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A legal update from Dechert's Finance and Real Estate and Financial Institutions Groups

Reform for the Covered Bond Industry on the Horizon

On the heels of the Administration's recently published report to Congress outlining its objectives for reforming the housing finance market,[1] new legislative action may come that would encourage the issuance of covered bonds. Secretary of the Treasury Timothy Geithner on March 1, 2011 in testimony before the House Committee on Financial Services ("Committee") stated that the development of a legislative framework for a covered bond market should be included as part of the consideration of new means to provide mortgage credit.[2] Notwithstanding earlier delays in implementing reform for this industry,[3] proposals for legislative action addressing covered bonds are likely to be a focal point for the Committee[4] during this session of Congress. A discussion draft of a bill sponsored by Representative Scott Garrett (R-NJ), which aims to establish standards for covered bond programs and a covered bond regulatory oversight program, has been circulated to members of Congress and securitization market participants. The draft bill, if enacted in its current form, would (i) define the issuers and asset classes that would be subject to the oversight program; (ii) establish a framework for a federal regulatory oversight program for covered bonds; and (iii) implement a default and insolvency resolution process. This *DechertOnPoint* summarizes the February 2011 discussion draft, entitled the

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1 For a more detailed description of this report, *see* "Administration Report Offers New Directions for the Federal Role in Housing Finance," *DechertOnPoint*, Special Alert (February 2011), *available at* http://www.dechert.com/library/FI_FRE_SA_02-11_Administration_Proposes_to_Wind_Down.pdf; *see also* The Department of the Treasury and The U.S. Department of Housing and Urban Development, "Reforming America's Housing Finance Market" *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

2 "Written Testimony by Secretary Timothy F. Geithner before the House Committee on Financial Services" (March 1, 2011), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1082.aspx.

3 Attempts to incorporate covered bond industry reform in the Dodd-Frank Wall Street Reform and Consumer Protection Act failed to garner adequate support, likely due in part to concerns raised by the Federal Deposit Insurance Corporation ("FDIC") and the U.S. Department of the Treasury. *See* "Statement of Michael H. Krimminger. Deputy to the Chairman, Federal Deposit Insurance Corporation, on Covered Bonds: Potential Uses and Regulatory Issues, Committee on Banking, Housing and Urban Affairs, U.S. Senate" (September 2010), *available at* http://www.fdic.gov/news/news/speeches/archives/2010/spsep1510_2.html (indicating that the FDIC supports balanced covered bond legislation provided that the legislation (i) clarifies the rights and responsibilities of investors, issuers and regulators; (ii) ensures that investment risks will not be transferred to the public sector and (iii) is not inconsistent with U.S. law and policy for secured creditors). The FDIC issued a final policy statement in July 2008 regarding its treatment of covered bonds in the event of a conservatorship or receivership of an insured depositary institution. *See* Covered Bond Policy Statement, 73 Fed. Reg. 43754 (July 2008); *see also* "FDIC Releases Final Covered Bond Policy Statement," *DechertOnPoint*, Issue 8 (July 2008), *available at* http://www.dechert.com/library/FRE_07_18_08.pdf.

4 The Committee plans to hold a hearing on issues surrounding covered bonds on March 11, 2011.

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"United States Covered Bond Act of 2011" (the "Act"), which is expected to be introduced later this year.

Covered Bond Act Definitions

A central component of the draft bill involves the definition of the types of programs and entities that would be subject to it. Under the draft bill, a "covered bond program" is defined as any program of an eligible issuer under which, on the security of a single cover pool, one or more series or tranches of covered bonds may be issued. Eligible issuers would include (i) any insured depository institution;[5] (ii) any bank holding company; (iii) any savings and loan holding company; (iv) any non-bank financial company (as defined in the Dodd-Frank Wall Street and Consumer Protection Act (the "DFA")) that is approved as an eligible issuer by the applicable covered bond regulator (*i.e.*, the appropriate federal banking agency (as such term is defined under the Federal Deposit Insurance Act ("FDI Act")) or the Board of Governors of the Federal Reserve System); and (v) any issuer that is sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis.[6]

Additionally, the draft bill contains nine categories of eligible asset classes that are permitted to be part of a covered bond program. The eligible asset classes include residential mortgage assets, home equity assets,[7] commercial mortgage assets, public sector assets, automobile assets, student loan assets, credit or charge card assets, small business assets and any other eligible asset class designated by the Secretary of the Treasury.[8] Additionally, no eligible asset may be (i) a loan that has been delinquent for greater than 60 consecutive days; (ii) an asset that does not satisfy the credit quality requirements of the Act (such as the minimum overcollateralization requirements described in further detail below); or (iii) an asset that is subject to a prior perfected security interest granted in an unrelated transaction.[9]

