

Clients & Friends Memo

New U.S. Covered Bond Legislation Introduced

March 25, 2010

Introduction

In order to facilitate a covered bond market in the United States, Representative Scott Garrett, along with co-sponsors Representative Paul Kanjorski and Representative Spencer Bachus, introduced the “United States Covered Bond Act of 2010”¹ (the “**Act**”) in the House of Representatives on March 18, 2010. The Act expands upon legislation that Representative Garrett previously introduced in the House of Representatives on July 30, 2008, entitled “Equal Treatment of Covered Bonds Act of 2008”², which was never passed into law.

A covered bond is a security issued by a bank (or a similar regulated institution) (the “**Issuer**”) that is backed by a specified yet dynamic pool (the “**Cover Pool**”) of high quality assets that are intended to be insulated from the estate of the Issuer in the event of the Issuer’s insolvency. In contrast to typical mortgage-backed securities transactions, investors in covered bonds are provided recourse to the Issuer in the event that the Cover Pool is insufficient to pay principal and interest due on such bonds. Furthermore, loans in a Cover Pool that are not performing or have prepaid are required to be replaced with performing loans or other permitted collateral. The outstanding loans in the Cover Pool also remain on the balance sheet of the Issuer for the life of the transaction.

Even though covered bonds have been utilized in Europe for centuries, unique regulatory matters relating to the insolvency of U.S. financial institutions have provided various obstacles to establishing a covered bond market in the United States, which the Federal Deposit Insurance Corporation (the “**FDIC**”) sought to mitigate in releasing its Covered Bond Policy Statement (the “**Policy Statement**”) on July 15, 2008.³ While the Policy Statement did provide some guidance to investors regarding the treatment of covered bonds in the event of the insolvency of an Issuer, it did

¹ See <http://www.americansecuritization.com/uploadedFiles/GarrettUSCoveredBondAct.pdf> for a copy of the Act.

² A copy of the Equal Treatment of Covered Bonds Act of 2008 is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h6659ih.txt.pdf.

³ A copy of Policy Statement is available at <http://www.fdic.gov/news/news/press/2008/pr08060a.html>.

not go as far as to provide the investors the same protections available in Europe.⁴ The Act now seeks to establish a regulatory framework in the United States for covered bonds and extend similar protections provided in the European market to the U.S. market. This memorandum summarizes certain provisions of the Act.

Regulatory Oversight and Eligibility Requirements

The purpose of the Act is to establish a regulatory oversight program for covered bonds. To further such purpose, the Act would appoint a covered bond regulator (i.e., the Secretary of the Treasury or a designated officer of the Treasury appointed thereby) that would have the power to establish a regulatory oversight program as well as provide any additional requirements that are consistent with both “safe and sound banking practices” and the provisions of the Act.⁵

The Act would only apply to covered bonds that are issued by an “eligible issuer”⁶ under a covered bond program that is approved by the covered bond regulator. The covered bond regulator would have to consult first with the primary Federal regulator of the Issuer prior to approving any covered bond program.

The Act also imposes certain minimum requirements for the covered bonds and the Cover Pool. The Act mandates that each covered bond “(A) has an original term to maturity of not less than 1 year; (B) is secured directly or indirectly by a perfected security interest in a cover pool which is owned directly or indirectly by the issuer of the obligation; (C) is issued under a covered bond program that has been approved by the covered bond regulator and is identified in a register of covered bonds maintained by the covered bond regulator; and (D) is not a deposit (as defined in section 3 of the Federal Deposit Insurance Act).”⁷ The Act also requires that the Cover Pool consist only of eligible assets within a particular eligible asset class (as further described below), specified substitute assets (e.g., cash or other specified obligations guaranteed by the full faith and credit of the United States government) or ancillary assets (e.g., swaps, guarantees, letter of credit

⁴ For a further discussion of the Policy Statement and insolvency issues relating to the issuance of covered bonds in the United States, see the Clients and Friends Memo entitled “*What are Covered Bonds and Why Should Anyone Care?*”, available on Cadwalader’s website at http://www.cadwalader.com/assets/client_friend/091008CoveredBonds.pdf.

⁵ See Section 3(a)(1) of the Act.

⁶ An “eligible issuer” is defined in Section 2 of the Act as “(A) any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act) and any subsidiary of any such institution; (B) any bank holding company (as defined in section 2 of the Bank Holding Company Act of 1956) or any savings and loan holding company (as defined in section 10 of the Home Owners’ Loan Act); and (C) any issuing entity that is sponsored by or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis.”

