

## Client Alert Financial Markets Developments

### Understanding the New Covered Bond Market in the US

On July 28, 2008, United States Treasury Secretary Henry Paulson announced best practices for the development of a covered bond market in the United States. Secretary Paulson stated that "covered bonds have the potential to increase mortgage financing, improve underwriting standards and strengthen US financial institutions by providing a new funding source that will diversify their overall portfolio."<sup>1</sup> This statement coincided with the publication, by the United States Department of the Treasury, of a *Best Practices Guide for US Residential Covered Bonds*<sup>2</sup> (the "*Best Practices Guide*"), which is intended to promote simplicity and homogeneity in the covered bond market, using high-quality mortgages as collateral. The Best Practices Guide complements the Federal Deposit Insurance Corporation's (the "FDIC") Policy Statement dated July 15, 2008 (the "FDIC's Statement"),<sup>3</sup> in which the FDIC clarified the circumstances under which it would make available collateral pledged for covered bonds in the event of an FDIC receivership or conservatorship of any issuer of covered bonds that is subject to the Federal Deposit Insurance Act. The Best Practices Guide addresses only covered bonds that will be issued by depository institutions subject to the Federal Deposit Insurance Act.<sup>4</sup>

Many market participants are hopeful that covered bonds will help revitalize the debt markets in the United States, by creating a new source of liquidity for US financial institutions and by encouraging investors to return to the market for mortgage-related securities. A little perspective on how the United States came to import this largely European financial device called a "covered bond"<sup>5</sup> may be helpful in charting the path forward.

#### How It All Started

Numerous factors contributed to the perfect credit storm of last year, one of which is simple: lenders lost their traditional focus on the creditworthiness of borrowers. With a mortgage lending model of originating mortgage loans and distributing them in the form of securities, and with less focus on the ability or the willingness of the borrower to pay his or her mortgage, originators became more concerned about fitting each loan in a standard box for securitization than about the quality of the loan.

As lenders continued to package their mortgage loans into rated securities and place less emphasis on reviewing borrowers, the securities ultimately backed by the mortgages began to experience problems as housing prices fell, mortgage interest rates reset to higher levels and the economy deteriorated. Investors soon realized that the statistical models used to provide credit ratings for securities backed by mortgages were not infallible. Once investors lost confidence in their ability to understand fully the risks underlying structured finance securities, they became uncertain and fearful. Since the second half of 2007, investors have largely sat on the sideline, avoiding new investments in structured products. Lack of confidence and suspicion spilled over



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into other markets, including the financial institution debt market, as investors wondered what potential problems lay beneath the numbers on the balance sheet.

As a result of several factors, including the inability to establish risk premiums with any confidence, the US debt market struggled through the last year. Investments that were once considered predictable and safe were viewed as volatile and undesirable. One of the primary sources of liquidity for financial institutions and other borrowers became severely limited.

### The Potential Solution

Bring on the covered bonds. The covered bond market originated in Europe centuries ago and has proliferated there over the last 10 to 15 years. European regulatory authorities have established a legal framework for the issuance and treatment of such bonds. Covered bonds are debt instruments issued by a depository institution (the “issuer”) for which recourse exists against the issuer and that are secured by a perfected security interest in a specific pool of collateral that remains on the issuer’s balance sheet. The collateral pool is referred to as the “cover pool.” To the extent the cover pool is insufficient to repay the covered bonds, the holders thereof retain an unsecured claim against the issuer for the deficiency.<sup>6</sup> The covered bonds provide funding to the issuer and the interest on and principal of the covered bonds are paid to the investors from the issuer’s general cash flows.

