

## Client Advisory

### FDIC and Treasury Department Guidance May Spur Growth of U.S. Covered Bond Market

In response to the developing housing turmoil and credit crisis, which continues to restrict the securitization of residential mortgage loans, U.S. federal regulators have issued guidance regarding a potential alternative method of on-balance sheet financing of these loans—covered bonds. The four largest U.S. banks have publicly announced their intention to establish covered bond programs, which, as Treasury Secretary Henry Paulson noted on July 28, “have the potential to increase mortgage financing, improve underwriting standards, and strengthen U.S. financial institutions by providing a new funding source that will diversify their overall portfolio.” Although there have been only two U.S. covered bonds issuances to date, a large and liquid market for covered bonds has existed in Europe for many years, and many expect that recent regulatory developments will spur the growth of the U.S. covered bonds market.

On July 15, the Federal Deposit Insurance Corporation (“FDIC”) released its Final Covered Bond Policy Statement (the “Policy Statement”), and on July 28, the Department of the Treasury released its Best Practices Guide for Residential Covered Bonds (the “Best Practices Guide” and, together with the “Policy Statement,” the “Guidelines”). The Policy Statement clarifies how the FDIC will apply the consent requirements of Section 11(e)(13)(c) of the Federal Deposit Insurance Act (“FDIA”) to covered bonds structured in compliance with the Policy Statement, and the Best Practices Guide seeks to present a standardized model for U.S. covered bond issuances in the absence of a specific legislative framework.

A covered bond is a debt obligation issued by a depository institution (the “Bank”) that is secured by a pledge of a segregated pool of assets, or “cover pool,” that remains on the Bank’s balance sheet. Although similar in some ways to mortgage-backed securities, covered bonds differ in that: (i) they are on-balance sheet; (ii) investors are paid principal and interest from general cash flow of the issuing entity, with the cover pool serving as collateral only; (iii) the cover pool may be actively managed by the substitution of eligible assets for nonperforming or prepaying loans; (iv) covered bonds are structured with deposit and swap agreements to avoid prepayment risk; and (v) covered bond investors retain recourse to the issuing entity in the event of less than full repayment from the cover pool.

The Guidelines specify that covered bonds may be issued either directly by Banks or through bankruptcy remote SPVs where the covered bond is secured by a mortgage bond issued by the Bank. In each case, the covered bonds are secured by a perfected first priority security interest in the assets of the cover pool, which remains on the Bank’s balance sheet. The cover pool must consist only of “eligible mortgages,” although (i) no more than 10% of the cover pool may consist of AAA-rated mortgage-backed securities secured by eligible mortgages, and (ii) cash and U.S. Treasury and agency securities may be substituted for nonperforming or prepaying collateral.

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**For more information about covered bonds, please contact one of Katten’s Covered Bonds Team Co-Chairs:**

**Eric Adams**

212.940.6783

eric.adams@kattenlaw.com

**Hays Ellisen**

212.940.6669

hays.ellisen@kattenlaw.com

An “eligible mortgage” is (i) a performing, first-lien residential mortgage on a one-to-four family property with a maximum 80% LTV, (ii) that is underwritten at the fully-indexed rate, relying on documented income and in compliance with specified underwriting standards, and (iii) that is not a negative amortization loan. No single Metro Statistical Area may make up more than 20% of the cover pool and any mortgages that become more than 60 days past due must be replaced.

Covered bonds may be issued in maturities of between one and 30 years, but the total amount of covered bonds issued by a Bank may not exceed more than 4% of the Bank’s total liabilities after issuance. Banks must perform a monthly “asset coverage test” reviewed by an appointed “Asset Monitor” to ensure collateral quality and maintain overcollateralization of at least 5% of the outstanding principal balance of the covered bonds. Banks must also obtain approval from their primary federal regulators in order to issue covered bonds. The Best Practices Guide provides for disclosures to investors of certain facts regarding the cover pool, substitutions, swap arrangements, and the Bank and SPV, if applicable.

For properly structured covered bond transactions, in the event of insolvency of the Bank, the Guidelines reduce the FDIC’s automatic stay period from 45 days or 90 days, with respect to conservatorship or receivership, as applicable, to a maximum of 10 business days. In the event that either (a) a Bank remains in monetary default for 10 business days after delivery to the FDIC of a request to exercise contractual rights, or (b) the FDIC does not pay the damages due within 10 business days of its notice of repudiation of the covered bonds, the Guidelines specify that the FDIC consents to the orderly liquidation of the cover pool collateral without its involvement. Damages payable to covered bond investors, however, are limited to par value of the covered bonds plus interest accrued up to the date of the appointment of the FDIC as conservator or receiver.

In order to avoid prepayment risk caused by the liquidation of the cover pool prior to maturity of the covered bonds, the Guidelines specify that the Bank may invest the covered pool proceeds through a deposit agreement or guaranteed investment contract (“GIC”) providing continued payments of principal and interest to covered bond holders in the event of a Bank insolvency. Any interest rate mismatch between the GIC and covered bond coupons may be hedged through a swap agreement (in addition to any necessary currency or other swap agreements).

Although many industry participants had hoped that the Guidelines would provide even greater flexibility—allowing the cover pool to contain commercial mortgages or public sector debt, for instance—many expect that the issuance of the Guidelines may mark the beginning of a period of growth for the nascent U.S. covered bond market.

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