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The Conundrum of Covered Bonds

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Abstract: Covered bonds, which have been part of European finance since the time of Frederick the Great, are now being widely touted as the answer to securitization’s imperfections. There is great confusion, though, about the nature of covered bonds and their relationship to secured bond financing and securitization. This article attempts to demystify covered bonds, examining how they fit within a larger financing framework, analyzing their legal rights and obligations, and comparing their costs and benefits. The benefits of covered bonds are similar to those of securitization; both can access low-cost capital market funding with low risk to their investors, and both can be used to regenerate lending markets. The costs of covered bonds may be higher, though, because the “dynamic” collateral pools and “dual” recourse to the issuer that protect covered bonds shift virtually all risk to unsecured creditors. Whether that risk should be allowed to be shifted so asymmetrically is a policy question for any nascent covered bond regime.
I. INTRODUCTION

Market observers have noted that although some securitization products, such as structured investment vehicles (SIVs) and highly-leveraged “ABS CDO” securities, may be gone forever from the capital markets, they will be replaced. The most likely candidate is covered bonds, which have a long history in European securities markets and are being touted by governments and market observers alike. Investment bankers and law firms are investing in getting up to speed in this area to develop and market their expertise before this becomes the next “next thing.”

Covered bonds are long-term debt securities that are secured by specific assets of the issuer of the bonds. The assets so constituting collateral are called “cover-pool” collaterals.

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3 For an introduction to these securities, see infra notes 134-141 and accompanying text.  
4 See, e.g., Henry M. Paulson, Sec. of the Treasury, Statement on Covered Bond Best Practices (Jul. 28, 2008) available at http://www.treas.gov/press/releases/hp1101.htm (last visited May 31, 2010) (stating “I believe covered bonds have the potential to increase mortgage financing, improve underwriting standards, and strengthen U.S. financial institutions by providing a new funding source that will diversify their overall portfolio.”); Brian J.M. Quinn, The Failure of Private Ordering and the Crisis of 2008, 5 N.Y.U. J. L. & BUS. 549, 604-05 (2009) (arguing that the subprime mortgage crisis “offers an opportunity to rethink the securitization model, and perhaps, structure a new approach that is both efficiency-enhancing, as well as sustainable over time” and suggesting covered bonds as one alternative); CRE Finance Council, Press Release, CRE Finance Council Urges Support for U.S. Covered Bond Market (Jul. 27, 2010) (supporting legislation to create a U.S. legislative covered bond regime to as an additional financing tool for commercial real estate markets, though not suggesting a complete supplanting of commercial mortgage securitization).  
5 E-mail from Martin Fingerhut, partner at Blake, Cassels & Graydon LLP and Co-Chair, Committee on Securitization and Structured Finance of the ABA Business Law Section, to the author (Apr. 6, 2010). See also Sam Jones, The Long Arm of the Law: Covered
assets. To the extent the cover-pool assets are insufficient to repay principal and interest on the covered bonds, investors in the bonds (covered “bondholders”) have an unsecured claim against the issuer for the insufficiency. As with any granting of collateral, the cover-pool assets are deemed to remain on the issuer’s balance sheet (i.e., they remain owned by the issuer) for accounting purposes. Unlike normal collateral, however, these assets are “ring-fenced” to give covered bondholders greater protection in the event of the issuer’s bankruptcy. Additionally, weak cover-pool assets are required to be replaced by good-quality assets throughout the life of the covered bonds, thereby maintaining a requisite level of “overcollateralization”—a surplus of collateral value over indebtedness.

To ensure this is all enforceable by covered bondholders against other creditors of the issuer, some countries have promulgated specific covered bond legislation (a “legislative” covered bond regime). Absent such legislation, covered bondholders must rely on contractual protections and related commercial law (a “structured” covered bond regime).

This article, which is both descriptive and normative, proceeds as follows. It first examines the history of covered bonds and reviews the covered bond market that exists today. It then deconstructs and demystifies covered bonds as a financing tool, arguing that covered bonds should be classified within the broader category of structured finance, a category that includes securitization. In that context, the article analyzes how covered

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For a discussion of ring-fencing, see infra notes 34-38 and accompanying text.


See, e.g., Steven L. Schwarcz, Securitization Post-Enron, 25 CARDOZO L. REV. 1539, 1562 (2004) [hereinafter Securitization Post-Enron] and Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133, 148 n.52 (1994) [hereinafter Alchemy] (explaining that because securitization is specific-asset-recourse only whereas regular debt is full recourse, securitization increases or leaves static the expected value of unsecured creditors’ claims on issuer/borrower while secured debt has an ambiguous impact on the expected value of such claims.).
bonds relate to both securitization and bond finance generally, demonstrating that covered bonds incorporate fundamental financial and legal elements of both. Finally, the article examines how normative critiques of securitization might apply to covered bonds, asking whether the long history in Europe of covered bonds, as well as an obscuring of substance behind its innocuous name, give covered bonds an aura of innocence that may not be wholly deserved.

A. History of Covered Bonds

Covered bonds emerged in 18th century Prussia with the inception of the Pfandbrief. In the wake of the Seven Years War, King Frederick the Great introduced a new mortgage finance mechanism to restore liquidity for Prussia’s landed gentry whose lands and financial position had been battered by the conflict. In 1769 he issued a decree mandating the establishment of public law associations of landed nobles (“Landschaften”) that could access agricultural credit by issuing full recourse bonds using the nobles’ estates as collateral. Landschaft members had a right to credit from the association, which was delivered in the form of a security (the Pfandbriefe) that a member could sell to investors to raise cash. In 1900, the German Mortgage Bank Act established a formal framework in law for the Pfandbrief system and codified features

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9 For example, securitization can be treated, for accounting purposes, as either an off-balance-sheet sale of receivables or an on-balance-sheet transfer while still performing its key fundraising and risk transfer functions. It is possible to structure a securitization as a true sale for bankruptcy purposes, but not necessarily for accounting purposes, allowing the originator to raise funds and transfer credit risk while retaining the securitized assets on its balance sheet. Compare STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION §4:2-6, at 4-6 – 4-7 (3d ed. 2010 (incorporating supps.)) [hereinafter, STRUCTURED FINANCE] with infra note 92 and accompanying text (explaining the factors considered in determining true sale status for bankruptcy and accounting purposes, respectively).


11 Id.

12 Id.
such as the ring-fencing of cover-pool assets on an issuer’s balance sheet and investors’ recourse to both the asset pool and the issuer in the event of default.\textsuperscript{13}

Throughout the 19\textsuperscript{th} century, the Pfandbrief system proliferated throughout Europe and, as the century drew to a close, became a popular method of refinancing public sector debt.\textsuperscript{14} Covered bonds waned in influence after the mid-twentieth century and were largely displaced by retail deposits as a source of mortgage financing.\textsuperscript{15} Then, in the 1990s, the market for covered bonds was revitalized by introduction of the German benchmark Pfandbrief in 1995 and also by investor demand for securities diversification in response to the introduction of the Euro, which hampered the ability to use currencies to diversify investments.\textsuperscript{16}

B. Today’s Covered Bond Market

Although covered bonds historically have been primarily a European phenomenon, they are beginning to extend their reach to North America and Asia. U.S. issuers entered the covered bond market with Washington Mutual’s inaugural structured covered bond issue in September 2006.\textsuperscript{17} Bank of America subsequently made its first covered bonds issuance, in March 2007.\textsuperscript{18} The U.S. Congress is currently considering a legislative covered bond regime to supplement structured covered bond offerings.\textsuperscript{19}

\textsuperscript{13} Id.; Barclays Capital and Morrison & Foerster, \textit{Covered Bonds} 3 (May 2010) (on file with author).
\textsuperscript{15} Id.
\textsuperscript{16} Burmeister et al., \textit{ supra} note 14, at 86.
\textsuperscript{17} Dow Jones Newswire, \textit{Washington Mutual: $5.1 Billion in Covered Bonds Sold in Europe}, CHI. TRIB. (Sept. 21, 2006), \textit{available at} LEXIS, News & Business, MAJPAP File.
\textsuperscript{19} On March 18, 2010, Representative Scott Garrett (R-NJ) and co-sponsors Rep. Paul E. Kanjorski (D-PA) and Rep. Spencer Bachus (R-AL) introduced the “United States Covered Bond Act of 2010” (H.R. 4884, later renumbered as H.R. 5823, 111\textsuperscript{th} Cong.).
The Royal Bank of Canada became the first Canadian issuer of covered bonds, in 2009, followed up by a second issue in March 2010. Kookmin Bank became the first Asian issuer of covered bonds when it sold $1 billion of bonds in May 2009. And New Zealand entered the covered bond market with the recent announcement of a NZ$425 million covered bond issue by the Bank of New Zealand.