Federal Regulatory Oversight Program

The draft bill also requires that covered bonds issued by an eligible issuer under a covered bond program be approved by the applicable covered bond regulator under a regulatory regime[10] to be implemented by the Secretary of the Treasury (in consultation with covered bond regulators) within 180 days of the enactment of the draft bill. All covered bonds would be subject to approval regardless of when the covered bond was issued. The draft bill provides that the oversight program must require each approved covered bond program to contain, at a minimum, the following features:

- A publicly available registry containing information necessary to adequately identify (i) the covered bond program and the eligible issuer and (ii) all outstanding covered bonds issued under the covered bond program;

- A cover pool consisting of one or more eligible assets from no more than one eligible asset class;

5 As currently drafted, the bill would not permit non-insured branches of foreign banks to have eligible issuer status. Additionally, the draft bill provides that covered bonds issued or guaranteed by a bank would be treated as a security issued or guaranteed by a bank under section 3(a)(2) of the Securities Act of 1933, as amended (the "Securities Act"), section 3(c)(3) of the Investment Company Act of 1940, as amended, and Section 304(a)(4)(A) of the Trust Indenture Act of 1939, as amended. No covered bond issued or guaranteed by a bank would be treated as an asset-backed security (as such term is defined in Section 3 of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). It is unclear whether bonds issued by other eligible issuers (including savings and loan institutions typically covered under Section 3(a)(5) of the Securities Act) would be provided with similar exemptions under the Act.

6 The inclusion of this category could facilitate small financial institutions collaborating with each other on covered bond deals.

7 The "home equity" asset class may be broad enough to include open- and closed-end home equity loans.

8 While the Secretary of the Treasury would be given discretion to do so, it is unclear whether floor plan receivables and equipment leases would ultimately be permitted eligible asset classes. Similarly, it is unclear whether securities backed by eligible asset classes (such as derivative securities as opposed to entirely whole loans) would be included among these categories. The latter category may not be included among eligible asset classes given congressional concerns.

9 While the draft bill has perfection requirements, it does not contain any provisions which would supplant the Uniform Commercial Code.

10 The draft bill does not discuss in great detail the nature of the covered bond program approval process; instead the bill largely leaves this aspect of its implementation to the discretion of the Secretary of the Treasury.

- A minimum level of overcollateralization (to be set by rules adopted by the Secretary of Treasury in consultation with covered bond regulators) for covered bonds backed by the applicable eligible asset class; the overcollateralization level must be based upon credit, collection and interest rate risks (excluding liquidity risks) associated with the applicable eligible asset class;[11] and

- An undertaking to have monthly reports certifying compliance with minimum overcollateralization requirements, which must be prepared by an independent unaffiliated asset monitor (which may also be the indenture trustee) to be appointed by the issuer for the covered bond program; the reports must be delivered to the Secretary of the Treasury, the applicable covered bond regulator, the indenture trustee and bondholders for the program.

Default and Insolvency Resolution Process

The proposed bill creates a resolution process for defaults on covered bonds both prior to and after the issuer enters conservatorship, receivership, liquidation, bankruptcy or any other insolvency proceeding. In the event of a default on a covered bond prior to the issuer's insolvency event, the proposed bill requires that an estate separate and apart from the issuer be immediately and automatically created by operation of law for *each* affected covered bond program.[12] The proposed bill does not identify who would administer the estate. The estate would be comprised of the cover pool that secured the covered bond, which would be immediately released to and held by the 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 other assets of the issuer. The issuer would retain the residual interest in the estate. The estate would be liable on the covered bonds and related obligations of the issuer that are secured by a perfected security interest in, or other lien on, the cover pool when the estate is created. Any holder of a covered bond or related obligation would retain a claim against the issuer for any deficiency with respect to the covered bond or related obligations. The estate would not be liable on any obligation of the issuer that were not secured by a perfected security interest in, or other lien on, the cover pool when the estate was created.

If the issuer of a covered bond was an insured depository institution placed into receivership or conservatorship under the FDI Act or a nonbank financial institution placed into receivership under Title II of the DFA before an uncured default on the covered bond occurred, the Federal Deposit Insurance Corporation ("FDIC"), as receiver or conservator for the issuer, would have the exclusive right, during the 180-day period beginning on the date of its appointment, to transfer the cover pool in its entirety, together with all covered bonds and related obligations secured by a perfected security interest in, or other lien on, the cover pool, to another eligible issuer, which must agree to become fully liable on all covered bonds and other related obligations of the issuer secured by the cover pool. If the FDIC were to cease performance under the applicable covered bond program[13] or to fail to complete a transfer to an eligible issuer within the 180-day period, or if a conservator, receiver or trustee in bankruptcy other than the FDIC was appointed for an issuer before an uncured default on a covered bond occurs, then the covered bond program would become an estate separate and apart from the defaulting issuer by operation of law. Similar to the estate created prior to an insolvency event, the estate would be comprised of the cover pool that secured the covered bond, which would be immediately released to and held by the 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 other assets of the issuer.

