Covered Bonds: Shelter From Financial Turmoil, Exposure to the 1940 Act

Steve Flantsbaum*
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INTRODUCTION

The current credit crisis, a consequence of business and consumer deleveraging, has raised financial stability concerns for many major national and regional banks.1 Falling home prices, soaring mortgage defaults and an exorbitant rise in the LIBOR2 – the lending rate banks use as a benchmark to loan money – have recently made it impossible for many homeowners to refinance their mortgages to affordable levels.3 Though the Federal Reserve took drastic action to lower the lending and mortgage rates,4 many homeowners whose mortgage obligations exceeded the value of their homes simply chose to not pay their mortgages,

∗ J.D. Candidate 2009, Fordham University School of Law; B.B.A., summa cum laude, Lubin School of Business, Pace University, 2006. I would like to dedicate my first legal publication to my father, Ilya Flantsbaum, who has been the most positive and inspirational influence in my life and whose memory will always be with me, my mother, Elina Dyakovetsky, whose love, support and perseverance through life’s hardships have been the greatest motivation in my own life, and Anna Drynda for her unfailing patience and optimism. I would also like to thank Professor Harold Moore for his supervision and guidance and the members of the Fordham Journal of Corporate & Financial Law for their editorial assistance and diligent help throughout the writing process.


to default, and to walk away. This caused great uncertainty as to the value of assets the banks have bundled up, securitized and sold to investors. As a result, banks that decided to keep some of these assets, as well as investors who hold many of those securitized loans in their portfolios, suffered steep write-downs because of depressed asset market prices. Such events effectively demolished the market for securitized mortgage bonds, and many financial institutions that had once participated in that market have exited with no indication of recommitting themselves to issuing those types of securities in the near term. Moreover, the increase in the interbank lending rate led the inversely correlated prices of banks’ bonds to plummet. This triggered the need to recapitalize banks, which began hoarding cash and minimizing consumer lending as they realized that their very survival was at stake due to insufficient capitalization. Analogous to a negative feedback loop, the banks’ hoarding of cash led to further increases in overnight lending rates, further decreases in asset prices, and further drops in securitized debt issuances.

The United States Department of the Treasury (the “Treasury”), under the guidance of then Treasury Secretary Henry Paulson, realized that to recapitalize, financial institutions needed to provide avenues beyond the currently dysfunctional securitization market to encourage

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6. Dan Levy, U.S. Foreclosures Jump 57% as Homeowners Walk Away, BLOOMBERG, Apr. 15, 2008, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=ahJfJhKyxAWI. This phenomenon has also been exacerbated by “mark-to-market” accounting, which mandates that assets be marked down to the price for which there exists market consensus. When there are vastly more sellers than buyers, however, the markdowns can be enormous, sometimes not reflecting the assets’ eventual recovery value.

7. See Levine, supra note 3.


10. Levine, supra note 3 (“Issuance of mortgage-backed debt this year through July has dropped 83% from last year.”).


12. In a securitization, the originating institution pools together its interest in
investors to buy loans from the banks’ books. Investors’ purchases of these loans would increase asset prices and decrease mortgage rates, which would in turn incentivize new buyers to enter the devastated real estate market. The Treasury has therefore decided that we must look beyond the current structure of securitized lending that lets banks divest themselves of mortgage loans. We should instead look into new issuances that help lenders make long-term loans and hold those loans on their balance sheets. One possible way to lower borrowing costs and revive lending is to issue debt secured by collateral kept on the banks’ books. This is the essential feature of a covered bond, an established financial instrument in Europe. The Treasury specifically recommended the establishment of a covered bond market in the U.S. with the goal of developing it as an alternative method for banks to issue and sell mortgage loans to investors.

While creation of a covered bond market may alleviate stress from dysfunctional securitization markets, issuance of covered bonds must be complementary to business goals of investors and issuers alike. From the investors’ standpoint, covered bonds offer recourse to the issuers’ assets, thus giving investors security in the event of default. From the issuers’ view, covered bonds attract investors – and their capital – due to characteristics such as offering a higher credit rating and recourse to the issuer’s assets. Issuers, however, would be more reluctant to offer covered bonds if they had to comply with an additional substantial burden of compliance, such as that of the Investment Company Act of financial assets with identifiable future cash flows, and sells those claims to a Special Purpose Entity (“SPE”) whose only role is to hold those assets. Investors then purchase these assets from the Special Purpose Entity. Therefore, the originating institution obtains ready capital in exchange for those assets’ future cash flows. See Frank J. Fabozzi & Vinod Kothari, Securitization: The Tool of Financial Transformation (Yale Int’l Ctr. for Fin., Working Paper No. 07-07, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997079.

See supra note 3.


Salmon Posting, supra note 8.


See infra Parts II-III.

See infra Parts II-III.
1940 (the “1940 Act”)\(^\text{19}\), without another avenue that would avoid such reporting complications.

Part I of this Note describes the European covered bond market and identifies some regulatory frameworks that allowed the covered bond to develop there into a promising financial instrument. Part II of this Note briefly explains recent efforts by the Treasury and the Federal Deposit Insurance Corporation (the “FDIC”) to cultivate a covered bond market in the United States, focusing on the treatment of covered bond investors in case of issuer’s default. Finally, Part III uncovers a potential obstacle for covered bond issuers: the loss of a specific 1940 Act exemption from “investment company” status for public offerings of structured financings, Rule 3a-7.\(^\text{20}\) Part III then identifies an alternative way issuers could achieve this exempted status and makes a brief recommendation regarding the future benefit of expanding Rule 3a-7 for the sake of developing the covered bond market.

I. THE EUROPEAN COVERED BOND MARKET

A. History and Description of the European Covered Bond Market

During the last decade, the European mortgage market has expanded at an annual rate of more than 8%.\(^\text{21}\) In order to turn mortgage loans into available capital, European financial institutions employed covered bonds,\(^\text{22}\) as opposed to issuing securitized debt.\(^\text{23}\) Several European laws adopted specifically for covered bond issuances tremendously helped lift that market. As a result an estimated €2.11 trillion worth of covered bonds was outstanding as of the end of 2007.\(^\text{24}\)


\(^{20}\) 17 C.F.R. § 270.3a-7 (1992).


