

Covered Bonds: FDIC Action Might Spur U.S. Covered Bond Growth

Will U.S. Institutions and Investors Join the Covered Bond Bandwagon?

Covered bonds have recently begun to receive significant attention in the United States as a result of the first U.S. structured covered bond issuance, the FDIC's approval on April 15, 2008, of the issuance of an interim final covered bond [policy statement](#), and the credit crisis. Although covered bonds are one of the oldest asset financing techniques, they are still relatively unknown in the United States. Given the size of the worldwide covered bond market and the appeal of covered bonds to both issuers and investors on a worldwide basis, we believe that covered bonds will become a significantly larger part of U.S. mortgage finance.

What are Covered Bonds?

Covered bonds are securities issued by a bank and backed by a specified pool of loans, typically residential or commercial mortgage loans, known as the "cover pool" to which bondholders have a preferential claim in the event of the issuer's insolvency. If the issuing entity becomes insolvent, the loans in the cover pool are separated from the issuer's other assets and are made available solely to satisfy the covered bond debt. In other words, covered bonds are essentially a form of on-balance sheet financing for the issuer, which retains control of the loans and remains directly or indirectly liable for payment of the covered bonds.

Most covered bonds are structured to receive AAA ratings based on the credit quality of the assets included in the cover pool, over-collateralization, and other features. Covered bond transactions require the appointment of an independent asset monitor that is responsible for monitoring the loans in the cover pool on a regular basis,

removing loans from the cover pool if they become impaired, and requiring the issuer to supplement the cover pool with additional loans in the event that the current value of the cover pool falls below the transaction's required level of over-collateralization.

In today's markets, all covered bonds incorporate certain core principles:

- covered bonds must be secured by relatively high quality assets;
- management of the cover pool must be supervised by an independent asset monitor; and
- covered bondholders receive priority creditor status with regard to the cover pool upon an issuer's insolvency.

History of Covered Bonds

Covered bonds are not new by any means. The German *Pfandbrief* is considered to be the first covered bond product with its history predating the U.S. Declaration of Independence. Covered bonds issued in most European jurisdictions are typically governed by national laws implementing European Union legislation.

The first U.S. entry to the covered bond market was in September 2006, when Washington Mutual Bank issued a structured covered bond transaction, with a cover pool consisting of U.S. residential mortgage loans. Bank of America quickly followed up with a similar transaction.

Unlike most European jurisdictions, the United States does not yet have covered bond legislation, so U.S. deals will continue to rely on structured finance techniques.

Market Size

Announced issuance of covered bonds has increased from less than \$156.7 billion per year in the mid-1990s to over \$548.7 billion in 2006 and \$2.7 trillion by mid-2007 with new issuance at a total volume of \$41.5 billion during the first quarter of 2008.

The covered bond market offers investors an alternative to government securities, unsecured bank debt, and securitized bonds. While there is some evidence of variance in the pricing of covered bonds by nationality of issuer, this appears to be only weakly related to differences in the respective legislative frameworks. Recent cases show the pricing of covered bonds to be resilient in the face of shocks to issuer credit risk as well as more systemic shocks to the value of cover pools.

Benefits of Covered Bonds

Covered bonds allow issuers to obtain large volumes of inexpensive long-dated funds. Banks issue covered bonds to finance loans on their books. In addition to relatively stable spreads and substantial market liquidity, covered bonds can offer many benefits that other financing tools cannot, including:

- credit ratings higher than the issuer's credit rating, typically AAA, and thus a lower cost of funding;
- bullet maturities without exposure to pre-payment or acceleration risk;
- dual recourse to a financial institution and to an over-collateralized pool of high-quality loans, which ensures that the cover pool is sufficient to repay the covered bonds;
- a dynamic rather than static pool of assets; and
- favorable capital treatment in certain jurisdictions.

The cover pool must provide sufficient collateral to satisfy bondholder claims throughout the entire term of the covered bond. While in a typical securitization, the collateral consists of a fixed pool of mortgages that is constantly amortizing and pre-paying, in a covered bond transaction, the mortgage pool must be replenished as mortgages are prepaid so that the remaining portfolio is always sufficient to fully back the covered bonds. As a result, the cover pool securing a covered bond will change over the life of the bond, with new loans that meet the eligibility criteria being added on a regular basis. This ability to substitute assets arguably offers more flexibility to the issuer and protection for investors than a static pool. Active management of the cover pool allows the issuer to substitute higher quality loans for those in distress or default, maintaining a higher quality cover pool overall.

