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News Bulletin

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U.S. Covered Bond Legislation Introduced in Congress

On June 16, 2009, Republican Representative Scott Garrett and Democratic Representative Paul E. Kanjorski jointly introduced a bill in the U.S. House of Representatives to enact the "Equal Treatment of Covered Bonds Act of 2009."[1] Representatives Garrett and Kanjorski are a Ranking Member and the Chairman, respectively, of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

In 2007, development of the nascent U.S. covered bond market was put on hold as the financial crisis unfolded. Regulatory efforts in 2008 to encourage development of the covered bonds market were well received. However, these efforts were not sufficient to launch a U.S. covered bond market both because the efforts did not allay investor concerns regarding the treatment of covered bonds upon the insolvency of an issuing bank, and because most prospective covered bond issuers were unable to act given the extreme dislocation of the capital and credit markets.

Covered bonds have the potential to provide issuers with an alternative to securitization as part of a well-diversified liquidity management program and to provide investors with an asset-backed debt instrument that protects against many of the risks recently experienced in the originate-to-sell model. However, since late 2008, federal government financial crisis recovery efforts have focused on restarting the securitization markets.

The legislation proposed by Representatives Garrett and Kanjorski would address at least two of the remaining impediments to the further development of a covered bond market in the United States. First, the legislation would provide a statutory scheme for the treatment of covered bonds upon the insolvency of a financial institution issuer, ensuring that the treatment of covered bonds upon the issuer's insolvency could not be changed by regulatory whim. Second, the legislation would provide a measure of damages that would more likely make investors whole upon an issuer's insolvency than the formula applicable under current law.

Below, we provide a brief overview of covered bonds, recent actions taken by the federal regulatory agencies, and the significance of the proposed legislation. For additional information on the government's recent actions, covered bonds and the financial crisis generally, please see our Client Alerts and resources at Financial Crisis Legal Updates and News. For more general information on covered bonds, please see our covered bonds resources here.

Background

Covered bonds are debt obligations with recourse either to the issuing entity or to an affiliated group to which the issuing entity belongs, or both. Upon an issuer default, covered bondholders also have recourse to a pool of collateral, known as the "cover pool." Covered bonds are generally fixed rate bonds with a maturity of no less than one year and no more than 30 years. The bonds are low risk yield-bearing products having long maturities.

[1] This is bill H.R. 2896.

Unlike securitization, where assets are removed from an issuer's balance sheet, in a covered bond structure, the cover pool remains on the issuer's balance sheet but is 'ring fenced' from the issuer's other assets. The cover pool usually consists of high quality assets, including residential mortgages, public debt, or ship loans. Cash, or cash equivalents, also may serve as cover pool collateral. The cover pool is subject to ongoing eligibility criteria, and cover pool assets must be replaced if the pool fails to meet such criteria. By requiring ongoing maintenance of the cover pool, a covered bond protects investors from asset degradation and ensures ongoing management by the issuer. Typically, the issuer is required to overcollateralize the cover pool.

Many European countries have covered bond legislation establishing a statutory framework for the structure and treatment of covered bond programs. This legislation typically provides exceptions for covered bonds in the event of bankruptcy. Specifically, in the event of an issuer insolvency, the European statutes typically provide that covered bondholders have priority rights over the cover pool assets.

2008 Regulatory Actions

Europe has had a developed covered bond market for many years, with precursor transactions dating back several centuries. In 2007, two U.S. banks undertook pioneering U.S. covered bond issuances. These transactions were accomplished despite the lack of a statutory framework for issuing covered bonds in the United States, and despite some uncertainty regarding the treatment of the covered bonds upon the insolvency of the issuing financial institution. It was clearly recognized that investors in these seminal U.S. transactions required additional compensation for the risks posed by uncertainty, resulting in potential pricing considerations.

As the securitization market began to falter in 2007 and ultimately collapse in 2008, U.S. regulators recognized that covered bonds could provide a promising vehicle to increase the availability and lower the cost of mortgage financing and loan originations while ensuring that originators kept "skin in the game" by retaining the financed mortgage assets on their balance sheets, thereby addressing one of the most damning criticisms of the "originate-to-sell" model underlying the traditional securitization market.

The FDIC Policy Statement[2]

On July 15, 2008, the FDIC issued a Final Policy Statement on covered bonds (the "Policy Statement"). The FDIC stated that the Policy Statement "define[s] the circumstances and the specific covered bond transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral." The intention of the Policy Statement was to provide needed clarity and certainty about the issuance of covered bonds in the U.S., and reflected the FDIC's desire to facilitate the development of a covered bond market.