\(^{22}\) “Covered bonds are debt instruments secured by a cover pool of mortgage loans (property as collateral) . . . to which investors have a preferential claim in the event of default.” European Covered Bond Council, About Covered Bonds, http://ecb.europa.hypo.org/Content/Default.asp?PageID=311 (last visited Mar. 6, 2008).

\(^{23}\) Treasury Best Practices Guide, supra note 16, at 9 (stating that the covered bond market dates back to over 200 years, to the initial Prussian issuance in 1770).

\(^{24}\) Id.
The performance of covered bonds has been more resilient during the credit crisis than either Asset Backed Securities ("ABS") or Mortgage Backed Securities ("MBS"). Admittedly, spreads on covered bonds have widened sharply and declining market values of their holdings have harmed covered bond holders. Indeed, sales of covered bonds declined over five straight months and global covered bond issuance for the year through September 2008 fell 10% from the same period in 2007. That is almost insignificant, however, compared to the same-stretch issuance of European mortgage-backed securities ("MBS"), which plunged an enormous 96% in 2008 through September, compared with the same period in 2007. As for the erosion of market value, although covered bonds suffered a 1.12% loss in September 2008, they still outperformed investment-grade company debt, which tumbled 3.9%.

The mechanics of a covered bond transaction bear great similarities to secured financings. Essentially, covered bonds are debt instruments secured against a pool of assets. European credit institutions issuing covered bonds use mainly long-term funding collateral, such as residential or commercial property, public sector claims and ship mortgage loans, to support their long-term lending activities. The issuing institution pledges a specific pool of collateral (the "cover pool") to an investor in return for capital, while the covered bond investor obtains the interest on covered bonds, which is paid out from the issuer’s general business

29. See id.
30. See Smith, supra note 27.
31. Id. N.B. This discussion relies on figures current through September 2008. In the late fall and winter of 2008 and continuing through the time of publication, a marked deterioration of the economy occurred that caused significant erosion of market value in all types of investments.
32. See Avesani et al., supra note 1, at 4.
33. Ralf Grossmann & Otmar Stöcker, Generic Section, in EUROPEAN COVERED BOND FACTBOOK 67 (2d ed. 2007).
cash flows. The issuing banks must keep the cover pool on their balance sheets and the covered bond investors retain a preferred claim against the assets in the cover pool in the event of an issuer default. Therefore, the issuing institution is still responsible for losses caused by borrowers’ defaults or delinquencies. In the event the issuing institution fails to make payments on a covered bond, the covered bond holders are entitled to recourse to the cover pool and, if that proves insufficient, to the issuer’s other assets. By contrast, an investor in a typical securitization only has recourse against the Special Purpose Entity (the “SPE,” also sometimes called a Special Purpose Vehicle, or “SPV”) that issued securitized loans, whose balance sheet typically consists strictly of those loans. Because of true sale, the investor in a securitization does not have recourse to the originating bank’s assets and so does not have a claim against the bank if the SPE’s loan pool is insufficient to satisfy his claim.

Covered bonds benefit investors by carrying a higher yield than European government bonds without significantly increasing the risk and credit quality of their portfolios. Most covered bonds carry ratings of double- or triple-A, ranking them extremely safe among corporate debt securities. To rate covered bonds so highly, all major rating agencies focus on the structure of the cover pool, including its ability to retain value in the event of issuer default and the quality of the mort-

35. See id. at 11.
36. See id. at 7; see also Bond Basics, supra note 21, at 3.
37. For this and other characteristics of SPEs, see, e.g., Gary Gorton and Nicholas S. Souleles, Special Purpose Vehicles and Securitization (Nat’l Bureau of Econ. Research, FRB Working Paper No. 05-21, 2005), available at http://knowledge.wharton.upenn.edu/papers/1314.pdf. Without any pledged collateral behind securitized bonds, investors have no recourse to the issuer’s assets. The SPE, which does not have any assets aside from the assets backing the receivables themselves, also does not offer any extra recourse. The investors are therefore left holding receivables that are not paying in accordance to the original structure.
38. “True sale” is a legally recognized transfer of receivables from the originator to the SPE, whereby these receivables become the legal property of the SPE and are not affected by the originator’s bankruptcy or claims by the originator’s unsecured creditors. See Fabozzi & Kothari, supra note 12.
39. See Bond Basics, supra note 21, at 2, 5.
The rating agencies are cautious, however, because even if the cover assets retain their value, creditors of the defaulted issuer who are not investors in its covered bonds could try to seize the assets in the cover pool to satisfy their claims. To maintain the product’s credit excellence, European covered bond legislation addresses this problem by specifying that assets within the cover pool must be high quality, the cover pool must be segregated for the benefit of covered bond holders, and investment in covered bonds must come with full recourse against the cover pool and the issuer.

B. The European Covered Bond Regulatory Framework

Most European countries use similar special-law based frameworks that govern issuances of covered bonds. The frameworks provide guidance as to what types of assets are eligible for inclusion in the cover pool, asset/liability management, credit enhancements and over-collateralization requirements. The existence of those frameworks is directly responsible for a liquid secondary market for covered bonds, which makes the financial instrument even more attractive to investors. Although a special-law based framework increases market homogeneity and simplicity, some countries in Europe still prefer to

41. See, e.g., Packer et al., supra note 40, at 47; Covered Bonds, FITCH RATINGS (Fitch Ratings, New York, N.Y.), http://www.fitchratings.com/web_content/sectors/covered_bonds/coveredbonds_factsheet.pdf (stating “[i]n order to maintain its covered bonds ratings, Fitch Ratings receives at least quarterly reporting from issuers about their cover pool and covered bonds, and carries out operational visits.”); see Bond Basics, supra note 21.
42. See Packer et al., supra note 40, at 47.
43. See Bond Basics, supra note 21, at 2.
45. Id. (“As of December 2007, special-law based frameworks exist in 26 countries in Europe.”).
46. See Avesani et al., supra note 1, at 4-5.
47. See id.
48. See TREASURY BEST PRACTICES GUIDE, supra note 16, at 9 (“Typically, a legislative framework exists in nations with a long history of Covered Bonds while nations with a relatively young Covered Bond market . . . have a structured framework.”).
operate under a general-law based framework that replicates special-law based covered bond issuances through general contract laws and regulations of those countries. What follow are certain European frameworks, directives and regulations that facilitated covered bonds’ success.