The introduction of covered bonds to the US market has, at the heart of the proposal, some basic strategies for restoring investor confidence:

1. *Two Sources of Credit Are Better Than One.* Investors in a covered bond have two sources of credit for repayment of their investment: (1) the corporate credit of the financial institution—because covered bonds are intended to be paid from the general cash flows of the financial institution and not from the pledged collateral and (2) the cover pool—because, in the event of a failed payment by the financial institution or insolvency of the financial institution, investors can receive payment on their covered bonds from the pool of residential mortgage loans. Simply put, there is some diversity in the two different sources of credit that should lower the investors’ risk of default and loss.
2. *Return to What We Know.* The covered bond harkens back to the days of disciplined credit analysis. Wall Street knows corporate credit analysis and has been performing it for well over one hundred years. Investors can return to the old-fashioned analysis of a financial institution’s ability to generate sufficient cash to repay its debt. As a bonus, investors receive the benefit of identifiable pledged collateral, providing them with a margin for error on their credit analysis. Any investor who may be suspicious of complex derivatives lurking on an institution’s balance sheet will have the additional comfort of the cover pool—collateral that has historically been reasonably well known and predictable. While not explicitly stated in the Best Practices Guide, we note that by using mortgages in the cover pool, investors are encouraged to become re-acquainted with mortgages as a potential source of repayment for their investment.
3. *Simplify, Standardize and Verify.* If anything, the covered bonds contemplated by the Best Practices Guide are the antithesis of the complex and opaque world of credit derivatives and leverage upon leverage from which the recent and ongoing credit crisis was born. The Best Practices Guide embraces simplicity and transparency, with set principal payments<sup>7</sup> and mandatory reporting<sup>8</sup> on the collateral. It rejects the model of the unique “one-off” and illiquid transaction of the recent years, encouraging standardized structures<sup>9</sup> and mandating standardized collateral<sup>10</sup>, making covered bonds both easy to understand across many issuers’ transactions, and hopefully, in the process, more liquid. Finally, the Best Practices Guide contemplates an independent third-party to monitor the cover pool on behalf of the investors<sup>11</sup>—someone to verify the collateral tests—countering some of the structures of recent years where persons with mixed incentives were responsible for monitoring and reporting on the collateral.

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## What Might We Find?

Certainly the most interesting part of the covered bonds analysis is gazing into the crystal ball. While no-one can predict what will become of this well-intentioned proposal, we can speculate on its future:

*A Compelling Reason to Issue.* Banks may find a compelling reason to issue covered bonds: the Treasury “requests” it—“an offer you can’t refuse.” Patriotic duty has called US financial institutions to action.<sup>12</sup> The Treasury has certainly taken steps to encourage institutions to participate in the market, and we may find that institutions feel less than subtle pressure to participate.

*The Four Percent Limitation.* The FDIC’s Statement limits issuances of covered bonds to four percent of the liabilities of the issuing financial institution. The FDIC maintains that a limit is necessary to preserve its ability to wind-up insolvent financial institutions.<sup>13</sup> The four percent limit may create a disincentive for smaller banking institutions to pursue the strategy because the “start-up” cost of the initial transaction is not capable of being spread out over numerous transactions.<sup>14</sup>

*Will Pricing Change?* For those investors comfortable with the basic credit of standardized mortgage loans, the covered bond truly offers a credit benefit over an unsecured obligation of a financial institution. Might there be sufficient benefit to lead to better pricing on covered bonds than on a financial institution’s unsecured debt? It should, especially for financial institutions that have lower credit ratings from rating agencies. In fact, savvy institutions may use the covered bond structure to showcase their high underwriting standards and their best performing mortgage assets. Theoretically, those financial institutions that produce superior mortgage pools for their covered bonds should, over time, be recognized by the market and achieve a distinct pricing advantage.<sup>15</sup>

*Expansion of Assets.* Europe has a variety of assets that are eligible for covered bonds under several jurisdictions’ regulatory regimes.<sup>16</sup> The mortgage market needs liquidity; without liquidity in the mortgage market, risk

premiums for mortgages will remain high and continue to adversely pressure the US housing market. Thus, consistent with the simplicity theme, the Best Practices Guide limits collateral to mortgages, providing the market help where it is needed most and allowing all to focus on this one asset class.<sup>17</sup> If the covered bond market proposed in the Best Practices Guide develops, then there will likely be a push for other asset types<sup>18</sup> to be eligible for covered bonds.

