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Client Alert

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Recent Regulatory Developments in the U.S. Covered Bond Market

The FDIC and the U.S. Treasury recently issued much anticipated guidance designed to support the development of the U.S. covered bond market. The FDIC's policy statement (the "*Policy Statement*") addresses the treatment of collateral pledged to secure covered bonds in the event of a conservatorship or receivership of a sponsoring entity, the deposits of which are insured by the FDIC. The U.S. Treasury issued a best practices template (the "*Best Practices Template*"), which incorporates the Policy Statement but provides more detail regarding covered bond structure, collateral and documentation.

I. FDIC Policy Statement

In its Policy Statement, the FDIC addresses concerns over the role of the FDIC in a receivership or conservatorship of an insured depositary institution (an "*IDI*")[1] sponsoring a covered bond program and the consequent potential inability of covered bond issuers to make full and timely payments to covered bondholders.

Specifically, the Policy Statement sets forth a number of requirements for covered bond transactions to qualify for expedited access to collateral, including the following:

- the covered bond issuance was made with the prior consent of the related IDI's primary federal regulator;
- the covered bond issued is (a) recourse debt with a term greater than one year and not more than thirty years, secured directly or indirectly by perfected security interests under applicable state and federal law on eligible mortgages, or (b) for no more than 10% of the collateral for any covered bond issuance or series, AAA-rated mortgage-backed securities secured by eligible mortgages; and
- the total covered bond exposure of the sponsoring IDI at the time of, and including, the issuance is not more than 4% of such IDI's total liabilities.

In addition, the FDIC clarifies in the Policy Statement that, when acting as receiver or conservator, it has the discretion to consent on a case-by-case basis to permit expedited access to collateral regardless of whether the collateral pledged by the affected IDI is subject to a transaction meeting the requirements set forth in the Policy Statement for expedited access. However, the FDIC states that it will not give consent sooner than ten (10) business days after default on the related IDI's monetary obligations to the covered

[1] The term "insured depositary institution" is defined as "any bank or savings association the deposits of which are insured by the [FDIC] pursuant to [Chapter 16 of the United States Code]." 16 U.S.C. § 1813(c)(2).

bond holders or, with respect to the FDIC's repudiation of any contract, ten (10) business days after the effective date of repudiation set forth in a written notice issued by the FDIC as receiver or conservator. The FDIC also affirms in the Policy Statement that "actual direct compensatory damages" caused by the FDIC's repudiation of any qualified covered bond contract will equal the par value of the covered bonds, plus interest accrued thereon, as of the date of appointment of the FDIC as receiver or conservator.

II. U.S. Treasury Best Practices Template

In the Best Practices Template, the U.S. Treasury discusses the use of covered bonds as an alternative source of funding that can complement existing financing options for high-quality residential mortgage loans and presents a preliminary model for future U.S. covered bond issuance. Like the Policy Statement, the Best Practices Template relates to covered bonds backed by residential mortgage loans and does not apply to prior covered bond issuances sponsored by U.S. depository institutions. However, unlike the Policy Statement, the Best Practices Template is advisory in nature and does not have the force of law.

The Best Practices Template expressly affirms the U.S. Treasury's position that the terms contained therein do not, in any way, provide or imply a government guarantee of any kind and highlights the U.S. Treasury's expectation that the U.S. covered bond market will evolve so as to include transactions currently beyond the scope of the Best Practices Template. However, the Best Practices Template does not attempt to address potential issues arising from the practical application of its terms in future U.S. covered bond transactions (for example, those raised by simultaneous application of the federal securities laws), thereby leaving these issues for resolution by the sponsoring IDIs and their advisors at the time of covered bond issuance.

III. Summary

Where the U.S. traditionally turned to government-sponsored enterprises such as Fannie Mae, Freddie Mac and the Federal Home Loan Banks to support residential mortgage loan funding, other countries, such as Germany and England, developed alternative legislative and contractual frameworks to promote the development of robust covered bond markets. As a result of careful regulation and cooperation in the marketplace, covered bonds have become a substantial source of residential mortgage loan funding in those countries.

The Policy Statement and the Best Practices Template provide the initial framework needed to encourage U.S. covered bond issuance by bringing homogeneity and regulatory guidance to a market where previously there was none. To ensure further development of the U.S. covered bond market, it will be essential for regulators and market participants alike to continue their current efforts to promote resilient liquidity options for U.S. depository institutions.

For the complete text of the Policy Statement, see:
http://www.fdic.gov/news/news/press/2008/pr08060a.html

For the complete text of the Best Practices Template, see:
http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf