

The Name is Bond. Covered Bond.

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Covered bonds are finding a new acceptability. Even before the subprime crisis blew up to its full dimensions, certain US issuers had started using covered bonds – Washington Mutual is perhaps the first one to come up with US covered bonds in Sept 2006, followed by Bank of America in the next year. Post the subprime crisis, US Treasury Secretary Paulson came out with the Treasury's plan to promote covered bonds, including a statement of Best Practices. This has created a promise that the USA, with its vast, and unarguably, the world's largest, mortgage finance market, would join the list of countries that use covered bonds.

Hitherto, US mortgage refinancing market has depended substantially on off-balance sheet securitizations over the past 3 decades. On the contrary, the European market, particularly the Continental Europe, has been using covered bonds for years. In some countries, for instance, in Germany, the history of mortgage bonds or *pfandbriefs* goes to some 300 years.

The growth in covered bonds issuance has been slower than that of securitization. The outstanding covered bonds issuance end-2007 was estimated to be about \$ 2.6 trillion, with the issuance in 2007 being \$ 242 billion.

Covered bonds have historically been associated with the German (Pfanbbrief) and Denmark (realkreditobligationer) market. However, over time, covered bond instrument has been promoted actively all over Europe, and even outside Europe. Some 20 European countries have passed laws to enable covered bonds. Outside of Europe, in Sept 2006, Washington Mutual became the first US issuer of covered bonds.

1. Understanding covered bonds:

Structure of covered bonds:

Covered bonds are on-balance sheet securitizations. If by "securitization" is meant the transfer of a pool and its transformation into securities, then covered bonds are not securitization: they are closer to a secured bonds issuance. In a mainstream covered bonds transaction, there is no transfer of the assets to a special purpose entity. On the other hand, the assets are identified and ring-fenced as per local law, and are placed as a security for the bonds. In the event of bankruptcy of the mortgage originator, a general secured lending law or a special law relating to the covered bonds grants the bondholders recourse against the pool of mortgages over which security interest had been created.. In the event of defaults on the mortgages, investors still have a recourse against the bond

issuer. In other words, investors have a recourse against the bond issuer as well against the collateral – a covered bond is a case of collateralized borrowing by the issuer.

The word “covered bonds” clearly indicates this feature of these securities. These securities, structured as bonds, are backed by assets of a particular value. The value of assets that back up the bonds are the “cover assets”. The bond instrument requires maintenance of a particular cover, mostly containing an element of over-collateralisation, at all times. In case of bonds backed by mortgages, the cover assets are obviously mortgages. Hence, like in case of securitization, there is identification of a pool. However, the pool is not isolated by true sale: the requirement of bankruptcy remoteness is satisfied by law rather than by sale of the assets.

While the generic legal structure of covered bonds is similar to a secured bond with security interest over a pool of assets, the finer details of the legal structure have been adapted differently in different jurisdictions. For example:

- In UK, a common law country, it is felt that a specific law is not required. Here, in some transactions, assets have been put in the name of an SPV. The SPV in turn guarantees the bonds issued by the borrower. The parking of the assets in the books of the SPV supposedly provides bankruptcy remoteness to the structure.
- In US transactions, the bonds have been issued by the SPV, which then onlends the money to the bank, and the bank creates collateral on the loans.

SPV and non-SPV structures are discussed below.

Covered bonds and securitisation:

Covered bonds have only illusory similarity with securitization, as they have features of borrowing whereas securitization is based on liquidation of an identified pool of assets. The few points of similarity between the two are: Both result into creation of securities; both are methods of funding from the capital markets; both involve creation of a pool of assets; both have trustees overseeing the implementation of the transaction covenants; etc. The structure of covered bonds would look very similar to the master trust structure of securitization, particularly if the structure is used in case of residential mortgages. However, there are significant points of dissimilarity, as follows:

	Covered bonds	Securitization
Purpose	Essentially, to raise liquidity	Liquidity, off balance sheet, risk management, Monetization of excess profits, etc.
Risk transfer	The borrower continues to absorb default risk as well as prepayment risk of the pool	The originator does not absorb default risk above the credit support agreed; prepayment risk is usually transferred entirely to investors.

Legal structure	A direct and unconditional obligation of the issuer, backed by creation of security interest. Assets may or may not be parked with a distinct entity; bankruptcy remoteness is achieved either due to specific law or by common law principles	True sale of assets to a distinct entity; bankruptcy remoteness is achieved by isolation of assets
Type of pool of assets	Mostly dynamic. Borrower is allowed to manage the pool as long as the required “covers” are ensured. From a common pool of cover assets, there may be multiple issuances.	Mostly static. Except in case of master trusts, the investors make investment in an identifiable pool of assets. Generally, from a single pool of assets, there is only issuance.
Maturity matching	From out of a dynamic pool, securities may issued over a period of time	Typically, securities are matched with the cashflows from the pool. When the static pool is paid off, the securities are redeemed.
Payment of interest and principal to investors	Interest and principal are paid from the general cashflows of the issuer	Interest and principal are paid from the asset pool
Prepayment risk	In view of the managed nature of the pool, prepayment of loans does not affect investors	Prepayment of underlying loans is passed on to investors; hence investors take prepayment risk
Nature of credit enhancement	The cover, that is, excess of the cover assets over the outstanding funding.	Different forms of credit enhancement are used, such as excess spread, subordination, over-collateralization, etc.
Classes of securities	Usually a single class of bonds are issued	Most transactions come up with different classes of securities, with different risk and returns
Independence of the ratings from the rating of the issuer	Theoretically, the securities are those of the issuer, but in view of bankruptcy-proofing and the value of “cover assets”, usually AAA ratings are given	AAA ratings are given usually to senior-most classes, based on adequacy of credit enhancement from the lower classes.
Off balance sheet treatment	Not off the balance sheet	Usually off the balance sheet

Capital relief	Under standardized approaches, will be treated as on-balance sheet retail portfolio, appropriately risk weighted. Calls for regulatory capital	Calls for regulatory capital only upto the retained risks of the seller
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Legal structure:

The key question as regards the legal structure of covered bonds is – can the bonds survive the bankruptcy of the bond issuer? The answer has to come from the legal structure of the country in question. In most of the continental European countries, there are special laws dealing with covered bonds. In absence of specific law, the issuance has to be backed by the common law security interest structure that effectively provides the bondholders the right of enforcement even in the event of bankruptcy of the issuer.

Covered bonds are structured with security covenants like asset cover, selection criteria, etc which are most common for most other secured bonds or debentures.

The differences between securitization and covered bonds are obvious – covered bonds do not rely on any isolation of assets for the sake of bankruptcy remoteness; hence, there is no legal separation of the assets. As such, the assets stay on the balance sheet of the issuer. Consequentially, there are no issues of booking of any profits on sale, etc.

What are the significant differences between covered bonds and traditional secured borrowings or bonds? Essentially, it is the efficacy of the security interest that outlines the difference, if any, between traditional balance sheet bonds and covered bonds. If special law, or special structure of security interest creation, ensures that the security would not be frustrated or partly compromised in the event of bankruptcy of the issuer, then covered bonds are a notch better than traditional secured corporate financings. It is only based on this test of survival in bankruptcy proceedings that can give higher ratings to covered bonds than the issuer.

Covered bonds: where is the cover?

Most of the European jurisdictions which have been using covered bond structures have special laws dealing with covered bonds; however, recently, covered bond structures have spread also to countries which do not have specific laws. In absence of specific national law that distinguishes covered bonds from traditional secured financings, the question that obviously comes up is – if covered bonds are immune from issuer bankruptcy risk, then there is no basic difference between other forms of secured financing and covered bonds. UK is an example – UK has been considering, but does not currently have, a law on covered bonds. The usual security interest principles of UK common law are used to create covered bonds. Netherlands is another example of a country that has successfully issued covered bonds recently, without any specific law.

The first of the US covered bonds has also been announced in the beginning of Sept 2006, and the US also does not have a specific law dealing with covered bonds.

This issue has been discussed in light of Art 22 (4) of the EU regulation Undertakings for Collective Investment in Transferable Securities (the "UCITS" Directive, 85/611/EEC). Art 22 (4) provides for a preferential treatment to covered bonds, at par with government securities, in view of their special nature. EU States may provide for 10% risk weight to covered bonds for the purpose of capital requirements.