Worldwide, by 2009 twenty-nine countries had either enacted specific covered bond legislation or allowed structured covered bonds based on extant contract and commercial law. Volume is also growing. By the end of 2008, the volume of outstanding covered bonds in Europe alone was approximately €2.38 trillion, up from €1.5 trillion in 2003.

This bill has been recommended by the House Committee on Financial Services for consideration by the full U.S. House of Representatives.


Burmeister et al., supra note 14, at 90. Europe has both legislative and structured covered bond regimes. Germany, France, Spain, and some other EU countries have legislative regimes. E-mail from Rick Watson, [cite]. The Netherlands and France are effectively structured regimes. Packer, et al., supra note 7, at 44. The United States, presently a structured regime, is considering adding a legislative regime. See supra notes 17-19 and accompanying text. In some countries, such as the United Kingdom, covered bonds are issued under both legislative and structured regimes. E-mail from Rick Watson, supra. Sometimes also, legislative and structured regimes overlap, illustrated by “enhanced covered bonds” that rely on contract to add investor protections to legislative covered bonds. Jonathan Golin, Uncovering Covered Bonds, in COVERED BONDS: BEYOND PFANDBRIEFE: INNOVATIONS, INVESTMENTS, AND STRUCTURED ALTERNATIVES 11, 15 (Jonathan Golin ed., 2006).

Burmeister, et al., supra note 14, at 88 (relying on data provided by the European Covered Bond Council). So-called “benchmark” covered bonds—Euro-denominated, bullet maturity, fixed annual coupon bonds with a defined minimum outstanding volume—are, after government issued securities, the largest European bond market with an outstanding volume of about €840 billion. Id. at 93. The largest issuers of covered bonds are:
The recent global financial crisis only temporarily halted this growth. Although the market for covered bonds, like all financial securities markets, was affected, the European Central Bank (ECB) responded with a €60 billion program to purchase covered bonds, an action that “revived” the market and caused interest-rate “spreads” to narrow. More recently, the ECB has taken steps to further increase the liquidity of the covered bonds market. Market observers indeed see covered bonds as an antidote for some of the problems that led to the financial crisis.

II. DECONSTRUCTING COVERED BONDS

A. The Characteristics of Covered Bonds

There is no formal international convention or treaty defining covered bonds. They are instead defined, de facto, by their characteristics, of which the discussion below
highlights the most typical. Terminology is loose, however. Characteristics evolve over
time, and sometimes market participants refer to secured bonds lacking one or more of
the typical characteristics or having additional characteristics as “covered” bonds.

Two typical characteristics of covered bonds appear to be critical: that they are
secured by collateral (often high quality assets such as mortgage loans and government
debt), and that they have also unsecured recourse against the issuer in the event of a
collateral deficiency (often referred to as “dual recourse”).32 In covered bond
transactions, it is also typical for the cover-pool assets to remain on the issuer’s balance
sheet for accounting purposes.33 Nonetheless, these assets are usually “ring-fenced” to
protect covered bond investors in the event of the issuer’s bankruptcy. Although the term
is not well defined,34 ring-fencing in a covered bond context entails segregating the

2009 O.J. (L302) 63. The EU’s Capital Requirements Directive (CRD) incorporates this
definition by reference and adds restrictions on the nature of cover-pool assets permitted
in covered bonds. 2006 O.J. (L177) 89. Neither is an exhaustive definition, leaving space
for EU Member State legislation to fully define covered bonds. Definitions included in
the EU regulations also appear in the special context of capital requirements and are not
general, statutory definitions of covered bonds; indeed some structured covered bonds
operate outside their purview. Nor do they apply to the increasingly numerous covered
bond issues in non-EU jurisdictions.

30 The European Covered Bonds Council offers the following as “essential
characteristics” of covered bonds from either legislative or structured regimes:

1) The bond is issued by—or bondholders otherwise have full recourse to—a credit institution
which is subject to public supervision and regulation; 2) Bondholders have a claim against a cover
pool of financial assets in priority to the unsecured creditors of the credit institution; 3) The credit
institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the
claims of covered bondholders at all times; 4) The obligations of the credit institution in respect of
the cover pool are supervised by public or other independent bodies.

ECBC, “ECBC Essential Features of Covered Bonds” available at
ECBC stresses that these are “minimum standards” used by the Council to define covered
bonds and are not an official definition. Id.


32 Dual recourse is the characteristic that most distinguishes covered bonds from
securitization and other forms of “non-recourse” financing, in which investors have
recourse solely to the collateral. See infra note 60 and accompanying text.

33 Bernard Volk, RMBS VS. COVERED BONDS, in ECBC EUROPEAN COVERED BOND
FACTBOOK 100, 103 (Wolfgang Kälberer, et al. ed., 2009).

34 “Ring-fencing” can have many meanings. In addition to the meaning used in this
article (the protection of collateral assets from claims by most creditors for the benefit of
cover-pool assets to protect them from claims of the issuer’s creditors, other than the covered bondholders, in the event of the issuer’s bankruptcy. In legislative regimes, ring-fencing is usually accomplished by statutory fiat separating the cover-pool assets from the issuer’s insolvency estate or creating a priority claim against those assets. In structured regimes, ring-fencing often involves selling the cover-pool assets to a wholly-owned, bankruptcy-remote SPV subsidiary. The goal is to ensure that other creditors have access to cover-pool assets only if and when the covered bonds have been paid in full.

Another defining characteristic of covered bonds is that weak cover-pool assets are typically replaced by good-quality assets throughout the life of the bonds (cover pools so replenished are sometimes called “dynamic” cover pools), thereby maintaining the requisite overcollateralization. In a legislative regime, the statute sets the minimum level of overcollateralization and often dictates that a monitor be appointed by the issuer, subject to regulatory approval, to oversee and periodically test the cover pool to ensure it

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35 Burmeister, et al., supra note 14, at 97-98.
36 Id.
37 Id. Sometimes the SPV enters into a guaranteed investment contract (“GIC”) or other derivatives contract to invest cover-pool proceeds, especially during a default, to ensure that the return thereon is sufficient to cover interest on the covered bonds. Huxley Somerville, et al., The ABCs of U.S. Covered Bonds 1, Fitch Ratings U.S. and Canada Special Report (Sept. 3, 2008).
38 Although confusing, some refer to the protection offered by ring-fencing for cover-pool assets as bankruptcy-segregation rather than bankruptcy-remoteness. Golin, supra note 23, at 33-34 (distinguishing bankruptcy-remoteness – the legal independence of one corporate entity from another for bankruptcy purposes – from bankruptcy-segregation – the sheltering of certain assets from claims by ordinary creditors). Note that in some structured covered bonds, the cover-pool assets are held by a bankruptcy-remote SPV. See supra note 43 and accompanying text.
meets the statutory standards. Issuers are thus legally obligated to maintain cover-pool levels, usually by adding new assets to the pool. In a structured regime, the process is essentially the same but is mandated by contract and usually enforced by an independent auditor and a cover-pool trustee.

Finally, especially in legislative regimes, it is typical for issuers of covered bonds to be banks or other government-regulated financial institutions.

**Covered Bonds Distinguished From Ordinary Secured Bonds.**

The literature discussing covered bonds does not adequately differentiate them from ordinary secured bonds, which are long-term debt securities secured by assets of the issuer with full unsecured recourse to the issuer in the event of a collateral deficiency. Thus, as with covered bonds, secured bonds entitle their holders to an unsecured claim for the insufficiency if the issuer defaults and the collateral turns out to be insufficient. Moreover, in both covered bond and secured bond transactions, it is typical for the cover-pool assets/collateral to be deemed to remain on the issuer’s balance sheet for accounting purposes.

Covered bonds can nonetheless be distinguished from ordinary secured bonds in at least one and arguably two ways. Most significantly, the cover-pool assets in covered bond transactions are usually ring-fenced, whereas ring-fencing of collateral is not typical of secured bond transactions. The second, arguable, distinction is that covered bond transactions often require the issuer to replace weak assets in the collateral pool by good

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39 Id. at 31. Alternatively, public regulatory institutions may monitor licensed covered bond issuers to ensure the adequacy of their cover pools. Burmeister, et al., supra note 14 at 99.
40 Burmeister et al, supra note 14, at 98. Temporary substitute assets may be included in the pool until permanent replacements are originated, but these, too, are regulated for quantity (as a portion of the pool) and quality. Golin, supra note 23, at 31-32.
41 Burmeister et al, supra note 14, at 99.
42 Telephone Interview with Folake Shasanya, Director, Credit Division of the Association for Financial Markets in Europe (Aug. 16, 2010).
43 Burmeister et al, supra note 14, at 96-97.
quality assets throughout the life of the covered bonds to maintain the desired level of overcollateralization. That protection is often achieved in secured bond transactions, however, by contractual covenants that require the issuer to maintain a minimum level of overcollateralization (or that give the issuer the right to augment the collateral to avoid an event of default tied to insufficient collateral coverage).  

*Legislative Versus Structured Covered Bond Regimes.*

Legislative covered bond regimes offer two primary benefits to investors and issuers: a high degree of certainty regarding the investors’ legal rights and responsibilities in the event of issuer insolvency, and lower transaction costs in structuring a covered bond transaction. Certainty results from the statutory framework. Transaction costs are low for the same reason, that the statutory framework dictates by fiat the protection without the need to engage in complex structuring.  

But legislative covered bond regimes, being confined to their statutory frameworks, are rigid. For example, they often limit the types of collateral that may serve as cover-pool assets to such high-quality assets as mortgage loans, public sector debt, ship loans, and senior mortgage-backed securities. Furthermore, legislative covered bond regimes may be only as protective as the statutory framework provides.  

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45 Telephone Interview with Folake Shasanya, *supra* note 42.
48 Most legislative covered bond regimes also restrict eligible mortgage loans based on such criteria as loan-to-value (LTV) ratios. Burmeister, et al., *supra* note 14, at 91. The European Union’s Capital Requirements Directive (CRD), for example, limits residential mortgage loans eligible for the collateralization of covered bonds to those with an LTV of 80% or less. 2006 O.J. (L 177) 89.
50 *See* Jane Soldera and Juan Pablo Soriano, Moody’s Analysis of Legal Framework for German Pfandbrief 1, Moody’s Investor Service (Jul. 1, 2010).
example, Moody’s downgraded the credit ratings of two Allgemeine Hypotheken Bank Rheinboden (AHBR) covered bonds in January 2007 because the bank “could give no legally binding guarantee that it would not reduce overcollateralization to the minimum amount required by German law.”

Structured covered bonds regimes have less legal certainty and higher transaction costs than legislative regimes. Their enforceability (and corresponding investor protection) will be reliant on the contract and commercial law of the relevant jurisdiction, provisions of which may not always be tested in court in the ring-fencing context. As a result, structured covered bonds trade with spreads considerably wider than in those countries with national legislation. Transaction costs are high because ring-fencing usually requires issuers to form complex structures, not dissimilar to those used in securitization transactions. In Britain, Canada, and the United States, for example,


52 Jones, supra note 51. See also Golin, supra note 23, at 33 (noting the lack of covered bond defaults and explaining “there is essentially no practical experience with actual covered bond defaults”).

53 E-mail from Rick Watson, supra note 23.

54 The U.S. Congress is currently considering enacting a legislative covered bond regime to supplement structured covered bond offerings. See supra note 19 (discussing the proposed United States Covered Bond Act of 2010). If enacted, banks and other financial institutions would be able to issue covered bonds whose cover-pool assets include not only mortgage and public-sector loans but also credit card receivables, automobile loans, student loans, and small business loans, as well as other types of assets approved by a covered bond regulator (appointed by the U.S. Secretary of the Treasury). Clifford Chance Client Memorandum, US Covered Bonds—Proposed Legislation Introduced to Encourage Market Development 1 (Apr. 2010). Under the existing proposed legislation, however, each cover pool must be limited to only a single type of cover-pool asset, in order to “allow[] for a simpler credit analysis by investors.” Id. at 4. The proposed legislation also encompasses that legislative covered bonds would be exempt from many federal securities law restrictions. Id. at 7. Otherwise, the proposed U.S. legislative covered bond regime would appear to mirror a generic legislative covered bond regime. One reason advanced for the creation of a legislative covered bond regime in the United States is that U.S. federal and state law effectively limit the usefulness of a structured regime. Clifford Chance Client Memorandum, US Covered Bonds—Proposed Legislation
issuers must create a bankruptcy-remote, wholly-owned SPV to purchase the cover-pool assets for the benefit of the covered bond.55

The benefit of a structured covered bond regime is flexibility. Because the parties are not bound by statute, they can adjust the terms of their covered bond program to suit market conditions, available cover assets, and other particular requirements. Thus, structured covered bonds can be tailored, for example, to meet higher levels of overcollateralization, asset quality, or substitutability if investors so demand. Structured covered bonds could also be issued by companies that are not banks or financial institutions.56

B. The Relationship Between Covered Bonds and Securitization

Covered bond and securitization transactions have significant similarities. The most important is that both strive for bankruptcy remoteness—the goal of protecting covered bond investors in the event of the issuer’s bankruptcy. Covered bond transactions strive to achieve bankruptcy remoteness through ring-fencing, as discussed in Part II.A. Securitization transactions achieve bankruptcy remoteness by having the company originating the receivables (the “originator”) transfer those receivables, in a “true sale”

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55 Barclays and Morrison & Foerster, supra note 13, at 31-33. Somerville, supra note 37, at 41. Covered bonds issued under either framework may require swap agreements to hedge against currency or interest rate risk. Burmeister, et al., supra note 14, at 91. Because structured covered bonds are subject to greater uncertainty in the event of issuer default, the cost of these swaps are often higher. Barclays and Morrison & Foerster, id at 31-34; Somerville, supra note 37, at 42.

56 Cf. supra note 42 and accompanying text (observing that issuers of legislative covered bonds are typically banks and other government-regulated financial institutions).
under bankruptcy law, to a bankruptcy-remote SPV\textsuperscript{57}—steps that sometimes parallel ring-fencing.\textsuperscript{58}

Another important similarity is that after covered bondholders are paid in full, and also after securitization investors are paid in full, any residual value from the transferred assets is returned for the benefit of other creditors.\textsuperscript{59}

There are, however, several differences between covered bonds and securitization. A primary distinction—and one that has important normative implications—is that covered bonds have full recourse to the issuer in the event of a collateral deficiency whereas securitization constitutes non-recourse financing.\textsuperscript{60}

Another distinction is that, in covered bond transactions, the cover-pool assets typically remain on the issuer’s balance sheet for accounting purposes whereas, in securitization transactions, it has been more typical for the transfer of assets from the originator to the SPV to be accounted for as a sale.\textsuperscript{61} Such “off-balance-sheet” accounting allows the originator to transfer the credit risk of securitized assets to investors and raise capital without increasing its leverage.\textsuperscript{62}

This accounting distinction is somewhat artificial, however. Securitization transactions can be—and after a 2005 U.S. Securities and Exchange Commission (SEC)

\textsuperscript{57} STRUCTURED FINANCE, supra note 9, Chapters 3 & 4.
\textsuperscript{58} See supra notes 36-38 and accompanying text.
\textsuperscript{59} Cf. U.S. Department of the Treasury, Best Practices for Residential Covered Bonds 16, (Jul. 2008) available at http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf (last visited Aug. 16, 2010) (“If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the Federal Deposit Insurance Act.”).
\textsuperscript{60} See supra note 32.
\textsuperscript{61} Alchemy, supra note 8, at 142-43.
\textsuperscript{62} Id.
staff report on off-balance-sheet transactions, increasingly are—structured as on-
balance-sheet transactions. The absence of an accounting benefit does not undermine 
securitization’s key fundraising and risk-transfer functions. Because bankruptcy-
remoteness is maintained, the originator can still raise capital at significantly lower rates 
that reflect the creditworthiness of the receivables disassociated with the originator’s 
risks.

Several characteristics of covered bonds could be either similarities or 
distinctions, depending on the particular transaction. For example, weak cover-pool 
assets are typically replaced by good-quality assets throughout the life of the bonds. In 
many securitization transactions, however, investors take at least some risk that asset 
quality may deteriorate after purchase. However, collateral substitution clauses, 
requiring originators to replace non-performing assets, and recourse clauses, requiring 
originators to retake possession of non-performing assets during a certain period after a

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63 On June 15, 2005, the SEC staff released its report on off-balance-sheet transactions, 
REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(C) OF THE SARBANES–
OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, 
SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS. The Report 
focused, among other things, on whether financial statements of issuers of securities 
transparently reflect the economics of off-balance-sheet arrangements. Id. The Report 
recommended that “transactions and transaction structures primarily motivated by 
accounting and reporting concerns, rather than economics” be discouraged through a 
combination of changes to accounting standards by the Financial Accounting Standards 
Board (FASB) and greater awareness by participants in the financial reporting process. 
Id. at 3. The Report suggested that “improvement in transparency and comparability 
across issuers can perhaps most directly and quickly be accomplished by eliminating the 
use of . . . structured transactions” whose sole (or perhaps even primary) purpose is 
motivated by accounting treatment. Id. at 46.

64 Cf. Antony Curie, et al., Securitization Adds Up: The Cost of Accounting Reform, 4 
AMERICAN SECURITIZATION 34, 35 (2010) (noting that, at least for non-bank originators, 
securitization’s funding and risk transfer functions continue to make an attractive 
financing instrument even if it must be carried on-balance-sheet).

65 Because the factors considered in determining whether a transfer is a true sale for 
bankruptcy purposes and a sale for accounting purposes are different (see infra note 92 
and accompanying text), it is easy to structure a securitization transaction as a bankruptcy 
sale but an accounting loan.

66 Alchemy, supra note 8, at 137, 137 n.17.

67 STRUCTURED FINANCE, supra note 9 §4:2 at 4-7 – 4-8.
securitization, can be included in securitization agreements to produce requirements similar to those of covered bonds.

Another characteristic of covered bonds that could be either a similarity or a distinction is the nature of the cover-pool assets. At least historically for legislative covered bonds, cover-pool assets had been mostly high quality mortgage loans, whereas securitization involves virtually any type of financial assets. But this distinction will depend on the transaction. For example, cover-pool assets securing legislative covered bonds can now sometimes also include public sector debt, ship loans, and senior mortgage-backed securities. Structured covered bond regimes, on the other hand, have complete flexibility to select cover-pool assets and, as in securitization, are chiefly concerned with choosing assets that will withstand scrutiny by rating agencies.

III. ANALYSIS

This article next engages in a more normative analysis of covered bonds and securitization, examining critiques of securitization and comparing how they would apply to covered bonds and also examining if covered bonds could raise concerns that go beyond the concerns associated with securitization. Covered bonds and securitization each present certain costs and promise certain benefits. In large part, the benefits are similar. Both provide funds to an issuer or originator at interest rates significantly lower

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68 Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2062-63 (2007). Engel and McCoy argue that other securitization provisions that accomplish the equivalent of a dynamic cover pool include the provision of a liquidity facility in the event of non-performing assets (id. §2:1.1, at 2-2) and third-party credit enhancement in the form of surety bonds or bank letters of credit (id. §2:3, at 2-16).

69 Burmeister, et al., supra note 14, at 87.

70 STRUCTURED FINANCE, supra note 9, §2:1, at 2-1; §2:2, at 2-7 – 2-10.

71 See supra notes 48-49 and accompanying text.

than those paid on senior unsecured corporate bonds.\textsuperscript{73} From an investor perspective, both present relatively low-risk investments with liquid secondary markets.\textsuperscript{74} Furthermore, both can be used to regenerate lending markets by using collections on existing loans to repay securities issued to capital market investors and then using the proceeds of those securities to make new loans.\textsuperscript{75}

Commentators have alleged, however, that the costs of securitization are materially higher than the costs of covered bonds.\textsuperscript{76} The analysis below focuses on whether those allegations can be supported.

\textit{Moral Hazard.}

Securitization, particularly in residential mortgage markets, faced a considerable normative critique in the aftermath of the subprime mortgage crisis. Observers argued that securitization, at least as practiced in the run-up to the crisis, created unwarranted moral hazard through the use of an originate-to-distribute model,\textsuperscript{77} presented difficulties

\textsuperscript{73} Senior unsecured bank debt often trades at significantly higher rates than either covered bonds or ABS, with average spreads in July 2009 well in excess of 250 basis points. Volk, \textit{supra} note 33, at 100-01. During that same period, ABS spreads widened far beyond their historical average due to the crisis and traded at similar spreads, while covered bond spreads ranged from about 60 basis points for German Public Pfandbriefe to over 300 basis points for Irish covered bonds. \textit{Id.}

\textsuperscript{74} While securitization securities can vary significantly in credit ratings, especially if they represent different tranches of a senior/subordinate structure, covered bonds tend to receive high ratings from the three major ratings agencies. One sample of more than 10,000 European covered bonds showed that 95% had at least one triple-A rating. Packer, et al., \textit{supra} note 7, at 50 table 3.

\textsuperscript{75} \textit{Compare} Clifford Chance Client Memorandum, \textit{supra} note 54, at 8 (observing that a U.S. covered bond market would create “an alternative, private-sector, source of funding for residential mortgage loans, in competition to Fannie Mae and Freddie Mac”), \textit{with} \textit{STRUCTURED FINANCE, supra} note 9, \S\ 1:2, at 1-7 – 1-9 (observing a similar use for securitization).

\textsuperscript{76} \textit{See, e.g.}, Quinn, \textit{supra} note 4, at 604.

\textsuperscript{77} Indirectly related to moral hazard, the originate-to-distribute model is also said to have fostered unscrupulous lending practices. During the housing boom years, thinly-capitalized mortgage originators used securitization to tap into capital markets for funding, allowing them to originate far more loans than they would otherwise have been able to. Kurt Eggert, \textit{The Great Collapse: How Securitization Caused the Subprime Meltdown}, 41 \textit{CONN. L. REV.} 1257, 1262-63 (2009). Some unscrupulous lenders used this
in rectifying problems with underlying financial assets, and lacked the proper incentives for effective monitoring of widely dispersed risks.\textsuperscript{78}

Problems arising from the difficulty of \textit{a priori} risk assessments were augmented by the effects of moral hazard that disincentivized aggressive mortgage underwriting. Critics frequently argue that, in the context of mortgage lending, securitization does not offer the proper incentives for effective mortgage underwriting.\textsuperscript{79} Before the subprime crisis, originators were able to sell their loans either directly through securitization or to a mortgage aggregator that would, in turn, securitize the loans for the capital markets.\textsuperscript{80} Lenders not subject to the credit risk from their borrowers lacked an incentive to carefully screen those to whom they lent money, but did have an incentive to produce as many