## What Are We Recommending?

In these uncertain economic times, it is time to return to first principles. Consistent with that idea, White & Case recommends the following:

*Go With What You Know.* The securities markets have seen ups and downs over the decades. Both we and many of our clients have been active in the markets for corporate and asset-backed securities, private and public, as counsel, issuers, underwriters and placement agents. A framework for corporate issuances and asset-backed securities exists, and little more than the tools used in the past is needed to structure a covered bond issuance.

*Keep It Simple and Transparent.* In an effort to build confidence in the covered bond market, make the structure, the offering materials and the collateral reporting clear and simple. Restore confidence through transparency. Allow investors to return to fundamental credit analysis and regain confidence that they can fully appreciate, understand and assess the credit risk.

*Educate.* Provide a clear explanation of the covered bond’s structure. Educate investors with comparisons to both the corporate debt market and the mortgage-backed securities market.

*Go For Liquidity.* Where possible, create standardized markets and large issuances. Create confidence that a liquid market will develop; liquidity will reduce the fears relating to that initial investment step and will lower the psychological barrier and risk premium to stepping into this new market.

*Go With Experience.* While the covered bond market may be new to the United States, Europe traces the first covered bonds back to Prussian King Frederick the Great in 1769. We have been active in the covered bond market for many years, having advised on hundreds of issues in several jurisdictions, including, for example, Germany (*Pfandbriefe*) and Luxembourg (*Lettres de Gage*). While local regulatory variations exist across the covered bond regimes of Europe,

the primary legal principles and market standards remain consistent. Knowledge of the global covered bond market is crucial to those entering this new market in the United States, especially as regulators and market participants in the United States seek solutions to issues using other jurisdictions' regulatory regimes. We will bring our practical approach, our global experience and our regulatory knowledge to our clients and this market.

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1. Press Release HP 1101, US Department of the Treasury, Secretary Henry M. Paulson, Jr. Statement on Covered Bond Best Practices (July 28, 2008), available at <http://www.treas.gov/press/releases/hp1101.htm>.
  2. United States Department of the Treasury, Best Practices for Residential Covered Bonds (July 2008), available at <http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf>.
  3. Federal Deposit Insurance Corporation, Covered Bond Policy Statement, 73 Fed. Reg. 43754 (July 28, 2008). The FDIC's Statement can also be found as Exhibit B to the Best Practices Guide.
  4. Issuers who are not subject to the Federal Deposit Insurance Act, but are entitled to file for insolvency protection under the United States Bankruptcy Code, would face serious challenges to structuring a bond similar to the covered bonds described in the Best Practices Guide. A bankruptcy filing by a bond issuer that is subject to the Bankruptcy Code would likely be subject to a Section 362 automatic stay, blocking bondholders' access to the cash flow on the bonds and any pledged collateral.
  5. Unlike the covered bonds proposed in the Best Practices Guide, the covered bonds issued in Europe are largely based upon statutory regimes, which provide a greater degree of clarity and certainty.
  6. Under the Federal Deposit Insurance Act, secured claims (to the extent of the security), administrative expenses of the receiver and deposit liabilities of the institution (including those amounts owed to the FDIC as subrogee of depositors) receive priority over general unsecured claims. See 12 U.S.C. 1821(d)(11)(A), (g)(1). To the extent a covered pool is not sufficient to cover the full claim of a covered bond, the claim for the deficiency will be subordinate to other secured claims, administrative expenses and deposit liabilities.
  7. Covered bonds utilize specified investment contracts to provide reasonable certainty as to the timing of principal and interest payments. Under these contracts, proceeds of the mortgages will be deposited with an institution that commits to pay interest and principal on the covered bond as scheduled. Essentially, the institution party to a specified investment contract will, following a default on the covered bond or a repudiation of the covered bond by the FDIC, assume the risk that cash flows from the covered pool do not match the scheduled principal and interest payments on the covered bonds. Additionally, issuers may enter into swap agreements to mitigate other timing mismatches between interest income and interest payments and to provide for the payment of scheduled interest payments in the event of an issuer's insolvency. See Best Practices Guide at 13. Note that, following a conservatorship or receivership, the FDIC could choose to repay covered bonds at par plus interest accrued through the date of the appointment of the receiver or conservator. Presumably, investors would be forced to assume the prepayment risk of the covered bond in those situations in which the FDIC exercised that specific repayment right.
  8. The Best Practices Guide requires issuers to provide descriptive information on the cover pool at issuance and each month thereafter. Additionally, if more than ten percent (within any month) or 20 percent (within any quarter) of the cover pool is substituted due to nonperformance, updated cover pool information must be provided immediately. The Best Practices Guide references Regulation AB as a template for disclosure, noting in particular that summary information should be presented in tabular and graphical format and using appropriate groups and ranges. See Regulation AB, Item 1111 for more detailed guidance on disclosure. In addition to disclosure on the cover pool, the Best Practices Guide also requires disclosure of the financial profile of the issuer and any other relevant information that an investor would consider material. See Best Practices Guide at 14.
  9. In the Best Practices Guide, the Department of Treasury introduced two specific structures: the "direct issuance" structure (where the depository institution issues the covered bonds directly) and the "SPV issuance" structure (where the depository institution issues mortgage bonds which are sold to a special purpose vehicle, who then issues the covered bonds). In either case, the depository institution's debt obligation is secured by a cover pool, comprised of on-balance sheet assets. Both structures contemplate the inclusion of swaps and specified investment contracts (see *supra* note 6 for a discussion of these features). The Best Practices Guide also indicates an acceptance of other consistent structures. See Best Practices Guide at 11, 17-18.
  10. The cover pool contemplated by the Best Practices Guide consists of collateral meeting all of the following requirements: (i) the collateral must be performing first-lien mortgages on one-to-four family residential properties (or, in the case of substitution collateral, cash and Treasury and agency securities necessary to prudently manage the cover pool); (ii) mortgages must be underwritten at the fully-indexed rate (i.e., if the rate is to be reset during the term of the mortgage, the borrower must qualify at the time of origination for the maximum future rate (measured using values of reference rates at the time of origination)); (iii) mortgages must be underwritten with documented income; (iv) mortgages must comply with supervisory guidance governing the underwriting of residential mortgages when underwritten; (v) mortgages must be current when added to the cover pool; (vi) mortgages