It has been felt that the insolvency law of UK is highly creditor-friendly, as opposed to that of continental European countries. Therefore, it has been opined that in UK, a special law granting immunity to covered bonds is not required as the common law principles can effectively achieve the same purpose¹.

UK structures have been based on isolation of the assets into a special purpose vehicle. The bonds are issued by the originator, and not by the SPV, and the bonds are the obligations of the originator. The SPV guarantees the obligations of the issuer, and in consideration, the originator agrees to transfer the loans to the SPV. The transfer of the loans is a true sale, but since the bonds remain the obligations of the issuer/originator, the loans are not removed from the books of the originator. The structure is almost a mid-way between traditional secured bonds and a securitization transaction. The first of the UK covered bonds issuances, HBOS, used this structure, and since then, the structure has been repeated in several UK covered bonds.

Since the UK-type covered bonds have a lot of similarity with securitization transactions, these covered bonds have sometimes been called "structured covered bonds".

In essence, the UK covered bonds structure is an improvisation of the master trust structure so far being used in several UK RMBS transactions. The master trust structure creates a mismatch between the cashflow profile of the assets and those of the securities. The covered bonds structure extends that idea further – the issuer is required to maintain a certain degree of asset cover (aka overcollateralisation); in addition, there are several other covenants that he has to comply with. Subject to the covenants, the issuer is free to use the cashflows, whereas in securitization transactions, the cashflows are redirected to pay off the securities. Thus, there is a greater mismatch between the cash inflows from the mortgages and the cash outflows to the investors in covered bonds – with the mismatch being managed by the issuer rather than being transferred to the investors.

¹ "The reason that there is no UK equivalent to the Pfandbriefe legislation is that the problems that the Pfandbriefe legislation exists to solve do not arise in the UK system. In the UK, collateral coverage for the holders of Covered Bonds can be achieved through a transfer of assets to a special purpose vehicle established for the purpose. The special purpose vehicle will guarantee the obligations of the bond issuer and thus the collateral will be available to the bondholders in the event of a default by the issuer" – Issue 55, Asset-backed Bonds, a report of the Financial Markets Law Committee of the EU, at <http://www.fmlc.org/papers/Issue55Art22.pdf>, last visited Sept 7, 2006.

Besides the asset liability mismatch, there are interest rate mismatches also – the interest rate features of the securities are completely independent from those on the assets.

US covered bonds structure:

The first of the US covered bonds came from Washington Mutual (WAMU) , the largest S&L in North America. WAMU is itself a prominent issuer in securitization market: the fact that it thought of entering the covered bonds market is quite significant in itself.

The US structure does not use either true sale or guarantee from any special purpose entity. In fact, the transaction is based on a simple pledge of assets to a bond trustee. S&P's rating report for the WAMU transaction says: "In U.S. structured finance transactions, an FDIC insured bank may grant a perfected security interest in collateral, and the security interest, subject to certain conditions, will be enforceable against the bank and its receiver or conservator notwithstanding the insolvency of the bank".

Covered bonds structure under US Treasury Guidelines

US Treasury came up with Best Practices guidelines on covered bonds. The guidance note proposes two alternative structures: issuance of bonds by an SPV, and issuance of bonds by the originator directly.

Direct issuance by the originator:

Under this structure, the issuer is the entity holding the pool of mortgages. The issuer contains a mortgage interest on the pool of cover assets, and issues bonds.

Issuance through SPV:

In case of the SPV structure, the SPV acquires a mortgage bond issued by the originator. In other words, the originator takes a loan from the SPV and issues a mortgage bond in lieu. The SPV in turn issues the securities, backed by the mortgage bond it holds. The maintenance of the mortgage cover would be the responsibility of the originator. The conceivable advantage of using the SPV structure is that there might exist legal and structural enhancements at SPV level such as liquidity facility, independent trustees etc.