\footnotesize{model to originate loans to unqualified borrowers, quickly selling the loans to mortgage bundlers. \textit{Id.} at 1285-91 (discussing the increased use of low or no documentation underwriting; pressures on appraisers to inflate the reported values of properties to justify higher loan amounts (and higher commissions); occupancy fraud to disguise properties owned by real estate speculators as opposed to residents; excessive reliance on quantitative metrics like credit scores that are inaccurate indices of mortgage borrower risk; and underwriting only for low, introductory “teaser rates” when originating adjustable rate mortgages). When the costs from claims against a lender by aggrieved consumers exceeded the returns from continued operation, the lender exited the market by declaring bankruptcy or reaching a settlement with claimants. Christopher L. Peterson, \textit{Predatory Structured Finance}, 28 CARDOZO L. REV. 2185, 2275 (2007).\textsuperscript{78} Steven L. Schwarcz, \textit{Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown}, 93 MINN. L. REV. 101, 115-22 (2008) [hereinafter \textit{Protecting Financial Markets}]. However, in the context of the subprime mortgage crisis in particular, it is important to recognize the limits of what flaws can be ascribed to securitization in general as financing model. The risks associated with the securitization of subprime loans were very nearly unique and their acceptance by investors was largely fueled by the seemingly boundless appreciation of housing prices, suggesting the circumstances of the crisis carry greater weight than securitization as a causal element. \textit{See} Steven L. Schwarcz, \textit{The Future of Securitization}, 41 CONN. L. REV. 1313, 1317-18 (2009) [hereinafter \textit{Future of Securitization}].\textsuperscript{79} For contrary view on moral hazard and securitization, see \textit{Future of Securitization}, \textit{supra} note 78, at 1319-20 (arguing that other factors contributed to atrophied underwriting standards such as excess liquidity and conflicts of interest within firms responsible for underwriting).\textsuperscript{80} Preliminary Staff Report, \textit{Securitization and the Mortgage Crisis} 19 (Financial Crisis Inquiry Commission, Draft), available at http://www.fcic.gov/reports/ (follow hyperlink for “Securitization and the Mortgage Crisis (PDF)”) (last visited Jun. 22, 2010); Peterson, \textit{supra} note 77, at 2209.}
saleable loans for secondary markets as possible. Consequently, originators incurred the costs of underwriting only to the extent necessary to make mortgages marketable on those secondary markets. Because secondary market purchasers generally needed to examine large numbers of mortgages for securitizations, quantitative data from so-called “hard” underwriting was valued above individualized “soft” information and the latter form of underwriting often fell out of practice with originate-to-distribute lenders. Moreover, a number of mortgage-backed securities (“MBS”) offerings were conducted on a “to-be-announced” basis where investors purchased securities prior to the pooling of mortgages. Under such circumstances, rating agencies and purchasers of MBS would be unable to conduct additional due diligence until after originator exercises its discretion in selecting loans for the transaction.

Covered bonds, by contrast, are considered by some in the financial industry as a candidate for the “magic bullet” that can revitalize the flagging structured finance market. Among the advantages of covered bonds for investors often cited by their advocates are the dual recourse for investors in the event of issuer insolvency (resulting in potentially higher credit quality than in a securitization), the dynamic cover pool which helps ensure a minimum level of overcollateralization and asset quality, and the liquidity of the instruments themselves. Issuers gain the benefit of reduced borrowing costs and the flexibility offered by an additional funding technique.

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81 Eggert, Collapse, supra note 77, at 1277; Preliminary Staff Report, id. at 5.
82 Eggert, Collapse, supra note 77, at 1277.
83 Id. at 1278.
84 Engel & McCoy, supra note 68, at 2071.
85 Id.
86 Jones, supra note 51, at 23.
88 Id.
Unlike securitization, issuers of covered bonds often retain ownership of the cover-pool assets, maintaining these assets for accounting purposes on their balance sheet. In structured covered bond deals, however, originators often sell those assets to a wholly-owned, bankruptcy-remote SPV, which itself issues the bonds. Such a sale would be intended to constitute a “true sale” for bankruptcy purposes, exactly as in a securitization transaction. Unlike some securitization transactions, however, the cover-pool assets would be maintained for accounting purposes on the originator’s balance sheet because debt of a wholly-owned subsidiary generally must be consolidated on the parent’s balance sheet.

89 Golin, supra note 23, at 18.
90 See Barclays and Morrison & Foerster, supra note 13, at 31; Burmeister et al., supra note 14, at 97.
91 Id.
92 Financial Accounting Standards Bd., Accounting Research Bulletin No. 51 (1959). Securitization accounting would have come to this same result but for the “magic” of Financial Accounting Standard (FAS) 140. STRUCTURED FINANCE, supra note 9, § 7:4, at 7-10 – 7-11.]. FAS 140 allows originators who sell assets to a “qualifying SPE” to “[d]erecognize all assets sold” on its balance sheet while recording the proceeds of the sale. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140: ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, ¶ (9)(b); ¶ (11)(a)-(b) (September 2007). FAS 140 now has been superseded by the Financial Accounting Standards Board’s FAS 166 and 167, which eliminate the notion of a qualifying SPE (STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 166: ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS AND AN AMENDMENT OF FASB STATEMENT NO. 140, FAS ¶ (2)(a) (June 2009)), and instead emphasize qualitative analyses to determine whether a special purpose vehicle must consolidated with an originator for accounting purposes. Sale accounting is dependent on the outcome of an expanded bankruptcy-remoteness analysis, the freedom of third-party interest holders to exchange assets and the originator’s surrender of control of the financial assets. FAS 166 ¶ (9)(a)-(c). Consolidation of variable interest entities is determined by an extensive analysis to determine the primary beneficiary of such entities. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 167: AMENDMENTS TO FASB INTERPRETATION NO. 46(R) ¶ 14(A)-(G) (June 2009). The changes made in FAS 166 and 167 will themselves be incorporated in the FASB’s codification of financial accounting standards. News Release, Financial Accounting Standards Bd., FASB Accounting Standards Codification Launches Today, (Jul. 1, 2009) available at http://www.fasb.org/jsp/FASB/Page/SearchNews?filter_year=2009 (follow “July 1, 2009 hyperlink) (last visited Jun. 7, 2010).
Even when perverse incentives and information asymmetries conspire to inhibit quality underwriting by originators and effective due diligence by rating agencies and investors, contractual provisions offer another possible layer of protections for investors in securitization transactions. Investors can require originators to warrant that the assets sold in a securitization are compliant with applicable lending laws or that borrowers meet certain income criteria. Recourse clauses stipulate that if certain trigger events (such as borrower default) occur within a specified time after the securitization, the originator must buy back the weak asset. Related clauses sometimes call for originators to substitute performing assets for those that default. Yet another possible investor protection requires originators to retain servicing rights for the securitized assets and thereby absorb the increased collection costs associated with defaults.

However, contractual protections for investors are of limited effect because of their limited use and infrequent enforcement. In many securitization transactions, few covenants are included and representations and warranties of asset quality are extremely limited. Investors do not regularly enforce recourse provisions and, when they do, must decide whether litigation to compel performance would be cost prohibitive and, if the originator is even capable of buying back troubled assets. Finally, retention of servicing rights by originators is atypical with a well-developed third-party servicer industry at hand to take on such responsibilities for a fee.

Some have suggested that the incentives to better underwrite cover-pool assets, the retention of credit risk by issuers, and the dual recourse available to investors make covered bonds a safer investment than securitization (particularly of MBS) that uses an

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93 Engel & McCoy, supra note 68, at 2061-62.
94 Id. at 2062.
95 Id.
96 Id.
97 Id. at 2063.
98 Id. at 2073 (internal quotations omitted).
99 Id. at 2073 n.166.
100 Id. at 2073-74.
101 Id. at 2075.
originate-to-distribute model where credit risk is shifted from the originator to the investor and the latter has no recourse to the issuer in the event of asset default. For the issuer, the downside risk of covered bonds includes, at least, the transaction costs of replacing non-performing or prepaying assets in the cover pool and, at worst, claims by covered bondholders against the issuer proper if the cover pool is insufficient to repay the bonds. The retention of this credit risk creates a powerful added incentive to select high quality assets to serve as collateral in a covered bond transaction.