11 This requirement is intended to ensure that sufficient eligible assets (or substitute assets, such as cash or treasury bills) are maintained in the cover pool to satisfy all principal and interest payments on the covered bonds when due through maturity. It is unclear whether the required overcollateralization would be measured against the principal amount of the underlying assets or the market value of the underlying assets.

12 Under the draft bill, any estate created prior to or after the occurrence of an insolvency event would be exempt from all securities laws but would be required to comply with reporting requirements established by the applicable covered bond regulator and would succeed to any requirement of the issuer to file such periodic information, documents and reports in respect of covered bonds as specified under Section 13(a) of the Exchange Act.

13 Under the draft bill, the FDIC would be obligated to fully and timely satisfy all monetary and non-monetary obligations of the issuer under all covered bonds and the related transaction documents and fully and timely cure all defaults by the issuer (other than its conservatorship or receivership), until the FDIC transfers a particular covered bond program to an eligible issuer or provides notice that it is electing to cease further performance under a particular covered bond program. The draft bill may face some opposition from the FDIC because it significantly limits the flexibility (particularly as it relates to asset disposition) that the FDIC has enjoyed when it acts as receiver for an insured depository institution.

The estate would be fully liable on the covered bonds and related obligations of the issuer that were secured by a perfected security interest in, or other lien on, the covered pool when the estate was created. The estate would not be liable for any obligation of the issuer that was not secured by a perfected security interest in, or other lien on, the cover pool when the estate was created. After the creation of an estate following an insolvency event, neither the issuer (whether acting as debtor in possession or in any other capacity) nor any conservator, receiver, liquidating agent or trustee in bankruptcy for the issuer or any other assets of the issuer would be able to disaffirm, repudiate or reject the obligation to turn over property or to continue servicing the cover pool.[14] The residual interest in the cover pool would be held by the conservator, receiver, liquidating agent or trustee in bankruptcy for the issuer. Contingent claims for deficiencies with respect to covered bonds (such as insufficient overcollateralization) or other obligations would be allowed as a probable claim. The contingent claim would be estimated if awaiting the fixing of the claim would unduly delay the resolution of the conservatorship, receivership or bankruptcy case.

The resolution process for the Act also includes two other interesting components. The first is that any administrator or servicer of an estate created prior to or after an insolvency event would be permitted to use the cover pool to obtain liquidity for the estate (solely in the case of timing mismatches among the assets and liabilities of the estate) provided that such debt or credit extension was created on terms that (i) were fully subordinate to the interests of the beneficiaries of the estate; or (ii) had priority over (or were pari passu with) the interests of the beneficiaries of the estate, if such debt or credit extension was determined to be in the best interests of the estate and would maximize the value of the cover pool and was approved by the applicable covered bond regulator. The second component is that the Act would prevent taxpayers from incurring any losses. Specifically, if the Secretary of the Treasury and the FDIC jointly determined that the Deposit Insurance Fund incurred actual losses because the covered bond program of an insured depository institution was subject to resolution under the Act rather than as part of the receivership of the institution under the FDI Act, the FDIC would be authorized to recover an amount equal to those losses through an increase in deposit insurance assessments on insured depository institutions with approved covered bond programs. It is unclear whether any time limitations would be imposed on when loss determinations and related assessments could be made. This provision was likely included to address concerns that the FDIC outlined in General Counsel Michael H. Krimminger's September 2010 testimony before the Senate Committee on Banking, Housing and Urban Affairs regarding covered bonds.[15]

Conclusion

The subject of the draft covered bond bill is one that has been the source of ongoing debate in the area of financial reform over the past couple of years. Given the importance of the issues that are sought to be addressed by the draft bill, it is likely that we can expect substantial legislative and regulatory consideration and discussion of the substance of this draft bill in the near future.

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14 This provision of the draft bill would create a deviation from current practice in that a trustee in bankruptcy is generally not required to carry out all obligations of an issuer when an estate is in bankruptcy. Additionally, it is unlikely that this provision of the proposed bill would be palatable to a conservator, receiver, liquidating agent or trustee because an estate can remain in receivership or conservatorship for several years.

15 *Supra* fn 3.

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