certain investors, as they did not comply with the criteria contained in Article 22(4) of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive in Europe.

There are two main benefits of compliance with UCITS 22(4). Generally, a UCITS fund may not invest more than 5% of its assets in securities issued by a single entity. But if the covered bond is UCITS 22(4) compliant, the 5% threshold increases to 25%. In addition to the UCITS investment limits themselves, the Banking Consolidation Directive, which enacts Basel II in the European Union, provides that bonds that are UCITS 22(4) compliant attract a lower risk weighting than non-compliant bonds when held by a credit institution.

The requirements of Article 22(4) are that the bonds are issued by a credit institution with its registered office in a European Economic Area member state; that they are covered by assets capable of covering all obligations under the bonds throughout their life; that the assets would, upon the issuer's failure, be used to first pay amounts due on the bonds; and that the issuer is subject by law to special public supervision designed to protect bondholders. U.K. issuers previously were not able to satisfy this last criterion.

Hence, the U.K. recently enacted the Regulated Covered Bonds Regulations 2008, with the primary purpose of allowing U.K. covered bonds to comply with UCITS 22(4). However, the U.K. Treasury was careful to ensure that the new regulations allow U.K. issuers to continue using the SPV structures within the new framework.

The main features of the new regulations are:

- the issuer must be a credit institution with its registered office in the U.K. and authorized to accept deposits in the U.K.;
- the asset owner must be a company or limited liability partnership with its registered office and centre of main interests in the U.K.;
- the cover pool must consist of eligible assets such as mortgage loans and other assets (of a minimum credit quality) specified in paragraph 68 of Annex VI to the Banking Consolidation Directive, as well as certain other loans, all of which may only be located in the European Economic Area, Switzerland, the Channel Islands, the Isle of Man, Australia, New Zealand, the U.S., Canada or Japan;
- the covered bondholders are given priority over the cover assets in an enforcement or insolvency situation;
- the issuer and its covered bond program must be registered by the Financial Services Authority (FSA) as having satisfied certain minimum criteria; and
- the FSA is given extensive supervisory and enforcement powers, including the ability to require a cover pool to be topped up and to remove an issuer from the register.

The primary purpose of UCITS 22(4) compliance has been achieved, and we now await with interest investors' reaction to the new U.K. regulated structured covered bonds.

Clarification for the U.S.

In the U.S., the growth of the market has been hampered by uncertainty as to the treatment of covered bondholders in a bank issuer's insolvency. In particular, where the Federal Deposit Insurance Corporation (FDIC) is appointed as receiver of an insolvent bank, an automatic stay of up to 90 days under bank insolvency laws, during which a bank's creditors may not enforce security over its assets without the FDIC's consent, has given rise to particular uncertainty.

The U.S. Treasury Secretary recently encouraged U.S. banks to consider covered bonds as an alternative form of mortgage funding and urged the FDIC to clarify the uncertainties surrounding covered bonds in a bank's insolvency. Consequently, the FDIC recently published a Covered Bond Policy Statement, which states that, for covered bonds backed by certain mortgage loans (and up to 10% triple-A rated MBS), the automatic stay period would be reduced to 10 business days where the covered bonds have been approved by the issuer's primary regulator and do not exceed 4% of its total liabilities.

While it could have gone much further, the FDIC has expressly invited comment on the Statement, including as to the need for further regulatory innovation. This may be viewed as the start of a broader discussion among U.S. regulators and banks about the development of the U.S. covered bond market.

There will be much discussion about whether legislation or regulation is the best method of promoting U.S. covered bonds. Disenchantment with some previous U.S. financial legislation means that it is not certain that the responsibility will be handed to politicians.

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