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西盟斯律師行

Covered bonds

資產覆蓋債券

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Legal Overview

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Quite simply, a covered bond is a normal debt capital markets bond which is additionally supported, or "covered", by a ring-fenced and segregated pool of assets. Covered bonds are most typically issued by banks. You might hear it called a "dual-recourse" bond – with recourse to both a bank and a segregated pool of assets. Other people might call it a cross between a senior unsecured bond and a securitisation bond – having the upsides of both of these types of bonds. However they are described, covered bonds form a significant proportion of the global capital markets, with the European Covered Bonds Council reporting in 2020 that there were global covered bonds outstanding of approximately US$2.7 trillion.

Covered bond issuers

One of the strongest incentives for covered bond issuers, who are almost entirely banks, is the funding costs. According to IHS Markit, the spread on covered bonds has, over the last two years, generally been 40bps to 50bps cheaper than the spread on senior unsecured bank bonds. A number of covered bonds, including a recent one in Singapore, have even been issued with a negative yield.

This is a compelling reason for banks to use covered bonds as part of their overall balance sheet management strategy.

Covered bond investors

From an investor's, perspective, the most evident benefit of a covered bond, over senior unsecured bonds is the fact that there is an additional line of recourse to a segregated pool of assets. In the event the bank becomes insolvent and is unable to pay the covered bond, cashflows from the pool of segregated assets will be used instead, and the covered bond investors will have recourse over those cashflows in priority to any other creditors of the bank, in particular, senior unsecured creditors.

Covered bond assets

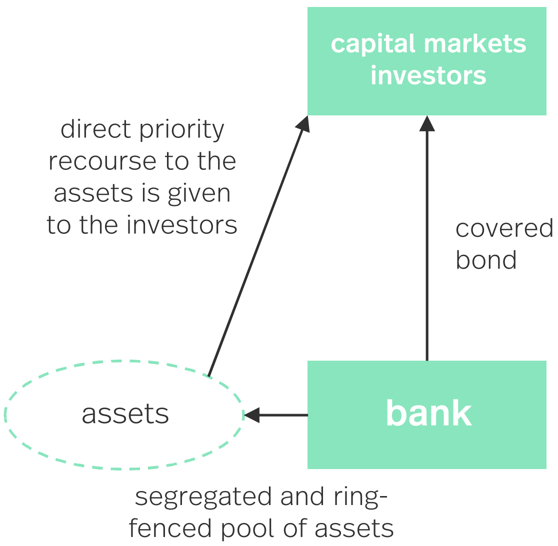
There are typically two categories of assets which banks use to support covered bonds:

- residential mortgages
- public sector loans (e.g., loans make to regional and local authorities)

Residential mortgage loans are by far the most common, supporting, for example, around 88% of all covered bonds issued globally in 2019.

Other assets, such as consumer loans, infrastructure loans or ECA loans can be used too, and occasionally are.

structure of a covered bond



Three categories

Lawyers often separate covered bonds into three sub-categories:

- EU regulated covered bonds – these are those issued by EU banks backed by assets, such as residential mortgage loans, which meet certain minimum criteria. Investors, such as banks, insurance companies, pension funds and UCITs benefit from preferential regulatory and investment treatment when they invest.
- ECBC labelled covered bonds – these are those which satisfy the applicable labelling conditions, and this is the category into which most Australian, Singapore and Canadian covered bonds fall.
- Structured covered bonds – which fall into neither of the other categories.

The toggle

At first glance, an investor might rightly question the difference between a covered bond and a normal secured bond. That difference is important. For a normal secured bond, once the issuer defaults, the investors look immediately at the collateral and seek to sell it to generate proceeds to repay the debt. Covered bonds work differently. Following an issuer default, there is a toggle, a switch and, from that point onwards, the pools of assets seeks to take over payments on the bond. That is to say that collections of interest and principal on the underlying assets (e.g., residential mortgage loans) will be used to make scheduled payments of interest and payments of principal on the bonds. The structure operates that the bond should continue paying as normal; albeit with cashflows from the assets rather than the issuer. There is no immediate requirement to simply dispose of the assets to generate proceeds to repay the outstanding bond.

Segregating the assets

One of the most critical features of a covered bond is the segregation, or ring-fencing, of the assets. In different jurisdictions this is achieved in different ways:

- statutory regimes – many jurisdictions, such as Korea, Spain and Germany, have tailor made statutory regimes which provide legislative protection to the ring-fenced assets. Provided the assets have been identified in accordance with the legislation, they will be protected in favour of the investors in the event of an issuer insolvency.
- assignment – a very common structure is for the assets to be assigned to an SPV (which may be in the form of a limited company like in Singapore or a limited liability partnership like in the United Kingdom). The assignment is structured, from a legal perspective as a "true sale", thereby isolating the assets from the insolvency of the issuer. The SPV then provides a guarantee to the investors and security over the assets which have been assigned to it.
- originator trust – where it is not possible to assign the assets to an SPV, for instance, due to restrictions on assignment, it may be possible for an issuer to hold the on trust for an SPV and still achieve legal "true sale" treatment. This is the case for some assets in all three existing Singapore covered bonds.

Regulatory incentives

Many jurisdictions, such as the EU and Hong Kong give a special regulatory status to covered bonds, allowing them to be counted in liquidity coverage ratios, net stable funding ratios and be used as collateral in central bank funding schemes.

Coverage requirements

A very typical feature of a covered bond is for the issuer to ensure that the value of the segregated assets always exceed the outstanding covered bonds by a specified margin. This results in a degree of overcollateralisation, providing additional protection for the investors. Sometimes the level of overcollateralisation is set by the relevant local covered bond rules. In the United Kingdom, 108% is the requirement. In Singapore it is 103%.

New issuers and jurisdictions

Issuing a covered bond for the first time can be a complicated endeavour. From the issuer's perspective, provided they have issued senior unsecured debt before and have done securitisation transactions before, their internal systems and governance should generally be capable of accommodating a covered bond.

For jurisdictions which have not seen covered bonds before, the most difficult structuring point is usually around how the assets should be segregated. In Singapore, given its common law legal system, it was possible to adopt a similar segregation structure to the United Kingdom. This would also be the case in Hong Kong. In non-common law jurisdictions – for instance – Mainland China, it may be necessary for a special regime to be introduced, but serious consideration should be given to whether existing domestic securitisation structures, such as CASS or ABN in Mainland China, could be adapted for use in covered bonds.

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