Pricing and risk assessment of covered bonds:

As per theory, the spreads on covered bonds should be lower than those for securitization, and higher than those for unsecured bonds. The spreads being higher than unsecured bonds is easy to understand, as covered bonds are backed by effective collateral and are mostly AAA rated. The reason for the spreads being lower than securitization is because in case of securitization, investors do not have a recourse against the originator, and importantly, investors face prepayment risk. The asset-liability mismatch inherent in the pay-back profile of the loans is taken entirely by the investors. In case of covered bonds, investors are not affected by the prepayment risk, and the payment term is mostly in form of hard bullet.

From investors' viewpoint, the key point in analysis of a covered bond is the quality of the underlying mortgage loans. As the pool is not static, the crucial issue is the underwriting standards and the selection criteria for introducing new loans into the pool

Accounting for covered bonds:

Can covered bonds lead to off-balance sheet treatment? Under IAS 39, true sale is not a precondition for off-balance sheet treatment. Transactions that qualify as pass-through arrangements, even if not backed by true sale, may lead to assets being off the balance sheet. However, the key question in case of covered bonds is whether covered would amount to pass through arrangements?

The very nature of covered bonds is that the presence of a mismatch between the cashflows from the pool assets and the repayment of the bonds. The pool is a dynamic pool that simply provides a security cover. Unlike in case of securitisation transactions, it is not that the cashflows from the pool are used to repay the bonds. Hence, covered bonds are not pass-through transactions. Therefore, off balance sheet treatment will not be applicable in case of covered bonds.

Capital requirements for covered bonds:

Regulatory capital requirements in various countries provide for lower risk weights in case of covered bonds. UK covered bond regulations, for instance, aim at a 10% risk weight, as against 20% for AAA corporate bonds. Unlike in case of the securitisation, there is no question of capital relief for the originator in case of covered bonds.

The future of covered bonds:

In the opinion of the author, the experimentation of the covered bond structure in traditional domains of securitization implies that the market is searching for a right method of bankruptcy-protected structures. It is a pity that covered bonds, a device that comes from civil law countries which did not have the flexibility of common law, is being tried in common law countries. The premise of isolation of assets by way of a true sale, on which securitizations are based, will increasingly prove to be too cosmetic to be real. At the same time, traditional secured financings cannot be entirely bankruptcy proof, as bankruptcy, by definition, is intended to provide an equitable distribution of assets of the bankrupt where the assets are not enough to pay everyone. Off balance sheet financing will increasingly become difficult with accounting standards trying to bring the SPVs back on the balance sheet by way of consolidation. If consolidation is the rule for books of account, it will, in long run, motivate courts also to see through the wall of separation between the seller and the SPVs. In fact, the whole device of SPVs may, at some stage, be questioned by law courts.

Therefore, legal systems need to be developed to accommodate the market's need to create asset-backed funding devices. Covered bonds does not look like an ideal solution, but surely, is a step in the search for the right solution in asset-backed funding.

2. Covered bonds regulations:

US covered bonds Best Practices guidance:

The US Treasury came up with a Best Practices guidance on covered bonds in July 2008, coupled with the FDIC's Policy document. The purpose of the guidance is obviously to encourage US issuers to use covered bonds. Since covered bonds are not bankruptcy remote under US bankruptcy laws, the FDIC's policy statement clarifies that in respect of bonds issued under the Best Practices guidance, the FDIC will grant automatic consent to access the pledged assets to the bondholders. In other words, in case of all FDIC-insured depository institutions, the covered bond holders get a bankruptcy-unaffected right against the pool of mortgage assets backing up the bonds. Of course, if the pool of mortgages is not sufficient to repay the bonds, the recourse obligation against the originator is subject to the originator's bankruptcy administration.

