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News Bulletin

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The FDIC Offers Certainty on Covered Bonds – a step in the right direction

In March 2008, Treasury Secretary Paulson mused that covered bonds were "worth considering." However, with the credit crisis still under way and financial institutions battling increasing market pressures, Paulson has a decidedly more optimistic tone. In a speech on July 8, 2008, Paulson stated that covered bonds were a "promising vehicle" to increase the availability and lower the cost of mortgage financing. He went on to say that "[a]s Treasury seeks to encourage new sources of mortgage funding in the United States, improve underwriting standards and strengthen financial institutions' balance sheets, covered bonds have the potential to serve these purposes and reduce the costs for first-time home buyers, and for existing homeowners to refinance." Treasury also called a meeting in late June with bankers, issuers and other regulators in an effort to jump start the covered bond market in the U.S. and to create a regulatory and market practice regime that facilitates the issuance of covered bonds in the U.S.

The Final Policy Statement on Covered Bonds

On July 15, 2008, the FDIC issued its Final Policy Statement on covered bonds. The FDIC noted that Policy Statement "define[s] the circumstances and the specific covered bonds transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral." The Policy Statement provides needed clarity and certainty about the issuance of covered bonds in the U.S. and reflects the FDIC's desire to facilitate the development of the covered bond market. It is an important step forward along the path of developing a U.S. covered bond market.

Compensatory Damages

Comments on the Interim Policy Statement stressed the need for the FDIC to provide a definitive statement regarding the actual compensatory damages the FDIC will pay holders of covered bonds if it were acting as conservator or receiver. The Policy Statement confirmed that the FDIC will indeed pay as actual compensatory damages the outstanding principal amount plus accrued and unpaid interest. With respect to covered bonds, 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 will pay to holders of covered bonds the outstanding principal amount plus accrued and unpaid interest on the covered bonds 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 will retain the excess for distribution under the FDIA and if there is not enough collateral, it will limit the amount of secured claims up to the collateral value. These affirmative statements provide certainty to investors and eliminate the risk that investors may lose a portion of their principal.

Flexibility

Commentators suggested certain revisions to the Interim Policy Statement that the market believed would encourage innovation. Among these were objections to the limitation on maturity and the hard 4% cap on issuances. Responding to requests from market participants, the FDIC increased the term limit for covered bonds from 10 to 30 years. However, the FDIC declined to remove the 4% cap on issuances. It indicated that the 4% cap is designed to permit regulators an opportunity to evaluate the market. In a sign of flexibility, the FDIC indicated that it may, in the future, change the limitation on issuances as the market develops.

The FDIC also noted that nothing in the Policy Statement requires the use of an SPV to issue covered bonds. Rather, the FDIC will use its "well-defined standards to determine whether to treat such entities as separate from" the depository institution. The determination as to whether an SPV is a separate entity will be based on specific facts and circumstances.

Eligible Mortgages

The Interim Policy Statement defines "eligible mortgages" as performing mortgages on one-to-four family residential properties underwritten at the fully indexed rate and relying on documented income. Though market participants had suggested that the FDIC expand the definition of eligible mortgage (including changing the criteria for such mortgages to an LTV, delinquency and negative amortization assessment), the FDIC determined that its interest in efficient regulation of FDIC-insured institutions, as well as the initial development of a resilient covered bond market that can provide reliable liquidity for well-underwritten mortgages, supported retention of the collateral limitations specified in the Interim Policy Statement. However, while it would not amend the definition of eligible mortgage to use LTV, the FDIC will urge issuers to disclose LTV for mortgages in the cover pool. The FDIC also declined to grandfather existing covered bond programs that would not otherwise qualify under this definition.

Cover Pool

The FDIC clarified that the Policy Statement permits the substitution of cash as cover pool collateral. However, the FDIC declined to further expand the assets, believing that many of the suggested assets are subject to substantial volatility, while others would not specifically support additional "liquidity for well-underwritten residential mortgages." However, again showing its determination to be flexible, the FDIC indicated that it may, in the future, reconsider the limits placed on the composition of cover pools.

Conclusion

The FDIC has provided the market with some much needed certainty and clarity. And it has left open the door for future revisions to the Policy Statement, noting that as the U.S. covered bond market develops, future modifications or amendments may be considered. While some market participants hoped that the Final Policy Statement might have gone further, they are quick to observe that a robust U.S. covered bond market is a large step closer to reality.

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