1. The Jumbo Covered Bonds Model

The “jumbo” or “benchmark” model, first introduced in Germany in 1995, has been the initial driver for covered bonds’ success. Its influence has now expanded into other European countries. The jumbo model added several features to a regular covered bonds issuance to increase liquidity and improve the covered bond issuance structure to suit foreign institutional investors:

1. The minimum issuance size is €1,000,000;
2. Jumbos must be plain vanilla bonds (fixed, not variable coupon, paid annually in arrears);
3. Buybacks are permitted;
4. The bonds must be officially listed on an organized market; and
5. At least three market makers must quote bid/ask prices simultaneously to maintain a liquid market.

2. The UCITS Directive

After the launch of jumbo covered bonds, the covered bond market continued to expand through the 1999 introduction of Euro-denominated securities and the 2001 introduction of Europe’s common currency. More recently, Article 22(4) of the European Directive on Undertakings for Collective Investments in Transferable Securities (the “UCITS Directive”) has proved especially conducive to the covered bond mar-

49. See Essential Features of Covered Bonds, supra note 44. There is a movement by those countries, however, to standardize their legal frameworks relating to covered bonds to the tune of Europe’s majority. See, e.g., Avesani et al., supra note 1, at 4 n.5.
50. See Avesani et al., supra note 1, at 5; Bond Basics, supra note 21, at 4.
51. See Avesani et al., supra note 1, at 5; Bond Basics, supra note 21, at 4.
52. See Avesani et al., supra note 1, at 5.
53. Bond Basics, supra note 21, at 4-5.
This directive solidifies the privileged status of covered bonds as compared to MBS or unsecured bank debt.

Article 22(4) significantly lifts investment caps by allowing investment funds and insurance companies to invest up to 25% and 40% of their assets, respectively, as opposed to the usual 5% limit, in the covered bonds of a single issuer as long as the issuer and the bonds satisfy the following eligibility criteria:

(1) The covered bonds must be issued by an EU credit institution. According to the European Covered Bond Council (the “ECBC”), “[a] credit institution is an entity licensed to carry on one or more banking activities, such as receiving deposits from the public, granting loans or providing payment services” and is subject “to public supervision and regulation which prescribes standards for the management of credit, liquidity, interest rate and operational risks.”

(2) The covered bonds must be subject to special supervision by the public authorities with the specific aim of protecting the covered bond holders. The ECBC identifies the standard features of special supervision to include: a special cover pool monitor, periodic audits of the cover pool by the cover pool monitor and ongoing management, and maintenance of the cover pool upon the credit institution’s insolvency to ensure timely payment to covered bond holders. The public authorities, which may include rating agencies, must regularly supervise banking or capital markets activities. These authorities should regularly monitor the underlying cover assets and distribute that information to investors.

(3) The sums deriving from the issuance of covered bonds must be placed in assets which provide sufficient cover for the liabilities deriving from the bonds until maturity. The ECBC suggests that the value of the cover assets must be at least equal to the value of the covered bonds. Most jurisdic-

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55. See Bond Basics, supra note 21, at 1-2.
57. See id.
58. See id.
59. Id.
tions, however, either through a special-law framework, contract law or some combination of the two, also require over-collateralization, so that the value of the cover pool must exceed the value of the covered bonds by a prescribed amount.\textsuperscript{60} The issuing credit institution may be required to provide additional assets for cover if all or a portion of the original assets mature, default or otherwise fail to meet specified eligibility criteria, thus making the cover pool “dynamic.”\textsuperscript{61} Hence, there is no outright connection between a specific cover pool or individual loans and outstanding covered bonds since the cover pool’s composition is subject to change.\textsuperscript{62} If the cover pool is insufficient and the issuer cannot substitute or add assets or buy back the covered bonds, the pool accelerates and the debt obligation pays out prior to its due date.\textsuperscript{63}

\textbf{(4)} The bonds under consideration must be guaranteed by the issuer and should grant preferential rights to the bondholder in the event of the issuer’s default. The cover assets must be clearly identified, segregated and placed as security for the bonds.\textsuperscript{64} In bankruptcy proceedings, covered bond holders have recourse against that pool of assets against which the covered bond pool has been secured. If the pool of assets is insufficient to cover the default as a result of non-payments on underlying mortgage or lease payments, the investors also have recourse against the issuer itself.\textsuperscript{65} General, unsecured creditors have no claim against the cover assets.\textsuperscript{66}

\begin{itemize}
\item \textsuperscript{60} Id.
\item \textsuperscript{61} See id.; Alain Marcel & Bernd Volk, \textit{Covered Bonds: Influence of Securitisation Techniques, in EUROPEAN COVERED BOND FACTBOOK 61} (2d ed. 2007).
\item \textsuperscript{62} See Marcel & Volk, supra note 62, at 61.
\item \textsuperscript{63} See id.
\item \textsuperscript{64} See id.
\item \textsuperscript{66} Bond Basics, supra note 21, at 3.
\end{itemize}
The Capital Requirement Directive (the “CRD”) originated in a Basel Committee on Banking Supervision proposal and was adopted on June 7, 2006 to amend the supervisory regulations that direct the capital adequacy of international banks. The CRD significantly lowers risk weighting for certain covered bond holders, enabling them to hold less capital in reserve against the bonds. It allows credit institutions investing in covered bonds to assign a 10% risk weighting – down from 20% – to covered bonds complying with these criteria. Credit institutions can take advantage of the CRD benefits if the bonds:

1. Meet the UCITS Directive criteria, and
2. Are backed by high-quality asset classes.

II. THE DEVELOPMENT OF COVERED BONDS IN THE UNITED STATES – THE FDIC FINAL COVERED BOND POLICY STATEMENT AND THE TREASURY BEST PRACTICES FOR RESIDENTIAL COVERED BONDS GUIDE

Although securitization has been the preferred method of pooling and repackaging cash-flow producing financial assets for sale to investors, originations of ABS, MBS, and covered bonds slowed to a trickle during the credit crisis. Some are optimistic, however, that a covered bond framework may appeal to U.S. investors and help financial institutions recapitalize themselves through new debt issuances. Federal regulations have been introduced in many countries, including the United States, to support the issuance of covered bonds. In the United States, the Federal Deposit Insurance Corporation (FDIC) issued a final covered bond policy statement in 2008, and the Treasury introduced best practices for residential covered bonds in 2009.

