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COVERED BONDS: *A Primer*

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As the securitization of residential mortgage loans ground to a halt during the current credit crisis, the Department of the Treasury and the Federal Deposit Insurance Corporation published guidance for the issuance of covered bonds as an alternative means of financing residential mortgages. A covered bond is a debt instrument that is secured by a pledge of a segregated pool of assets (a "cover pool"), but is paid back from an issuer's cash flow rather than from the assets themselves. A depository institution may directly issue covered bonds or issue a mortgage bond to a bankruptcy remote special purpose vehicle that, in turn, issues covered bonds. Both the Treasury and the FDIC currently restrict the cover pool to residential mortgages, but each of these institutions anticipates that the development of a U.S. covered bond market could lead to other as-set classes serving as collateral in cover pools.

There are significant differences between covered bonds and mortgage-backed securities: (i) a covered bond remains on the issuer's balance sheet; (ii) an investor has recourse against both the issuer and the cover pool; (iii) principal and interest on the covered bond are paid from an issuer's cash flow; (iv) non-performing assets in the cover pool can be replaced; and (v) guaranteed investment contracts limit the prepayment risk for covered bonds in the event of the issuer's default.

Given that a covered bond is the direct obligation of an issuer, potential investors were concerned about their access to the cover pool upon the issuer's failure. The FDIC addressed this concern in its Final Covered Bond Policy Statement, dated July 15, 2008, which grants investors accelerated access to a cover pool by shortening the "stay" period to ten business days (from 45 days in an FDIC conservatorship and 90 days in an FDIC receivership), provided that the cover pool is comprised of "eligible mortgages" and the covered bond transaction meets certain requirements. An "eligible mortgage" is a performing, first-lien residential mortgage that (i) is underwritten at the "fully-indexed rate" (i.e., the index rate at origination plus the margin arising upon the expiration of an introductory interest rate); (ii) relies on documented income; and (iii) complies with existing supervisory guidance governing the underwriting of residential mortgages. In addition, a covered bond must have a term from one year to thirty years, the primary federal regulator must consent to the covered bond issuance, and the total covered bond obligations of a depository institution must be no more than four percent (4%) of its total liabilities. In the event that covered bonds do not meet the foregoing requirements, the FDIC still possesses discretion to grant consent to expedited access on a case-by-case basis.

On July 28, 2008, the Treasury issued a Best Practices Guide for Residential Covered Bonds that establishes a standardized model for the issuance of covered bonds. The Best Practices Guide adds several limitations for eligible mortgages: (i) any mortgage that is sixty days past due must be replaced; (ii) the loan-to-value ratio cannot exceed 80 percent; and (iii) a mortgage cannot secure a loan with negative amortization. In addition, the cover pool must maintain an over collateralized value that is five percent greater than the aggregate value of the covered bonds secured by the cover pool. An independent asset monitor is appointed to make monthly determinations as to whether the cover pool satisfies the over collateralization requirement. Finally, an issuer may replace non-performing mortgages with performing residential mortgages, cash, U.S. Treasuries or agency securities.

An emerging covered bond market confronts several obstacles. The most substantial is the credit crisis itself, which generally undermines the issuance of debt by a depository institution and dampens financial innovation. Furthermore, the structure and documentation for a covered bond transaction have not been standardized. The relative novelty of a covered bond transaction will result in increased execution costs, and the pricing advantage of covered bonds is unclear. Other funding sources (e.g., advances from the Federal Home Loan Banks) are competitive as to pricing and ease of execution. Finally, eligible mortgages in the covered bond context are also prime candidates for securitization (if and when that market re-emerges). Despite these obstacles, certain aspects of covered bonds (e.g., retained credit risk, transparency, and enhanced security) provide incentives and could help establish a competitive alternative to securitization.

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