In securitization, however, the originator is not without incentives to select high quality assets when structuring a deal. This is because in both covered bond and securitization transactions, the upside reward of residual value\(^\text{103}\) from the underlying assets is retained by the originator/issuer. Once principal and interest on the bonds or securitized assets are paid in full, any surplus value redounds to the originator/issuer. Covered bonds in which the originator is the issuer achieve this by not selling the cover-pool assets. The same result is achieved both for covered bonds in which the originator is not the issuer and for securitization because, in both cases, the originator sells the financial assets to a wholly-owned SPV. Once the SPV repays its investors, any surplus value redounds to the SPV’s benefit; and that surplus value is then captured by the originator by dividend from, or merger with, the SPV.\(^\text{104}\) Consequently, originators and issuers of both ABS and covered bonds want the financial assets to perform well.

\textit{Adverse Selection.}

A related problem with mortgage securitization, some argue, is adverse selection.\(^\text{105}\) Mortgage originators have incentives to exploit information asymmetries between themselves and secondary market participants in order to sell their worst mortgages while retaining less risky loans on their balance sheet, a variant of the

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\(^{102}\) See Paulson, \textit{supra} note 4.

\(^{103}\) Alchemy, \textit{supra} note 8, at 141.

\(^{104}\) \textit{Id.} at 142.

\(^{105}\) Preliminary Staff Report, \textit{supra} note 80, at 19.
“lemons” problem.\textsuperscript{106} Securitization, so this argument goes, facilitates adverse selection through the senior-subordinate structure, in which originators create senior-priority and junior-priority classes of securities. The junior securities, which bear a higher interest rate than the senior securities, are sold to investors with a significant appetite for risk, thereby effectively increasing the overcollateralization of the senior securities and making them less risky.\textsuperscript{107}

One might question the adverse selection criticism. Even though investors in junior securities have a significant appetite for risk, they are, or at least should be, sophisticated enough to ensure that the risk they are taking is properly compensated by the interest rate. If the worst mortgages effectively support repayment of the junior securities, that interest, much less the principal, on the junior securities would be unlikely to be paid.

It is nonetheless true that covered bonds would be less susceptible than securitization to adverse selection. One reason is that covered bonds, at least currently, are not usually issued in senior-subordinate structures\textsuperscript{108}—although nothing prevents a senior-subordinate structure in a covered bonds transaction, as least a structured one. Another reason is that even a holder of junior covered bonds would (presumably) have a claim against the issuer if the cover-pool assets were insufficient. Furthermore, in legislative regimes that mandate only high quality cover-pool assets, especially where there is a dynamic pool, there should be relatively few “lemons.”\textsuperscript{109}

\textit{Servicing Costs.}

An additional criticism leveled against securitization in the wake of the financial crisis is that it inhibits modification of the underlying mortgage loans for troubled

\textsuperscript{106} Engel & McCoy, \textit{supra} note 68, at 2048–49 (citing George Akerlof, \textit{The Market for “Lemons”: Quality Uncertainty and the Market Mechanism}, 84 Q.J. Econ. 488 (1970)).
\textsuperscript{107} \textit{Id.} at 2054. \textit{Cf.} STRUCTURED FINANCE, \textit{supra} note 9, §2:4, at 2-17 – 2-18 (describing the senior-subordinate structure).
\textsuperscript{108} Volk, \textit{supra} note 33, at 103-04.
\textsuperscript{109} \textit{See} note 106 \textit{supra} and accompanying text.
borrowers because of restrictions contained in agreements with third-party loan servicers or because alterations require consent from diffuse MBS holders. For example, servicing agreements typically oblige servicers to manage loans in the “best interests” of MBS holders. Other provisions that sometimes appear in servicing agreements include absolute restrictions on changing the terms of loans, limits on the number of modifications for a given asset pool or for a given loan over its lifetime, maximization of the net present value of cash flows (even at the cost of foreclosure on a potentially salvageable loan), and the requirement of consent from outside parties such as bond insurers, rating agencies, and credit enhancement providers before altering more than five percent of the loans in a mortgage pool.

Structural credit enhancements may also inhibit modifications to securitized mortgage loans when the interests of different tiers of investors are pitted against each other in a phenomenon dubbed “tranche warfare.” Asset-backed securities with different tranches corresponding to different investor classes are sometimes subject to “performance clauses” establishing conditions precedent to changing the overcollateralization of the asset pool or releasing principal to investors in lower tiers. The treatment of modified loans for such “trigger tests” determines how the reduced value of the mortgage pool will be distributed amongst investors; if modified loans are treated as current, subordinate investor classes benefit while senior classes are protected if modified loans are treated as delinquent. Eggert concludes that “the complex webs that securitization weaves can be a trap and leave no one, not even those who own the loans, able to effectively save borrowers from foreclosure.”

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111 Eggert, Comment, id.
112 Id.
113 Id. at 290.
114 Id.
115 Id.
Empirical studies reveal that, even in the face of enormous government pressure to adjust mortgage terms for the benefit of homeowners, actual mortgage restructuring lags behind expectations, in part due to the structural complications of securitization.

In his most comprehensive study of mortgage modifications, Allen White examined data on 3.5 million securitized subprime and alt-A loans for the month of November 2008. In the November data, White found 233,000 mortgages in foreclosure and 69,000 in bankruptcy while lenders made only 21,219 modifications that month. Of these modifications, only ten percent included some reduction in interest or principal or a forgiveness of fees. The most recent available data show just under 2.9 million total mortgage modifications between July 2007 and first-quarter 2010 while, between first-quarter 2009 and first-quarter 2010, the number of loans more than sixty days delinquent increased from 2.85 million to almost 4 million. White points to securitization and the strictures of third-party servicing agreements as part of the reason for the low level of modification and the inability of troubled borrowers to obtain debt relief.

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116 Id. at 292.
119 White, Deleveraging, supra note 118, at 1112-13.
120 Id. at 1113.
121 Id. at 1116.
123 White, Rewriting Contracts, supra note 118, at 514-15.
124 White, Deleveraging, supra note 118, at 1128-29.
125 Interestingly, one of White’s key findings is that servicers’ fiduciary obligation to MBS investors is actually not well served by foreclosures since losses incurred are actually six times larger than the average principal or interest write-off in a modification. This suggests the chief impediment to modification may not be securitization per se, but rather inadequately drafted servicing contracts that do not allow servicers the flexibility necessary to protect investors’ interests. See id. at 1119, see also Eggert, supra note 110, at 288.
Covered bond proponents claim that covered bonds have more flexibility to accommodate troubled borrowers because loans in the cover pool remain with the originator/issuer, which could service these loans and modify them as appropriate.\textsuperscript{126} There are, however, at least two factors that restrict such flexibility: (a) modifications resulting in reduced collections from the cover-pool assets may expose the originator/issuer to recourse for a deficiency; and (b) non-performing or adjusted assets that decrease the value of the cover pool below the agreed level of overcollateralization may require asset replacement, creating additional transaction costs for the originator/issuer. Even in a covered bond context, therefore, mortgage originators will have to balance the costs of modification against those of foreclosure and non-action in determining whether and how to accommodate troubled borrowers.

