

**Milbank**

August 8, 2008

# Structured Finance Group

# Client Alert

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## Regulators Act to Boost Covered Bonds

Recent action by the Federal Deposit Insurance Corporation followed by an announcement by the U.S. Treasury Department have set the stage for an expansion of the nascent U.S. market for covered bonds. A long-established funding mechanism in Europe, covered bonds have been hobbled in the United States in part by uncertainty about bondholders' access to collateral in the event of an issuer's insolvency. Although this uncertainty was largely removed by the FDIC, it remains to be seen whether the market for this type of secured financing will develop in the face of significant constraints imposed by the FDIC and by the Treasury.

### FDIC Policy Statement

On July 15, 2008, the FDIC published "a final policy statement on the treatment of covered bonds in a conservatorship or receivership." Under section 11(e)(13)(C) of the Federal Deposit Insurance Act, the FDIC must consent as conservator or receiver within 45 days or 90 days, respectively, to any liquidation of collateral of an insured depository institution that is pledged to secure a transaction. In its policy statement, the FDIC consents to the exercise by a bondholder of its rights to collateral (i) if the issuer remains in default 10 days after delivery of a notice from the bondholder requesting such consent, or (ii) upon the failure of the FDIC to pay damages to the bondholder within 10 days of the effective date of a notice by the FDIC to a bondholder of its repudiation of the issuer's obligation. For a holder of a covered bond to qualify for the consent, however, the bonds must conform to the requirements of the policy statement. Of these requirements, the most notable are the following:

1. The covered bond must have been issued with the approval of the issuer's primary federal regulator.

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2. The issuer may be the depository institution or a subsidiary of the depository institution, or may be a bankruptcy-remote SPV that owns a mortgage bond issued by the institution.
3. The institution's total obligation under covered bonds outstanding after the issuance may not exceed four percent of its total liabilities.
4. The assets securing the covered bond obligation (or the mortgage bond in the case of an SPV issuer) must be "eligible mortgages" or, provided they do not constitute more than 10 percent of the collateral, "AAA-rated mortgage securities on eligible mortgages." "Eligible mortgages" means "performing, first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income and complying with existing supervisory guidance governing the underwriting of residential mortgages . . . ." Securities backed by other securities such as CDOs are not considered acceptable collateral.
5. Assets substituted for assets in the original collateral pool may include cash or Treasury and agency securities.

Commentators on an earlier proposed version of the statement asked that the FDIC clarify that it has the discretion to grant the consent required under section 11(e)(13)(C) before the expiration of the 45- or 90-day period in the case of covered bonds that do not conform to these requirements. In response, the FDIC stated only that it already has that discretion under the terms of the statute.

### Treasury's Best Practices

Two weeks after the release of the FDIC's policy statement, the Treasury Department on July 28 issued a document entitled "Best Practices for Residential Covered Bonds." The document was prepared "in order to encourage the growth of the Covered Bond market in the United States" and "to present a standardized model for Covered Bonds issued in the United States in the absence of dedicated legislation." It was intended "to serve as a complement" to the FDIC's policy statement. The Federal Reserve, Office of the Comptroller of the Currency, Office of Thrift Supervision and the Securities and Exchange Commission all issued statements endorsing the Best Practices.

The essence of the Best Practices is a model term-sheet that includes the FDIC's requirements listed above. Terms added by Treasury, however, include the following:

1. Mortgages in the collateral pool must be current when they are added to the pool and must be replaced if they become more than 60 days past due.
2. These mortgages must have a maximum loan-to-value of 80 percent at the time they are added to the collateral pool.

3. Borrowers from a single Metropolitan Statistical Area may not make up more than 20 percent of the collateral pool.
4. Issuers must over-collateralize their covered bonds by at least five percent at all times.
5. Covered bonds should be issued only by well-capitalized institutions.
6. Covered bonds may either be fixed or floating instruments, registered or privately offered, and may be issued in any currency.
7. To prevent an acceleration of the covered bond due to the insolvency of the issuer, an issuer must enter into a deposit or other agreement with “one or more financially sound counterparties” under which the proceeds of the mortgages serving as collateral are invested.
8. Issuers must make available to investors at the time an investment decision is made and no later than 30 days after the end of each month “descriptive information” on the assets in the collateral pool.
9. The issuer must perform an “asset coverage test” on a monthly basis to ensure “collateral quality and the proper level of over-collateralization” and to make any necessary substitutions of assets. The issuer must designate an independent “asset monitor” to determine periodically compliance with the asset coverage test.

#### Future prospects

Despite the notable degree of support for covered bonds demonstrated by the Best Practices and accompanying statements of the federal regulators, the combination of the FDIC’s policy statement and the Treasury’s model term-sheet limits this fundraising option to a narrow band of conforming instruments. Despite the fact that the Best Practices have no legal effect, an institution’s primary federal regulator is unlikely to grant the approval required by the FDIC’s policy statement unless the issuance also conforms to the terms of Treasury’s template.

Given the significant limitations effectively imposed by the FDIC and Treasury on what is by its nature already a conservative debt instrument, the challenge for issuers and their underwriters will be to push for regulatory approval of non-conforming offerings that have characteristics equivalent to the “safe and sound” terms of the Treasury template. According to the Best Practices, “Treasury expects that the Covered Bond market [will] develop over time and [that] the collateral securing Covered Bonds may eventually include other asset classes.” If the market demands the certainty afforded by the FDIC’s policy statement, pressure will need to be brought first on the FDIC to liberalize its requirements, and thereafter on other federal regulators to depart from the Treasury template. If, against likely odds in the near-term environment, the regulators are receptive to this pressure, the opportunity for creative and attractive funding instruments could be substantial.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Structured Finance Group, whose names and contact information are provided below.

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