CAPITAL MARKETS UPDATE

US Treasury Issues Best Practices for Residential Covered Bonds

July 30, 2008

A Best Practices Guide has been prepared by the US Department of the Treasury (Treasury) in order to encourage the growth of the covered bond market in the United States. The Treasury believes that covered bonds represent a potential additional source of financing that could reduce borrowing costs for homeowners, improve liquidity in the residential mortgage market and help depository institutions strengthen their balance sheets by diversifying their funding sources. In the Best Practices Guide, the Treasury seeks to bring increased clarity and homogeneity to the United States covered bond market by developing a series of best practices (the "Best Practices"). The Treasury observes that the Best Practices may serve as a starting-point for the market, by encouraging issuers to use a common and simplified structure with high quality collateral for covered bond issuances.

The Best Practices Guide complements the Federal Deposit Insurance Corporation's Final Covered Bond Policy Statement dated July 15, 2008, which indicates how the Federal Deposit Insurance Company (FDIC) will treat covered bonds in a conservatorship or receivership of an issuing insured depository institution (IDI).

While covered bonds have a long history in Europe, they are a newcomer to the US capital markets. Bank of America and Washington Mutual were the first US issuers, with initial issuances in 2006. Bank of America, Citigroup, JP Morgan Chase and Wells Fargo & Co. have all recently indicated that they will begin issuance programs.[1] Covered bonds are full-recourse obligations of the issuing IDI, secured by collateral (most often mortgage loans) that remains on the IDI's balance sheet. What distinguishes covered bonds from typical US secured debt is that they are meant to provide investors with uninterrupted access to the collateral, notwithstanding the insolvency of the issuer. From an investor's point of view, covered bonds combine some of the best aspects of traditional corporate bonds with those

of asset-backed securities: a yield that is higher than government or agency bonds, bullet maturities with little prepayment or acceleration risk and recourse to both a regulated financial institution and a high quality pool of collateral.

The insolvency regime for US IDIs does not permit investors in covered bonds to enjoy all of the benefits available under some European legal systems. However, the final policy statement describes two structures that provide some of those benefits:

- An SPV Structure, in which covered bonds are issued by a bankruptcy-remote special purpose vehicle, the primary asset of which is a mortgage bond purchased from a depository institution. The mortgage bond must be secured at the depository institution by a dynamic pool of residential mortgages.
- A direct issuance structure, in which an IDI and/or a wholly-owned subsidiary of an IDI designates a cover pool of residential mortgages as the collateral for the covered bond.

In each case, the final policy statement requires that the eligible mortgages and other collateral pledged for the covered bonds be held and owned by the IDI. This requirement is designed to protect the FDIC's interests in any overcollateralization and avoid structures involving the transfer of the collateral to a subsidiary, or to an SPV, either at initiation or prior to any IDI default under the covered bond transaction.

The US covered bond structures described above are meant, among other things, to reduce acceleration risk relating to insolvency of the issuing IDI or a mortgage bond default. Unfortunately, at about the time that the initial transactions using this structure were completed, Congress amended the Federal Deposit Insurance Act to add Section 11(e)(13)(C), which creates an automatic stay on certain actions for 45 days after the FDIC is appointed as conservator and for 90 days after the FDIC is appointed as receiver. As a result, no party can exercise contractual rights to liquidate collateral pledged by a failed IDI during the applicable stay period without the FDIC's consent.

While market participants believe that transactions could be structured to survive these stay periods, doing so would create significant incremental transaction costs. As a result, various parties approached the FDIC asking for advance consent to the exercise of liquidation rights in covered bond transactions. The resulting final policy statement provides the requested advance consent, but only for specified actions and only for covered bond transactions that satisfy several requirements.

Specifically, in qualifying transactions, the FDIC has granted its prior consent to covered bond obligees to exercise their contractual rights over collateral no sooner than 10 business days after either a monetary default on an issuing IDI's obligation to the covered bond obligee, or the effective date of the FDIC's repudiation of the covered bond

obligations, as provided in a written notice by the conservator or receiver. Under the Federal Deposit Insurance Act, contracting parties cannot terminate agreements with an insolvent IDI solely on account of either the insolvency itself or the appointment of the FDIC as receiver or conservator. The policy statement does not alter this limitation or permit contracting parties to exercise remedies triggered solely by insolvency or the appointment of the FDIC as receiver or conservator.

To qualify for the advance consent:

- The issuing IDI must obtain the consent of its primary federal regulator prior to the issuance;
- The issuing IDI's total covered bond obligations may not comprise more than 4 percent of its total liabilities at the time of issuance;
- The collateral must be limited to "eligible mortgages," except that as much as 10 percent of the collateral for any covered bond issuance or series may consist of AAA-rated mortgage securities backed solely by eligible mortgages and, in addition, substitution collateral for the covered bonds may include cash and Treasury and agency securities as necessary to prudently manage the cover pool; and
- The initial term of the covered bonds must be greater than one year and no more than thirty years.

"Eligible mortgages" are defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income in accordance with existing supervisory guidance governing the underwriting of residential mortgages applicable at the time of origination.

The Best Practices promulgated by the Treasury elaborate on the requirements of the final policy statement and impose additional requirements, several of which are noted below. While the final policy statement declined to impose a loan-to-value (LTV) test, the Best Practices permit a maximum LTV of 80 percent at the time of inclusion in the cover pool. The Best Practices also require that loans be current when they are added to the pool and that any mortgages that become more than 60 days past due be replaced. Further, all loans must be secured by a first lien mortgage and any loans secured by properties in a single metropolitan statistical area cannot make up more than 20 percent of the cover pool. Negative amortization mortgages are not eligible, and bondholders must have a perfected security interest in the mortgage loans.

The Best Practices also adopt several features of existing covered bond transactions, including an asset monitor, a requirement that disposition proceeds of any covered bond assets be invested in a specified investment contract that is entered into at the time

of issuance and which effectively defeases the covered bonds, and an asset coverage test. The Best Practices cause a program wind down if a monthly 105 percent asset coverage is uncured for 30 days following breach. The coverage test is calculated using the lesser of the unpaid balance of the loan and 80 percent of the associated collateral value as updated on a quarterly basis using a nationally-recognized, regional housing index or comparable measurement.

Endnotes

[1] *The Wall Sreet Journal* (July 29, 2008), p. C3.

If you have any questions with regard to the above memorandum, please feel free to contact the following attorneys or any of your regular contacts at the firm.

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