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Creating a Level Playing Field -- A Covered Bond Framework for the UK

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In the last six months, banks and credit institutions have experienced the worst liquidity drought in living memory. In the wake of the US subprime crisis, residential property based structured financings have almost completely dried up. The UK government, no doubt keen to engineer a soft landing for the UK property market, has been looking at ways to increase the access of UK mortgage lenders to cheap, long term funds, in the hope of promoting availability of long term, fixed rate mortgages for UK homeowners. To that end, it has charged the UK Treasury with the task of developing a legislative framework for the issuance of covered bonds.

A covered bond is a debt instrument, which like a securitisation bond has the benefit of a priority security interest over a dedicated pool of assets, most commonly mortgage loans or public sector loans. Unlike a securitisation bond, a covered bond also retains the benefit of full recourse to the entity that originated the assets.

Covered bonds are typically backed by high quality assets of a sufficient value to ensure a high credit rating for the bonds, usually AAA. German covered bonds or ‘Pfandbrief’ have been around for over two centuries and other continental European jurisdictions also have extremely active covered bond markets. In contrast, the first UK covered bond was not issued until 2003 and so far, only a handful of UK credit institutions have tapped this market.

The primary reason for this disparity is that the structure of continental European covered bonds makes them more attractive to certain investors than UK covered bonds. Specifically, the most active covered bond markets have all enacted specific covered bond legislation, governing the types of assets that can be used to secure the covered bonds and how those assets should be segregated. Most importantly, it provides for the covered bondholders to have priority rights over the cover assets, even in the event that the asset owner becomes insolvent. Under such legislation, a credit institution typically issues bonds which are secured by a certain pool of the issuer’s assets. These are then ring fenced by the operation of the relevant statute for the benefit of the holders of those bonds. This structure is often referred to as the ‘integrated’ approach, since the issuer and asset owner are the same entity.

To date, the UK has not enacted any covered bond legislation. Instead issuers have applied structured financing techniques that provide broadly equivalent investor protection and ratings. This type of covered bond is commonly known as a structured covered bond, as opposed to the ‘legislative’ covered bond commonly seen in continental Europe.

Broadly, under the structured approach, the UK credit institution issuing the covered bonds transfers the assets in the cover pool, usually residential mortgage loans, to a special purpose vehicle (SPV), which is typically a UK limited liability partnership. The SPV provides a guarantee of the issuer’s obligations to the covered bondholders and secures that guarantee with a charge over the SPV’s assets, essentially the loan portfolio. Over collateralisation will usually be built into the structure, the amount of which will depend on the credit quality of the issuer and the assets and the desired rating of the covered bonds.

Since the SPV does not carry on any activities except that ancillary to the particular issue of covered bonds, it does not incur any obligations to creditors other than to 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 should be able to claim back the assets. Consequently, the covered bondholders have assurance that there will be no competing external creditors of the issuer or the SPV for the rights to the pool of assets, even in the event of the issuer's insolvency.

Although structured covered bonds issued by UK institutions can offer investors essentially the same protection and ratings as the legislative covered bonds, they still remain less popular with certain types of investor. There are a few reasons for this. Firstly, the provisions of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive make investment in legislative covered bonds preferable to structured covered bonds for UCITS funds. Among other things, the directive lays down regulations regarding the assets that a UCITS fund may invest in. Article 22 states that a UCITS fund may not invest more than 5 percent of its assets in securities issued by the same entity. However, Article 22(4) states that this 5 percent threshold may be raised to 25 percent where bonds are issued by a credit institution with its registered office in an EEA Member State and where bonds are issued by a credit institution that is subject by law to special public supervision designed to protect bondholders. This principle also applies to where bonds are covered by assets which are capable of covering all obligations under the bonds throughout their life and which, in the event of the issuer's failure, would be used on a priority basis for the reimbursement of principal and interest on the bonds.

Legislative covered bonds typically meet all of these criteria. Structured covered bonds do not however, as the reference to 'law' in the second criteria is interpreted as meaning statutory law. Consequently, UCITS funds have much greater scope for investing in legislative covered bonds than structured covered bonds.

The Capital Requirements Directive (CRD) also makes it more attractive for credit institutions to invest in legislative covered bonds. The CRD, which effects the changes prescribed by the BASEL II framework, obliges European credit institutions to hold a certain amount of eligible capital depending on the risk weighting of their assets. Where those assets consist of bonds issued by another credit institution, they will attract a risk weighting of 20 percent or more. In the case of legislative covered bonds, which meet the criteria specified in Article 22(4) of the UCITS Directive and in the CRD, they attract a more favourable risk weighting of 10 percent or more. Since a legislative covered bond meets the Article 22(4) criteria, where it is intended to be used by the bondholder as collateral for repurchase agreements and other transactions in the Eurosystem, it is also subject to less stringent eligibility requirements than non-UCITS compliant bonds.

Given these challenges, the Treasury's first and foremost concern in drafting the UK covered bonds legislation has been to ensure that bonds issued under the new framework will meet the criteria laid down in Article 22(4). It has also been paramount to ensure that the new legislation will enable existing structures developed for the UK covered bond market to continue. At the same time, the Treasury does not want the legislation to end up being overly prescriptive and inflexible. Consequently, the proposed framework is 'principles based and outcome focused'.

The draft Treasury regulation includes the maintenance of a register of recognised covered bond issuers and their covered bonds by the Financial Services Authority (FSA). The FSA will grant admission to the register only if the issuer meets the minimum criteria laid out in the regulation. The FSA will have powers to impose additional requirements, as well as the power to remove issuers from the register. The regulation also covers specification of the types of assets eligible for inclusion in the cover pool, power for the FSA to require an asset pool to be topped up if it is not satisfied that the assets are sufficient to cover all claims arising on the covered bonds throughout their life and other FSA powers to enforce compliance with the regulation. Following the consultation process referred to below, the regulation limits issuance to credit institutions which have their registered office in the UK. The SPV must also have its centre of main interest in the UK.

The results of the consultation process and the revised regulation have been published as this article is going to print. Responses to the proposals indicate that the regulation will be welcomed as a workable and helpful UK scheme for the issuance of UCITS-compliant bonds where the SPV approach is used. The revised regulation reflects concerns raised about the breadth of the types and locations of assets originally proposed by the Treasury as eligible cover assets and limited these to high quality assets in a restricted number of jurisdictions. Concerns, in the case of the integrated approach, as to the effectiveness of the ring fencing provisions in cases of insolvency, have resulted in the integrated approach being dropped from the draft regulation although this will be reconsidered in the future. The revised regulation will now go before the UK Parliament and is likely to come into force on 6 March, 2008. We can expect the revised regulation to accelerate growth in the UK Covered bond market by allowing issuers to compete on equal terms with institutions in continental Europe.