68. See Avesani et al., supra note 1, at 6; Bond Basics, supra note 21.
69. See Avesani et al., supra note 1, at 6.
70. High-quality asset classes include commercial and residential mortgages, public sector loans, ship loans, and Senior MBS. See Bond Basics, supra note 21. However, market participants in countries that do not have specific covered bond legislation, but instead use the general-law framework, such as the U.K., expand the definition to include bonds issued under private contractual arrangements using elements from structured finance. See Packer et al., supra note 40, at 52.
Reserve Governor Kevin Warsh stated that covered bonds are of such high rating and high quality that they would generally fall within the range of eligible collateral that the Federal Reserve has long accepted from depository institutions at its discount window. Therefore, “[p]rivate lenders also are likely to find such bonds attractive as collateral for credit extensions” in the United States.

To date, only two U.S. institutions have issued covered bonds: euro-denominated sale by Washington Mutual in 2006, followed by Bank of America’s euro-denominated and dollar-denominated sales in 2007. Without a special-law framework, these issuances were done through contractual dealings. In view of the credit crisis, however, the Treasury has taken a special interest in developing a specific covered bond framework in the United States. The Treasury believes that such a market will create a viable alternative to securitization while the latter market is struggling, and will later serve as a complement to securitization when the market picks up. The Treasury’s proposal has already attracted interest and enlisted support from the country’s largest banks –

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74. Warsh Remarks, supra note 73.

75. Id.


77. TREASURY BEST PRACTICES GUIDE, supra note 16, at 9.

78. Id. at 5 (“Covered Bonds present an alternative source of funding for institutions that can complement other sources of financing for a wide range of high-quality assets.”); id. at 3 (“Treasury believes that Covered Bonds represent a potential additional source of financing that could reduce borrowing costs for homeowners, improve liquidity in the residential mortgage market, and help depository institutions strengthen their balance sheets by diversifying their funding sources.”).
J.P. Morgan Chase, Bank of America, Citigroup and Wells Fargo. Domestic brokerages like Goldman Sachs are also directing staff and resources to concentrate on underwriting, marketing and trading covered bonds.


As a guide for a fledgling market, the Treasury has adopted particular features of European covered bonds that helped the European market to grow. Most importantly, the depository institution that issues covered bonds must retain that cover pool on its balance sheet, unlike the MBS where mortgages are packaged, securitized and sold off to investors. Covered bond holders must also have full recourse to the cover pool and the issuer’s assets. Taking another cue from the European special-law framework, the Treasury advises that the interest on covered bonds not be paid from mortgage income, as in the MBS structure, but rather from the issuer’s general cash flows.

Additionally, issuances of covered bonds are limited to 4% of the issuer’s liabilities, inclusive of the bonds, and set strict requirements regarding which type of collateral is eligible to be part of the cover assets. The collateral securing covered bonds must consist of, among

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80. See id.
82. See TREASURY BEST PRACTICES GUIDE, supra note 16, at 6.
83. See id. at 3.
84. See id. at 7-8.
85. See id. at 6.
86. See id. at 7-8.
87. See id.
88. See id. at 15 (explaining that this is done so that the FDIC, the Treasury, and
other requirements: performing first-lien mortgages, underwritten at the fully-indexed rate with documented income and a maximum Loan-to-Value ratio ("LTV") of 80% and one-to-four family residential properties, in which the covered bond holders must have a perfected security interest. The mortgages must also be current on the date of inclusion in the cover pool, and the issuer must replace any mortgages that become more than 60-days past due. This stands in contrast to the MBS structure in which the underlying mortgages remain in each MBS until maturity. The Treasury granted some leniency, however, in acceptance of eligible collateral by providing that covered bonds may be secured by a limited volume of AAA-rated mortgage securities and certain substitution collateral such as cash and Treasury and agency securities, on the condition that limited volume not exceed 10% of eligible collateral. Moreover, the Treasury specifies that maturity for covered bonds must be between one year and thirty years, and that issuers must overcollateralize the cover assets in excess of the notional value of the

other regulators could evaluate the development of the covered bond market).

89. See id. at 19 ("The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate.").

90. The issuer must update the LTV based on the most recent valuation of the underlying assets. See id. at 12; Kothari, supra note 66 ("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.").


92. See id. at 12.

93. See id. at 12-14.

94. Issuers of covered bonds can perhaps earn interest on excess spread within covered bond funding transactions to alleviate the burden of holding extra collateral. Excess spread is the difference between the weighted average interest rate of the underlying loans that a financial institution receives from mortgage borrowers and the weighted average funding cost of the transaction in the form of coupon payments to covered bond investors. The funding cost of the transaction should be less than the weighted average rate of the underlying loans. Fabozzi & Kothari, supra note 12. Because a covered bond transaction is a secured financing deal and covered bond payments are disbursed from an issuer’s cash flow instead of the underlying mortgage payments, a covered bond issuing SPE should structure interest payments earned on the excess spread to the issuing bank. Although excess spread is commonly used to absorb expected losses from the asset pool, the issuing bank is nonetheless under an obligation to replace non-performing assets, diminishing the benefit of a SPE retaining the excess spread.
covered bonds by at least 5% of the outstanding principal balance at all times.\footnote{See Treasury Best Practices Guide, supra note 16, at 11-12; Kothari, supra note 66 ("The asset cover or pool value . . . should at least be 105% of the outstanding bond liabilities at any time.").}

Moreover, the issuer must appoint an independent Asset Monitor, such as a rating agency or some other entity of that capability, to perform a monthly Asset Coverage Test to ensure collateral quality and the proper level of overcollateralization, to determine whether any cover pool asset substitutions are necessary and to report this documented information to investors.\footnote{Treasury Best Practices Guide, supra note 16, at 14. In addition, aside from rating the quality of the cover assets, a covered bond transaction shines a spotlight on the credit quality of the financial institution. If the cover pool is insufficient to make scheduled payments to covered bond holders, those holders have recourse to the issuer’s assets. From the investors’ perspective, “as long as the bank is solvent, they are really looking to the bank to pay the obligation on the covered bonds. They’re not looking to the cover pool.” John Arnholz et al., Covered Bonds: Shelter from the Storm?, Asset Securitization Rep. Roundtable, May 26, 2008, at 12, 16-17 [hereinafter ASR Report], available at http://www.mckeenelson.com/files/Publication/aa07bcfc-2ef7-4ccc-9ed9-07acb7b0f1e7/Presentation/PublicationAttachment/b96095b8-0468-4651-befc-042bc3eab2/11.pdf (statement of Roundtable participant Prue Larocca, Managing Dir., RBS Greenwich Capital). Consequently, overuse of covered bond obligations could hurt issuer ratings, as the rating agencies could deem the issuers oversubscribed with obligations, which ultimately could hinder the issuing banks’ ability to obtain other debt funding and thus deter unsecured investors. See Al Yoon, Covered Bonds Won’t Replace Securitization – BofA, Reuters, Feb. 8, 2008, available at http://uk.reuters.com/article/marketsNewsUS/idUKN0846274820080208; see also Yair Listokin, Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis, 57 Duke L.J. 1037, 1047-48 (1981) (discussing drawbacks of secured debt).}

For disclosure, the Treasury recommends looking to Regulation AB\footnote{17 C.F.R. §§ 229.1100-.1123 (2005).} for guidance on supplying investors with descriptive information on the asset pool.\footnote{Treasury Best Practices Guide, supra note 16, at 14.}

The Best Practices Guide also specifies that a depository institution may issue covered bonds under one of two proposals: it can issue covered bonds directly, including through its wholly-owned subsidiary ("direct-issuance structure"), or through a bankruptcy-remote SPE created for the purpose of issuing covered bonds ("SPE-issuance structure").\footnote{See id. at 11, 17-18.} If the depository institution or its subsidiary directly issues covered bonds, the bank designates a dynamic mortgage pool of
revolving mortgage loans on its balance sheet that secures the mortgage bonds and that ultimately backs the covered bonds. Under the SPE-issuance structure, the SPE must purchase mortgage bonds from the depository institution, and must secure the mortgage bonds against a dynamic pool of residential mortgages. The SPE then issues covered bonds backed by assets in the cover pool to investors. In both structures, however, the covered bond holders have a first-priority claim on the cover assets. In addition, the cover pool will always remain on the balance sheets of depository institutions, regardless of the covered bond issuance structure.

In view of the dynamic nature of the cover pool, prepayment of loans does not affect investors because new assets will be substituted into the cover pool. An important issue arises, however, regarding covered bond holders’ protection against prepayment risk in case of issuer default. The SPE-issuance structure is primarily designed to protect covered bond holders against such prepayment risk if the originating depository institution defaults; it is also intended to enable the FDIC to access potential excess residual collateral over the limit necessary to protect covered bond holders. It is possible that the SPE-issuance structure, which was used in the previously mentioned Bank of America and Washington Mutual U.S. covered bond transactions, can benefit covered bond holders in case of issuer default by retaining elements of securitization while capitalizing on the advantages of a covered bond structure. This may be accomplished through asset segregation, which involves creation of a bankruptcy-remote SPE and swap

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100. See id. at 11.
101. Id.
102. Id.
103. Id.
104. Id.
105. See Kothari, supra note 66.
108. Id.
109. True sale, however, while an important benefit of securitization, is lost in a covered bond transaction because the presence of a recourse obligation defeats the point of transferring the risks and rewards of the assets to investors. A covered bond issuance clearly reflects a financing transaction between the depository institution and the SPE.
arrangements with a Specified Investment Contract Provider, as described below.\textsuperscript{110}

The depository institution makes the SPE bankruptcy-remote by restricting the SPE’s activities in as many ways as possible. Primarily, this is done by appointing independent directors whose consent is required for the SPE to file a voluntary bankruptcy petition, limiting the amount of debt an SPE can have, limiting the number of creditors and employees so they are not able to put the SPE into involuntary bankruptcy, observing all appropriate arms-length third-party formalities with the originator, and adopting provisions in the articles of organization prohibiting asset sale, merger, consolidation, dissolution and liquidation.\textsuperscript{111} The result is that the SPE-issuance structure creates a separate trust dealing exclusively with covered bond issuances. Bankruptcy-remoteness ensures that even if the issuing bank defaults, the SPE will continue functioning as intended.

Despite the creation of a bankruptcy-remote SPE, investors may remain wary of the treatment of their covered bonds in case of default, with particular focus on acceleration of their covered bond investments. If an issuing depository institution defaults, the cover pool along with the issuer’s remaining balance sheet assets transfer under FDIC control. The FDIC may then enter into a conservatorship\textsuperscript{112} or a receivership\textsuperscript{113} role and will try to transfer the defaulted issuer’s operations to a buyer that will assume its obligations. In those roles, the FDIC has three options regarding covered bond transactions of that depository institution:\textsuperscript{114}

(1) Continue to perform on the depository institution’s covered bond contracts;


\textsuperscript{111} Gorton & Souleles, supra note 37.


\textsuperscript{113} A court order whereby all the property subject to dispute in a legal action is placed under the care of a disinterested party, in this case the FDIC, whose goal is to preserve the defaulting institution’s property from adverse claims. See Black’s Law Dictionary 1296-97 (8th ed. 2004); see also 12 U.S.C. § 1821(c)-(d) (describing the appointment, functions, and powers of an FDIC receivership).

(2) Use cash to pay off the covered bonds up to the value of the pledged collateral; or
(3) Permit liquidation of the pledged collateral to pay off the covered bonds.\textsuperscript{115}

Even if the issuing institution enters insolvency proceedings, it is far from certain that covered bond obligations will be accelerated because the FDIC may choose the first option. If the FDIC selects either of the latter two options, covered bond holders may be at some risk of non-payment from the FDIC’s exercise of an automatic stay over the defaulting institution’s assets.\textsuperscript{116} The covered bond holder, however, obtains direct access to the cover pool ten days after the FDIC’s appointment as conservator or receiver through the FDIC’s automatic consent if the depository institution taken over by the FDIC remains in monetary default and the covered bond holder provides written request to exercise his contractual remedies.\textsuperscript{117}

In the event that the FDIC does not wish to continue performance on the defaulted issuer’s covered bond obligations and repudiates the covered bond contract, the Treasury, as a precaution, advises that the SPE must enter into a Specified Investment Contract through a swap arrangement, in which “[f]ollowing a payment default by the issuer or repudiation by the FDIC as conservator or receiver, the Specified Investment should pay ongoing scheduled interest and principal payments so long as the Specified Investment Provider receives proceeds of the Cover Pool assets at least equal to the par value of the Covered Bonds.”\textsuperscript{118} Therefore, even if the depository institution defaults, the Specified Investment Contract continues the arrangement between the issuer and the covered bond holders; the covered bond holders receive scheduled payments from the proceeds of the Cover Pool instead of the institution’s cash flows. Nevertheless, it is still possible that the liquidation proceeds of the covered bonds may be insufficient to reimburse the covered bond holders or the Specified Investment Provider. This problem can be cured, however, through another swap agreement with a third

\textsuperscript{115} Id.
\textsuperscript{117} Such remedies may include liquidation of the pledged collateral. \textit{TREASURY BEST PRACTICES GUIDE}, supra note 16, at 32-33; \textit{see FDIC Press Release, supra note 82. In contrast, European law only provides two options in case of issuer’s insolvency: government bailout or liquidation. \textit{See ASR REPORT, supra note 97, at 13 (statement of Roundtable participant Michael Krimminger, Special Advisor, Fed. Deposit Ins. Corp.).}
\textsuperscript{118} \textit{See TREASURY BEST PRACTICES GUIDE, supra note 16, at 13.
party. The third party, who could be the Specified Investment Provider or another market participant, will agree to compensate the covered bond holders for the deficiency in exchange for a certain sum, which could be part of the overcollateralization percentage. In any event, if the covered bonds repay investors less than the principal and accrued interest owed, investors can preserve an unsecured claim on the issuer’s other assets ranking pari passu, or equal, with other unsecured investors.\(^{119}\) In essence, the cover pool achieves securitization’s goal of avoiding substantive consolidation during bankruptcy, since the cover pool assets may not be combined with assets destined for unsecured creditors in the event of default.

Another potential source of apprehension is a lack of guidance as to how the FDIC will transfer covered bond liabilities to a buyer in case of issuer default. This concern has been somewhat ameliorated, however, by the September 2008 bankruptcy filing of Washington Mutual, one of the two previous issuers of covered bonds in the U.S.\(^{120}\) When the FDIC was named receiver of Washington Mutual, following the closure it transferred to JPMorgan Chase & Co. all deposits, assets and certain liabilities of the failed institution.\(^{121}\) The FDIC kept Washington Mutual’s covered bonds separate from its other liabilities and passed them in their entirety to JPMorgan Chase & Co., which assumed all obligations of the covered bonds.\(^{122}\) Nevertheless, Washington Mutual was very fortunate to find a buyer that assumed its covered bond obligations,\(^{123}\) and investors remain nervous about what would happen if the FDIC could not find such a purchaser.\(^{124}\)

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119. See id. at 7.
122. Id.
124. The concern is that if banks are not able to pay their covered bonds obligations, the taxpayer is ultimately liable for covered bond obligations if the FDIC decides to save a large covered bond issuer. Peter Coy, Are Covered Bonds a Safe Way to Finance Mortgages? Not Likely, BUS. WEEK, July 30, 2008, at 25 available at http://www.
III. 1940 ACT EXEMPTIONS FOR PUBLIC ISSUERS OF COVERED BONDS

It has been a long-standing principle of securities laws that regulation is necessary to counteract the latent industry abuses that arise when persons or companies manage assets other than their own.125 The Securities and Exchange Commission (“SEC”) promulgated the 1940 Act as part of a broad effort to enact federal securities legislation during the 1930s to curb gaming of the financial system and mandate disclosure to investors.126

The broad reach of the 1940 Act does not overlook issuance structures built around SPEs. Under the 1940 Act, most securitizations are viewed as “investment companies”127 and thus must comply with its imposed regulatory scheme. Investment companies are subject to intense federal oversight and compliance with the 1940 Act is typically very expensive and onerous.128 In fact, its provisions are so burdensome for businessweek.com/magazine/content/08_32/b4095000911375.htm (“[C]overed bonds wouldn’t reduce risk as much as transfer it from bond buyers to the U.S. taxpayer.”). The FDIC could potentially extinguish its own internal insurance fund not for the advantage of bank depositors, its intended beneficiaries, but for the benefit of covered bond investors. See id.; Johnson, supra note 80; Coy, supra note 125. It is also possible, however, that because of overcollateralization or some other variable the value of the pledge collateral for covered bonds is greater than the total amount of all valid claims held by the covered bond holders. TREASURY BEST PRACTICES GUIDE, supra note 16, at 16. In that case, the excess amount belongs to the FDIC and serves as an addition to its insurance fund.