Disadvantages of Covered Bonds

Despite the attractiveness of covered bonds, there are some drawbacks that potential issuers must understand. First, the cover pool may only consist of high-quality mortgage loans, while a wider variety of mortgage loans, including subprime, high loan-to-value, and other non-prime mortgage loans, can be effectively securitized. Second, while a typical securitization transaction is often structured to ensure off-balance sheet treatment of the securitized assets, in a covered bond deal, the cover pool stays on-balance sheet. Finally, there are a variety of limitations on who can issue covered bonds (generally only highly rated financial institutions), while many unrated non-financial entities have completed successful securitization transactions.

Differences from Traditional Securitization

Covered bonds are on-balance sheet transactions in which the issuer retains the risk of loss on the cover pool. On the other hand, a conventional mortgage securitization transaction is off-balance sheet. Therefore, in a securitization the risk is removed from the lender's balance sheet at the time of issuance of the securities, and the issuer need not worry about the ultimate performance of the issued securities. Covered bond investors have full recourse to the issuer and the cover pool (which is constantly monitored and revised); whereas investors in residential and

commercial mortgage-backed securities have recourse to the original pool of securitized assets only.

Covered bonds typically have lower spreads than securitization bonds. This is partially because, as mentioned above, in terms of collateral, covered bond statutes or contractual provisions in structured covered bond deals only allow the use of high-quality, low loan-to-value mortgages, while assets of varying quality may be included in securitization transactions.

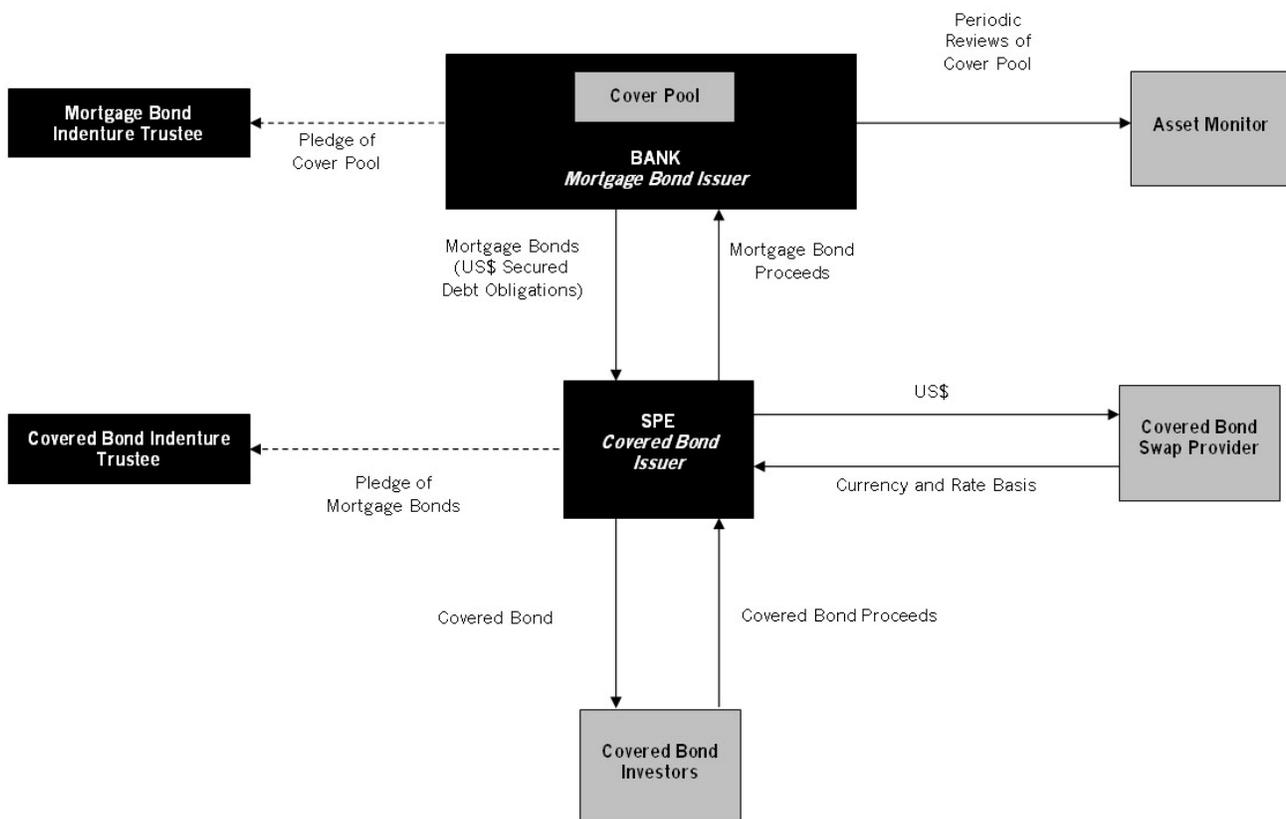
Structure

U.S. covered bonds issuances to date have been structured to have bank-issued obligations (mortgage bonds) backed by a cover pool of residential mortgages that remain on the bank's balance sheet (see structure chart below). In the event of the bank's insolvency, the bondholder indirectly receives payments from the cover pool.

