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Treasury and FDIC Promote Covered Bonds to Stimulate Mortgage Funding

In coordinated actions to address the turmoil in the financial markets, the Department of the Treasury ("Treasury") and the Federal Deposit Insurance Corporation ("FDIC") have recently taken steps to open the door for US banks and thrifts to issue residential mortgage covered bonds ("Covered Bonds"). On July 28, 2008, Treasury Secretary Henry G. Paulson, accompanied by the chairman of the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, a governor of the Federal Reserve Board and representatives of four of the five largest US banks, released the Treasury's "Best Practices for Residential Covered Bonds." On the same day, the FDIC's "Covered Bond Policy Statement," adopted July 15, 2008, was published (73 *Federal Register* 43754), setting forth the terms under which investors in Covered Bonds may obtain expedited access to the collateral underlying their bonds in the event that a bank or thrift issuer is placed in receivership or conservatorship. In addition, at the Treasury presentation, Governor Kevin Warsh of the Federal Reserve Board announced that high-quality, highly rated Covered Bonds would be accepted as collateral at its discount window. The Best Practices and the Policy Statement are intended to establish ground rules for what the Treasury and the banking agencies hope will become an important supplemental source of funding for the US banking and housing industry.

Covered Bonds are a well-established method of funding for banks outside the US and are particularly popular in Europe. The Treasury estimates that the European market for Covered Bonds was valued at $3.3 trillion in 2007. However, only two US depository institutions, Bank of America, N.A. and Washington Mutual Bank, have entered the market.

Description. A Covered Bond is a non-deposit obligation issued directly or indirectly by a bank or thrift and secured by a pool ("Cover Pool") of qualifying loans that remain on the issuer's books and are actively managed by the issuer. Under the Best Practices and the Policy Statement, standards are established for qualifying loans and additional conditions for issuers are set forth. Qualifying loans are limited to perfected first priority home mortgage loans and a limited amount of qualifying mortgage-backed securities ("MBS"). Cash, Treasury securities and US agency securities also may be included in a Cover Pool as required as part of its management. The Cover Pool must be sufficient at all times to over-collateralize the Covered Bonds by five percent.

Principal and interest on Covered Bonds are a general obligation of the issuer and are paid by the issuer from its general cash flow; the mortgages in the Cover Pool serve as collateral. If an asset in the Cover Pool becomes non-performing, the issuer must replace it with a performing loan that meet the original underwriting criteria or with qualifying substitute collateral, such as MBS. Credit default swaps and other derivative instruments also are used to provide an uninterrupted payment stream in the event the issuer fails to make timely payment. If the issuer nevertheless defaults on its Covered Bonds and repayment is accelerated, and the investors do not recover all principal and accrued interest by liquidating the Cover Pool, the investors have a general unsecured claim against the issuer for the deficiency.

A bank or thrift may issue Covered Bonds directly or through a wholly-owned subsidiary. A bank or thrift also may use a bankruptcy-remote special purpose vehicle ("SPV"), which would hold mortgage bonds issued by the bank or thrift and issue corresponding Covered Bonds to investors.

Standards. The Best Practices and the Policy Statement are intended to provide consistency and ensure relative stability for the fledgling US market for Covered Bonds. The standards are summarized below.

Issuer Eligibility:

- Well capitalized;
- Consent obtained from the issuer's primary federal banking regulator, based on the agency's policies and procedures; and
- Covered bonds may account for not more than 4% of the issuer's liabilities after issuance.

Qualifying Mortgage Criteria:

- Performing, perfected first lien mortgage on a one-to-four family residence;
- Maturity up to 30 years;
- Fixed or floating interest rate;
- Fully documented and underwritten at fully indexed rate;
- May not permit negative amortization;
- Complies with all applicable supervisory guidance on residential mortgage underwriting;
- Maximum loan-to-value ratio ("LTV") of 80%;[1] and

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[1] If the LTV of a mortgage exceeds 80%, the value of the mortgage must be discounted to the 80% LTV ceiling. For example, if a loan for $180,000 was made to purchase a home valued at $200,000, resulting in a 90% LTV, only the amount of the mortgage equal to 80% of the home's value (or $160,000) may be included in the calculation of the asset size of the Cover Pool. Similarly, if the property value of a residence declined after a loan was made in an amount sufficient to cause the mortgage to exceed the 80% LTV ceiling, the same discount of the mortgage's collateral value must be made, and additional collateral must be added to the Cover Pool to cover any resulting deficiency in the mandatory 105% coverage of the outstanding Covered Bonds.