One of the key accomplishments of the Policy Statement was to provide a definitive statement regarding the actual compensatory damages the FDIC would pay holders of covered bonds if it were acting as conservator or receiver for the issuing financial institution. The Policy Statement confirmed that the FDIC would pay as actual compensatory damages the outstanding principal amount of the covered bonds plus accrued and unpaid interest. The FDIC noted that it has three options when acting as conservator or receiver for an FDIC-insured institution: (1) continue to perform on the covered bonds, (2) pay off the covered bonds in cash up to the value of the pledged collateral, or (3) allow liquidation of the pledged collateral to pay off the covered bonds. Under scenario 1, payments on the covered bonds would be made as scheduled. Scenarios 2 and 3 would be triggered if the FDIC were to repudiate the transaction or if a monetary default were to occur. In both cases, the FDIC would pay to holders of covered bonds the outstanding principal amount of the covered bonds plus accrued and unpaid interest to the date of the FDIC's appointment as conservator or receiver, up to the value of the cover pool (the collateral). If there is excess collateral, the FDIC would retain the excess for distribution in accordance with distribution priorities established under the FDIC's enabling statute and, if there is not enough collateral, the FDIC would limit the amount of secured claims up to the collateral value.

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[2] Please see our July 16, 2008 Client Alert, "The FDIC Offers Certainty on Covered Bonds – a step in the right direction."

Although the Policy Statement substantially increased the certainty and clarity surrounding the treatment of covered bonds issued by financial institutions, the treatment under scenarios 2 and 3 described in the preceding paragraph may not have been fully satisfactory to investors. Under those scenarios, investors would receive interest only to the date of the institution of the conservatorship or receivership, even though they might actually receive the return of their principal much later, resulting in a shortfall of interest. Moreover, investors would assume the reinvestment risk of receiving their principal in an adverse interest rate environment in which they might be required to reinvest at a substantially lower interest rate, thereby being deprived of the benefit of their bargain in acquiring the covered bonds. These shortcomings were the subject of extensive discussion in the comments received by the FDIC prior to the adoption of the Policy Statement. However, the FDIC's position was that its hands were tied, since the definition of "actual compensatory damages" was established by the FDIC's enabling statute, and could not be expanded by regulatory action.

U.S. Treasury Best Practices[3]

On July 28, 2008, then-Treasury Secretary Paulson announced the publication of a Best Practices guide for U.S. covered bonds, intended to promote covered bond issuances and to complement the Policy Statement. Flanked by regulators, including the Chair of the FDIC, the OCC Comptroller, the Governor of the Federal Reserve, and representatives from large financial institutions, Secretary Paulson stated that "covered bonds 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."

The Best Practices were intended to establish a template for U.S. covered bond issuances and outline additional standards for covered bonds that would bolster investor confidence in these instruments. It was evident that the formulation of the Treasury's rules as relatively toothless "best practices" instead of binding regulations resulted from the lack of any statutory authority of the Treasury to act in this area.

In a "Fact Sheet" accompanying the release of the Best Practices, the Treasury asserted that, "[w]hile in Europe specific legislation often defines the debt instrument, the U.S. regulatory environment is different and does not require legislation." Notwithstanding this statement, the investor community may not be entirely comfortable that the U.S. regulatory regime provided as much protection to investors as the various statutory schemes in Europe, in part because of the relative ease by which regulators can change their own rules as compared to the perceived greater difficulty of effecting legislative changes.

The Proposed Legislation

The proposed legislation would provide a statutory definition of the term "covered bond" and would include "covered bonds" as an enumerated type of "qualified financial contract," or "QFC," entitled to expedited, favored treatment upon the conservatorship or receivership of a financial institution. The legislation would further specify the amount payable to holders of covered bonds issued by insured financial institutions in conservatorship or receivership by including, in addition to the current entitlement to outstanding principal and interest to the date of the appointment of the conservator or receiver, the cost on the date of appointment of a guaranteed investment contract, deposit agreement, or other instrument that would provide for scheduled payments to be made on the covered bond until its originally scheduled maturity date, as well as the costs incurred through the date of the conservator's or receiver's appointment that arise from or relate to the exercise of any right, power or remedy under the covered bond or related transaction documents. This formulation would ensure that investors receive, in a single, liquidated payment, the value of their foregone interest and any reinvestment losses.

What Does this Mean for the U.S. Covered Bond Market?

While the proposed legislation does not go so far as to affirmatively "enable" or authorize the issuance of covered bonds to the same extent as some European statutes, the statutory recognition of covered bonds as a specific type

[3] Please see our July 29, 2008 Client Alert, "Treasury Announces Best Practices for Covered Bonds."

of financial instrument, and especially the designation of covered bonds as a type of QFC entitled to special treatment, should go a long way toward providing investors with the certainty they have desired from a federal statutory framework for covered bond issuance. Moreover, the expansion of the definition of compensatory damages payable to covered bondholders upon an institution's insolvency should address the concerns of investors that they might be short-changed under the current Policy Statement formulation.

It should be noted that the legislation currently proposed is a first draft, and there are numerous respects in which it is likely to be refined as it proceeds through the legislative process. Assuming, however, that the legislation is ultimately enacted in a form similar to this initial proposal, this legislation would represent a major step in removing two of the most significant impediments to the development of a robust covered bond market in the United States.

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