The U.S. model utilizes structured finance techniques, including using a special-purpose entity as the issuer. The covered bonds that are issued constitute limited recourse obligations of the issuer and are secured primarily by the related series of mortgage bonds issued by a bank. (To oversimplify, the covered bonds are secured by the mortgage bonds, which are in turn secured by the mortgage loans).

The limitations imposed by the U.S. insolvency regime and the absence of covered bond legislation are fundamental in explaining the particularities of this structure. In the event of a bank's insolvency, the Federal Deposit Insurance Corporation (FDIC) is appointed conservator or receiver for the insolvent bank. In such capacity, the FDIC has the power to repudiate a contract entered into by the relevant institution and limit the amount of compensation paid to "actual direct compensatory damages." As a result of this requirement, the special purpose entity that issues the covered bonds is required to invest all of the damages paid by the FDIC in a guaranteed

Basic Structure



investment contract or similar instrument. The income produced from this contract can be used by the covered bond issuer to pay interest on the covered bonds up until their maturity.

To further support this structure, a swap is entered into to cover shortfalls in interest that may arise between the appointment of the FDIC, as receiver, and the time that damages/proceeds are received and invested by the covered bond issuer. Further, under current FDIC regulations, there is an automatic stay for as long as 90 days of any attempt to foreclose on a failed bank's property or to affect its rights under contract. As a result, the 90-day delay could cause missed payments on the covered bonds, which forces issuers to enter into third party contracts to cover the risk of non-payment, adding expense to the transaction.

On April 15, 2008, the FDIC approved the issuance of an interim final policy statement, subject to comments received within 60 days following publication of the statement in the Federal Register, that removes these impediments for qualifying covered bonds. In the event of the issuing bank's insolvency, the FDIC, in its capacity as conservator or receiver, would consent to the exercise of rights over the covered bond collateral as soon as 10 business days after a monetary default of the bank on the covered bond obligations or 10 business days after the FDIC repudiates the contract in writing. To qualify for such treatment, the term of the covered bond must be greater than 1 year but no more than 10 years, the bank's total covered bond obligations at issuance of such covered bonds must not exceed 4% of the bank's total liabilities, and the collateral securing the bonds must be limited to performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and in accordance with existing guidance on residential mortgages and relying on documented income ("Eligible Mortgages"). Up to 10% of the collateral may consist of AAA-rated mortgage securities backed by Eligible Mortgages.

As a result, this interim final policy statement should provide comfort to issuers and investors with respect to covered bond transactions that meet the foregoing criteria. It is important to note that at this point neither commercial mortgage loans nor AAA-rated CMBS qualify as Eligible Mortgages. As a result, covered bond transactions issued by banks that contain such assets would still be subject to the 90-day stay. The interim final policy statement contemplates possible later changes in response to

comments received, and we anticipate there will be industry comments to expand the eligibility criteria to include certain high quality commercial loans and CMBS.

Future of Covered Bonds

In recent months, it has become difficult to sell mortgage-backed securities, and there is increasing speculation that an emerging covered bond market could help amidst the current credit crisis by providing another mechanism for funding both residential and commercial mortgages. Also, regulators and certain investors appear to be of the opinion that covered bonds would encourage more conservative underwriting and risk management than has been the case with securitization, as an issuing bank would hold the cover pool of mortgage loans on its balance sheet.

Covered bonds have played, and will continue to play, an important role in the financial system in Europe and contribute not only to the efficient allocation of capital, but also ultimately to economic growth. Covered bonds manage to offer a "hybrid approach" between traditional bank lending and securitization because they allow banks to tap into the capital markets while holding the cover pool on their books. As a result of the long, stable history of the covered bond market in Europe and the many benefits covered bonds provide, it would not be surprising to see the rapid development of a covered bond market in the United States as a means to finance residential and commercial mortgages in the post-credit crisis world.



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