⁷ See the definition of “Covered Bond” in Section 2 of the Act.

rights or other credit enhancements).⁸ A Cover Pool cannot include assets from more than one asset class.

The Act would establish the following nine eligible asset classes:

1. **Residential mortgage asset class:** first lien, 1- to 4-family residential mortgage loans that comply with supervisory guidance, FHA and VA loans and certain other loans guaranteed, insured or made under Chapter 37 of Title 38 of the United States Code and certain RMBS that are of the highest investment grade (as long as such RMBS do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool);
2. **Home equity asset class:** home equity loans secured by 1- to 4-family residential properties that comply with supervisory guidance and any asset backed securities backed by home equity loans of the highest investment grade (as long as such asset-backed securities do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool);
3. **Commercial mortgage asset class:** commercial mortgage loans (including multifamily mortgage loans) that comply with supervisory guidance and any CMBS that are of the highest investment grade (as long as such CMBS do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool);
4. **Public sector asset class:** investment grade securities issued by states or municipalities, loans made by states or municipalities and loans, securities or other obligations that are insured or guaranteed by the full faith and credit of the United States;
5. **Auto asset class:** auto loans or leases that comply with supervisory guidance and asset-backed securities that are backed by auto loans or leases that are of the highest investment grade (as long as such asset-backed securities do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool);
6. **Student loan asset class:** student loans that comply with supervisory guidance and asset-backed securities that are backed by student loans that are of the highest investment grade (as long as such asset-backed securities do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool);
7. **Credit or charge card asset class:** credit or charge card loans that comply with supervisory guidance and asset-backed securities that are backed by credit or charge card loans that are of the highest investment grade (as long as such asset-backed securities do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool);
8. **Small business asset class:** loans made under any programs established by the Small Business Administration and asset-backed securities that are backed by such loans that are of the highest investment grade (as long as such asset-backed securities do not exceed 20% of the outstanding principal amount of the assets of the Cover Pool); and
9. Any other eligible asset classes designated by the covered bond regulator.

⁸ For a further description of eligible assets, see the applicable definitions in Section 2 of the Act.

Notwithstanding the foregoing, no loan will qualify as an eligible asset if it is delinquent for more than 60 consecutive days and no security will qualify as an eligible asset if it does not meet the above applicable highest investment grade criteria (i.e., AAA rated).

The Act also provides that the covered bond regulator must maintain a website that contains the name of each approved covered bond program as well as information about each covered bond issued pursuant to such programs. The Act also empowers the regulator to levy fees on the Issuers for implementing the provisions of the Act. In order to qualify under the Act, each Issuer must also clearly mark its books and records to identify the assets of the Cover Pool and provide the related indenture trustee (on a monthly basis) a schedule of the assets that are included in the Cover Pool.

Minimum Overcollateralization Requirements

The Act directs the covered bond regulator to establish a minimum overcollateralization requirement for each of the eligible asset classes based on the “credit, collection, and interest-rate risks, but not the liquidity risks” associated with each eligible asset class, which such requirements may be established by relying on the levels used for similar asset classes by the Board of Governors of the Federal Reserve System.⁹

The Cover Pool must meet the minimum overcollateralization requirement (i.e., the asset test) at all times and the Issuer is required to test monthly whether the Cover Pool meets the asset test and report the results to the Issuer’s primary Federal regulator, the covered bond regulator and the related bondholders. The indenture trustee (or another unaffiliated entity) must also test the pool on an annual (or more frequent) basis and disclose such results to the same parties noted above. The covered bonds will remain subject to the Act at all times regardless of whether the asset test is satisfied (although failure to cure such defect in the time frame specified in the related transaction documents will result in a default that triggers the creation of an “estate” as described below).

Default and Insolvency

The heart of the Act is Section 4, which attempts to address investor concerns regarding access to the Cover Pool in the event of the insolvency of the Issuer. Section 4 is broken into two parts: Section 4(a) addresses uncured defaults on the covered bonds that occur prior to the conservatorship, receivership, liquidation or bankruptcy of the Issuer and Section 4(b) addresses uncured defaults that occur on the covered bonds after the FDIC has been appointed as conservator or receiver for the Issuer.