127. 15 U.S.C. § 80a-3(a)(1) (2004) (“Investment company” is defined in pertinent part as an issuer of securities that either “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.”); see also 15 U.S.C. § 80a-2(a)(36) (broadly defining “security” to include notes, stocks, bonds, evidences of indebtedness, investment contracts, and “any interest of instrument commonly known as a ‘security’”).
128. See generally 15 U.S.C. § 80a-18 (prohibitions or restrictions on issuing debt securities); 15 U.S.C. §§ 80a-10, 80a-16 (restrictions and limits on the composition of
SPEs that securitization structures strive to find exemptions from investment company status so as to rid themselves of the compelled oversight. In theory, because SPE-issuance covered bond financing structures resemble securitization, issuers of covered bonds would not be excused from complying with the 1940 Act and its accompanying burdens without specific exemptions.

Attorneys in securitizations rely primarily on one proviso in the 1940 Act to exempt public offerings of structured financings from its burdens: Rule 3a-7. Hypothetically, attorneys involved in covered bond issuances could also attempt to use this exemption to escape the 1940 Act. The inherent structure of covered bonds, however, could potentially disqualify issuers of this asset class from using this exemption. Therefore, covered bond issuers would be left with little choice but to use a different exemption, most likely Section 3(c)(5)(C) of the 1940 Act, which is not tailored specifically for structured financings, or to attempt an expansion of the applicability of Rule 3a-7 to include covered bonds. While using Section 3(c)(5)(C) might be acceptable for now, since covered bonds in the U.S. are restricted to residential mortgages, expansion of Rule 3a-7 is more favorable to the future development of covered bonds should it expand to other asset classes because it eliminates exemptions based on asset classifications.

A. Rule 3a-7

In November of 1992, the SEC issued Rule 3a-7 with the primary purpose of exempting nearly all SPEs involved in securitizations from the board of directors); 15 U.S.C. §§ 80a-13, 80a-15(a) (requirements of shareholder votes for certain issues); 15 U.S.C. § 80a-30 (continuing reporting and disclosure requirements).

129. 17 C.F.R. § 270.3a-7 (1992).
130. 15 U.S.C. § 80a-3(c)(5).
131. Besides Section 3(c)(5) and Rule 3a-7 exemptions, the 1940 Act contains other exemptions from “investment company” status for issuers in public offerings. They are not as favorable, however, for securitization structures. See, e.g., 15 U.S.C. § 80a-3(b), -3(c)(3), -3(c)(4), -3(c)(6). Other exemptions from “investment company” status apply to private, not public, offerings. See, e.g., 15 U.S.C. § 80a-3(c)(1), -3(c)(7). If no statutory exemption is available, an SPE can petition the SEC under Sections 3(b)(2) and 6 of the 1940 Act to issue an order exempting the SPE from registering as an “investment company,” although there is no guarantee that the SEC will grant one. See 15 U.S.C. §§ 80a-3(b)(2), -6(c) (1996).
the definition of “investment company” as long as they meet certain criteria. This rule exempts most structured financings currently used in the capital markets for all sectors of the economy, not just the mortgage segment.

Rule 3a-7 provides that an SPE that purchases or otherwise holds receivables will not fall within the definition of “investment company” if it complies with the following four conditions:

(1) the SPE issues securities whose payment depends primarily on the cash flow from “eligible assets;”
(2) the securities issued must be high-rated (investment-grade or better) by at least one nationally-recognized rating agency (in addition to other regulation exemptions for private offerings);
(3) the SPE does not buy or sell the receivables unless it is within the terms of the agreements pursuant to which the SPE’s securities are issued, and not “for the primary purpose of recognizing gains or decreasing losses resulting from market value changes;” and
(4) unless the SPE issues securities that are not exempt from registration with the SEC under Section 3(a)(3) of the 1933 Act, the SPE must appoint an independent trustee for those securities.

Currently, for purposes of Rule 3a-7, the SEC defines “eligible assets” as “financial assets, either fixed or revolving, which by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.” By their nature, covered bonds fall within this definition: upon maturity covered bond investors are reimbursed their investment in cash and may keep all interim interest payments. The SEC acknowledged that the scope of the definition of “eligible assets” may not encompass all types of assets that can be securitized as of the rule’s release date and that the definition may be expanded.

134. See 17 C.F.R. § 270.3a-7.
135. 17 C.F.R. § 270.3a-7(b)(1).
136. Rule 3a-7 Release, supra note 134.
Satisfaction of the first condition, however, is still potentially problematic for issuers of covered bonds. Payments to covered bond investors do not come out of the underlying assets but arise out of the issuer’s general cash flows. Ultimately, covered bond payments have little to do with the cash flows from the actual cover pool. The cover assets are held on the issuer’s balance sheet as collateral to provide recourse in case of default, not for the purpose of relaying their cash streams to covered bond holders. Since covered bond structures cannot comply with the first requirement of Rule 3a-7, this nonconformity effectively disqualifies Rule 3a-7 as an exemption from the 1940 Act for covered bond issuers.

Neither the text of Rule 3a-7 nor the comments to its release provide guidance as to what percentage of required payments must be covered by cash flows from these eligible assets to satisfy the “primarily” requirement. Shifting focus to another aspect of a possible exclusion from “investment company” status leads to an examination of the SEC’s intent in forming the relationship between payments and cash flows from eligible assets. The SEC’s Investment Company Act Rule 3a-7 release (“Rule 3a-7 Release”) states that “[t]he provision tying payments to cash flows is intended to include payments obtained in any manner other than from the market value or fair value of the eligible assets.” The Rule 3a-7 Release thus indicates that payments from cash collateral accounts and proceeds from credit enhancements constitute “cash flow from eligible assets.” A covered bond originator retains cover assets on its balance sheet and the issuing SPE pays investors out of the originator’s general cash flows for the purpose, in part, of providing a credit enhancement to its covered bonds. Thus, it may be logical to conclude that these general cash flow payments to investors also constitute “cash flow from eligible assets.” Furthermore, since the payments on covered bond obligations come from the issuer’s general cash flows, covered bond payments do not depend on the market value or fair value of the underlying assets.