Additionally, the servicing of underlying financial assets in covered bond and securitization transactions often converge. In securitization transactions, for example, the originator often acts as the servicer.\textsuperscript{127} And in covered bond transactions, originators/issuers could contract with third-party loan servicers despite on-balance-sheet accounting. Moreover, with both covered bond and securitization transactions, investors themselves can restrict the originator/issuer’s right to modify the underlying financial assets,\textsuperscript{128} a type of restriction that is not atypical of covenants in ordinary secured loan

\begin{itemize}
\item \textsuperscript{126} \textit{Covered Bonds: Prospects for a U.S. Market Going Forward: Hearing Before the H. Comm. on Fin. Services}, 111th Cong. 3 (2009) (statement of Scott A. Stengel, Partner, Orrick, Herrington, & Sutcliffe LLP for the U.S. Covered Bond Council) (arguing that on balance sheet accounting “creates a 100% ‘skin in the game’ and, as a result, incentives relating to underwriting, asset performance, and loan modifications are strongly aligned.”) and \textit{Covered Bonds: Prospects for a U.S. Market Going Forward: Hearing Before the H. Comm. on Fin. Services}, 111th Cong. 4 (2009) (statement of Bert Ely, Ely & Co., Inc.) (“If a lender retains 100% of the credit risk of the loans it makes – the case with loans funded with covered bonds – the lender can more easily modify a loan should the borrower experience financial difficulty.”).
\item \textsuperscript{127} \textit{Structured Finance, supra} note 9, § 4:5, at 4-10.
\item \textsuperscript{128} See Eggert, \textit{Comment, supra} note 110, at 87-88; \textit{cf.} Golin, \textit{supra} note 23, at 31-32 (discussing the restrictions placed on substitutions for cover pool assets in most covered bond regimes).
\end{itemize}
agreement. The extent to which covered bond transactions have more flexibility than securitization transactions to accommodate troubled borrowers is thus unclear and highly context dependent.

*Overreliance on Complex Mathematical Models.*

Complex asset-backed securities of the type commonly issued prior to the subprime mortgage crisis defied easy analysis and led both investors and ratings agencies to rely on mathematical models to assess the risks of such securities. Securities ratings became an attractive heuristic device for investors with neither the time nor inclination to fully comprehend the risks entailed in securitization transactions. The models from which these ratings derived were themselves flawed due to their reliance on misleading historical data or pure assumption when historical data did not exist.

Moreover, certain highly leveraged asset-backed securities, especially asset-backed securities of collateralized debt obligations (ABS CDO), turned out to be difficult to value and extremely sensitive to errors in initial credit-risk estimates. Collateralized

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129 *See, e.g.*, Accounts receivable – Debtor’s right to collect and compromise - restricted, 19 AM. JUR. LEGAL FORMS 2d Secured Transactions § 253:1949 (providing a standard term for secured loans with intangible collateral specifying the permissible procedures for the debtor’s “collection, compromising, or enforcing of any account, chattel paper, or general intangible” and providing for default if the debtor deviates from such procedures).


131 *Regulating Complexity*, *id.* at 222; *see also* Eggert, *Collapse, supra* note 81 at 1277 (explaining how investors in mortgage-backed securities moved away from individualized risk assessments to data-driven “hard underwriting” practices).

132 Future of Securitization, *supra* note 78 at 1323-24 (noting that the mortgage market’s risk assessment models failed to anticipate both the striking decline in housing prices and the high default rate seen in the recent crisis).

133 *Id.* at 1324 (explaining that valuation models for some complex securities were based entirely on models when there were no active trading markets to provide historical data).

debtfication, or “CDO,” securities are issued with the backing of a pool of various mortgage loans or other financial assets held by an SPV, the proceeds of which supply the funds for repayment of the securities.\textsuperscript{135} The securities may be issued in prioritized tiers called tranches to structurally enhance the credit rating of the upper tranches.\textsuperscript{136} The tiers allocate the default risk of the cover-pool assets, with senior tranches being paid before mezzanine tranches, which, in turn, are paid before junior tranches.\textsuperscript{137} Any shortfall in returns from the pooled assets is thus absorbed by the lower tranches first, shielding senior tranches and allowing those securities to receive a higher credit rating than the average rating of the underlying assets.\textsuperscript{138} ABS CDO securities operate in a similar fashion but are backed by mixed pools of ABS and/or MBS securities in a process sometimes called “re-securitization.”\textsuperscript{139} Here, repayment derives from the returns on the assets underlying the pooled ABS and MBS securities.\textsuperscript{140} Relatively small variances in assumptions about the default probability of assets underlying tranches of CDO or ABS CDO securities as well as the level of correlation between the default rates of different securitized assets can be magnified by the ABS CDO structure, resulting in very different outcomes than investors bargained for when they purchased the securities.\textsuperscript{141}

Covered bonds, at least in legislative regimes with strict cover-pool regulations, are inherently less risky than subprime mortgage-backed securities, but are nevertheless susceptible to the same pressures that led to an overreliance on modeling in securitization markets. Investors in covered bonds must determine the risks associated with large pools of mortgage loans or other assets, often valued in billions of dollars.\textsuperscript{142} Additionally,
covered bond investors must also account for the default risk of the issuing entity and the extent to which this may impact the solvency of the cover pool. High quality control standards for cover-pool assets, overcollateralization, and thorough hedging against asset-liability mismatch may reduce the risks faced by covered bond investors, but they do not make those risks any easier to calculate with great accuracy.

The analysis so far has shown that most costs of securitization are not materially different than the costs of covered bonds. There are nonetheless real differences in those costs as regards the relative impact of covered bonds and securitization on non-adjusting creditors.

**Impacts on Non-Adjusting Creditors.**

Secured debt instruments and securitization often prompt concerns surrounding their efficiency and potential negative impact on the unsecured creditors of a borrower or originator. These concerns are rooted in the Modigliani-Miller hypothesis that when a firm realizes savings through a change in one part of its capital structure it will, ceteris parabus, see offsetting costs to other parts of its capital structure. This theory led to two subsidiary claims; first, that unsecured creditors of firms benefiting from interest rate savings (through a secured debt issue or through a securitization) will raise their interest rates by an amount equivalent to the firm’s savings to compensate for their increased risk

143 Fitch Ratings calls this “the discontinuity factor” and defines it as “the likelihood of an interruption . . . of payment on the covered bonds in case of a default of the issuing institution.” Stefan Potocki, et al., Comparative Study of Covered Bonds 2008/09 3, Fitch Ratings (May 6, 2009).
145 See Securitization Post-Enron, supra note 8, at 1568 n. 148 (referencing scholarship critical of securitization’s impact on unsecured creditors) and Steven L. Schwarcz, The Easy Case for the Priority of Secured Claims in Bankruptcy, 47 Duke L.J. 425, 426 n.1 (1997) [hereinafter Easy Case] (summarizing scholarship on secured debt’s impact on unsecured creditors).
in the event of insolvency,\textsuperscript{147} and, second, that unsecured creditors who cannot adjust their interest rates (“non-adjusting creditors”) are subject to an uncompensated transfer of risk from new secured creditors.\textsuperscript{148} Observers have argued at length that both of these claims are exaggerated and that, in almost all cases, unsecured creditors actually benefit from the liquidity provided by securitization and secured debt.\textsuperscript{149} However, because covered bonds are to a certain extent a hybrid, combining aspects of both securitization and secured debt, it is worth recapitulating some of these discussions and analyzing covered bonds from the standpoint of unsecured creditors of their issuer.

Generally, a new-money secured debt issue does not harm unsecured creditors and may actually benefit them.\textsuperscript{150} The net impact on the assets available to unsecured creditors of a lien securing a new-money loan is, at least at the outset, zero; the proceeds from the loan are available to repay the newly-incurred secured debt.\textsuperscript{151} Unsecured creditors would only be prejudiced to the extent that either the company’s risk of insolvency increases (assuming such creditors could not adjust their interest rates to compensate for this increased risk)\textsuperscript{152} or the company “overinvests” the proceeds, reducing their value.\textsuperscript{153} Because overinvestment is a generic risk for any company,\textsuperscript{154} the analysis below treats it as a neutral factor.