If an uncured default occurs on the covered bonds prior to the conservatorship, receivership, liquidation or bankruptcy of the Issuer, an “estate” is automatically created by the Act. The related Cover Pool is automatically released to the newly created estate, free and clear of “any right, title, interest, or claim of the issuer or any conservator, receiver, liquidating agent or trustee in bankruptcy for the issuer or any of its other assets.”¹⁰ The newly created estate is fully responsible for the

⁹ See Sections 3(b)(1) and 3(b)(2) of the Act.

¹⁰ See Section 4(a)(2) of the Act.

covered bonds and any of the Issuer's obligations relating thereto, although the bondholders would retain their claims against the Issuer for any deficiencies relating to the covered bonds. A residual interest that represents the right to receive any excess funds from the Cover Pool after satisfaction of all of the outstanding liabilities of the estate would be automatically granted to the Issuer.

If an event of default on the covered bonds occurs after the FDIC has been appointed conservator or receiver for the Issuer but before an estate has been created as described in the preceding paragraph, the FDIC is granted the right under the Act for a 15-day period starting from the date of its appointment to transfer the Cover Pool (and its related obligations) to another eligible Issuer. During this 15-day period, the FDIC is required to satisfy the obligations of the Issuer. If the FDIC is able to effect such a transfer, the designated transferee will become liable for all payments and obligations of the related covered bonds. If the FDIC is unable to successfully transfer the Cover Pool to another Issuer, an estate consisting of the Cover Pool, similar to that described in the preceding paragraph, will be automatically created. If such an estate is created, the conservator, receiver, liquidating agent or bankruptcy court, as applicable, is directed to estimate any contingent claims for any deficiencies relating to the covered bonds for the purpose of "allowing such claim as a provable claim if awaiting the fixing of that contingent claim would unduly delay the resolution of the conservatorship, receivership, liquidating agency, or bankruptcy case."¹¹ Upon creation of the estate, a residual interest in the estate would be automatically granted to the conservator, receiver, liquidating agent or trustee in bankruptcy for the Issuer.

If an estate is created under either Section 4(a) or Section 4(b) of the Act, the Issuer is required to transfer to the covered bond regulator (or its designee) books and records and other documents relating to the Cover Pool and may be required, at the option of the regulator, to continue to service the assets for 120 days after the estate is created. The regulator would act as trustee of the estate and would be required to appoint a servicer or administrator to manage the Cover Pool. The regulator is charged with supervising the appointed servicer or administrator (and may remove or replace them at any time). The Act specifies the powers and duties that are granted to the servicer or administrator, such as managing the Cover Pool.

Securities Laws and Miscellaneous Provisions

The Act also provides guidance regarding the application of the securities laws to covered bonds. The Act provides that covered bonds issued and sold by a bank will be subject to regulations issued by the primary regulator of such bank and any applicable antifraud rules, but will be exempt from all other federal securities laws. With respect to covered bonds that are issued by any other eligible Issuer, the SEC is directed to develop a "streamlined" registration scheme. Federal securities law exemptions are extended by the Act to any estate created by the Act and to any residual interest issued under the Act.

The Act would expand the reach of the Secondary Mortgage Market Enhancement Act of 1984 ("**SMMEA**") to include covered bonds that are subject to the Act.¹² The Act would also amend the

¹¹ See Section 4(b)(4) of the Act.

¹² Note, however, that the Act only amends a SMMEA provision that would authorize entities governed by federal or state law to purchase, hold or invest in covered bonds to the same extent that they may purchase, hold or invest in securities issued or

provisions of the Internal Revenue Code so that covered bonds secured by eligible assets from the residential mortgage asset class, the home equity asset class or the commercial mortgage asset class would be considered “qualified mortgages” for purposes of the REMIC rules. Furthermore, the Act clarifies that any estate created by its operation would not be taxable as a separate entity and that any transfer to such estate that occurs under the Act would not be a taxable event. Finally, the Act provides that, for federal income tax purposes, the acquisition of any covered bond would be treated as an acquisition of a security, not as a lending transaction, for purposes of determining the character of any related trade or business of the acquirer or of any asset held by the acquirer.

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guaranteed as to principal and interest by the United States or any agency or instrumentality thereof. As presently drafted, the Act would not amend the SMMEA provision whereby the registration requirements of state “Blue Sky” laws are preempted by deeming certain securities equivalent to obligations issued or guaranteed as to principal and interest by the US or any agency or instrumentality thereof. Absent that amendment, covered bonds would be subject to registration under applicable Blue Sky laws, unless otherwise exempt.