The Use of Covered Bonds In the Secondary Mortgage Market

By

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A new and interesting product has found its way to our financial markets: Covered Bonds.
It is not completely surprising that Wall Street Firms are looking for new ways to revamp the asset-backed and secondary mortgage market now that all other forms of restructured products are no longer in fashion and the credit and liquidity markets are still running dry despite the intervention and creative solutions of the Federal Reserve.
This publication will explain the origin, existence and role such new product can bring to revamp our liquidity.
It may not be the single and perfect solution, but it is worthwhile knowing about it and understanding it.

General introduction and history

Covered bonds are on-balance sheet securitized products, issued by a financial institution and backed by a pool of mortgages.
Such pool remains on the balance sheet of the issuer and therefore there is no separation or transfer of assets.
Covered bonds have been in use for over 300 years, primarily in Continental Europe and specifically in Germany where such instruments are referred to as *Pfandbriefe.*
Germany has specific legislation that governs such covered bonds and guarantees the holders of such bonds the access to the pool of mortgages in case of default of the issuer as well as default on the underlying mortgages against which interest was created.
In the absence of such specific law i.e. in The Netherlands and the UK, the issuance of covered bonds is governed by the common law of security interest structure that provides the bondholders the right of enforcement even in the event of bankruptcy of the issuer.

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The difference between covered bonds and securitized products

The main difference lies in the creation of interest while the underlying mortgages remain on the balance sheet of the originator or issuer.
There are primarily two methods to ensure that holders of covered bonds have access to and recourse against both the mortgage company and the issuer.

If and when issued in a country that has specific regulations applicable to the governance of covered bonds in case of default, then the interest of the covered bondholders is fully protected.
It gives the bondholders the right to have access to both the pool of mortgages and the mortgage company.

If such regulation does not exist, then we typically see the creation of a Special Purpose Vehicle (SPV) to separate and isolate the underlying mortgages against which interest was created.
However, it needs to be understood that the originator remains the issuer, not the SPV, and the originator retains full responsibility and all obligations to the bondholder.
The role of the SPV is to guarantee the obligation of the issuer/originator and therefore the issuer agrees to transfer the loans to the SPV.
This transfer is accurately described and considered a true sale of assets with the difference that the issuer has to retain the loans/mortgages on their balance sheet.
Structured products and securitized assets on the other hand are not retained on the issuer's balance sheet, meaning the holder of such securities have no legal recourse in case of loan default or bankruptcy.

US covered bonds

The first idea of issuing covered bonds started in 2006 when it was clear that a meltdown was about to occur in the secondary mortgage market and primarily in the structured products market.
The public did not become familiar with this phenomenon until late summer 2007 and now everybody knows the effect of packaged and structured loans.
Washington Mutual (WAMU), the largest S&L in the US, issued their first covered bonds recently.
This is a very interesting action on their part, given that WAMU was and is a very prominent issuer of securitized products.
The US, so far, has no specific legislation pertaining to covered bonds nor does it have any sale transaction with or guarantee from an SPV.

In general, the applicable law and S&P states in their rating report that any FDIC insured bank can and may grant a security interest in collateral and the security interest will be enforceable against the bank and its holder independent of the insolvency of the bank.

The future

After the still lingering hangover from the collapse of our structured and securitized markets, it is normal for banks to search for products and structures that are better bankruptcy-protected.
It is questionable whether this new product (new to the US) will actually work given that the covered bonds were first issued in a Civil Law environment with either specific applicable laws or SPVs to protect the interest of the bondholders at all times.
It remains to be seen whether such product can survive within the context of Common Law.

It will not be too long before courts question the role and use of SPVs, if and when implemented by other issuers and whether the wall of separation between issuer and SPV is legal and valid in case of a bankruptcy filing of the issuer.
While no traditional financings are fully bankruptcy proof, since bankruptcy, by definition, is intended to secure and provide an equitable distribution of assets to all interested parties, it remains to be seen whether the applicable laws can be enforced to transfer back the SPV assets to the bankrupt company's balance sheet for distribution.
The second problem that I foresee is the inequitable and preferred treatment of covered bondholders versus other stockholders and traditional bondholders.

From a pure securitization perspective, it goes without saying that covered bonds are a higher grade than the structured and securitized products.
It is an interim solution for the asset-backed market, but by no means the magical cure unless the legislation is adapted and enacted to oversee the market.

Conclusions

Since only one company has issued covered bonds, it is hard and too early to tell whether this product will start and revamp our depleted and dried up secondary mortgage market.
One thing is for sure; it cannot do any more harm than what has been done already.

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My reservation against the product is dual:
-The applicability of the existing Common Law.
-The regulatory oversight of the market and products.

Time will tell and many investors and issuers alike will watch very closely to see whether there is an appetite for such products or not.
At the same time we will have to wait and see how existing shareholders will react given that they will face a potential dilution of their company interest by being ranked below the covered bondholders as creditors in case of a bankruptcy filing by either the issuer or the mortgage company.
The other question to keep in mind is what the role of the FDIC will be in this case and whether taxpayers will accept the fact that federal funds will be used to secure and finance a bailout.

References

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