A conceivably advantageous approach to adapting Rule 3a-7 for exempting covered bond issuances would be to clarify this indication to specifically mention covered bonds and qualify that payments in relation
to covered bonds satisfy the “primarily” requirement despite not being dependent on the underlying receivables. Such a method would provide certainty to the developing covered bond market and relieve the concerns of would-be covered bond issuers that are wary of the burdens imposed by the 1940 Act.

B. Section 3(c)(5)(C)

Section 3(c)(5) of the 1940 Act has long been a fundamental exemption provision applicable to certain securitization transactions. Prior to the adoption of Rule 3a-7, Section 3(c)(5) was the primary avenue for exempting issuers of structured financings from “investment company” status. Even after Rule 3a-7’s implementation, however, Section 3(c)(5) remains available as an exemption from registration under the 1940 Act for issuers of certain recognized types of assets. Among Section 3(c)(5) exemptions, Section 3(c)(5)(C) is the most relevant for covered bonds, as the Treasury recommended that the development of the market should be confined to residential mortgages. Section 3(c)(5)(C) excludes from the definition of “investment company” entities not issuing “redeemable securities” and that are “primarily engaged” in “pur-

142. A “redeemable security” is “any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.” 15 U.S.C. § 80a-2(a)(32) (2006). The SEC has previously stated that securities would not be considered “redeemable” where significant restrictions are placed on the terms of their redemption. See Redwood Mortgage Investors VII, SEC No-Action Letter, 1990 WL 285819 (Jan. 5, 1990) (minimum one-year holding period, limitations on the source of funds for liquidation payments, and limitations on the aggregate amount of liquidation payments in any twelve-month period if an investor wanted to redeem).
143. The SEC generally interprets “primarily engaged” to mean that at least 55% of the issuer’s assets must consist of real estate fee interests and/or loans secured exclusively by real estate. See NAB Asset Corp., SEC No-Action Letter, 1991 WL 176787 (June 20, 1991). Additionally, at least 25% of issuer’s assets must be invested in real estate-type interests (subject to reduction to the extent that the issuer invests more than 55% of its total assets into real estate fee interests and/or loans secured exclusively by real estate), and the remainder, no more than 20% of the issuer’s assets may consist of miscellaneous investments, such as cash, cash equivalents, and any other non-real estate related asset. See Greenwich Capital Acceptance, Inc., SEC No-Action Letter, 1991 WL 177011 (Aug. 8, 1991).
chasing or otherwise acquiring mortgages and other liens on and interests in real estate.” 144

Similar to a securitized mortgage issuance, a covered bond issuance would satisfy Section 3(c)(5)(C) requirements. In a typical securitization transaction, the issuer cannot redeem the interests in receivables sold to investors. Nor could it do so in a covered bond transaction. In addition, an SPE is typically created to handle one particular securitization, such as of mortgage receivables, and so satisfies the “primarily engaged” requirement. Feasibly, an SPE in a covered bond issuance would be subject to the same limitation and would satisfy the “primarily engaged” provision.

CONCLUSION

The releases of the Best Practices Guide and the Policy Statement are appropriate initial steps in forming a U.S. covered bond market. Both take cues from the UCITS Directive guidelines as to maintaining a dynamic cover pool, clear identification of cover assets on the issuer’s balance sheet, recourse to the cover pool and the issuer in case of default, and mandatory asset monitoring and disclosure provisions. They avoid certain aspects of already-developed covered bond frameworks – the €1 billion requirement of the Benchmark Covered Bond Model and the CRD risk weighting benefits – for the sake of growing a covered bond market in the U.S.

Covered bonds can certainly be created with other high-quality cash-flow producing types of collateral, such as credit card receivables or municipal debt, but “when you start a market you always try to start small.” 145 Moreover, the Treasury and the FDIC did not address the actual mechanics of a covered bond transaction, such as bond pricing and yield. 146 Instead, they would prefer market participants to decide such factors through dynamic aspects of supply and demand, although

144. 15 U.S.C. § 80a-3(c)(5)(C).
146. See Johnson, supra note 80.
they recommended using swap agreements to mitigate market uncertainties such as currency and interest rate risks.\textsuperscript{147}

The potential lack of the Rule 3a-7 exemption from the 1940 Act does not indicate that covered bond issuances will be subject to the 1940 Act. Covered bond issuers in public offerings will still benefit from the Section 3(c)(5)(C) exemption because they are likely to satisfy its conditions. Looking forward, if the covered bond market expands beyond residential mortgages, Section 3(c)(5) is confined by artificial asset class distinctions in treatment under the 1940 Act.\textsuperscript{148} Rule 3a-7 standardizes the exemption by shifting the focus from whether a specific type of asset falls within the exclusion to whether the issuance form is that of structured financing. Therefore, Rule 3a-7 proves more beneficial should the covered bond market grow, mature and expand to assets beyond the applicability of Section 3(c)(5) and should be qualified specifically to include covered bond issuances.

As a result of the government’s commitment to developing the covered bond market, banks in the U.S. will be amenable to issuing covered bonds, since they provide significant benefits in the form of high credit ratings and lower cost of funding as compared to senior, unsecured corporate debt of the issuer.\textsuperscript{149} Given time and effort, the covered bond market will grow as investors’ appetite for risk abates and they seek cover in safer issuances that provide recourse to the originator.

\textsuperscript{147} Because the presence of recourse guarantees less risk, covered bonds should yield less than securitized assets and so their spreads should be lower.

\textsuperscript{148} Section 3(c)(5)(A) excludes entities that are “primarily engaged” in acquiring common types of receivables used in securitizations, such as student loans, credit card receivables and auto loan receivables. 15 U.S.C. § 80a-3(c)(5)(A). Section 3(c)(5)(B) refers to loans to manufacturers, wholesalers, retailers and to prospective purchasers of specified merchandise, insurance and service. 15 U.S.C. § 80a-3(c)(5)(B).

\textsuperscript{149} See Bond Basics, supra note 21 (in many European cases, covered bonds carry ratings even higher than those of the issuers); see also Packer et al., supra note 40, at 51.