- Not more than 20% of the mortgages in a Cover Pool may come from a single Metropolitan Statistical Area.

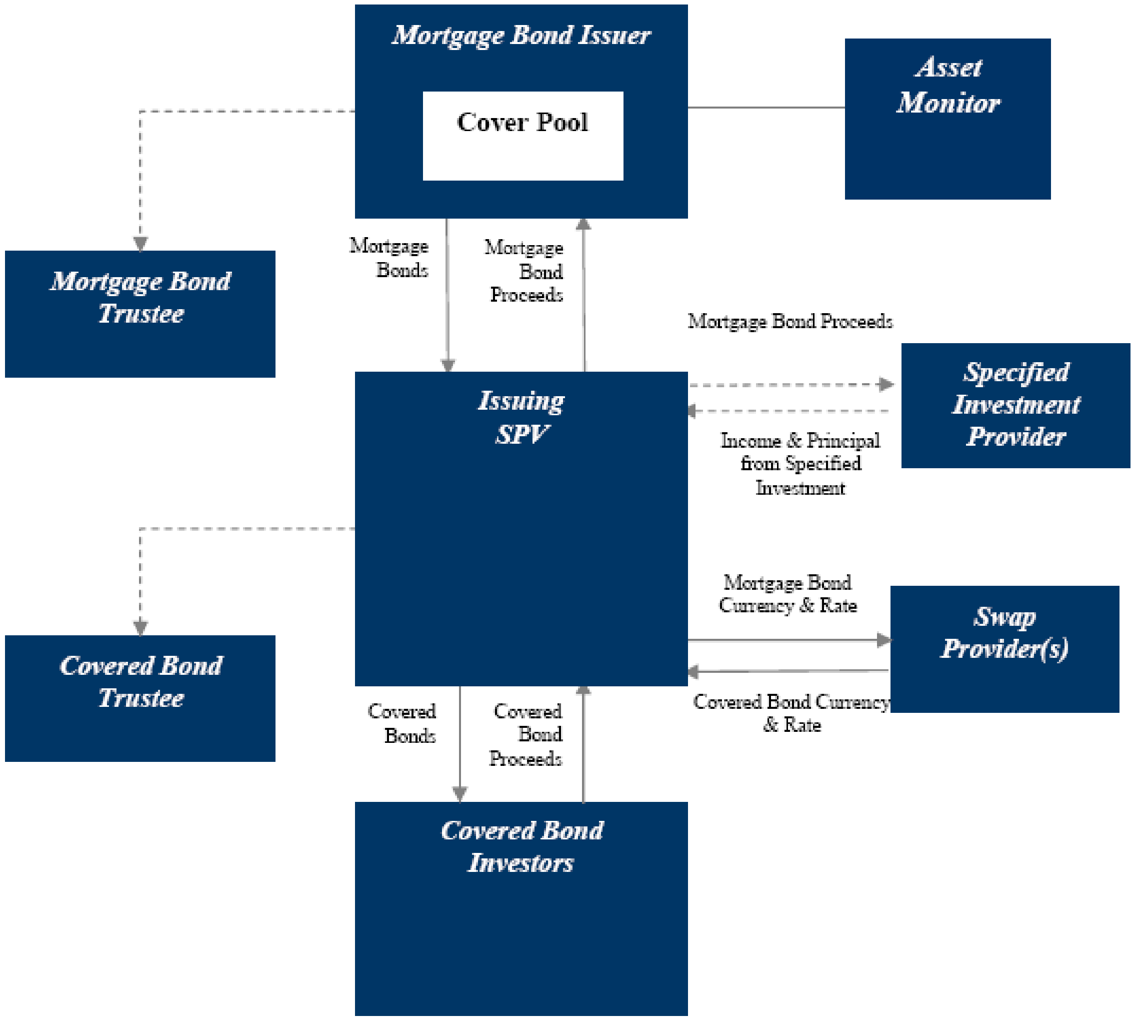
Cover Pool Maintenance:

- MBS may not constitute more than 10% of a Cover Pool;
- Designate an independent asset monitor to test asset coverage and make collateral substitutions monthly;
- Issuer must update market data for purpose of testing LTV at least quarterly;
- Designate an independent trustee to represent bondholders' interests in the event of the issuer's insolvency, among other duties. If a deficiency in the Cover Pool is not corrected within one month, the trustee may terminate the Covered Bond program, and no additional Covered Bonds may be issued while the breach exists; and
- A single Cover Pool may be used to cover multiple issuances of Covered Bonds. In the event of a default in a Cover Pool, any losses are shared *pro rata* by all issuances regardless of maturity.

Covered Bond Standards:

- May be publicly or privately issued;
- May be payable in any currency, but currency swaps must be used to cover currency risks; and
- Cover Pool information must be disclosed to bondholders monthly, within 30 days after the close of the reporting period for which the report is prepared.

Structure. A possible structure for a Covered Bond program, as it appears in the Treasury's Best Practices, is shown below:



Role of the Policy Statement. The FDIC's Policy Statement addresses issues that are of particular significance in the event of the failure of a bank or thrift and the appointment of the FDIC as receiver or conservator. Ordinarily, after a bank or thrift that issued Covered Bonds fails, the FDIC may elect to continue to perform the obligations of the failed institution under its Covered Bond program, to pay off the investors up to the value of the Cover Pool (and grant a general unsecured claim for any deficiency) or to allow the investors to seize and liquidate the Cover Pool (and grant a general unsecured claim for any deficiency). If the FDIC decides not to honor the Covered Bonds, interest is payable only through the date the issuer was closed by its primary regulator. However, the investors may not seize the assets of the failed institution without the FDIC's consent, and, before the adoption of the Policy Statement, the FDIC could wait up to 45 days after an institution was placed in conservatorship, and up to 90 days after an institution was placed in receivership, to give its consent. Under the Policy Statement, the FDIC must give its consent within 10 days if the Covered Bonds were issued in compliance with the Policy Statement. After 10 days, the investors may proceed to obtain the collateral without consent. The reduced waiting period for FDIC consent is significant for the pricing of Covered Bonds, because it enables issuers to reduce their hedging costs to cover the interest that may not be paid after the date they are closed by their regulators. The intended effect of the Policy Statement, in combination with the Best Practices and the endorsement of the federal banking agencies, is to create a level and, most importantly, a predictable playing field for Covered Bonds issued by US financial institutions.

The Policy Statement also contains one important caveat on the development of a market for Covered Bonds, by capping Covered Bonds at 4% of an issuer's liabilities after issuance. The cap was adopted out of concern that the amount of assets pledged to secure Covered Bonds may significantly increase the cost of resolving a failed institution to the FDIC, which relies primarily on unencumbered assets to recover the cost of paying off insured depositors. By contrast, no limit is placed on an insured depository institution's other secured liabilities, such as Federal Home Loan Bank advances, loans from the Federal Reserve Board's discount window, public deposits and repurchase agreements. The preamble to the Policy Statement indicates that, as the FDIC and the other federal banking agencies gain experience with the use of Covered Bonds in the context of the US financial system, the cap may be reconsidered. The FDIC also does not consider the amount of a depository institution's secured liabilities when setting assessments for deposit insurance. The Policy Statement does not address the issue of assessments, but the preamble to the Policy Statement observes that the FDIC's future experience with Covered Bonds may require that issue as well to be reconsidered.

Function of a Covered Bond Market. A Covered Bond is similar to a general secured borrowing that a bank or thrift might obtain from a third party insofar as the holder of a Covered Bond has a first priority security interest in certain designated collateral and a general unsecured claim against the issuer if the collateral is insufficient. However, no governmental agency or government-sponsored enterprise is involved in structuring or issuing Covered Bonds, and the absence of direct government involvement may have a variety of effects with regard to product innovation and price competition. The process of issuing Covered Bonds also has a superficial similarity to mortgage securitization, particularly if a SPV is used to issue the bonds. However, unlike a typical mortgage securitization, the collateral in a Cover Pool is actively managed. As a result, investors in Covered Bonds are exposed primarily to interest rate risk and have much less exposure to the more particularized credit risk and market risk involved in holding MBS. By keeping the Cover Pool on its books and actively managing those assets to maintain asset quality standards, the issuer has retained those risks, and also retained the obligation to maintain capital to support those assets on its expanded balance sheet. The issuer therefore has "skin in the game," and the moral hazards that some have identified in the originate-to-sell model of mortgage lending are largely avoided. These fundamental re-allocations of risks should cause Covered Bonds to appeal to their own category of investors and potentially create a new approach to financing mortgage lending activity among US financial institutions.

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