Some significant features of the Treasury's Best Practices guidance are as follows:

- **Aggregate limit of issuance:** Covered bonds are limited only to 4% of the issuer's liabilities, inclusive of the bonds. As the reference is to liabilities and not debt, it should logically include equity as well.
- **Loan level over-collateralisation:** The guidelines permit an updated LTV of not more than 80%. This would mean the LTV must be regularly updated based on latest valuation of the underlying properties. If the LTV is found to be more than 80%, only 80% of the value of the property will be considered for counting the size of the pool. In other words, the excess of the outstanding loan amount over 80% of the value of the property will be ignored for the purpose of counting the pool value.
- **Pool level over-collateralisation:** The asset cover or pool value, after applying hair cuts as per LTV test above, should at least be 105% of the outstanding bond liabilities at any time.
- **Qualifying mortgages:** Only first lien, full doc, 1-4 family mortgages, with initial LTV of no more than 80%, are allowed to be included in the cover pool. The mortgage must be current on the date of inclusion. If it becomes 60-days past due, it must be replaced. There are several other qualifying conditions too.
- **Maturity:** The bonds must have a maturity of 1 – 30 years.
- **Segregation of cover pools:** The Guidelines seem to leave open the possibility of having separate cover pools for different covered bond issuances by a single issuer. For example, let assume an issuer has 20 covered bond issuances (Series 1 to 20). The issuer may have a common pool for all the series of covered bonds, or may have segregated pools for each series, or may have a pool dedicated to series 1 to 5, another for series 6 to 10, and so on. In case of segregated pools, the issuer is required to allocate losses in the pool assets proportionally to all covered bonds drawing from a common pool. Notably, unlike securitization structures, loss allocation would not mean losses being allocated to investors: here, loss allocation would mean erosion of the over-collateralisation, requiring the issuer to put more assets into the pool to make up for the lost assets.

UK regulation:

UK enacted Regulated Covered Bonds Regulations 2008 to provide a legislative framework for covered bonds issuances. The UK structure involves a special purpose vehicle that issues the bonds, and then on-lends the proceeds to the owner of the pool. The owner guarantees the obligations of the SPV thereby creating a recourse. Hence, there is a statutory distinction between the issuer and the pool owner.

“Eligible property” for the purpose of the covered bonds issuance is defined in terms of para 68, Annexe VI of the Banking Consolidation Directive. It is felt that both residential and commercial mortgages will qualify for the purpose of the regulations. However, levels of over-collateralisation, LTV ratio of the mortgages, etc. have not been laid down in the regulations.

German Pfandbriefe law:

Under German law, pfandbriefs can be issued only by banks, also on the strength of a specific license issued on satisfaction of several conditions. These pfandbrief issues are expected on a regular and consistent basis, rather than on an opportunistic or sporadic one.

There are three different types of pfandbriefs permitted by the German Pfandbrief Act – mortgage pfandbriefs, public pfandbriefs and ship pfandbriefs. Mortgage and ship pfandbriefs, as the name implies, are backed by real estate and ships, respectively. Public pfandbriefs are those backed by claims against public sector authorities. Notably, the loan-to-value ratio in case of mortgage loans is limited to 60%.

The key feature of pfandbriefs is “covered assets,” the collateral backing up the pfandbriefs. Depending on the type of pfandbriefs, the covered assets should be qualifying mortgages, public sector financial claims or mortgages on ships. In addition, within specific limits, claims against central banks, credit institutions and derivatives transactions are also recognized as covered assets.

The key to the bankruptcy remoteness of pfandbriefs lies in Sec. 30 of the Pfandbrief Act. This section provides that if insolvency proceedings are opened in respect of the Pfandbrief bank’s assets, the assets recorded in the cover registers shall not be included in the insolvent estate. The claims of the Pfandbrief creditors must be fully satisfied from the assets recorded in the relevant cover register; they shall not be affected by the opening of insolvency proceedings in respect of the Pfandbrief bank’s assets. Pfandbrief creditors shall only participate in the insolvency proceedings to the extent their claims remain unsatisfied from the covered assets. Notably, this principle is very similar to the position of secured lenders under U.K. corporate insolvency laws.

There are independent administration provisions for the covered assets. Sec. 30.2 provides that the court of jurisdiction shall appoint one or two natural persons to act as administrators, whereupon the right to manage and dispose of the covered assets shall be transferred to the administrator.

Acquisition and disposal of covered assets is not illegal; the security interest of the pfandbrief holders on the covered assets is comparable to a floating charge under English law. However, once the appointment of the administrator has been done, the security interest crystallizes and any disposal of the assets subsequent to appointment of the administrator shall be invalid.