- must have a maximum loan-to-value ratio of 80 percent; (vii) a single Metro Statistical Area cannot make up more than 20 percent of the cover pool; and (viii) mortgages can not be negative amortization mortgages. Mortgages that become more than 60-days past due or otherwise non-performing must be replaced with substitution collateral. *See* Best Practices Guide at 12. Noticeably absent from the requirements for inclusion in the cover pool is any limit on the amount of a mortgage. So long as the requirements listed above are met, issuers can theoretically include jumbo mortgages in the cover pool securing covered bond issuances.
11. The independent party is responsible for ensuring compliance with the asset coverage test. The asset coverage test is intended to ensure the quality of the collateral and the maintenance of proper overcollateralization. In order to maintain the required overcollateralization, the issuer is required to keep the value of the cover pool (mortgages in the cover pool with a loan-to-value ratio greater than 80 percent are discounted by 20 percent when measuring the value for overcollateralization) at least equal to 105 percent of the principal amount of the covered bonds. The independent asset monitor is separate from the trustee for the Covered Bonds, who represents the interests of the investors and enforces the investors' rights in the event of insolvency and/or default. *See* Best Practices Guide at 14.
  12. Representatives of the four largest US Banks (Bank of America, Citigroup, JPMorgan Chase and Wells Fargo) were present when Secretary Paulson issued his statement on July 28, 2008. These banks subsequently issued a joint statement of support, stating: "We believe a robust US covered bond market would provide an additional stable and cost effective funding source for banks to originate and hold mortgages on their balance sheet. We look forward to being leading issuers as the US covered bond market develops, with programs consistent with the FDIC and Treasury statements." US investors have also indicated a willingness to participate in a covered bond market. Blackrock, Pimco and TIAA-CREF all publicly expressed interest in purchasing covered bonds. *See Deep-Pocketed Buyers Eye Covered Bonds, Asset Backed Alert* (August 1, 2008).
  13. Notwithstanding the fact that institutions issuing covered bonds require both regulatory approval and must be "well capitalized," the FDIC imposed this four percent limit, noting that an increase in the proportion of secured loans on a depository institution's balance sheet would reduce the amounts available to satisfy depositors and general creditors (consequently exposing the Deposit Insurance Fund to greater potential loss). *See* Best Practices Guide, Appendix B at 28. In response to commenters who called for a higher (or no) limit, the FDIC stated that the four percent limit "is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market [in the United States]." *See* Best Practices Guide, Appendix B at 26. We may see some struggle between the Department of the Treasury, which is concerned about the macro-economic environment for mortgages and the ability of all banks to find sources of liquidity, and the FDIC, which is charged with cleaning up the mess of failed financial institutions.
  14. However, the Best Practices Guide indicates that the SPV structure could be used by multiple depository institutions to pool assets for a single covered bond issuance. *See* Best Practices Guide at 19 n.4. Such a joint issuance may enable smaller banking institutions to overcome the barrier imposed by the four percent limit and access the covered bond market.
  15. It should be noted, however, investors in covered bonds may face risks, which are not faced by holders of conventional mortgage-backed securities. The rights available to holders of covered bonds under the FDIC Statement are predicated on the covered bonds meeting certain criteria. What will happen if one or more of the criteria is not satisfied? In the FDIC statement, the FDIC has retained the right to consent to release of the covered pool if the issuer failed to comply with the FDIC's specified criteria, but the FDIC offered no specific comfort beyond review on a "case-by-case basis." A more important point may be that, despite the noble intentions evidenced by the Best Practices Guide and FDIC Statement, the covered bond market will bear the burden of any new market: uncertainty surrounding execution, enforcement, liquidity and predictability.
  16. Covered bond issuances in Europe are typically supported by cover pools comprised of both residential and commercial mortgages, as well as certain mortgage-backed securitization products and loans to public sector entities. Other loans, bonds and derivative products may also be included in European cover pools. *See* European Covered Bond Council, ECBC Essential Features of Covered Bonds, *available* at <http://ecbc.hypo.org/>. As an example of the covered bond regime in Europe, *see* the Association of German Pfandbrief Banks' website at <http://www.pfandbrief.de/d/internet.nsf/tindex/en.htm>, which provides detailed information on the covered bond market in Germany.
  17. The Best Practices Guide noted that "focusing on one type of collateral while the market is nascent will provide simplicity for market participants," but also noted that covered bonds secured by other collateral may eventually develop. *See* Best Practices Guide at 6.
  18. The asset-backed market has largely lost the monolines, which served an instrumental purpose of introducing new assets classes and emerging markets to investors in the asset-backed markets. Covered bonds could, with a regulatory framework, help replace the monolines in the support of new asset classes for asset-backed securities by providing the second, corporate credit that investors desire when faced with riskier assets. When discussing the limitations on the types of assets to comprise a covered pool, the FDIC Statement noted that their position "may be reviewed and reconsidered as the US covered bond market develops." *See* Best Practices Guide, Appendix B at 26.

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