\textsuperscript{149} For a complete discussion of these arguments see Securitization Post-Enron, supra note 8, at 1553-69 and Easy Case, supra note 145.
\textsuperscript{150} It is important to distinguish between the effects of new-money secured debt and the provision of collateral pre-existing obligations. This analysis applies to the former; the effects on unsecured creditors of liens securing antecedent are more ambiguous and somewhat dependent on statutory protections for such creditors. Easy Case, supra note 145, at 433-434, 433 n.35; Alchemy, supra note 8, at 148 n.52.
\textsuperscript{151} Id. at 435.
\textsuperscript{152} Id. at 441.
\textsuperscript{153} See e.g. Securitization Post-Enron, supra note 8, at 1554 n.80 (quoting Alan Schwartz, Priority Contracts and Priority in Bankruptcy, 82 Cornell L. Rev. 1396, 1410 (1997) (defining overinvestment as “the taking of a negative net present value project”)). Note, however, that overinvestment itself harms unsecured creditors only if it
It is highly unlikely that new-money secured debt will increase a company’s risk of insolvency. To the contrary, access to credit and the resulting liquidity generally forestalls bankruptcy and increases the expected value of unsecured creditor claims, even with conservative assumptions. If a company’s financial situation is so precarious that it appears to have a realistic chance of going bankrupt even after borrowing new money, lenders would be reluctant to make the loan, even with collateral, because of the inherent imperfections in the bankruptcy system. Thus, the extension of new-money secured credit to a firm usually reduces its chances of becoming bankrupt, thereby having a neutral or positive impact on the firm’s unsecured creditors.

Securitization, much like a new-money loan, would not have a net adverse impact on unsecured lenders of a company to the extent it entails the exchange of one type of asset (e.g. mortgage loans, automotive loans, or other financial assets) for another asset, cash. Once again, only if securitization increases the company’s risk of insolvency (assuming unsecured creditors could not adjust their interest rates to compensate for this makes the company more likely to become insolvent; an unlikely eventuality given the reluctance of lenders to extend credit to an institution at risk of insolvency. Id. at 1558.

Securitization Post-Enron, supra note 8, at 1557 (explaining that, even absent borrowing, a company can overinvest assets, and that borrowing does not per se increase the risk of overinvestment).


Easy Case, supra note 145, at 441-43.

Id. at 455-56 (arguing that creditor’s will be reticent to lend on a secured basis to an at risk firm because of (i) the automatic stay against enforcement of remedies; (ii) a possible substitution of the creditor’s collateral; and (iii) fraudulent conveyance law’s restriction on securing a debt with excessive collateral and the inability to guarantee full recovery for an overcollateralized lender).

Id. at 466-71. This proposition is supported by empirical observations correlating receipt of secured credit by troubled companies and increases in those companies’ share prices as well as relaxation of their unsecured trade credit terms. Id.

Securitization Post-Enron, supra note 8, at 1562; Alchemy, supra note 8, at 146. Because of the necessity for overcollateralization, the actual amount of cash proceeds will be somewhat less than the assets sold in the securitization, but this merely reflects the real value of those assets discounted for the time value of money and risk of default. Securitization Post-Enron, supra note 8, at 1555-56.
increased risk) or the company “overinvests” the proceeds of the securitization will it harm unsecured creditors.\footnote{Securitization Post-Enron, supra note 8, at 1562 & 1555-57.} And, once again, because increased liquidity generally reduces the risk of insolvency and lenders avoid financing truly risky firms, securitization is likely to benefit unsecured creditors by increasing the likelihood they will be repaid in full in the long-term.\footnote{Id. at 1560.}

How do unsecured creditors fare when a company issues covered bonds? Similar to a securitization, covered bonds always result in a new money infusion for the company by leveraging assets for cash.\footnote{Id. at 1555.} Like a securitization, some level of overcollateralization is required to account for the underlying risk of the asset pool (although the level of overcollateralization required is dictated by law in legislative regimes\footnote{Burmeister et al., supra note 14, at 91.}). Therefore, covered bonds are roughly equivalent to a securitization in their neutral immediate impact on unsecured creditors. As before, unsecured creditors are only harmed to the extent a covered bond issue increases the issuer’s chance of bankruptcy or there is overinvestment of the proceeds of the bond issue. And, once again, it is likely that a company with a substantial default risk would not be able to issue covered bonds because of the wariness of investors.

Covered bonds, however, go beyond securitization in two ways that can harm unsecured creditors. In a securitization, if the overcollateralization is insufficient to repay investors, the investors take a loss because they only have recourse to assets that the SPV has already purchased.\footnote{Id. at 1563-65.} The pool of assets available for repayment is, in other words, effectively fixed or static.\footnote{Id. at 1555.} In contrast, in covered bond transactions, the cover pools are

\footnote{Structured Finance, supra note 9, Chapter 2.}
usually dynamic, \(^{166}\) requiring the covered bond issuer to continually segregate new assets as needed to maintain overcollateralization—thereby enabling the covered bonds to continue to be paid in priority to unsecured claims. \(^{167}\)

Covered bonds also go beyond securitization in their recourse. Whereas securitization transactions are non-recourse, \(^{168}\) covered bonds have dual recourse. \(^{169}\) If, therefore, the cover-pool assets are insufficient, covered bondholders have a recourse claim against the issuer. \(^{170}\) That claim, being pari passu with unsecured creditor claims, \(^{171}\) would further dilute unsecured creditor recovery. \(^{172}\)

As a result of the dynamic cover pool and dual recourse, covered bond transactions thus shift virtually all risk to unsecured creditors.

**IV. CONCLUSIONS**

Covered bonds have a long and distinguished pedigree, originating under the rule of King Frederick the Great in order to generate mortgage financing for Prussia’s landed gentry, who had been battered by the Seven Years War. Although historically limited to

\(^{166}\) See supra notes 38-40 and accompanying text.

\(^{167}\) Id. Another potential difference is the amount of overcollateralization. Whereas securitization transactions usually involve overcollateralization not exceeding 10%, some legislative covered bond regimes require higher overcollateralization, sometimes exceeding even 20%. See Jackie Ineke, et al., *Basel II and Covered Bonds, in COVERED BONDS: BEYOND PFANDBRIEFE: INNOVATIONS, INVESTMENTS, AND STRUCTURED ALTERNATIVES* 42, 50 (Jonathan Golin ed., 2006) (comparing overcollateralization typical for U.K. covered with that for Spanish covered bonds). The higher the overcollateralization, the more the risk is transferred to unsecured creditors.

\(^{168}\) See supra note 32.

\(^{169}\) See supra note 32 and accompanying text.

\(^{170}\) Id.

\(^{171}\) See Golin, supra note 23, at 18.

\(^{172}\) An interesting sidelight on legislative covered bonds is that they may not always be accelerated in bankruptcy. Burmeister et al., supra note 14, at 91. Sometimes, as long as the cover-pool assets are sufficient, the cover-pool trustee will continue to make normal interest and principal payments on the bonds. Golin, supra note 23, at 34. The impact this
European finance, covered bonds are now becoming an important part of North American and Asian finance. There is great confusion, though, about the nature of covered bonds and their similarities to, and differences from, secured bond financing and securitization.

This article attempts to demystify covered bonds, examining their utility as a financing tool and analyzing their legal rights and obligations. In these contexts, the article also compares covered bonds with bond financing and securitization.

The article also compares the costs and benefits of covered bonds and securitization, seeking to give covered bonds perspective within a financing hierarchy. Their benefits are similar: both covered bonds and securitization provide an issuer with low-cost capital market funding while offering investors relatively low-risk and liquid investments, and both can be used to regenerate lending markets.

Covered bonds are more likely than securitization, however, to harm non-adjusting creditors. Both forms of financing pay their investors from segregated asset pools; but whereas securitization effectively fixes the segregated asset pool, thereby allocating risk to all parties, the asset pool for covered bonds is usually “dynamic,” requiring the covered bond issuer to continue to segregate assets as needed to repay the covered bonds, in priority to paying unsecured claims. Furthermore, if those assets are ultimately insufficient to repay the covered bonds, covered bondholders have a legal claim against the issuer that is equal and ratable with claims of unsecured creditors, thereby further diluting repayment of the latter’s claims. The extent to which risk should be allocated so asymmetrically to unsecured creditors is a policy question that any nascent covered bond regime should address.

will have on unsecured creditors will depend, in part, on the interest rate on the covered bonds compared to the market rate of interest at the time.