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I. INTRODUCTION

In response to the current mortgage market meltdown, Treasury Secretary Henry Paulson advocated the issuance of covered bonds in the United States as a possible mechanism to help "increase mortgage financing, improve underwriting standards and strengthen U.S. financial institutions by providing a new funding source that will diversity [sic] their overall portfolio." Federal Reserve Chairman Ben Bernanke has also suggested that covered bonds may be one piece of future funding of mortgages that would not rely on government-sponsored entities, such as Fannie Mae and Freddie Mac, and could "create a robust mortgage securitization market that will function in bad times as well as good." To date, there is no legislation governing the issuance of covered bonds in the United States. Covered bonds have existed in Europe, however, for over two centuries, primarily subject to legislation. It is estimated that covered bonds in Europe "have grown into a $3.3 trillion business." In order for the U.S. market

4. See, e.g., DEPT OF THE TREASURY, BEST PRACTICES FOR RESIDENTIAL COVERED BONDS 9 (July 28, 2008), http://www.ustreas.gov/press/releases/reports/USCoveredBondBestPractices.pdf; see also FITCH RATINGS, ABCs OF U.S. COVERED BONDS 1 (Sept. 3, 2008) ("[L]egislation enabling covered bonds has been passed in several European countries.").
for covered bonds to flourish, it is necessary to implement legislation governing all transactions involving covered bonds. More precisely, it is the lack of certainty surrounding these investments that has hampered the growth of the market for covered bonds. Legislation is needed to relieve investors’ worries about default.

Section II of this Article will discuss covered bonds and explain how they operate under the current government guidelines. Section III will compare covered bonds with mortgage-backed securities (MBS). Section IV will discuss the potential exposure of the Federal Deposit Insurance Corporation (FDIC) in the covered bonds market, and Section V will urge the adoption of legislation to help stabilize and foster the market for covered bonds in the United States.

II. COVERED BONDS DEFINED

A covered bond is a debt issued by a financial institution and backed by a cover pool, consisting of performing residential mortgages that stay on the issuing institution’s balance sheet. The issuer of a covered bond may be a depository institution or a Special Purpose Vehicle (SPV), created for the purpose of issuing covered bonds. Under either structure, the mortgages that make up the cover pool are owned by the depository institution and “remain on the bank’s balance sheet.” Covered bond investors are “banks, central banks and others looking for high-quality investments with low risk.” “[T]he issuer’s general cash flows” are used to pay the investors interest on their investment.

6. See infra notes 10-96 and accompanying text.
7. See infra notes 97-128 and accompanying text.
8. See infra notes 129-145 and accompanying text.
9. See infra notes 146-192 and accompanying text.
10. DEP’T OF THE TREASURY, supra note 4, at 7; see also DEUTSCHE BANK, COVERED BONDS UNCOVERED 2 (Oct. 25, 2006) (“Covered bonds are highly-rated instruments that are backed by a ‘cover pool’ of assets (often mortgages) that remain on the bank issuer’s balance sheet.”).
11. DEP’T OF THE TREASURY, supra note 4, at 11.
Because the underlying mortgages remain on the issuer’s balance sheet, the issuer has a real interest in the performance of the mortgage, motivating issuing institutions to be mindful of their lending practices.\(^{15}\)

The cover pool is comprised of performing residential mortgage loans that serve as recourse for the bondholder, should the issuing institution default or become insolvent.\(^{16}\) Additionally, the issuing institution “must maintain a \[c\]over \[p\]ool in excess of the notional value of the \[c\]overed \[b\]ond.”\(^{17}\) This means that the value of the cover pool must be greater than the “outstanding principal balance of the \[c\]overed \[b\]onds.”\(^{18}\) “Overcollateralization” helps to protect investors should an issuer default by reducing the risk that the cover pool will have inadequate funds to pay investors.\(^{19}\) If, despite the overcollateralization, the cover pool proves insufficient upon liquidation, bondholders may recover from the issuer along with other unsecured creditors.\(^{20}\)

The dual recourse available to investors along with the overcollateralization of the cover pool makes covered bonds an attractive alternative to other mortgage-backed securities.\(^{21}\) In fact, because of the nature of covered bonds, they usually receive a higher rating than the issuing institution themselves,\(^{22}\) as the bonds’ ratings usually indicate “both the creditworthiness of the issuer and the strength of the bonds’ collateral protection, with the collateral protections arguably the more important factor.”\(^{23}\)

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15. Lewis, supra note 13 (statement of Peter Wallison) (“Covered bonds tend to force banks to be more careful in the lending that they do.”).
16. DEP’T OF THE TREASURY, supra note 4, at 7; see also FITCH RATINGS, supra note 4, at 1 (“The cover pool is a dynamic pool of assets that are separated, in an insolvency of the financial institution, from the issuer’s other assets for the benefit of the covered bondholders and include residential and commercial mortgage loans, or debt of public entities.”).
17. DEP’T OF THE TREASURY, supra note 4, at 7.
18. Id. at 12.
19. Id. at 7 (“[O]vercollateralization of the \[c\]over \[p\]ool helps to mitigate the risk that investors would receive less than par in the event of an issuer default.”).
20. Id.
21. Id.
22. FITCH RATINGS, supra note 4, at 1.
However, some ratings agencies analyze covered bonds based solely on the “cover pool upon an insolvency,” not taking the issuing institution into consideration.²⁴

The FDIC published an “Interim Final Covered Bond Policy Statement” in the Federal Register on April 23, 2008 for public comment.²⁵ After taking several comments into consideration, the FDIC Final Statement of Policy (Final Statement of Policy) was released on July 15, 2008 and then became effective when published in the Federal Register on July 28, 2008.²⁶ The Final Statement of Policy sets forth several requirements for covered bonds and explains how covered bonds that meet those requirements and qualify under the document would be treated should an issuing insured depository institution (IDI) be placed in conservatorship or receivership.²⁷ The FDIC is implicated by the issuance of these debt instruments because the FDIC acts as a conservator or receiver for any insolvent IDI.²⁸

A major concern for covered bond investors as well as issuers is FDIC “consent to obtain collateral for a covered bond transaction” once the FDIC has been appointed as conservator or receiver.²⁹ The Final Statement of Policy addresses this concern and allows for “expedited access” for those covered bonds that comply with the statement, which encourages issuers to comply.³⁰ Under the Federal Deposit Insurance Act (FDIA), “any liquidation of collateral of an IDI placed into conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively.”³¹ As a result

²⁶. Id.
³⁰. See id. at 43754 (“This policy statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds after the FDIC decides whether to terminate or continue the transaction.”).
³¹. Id.
of this requirement, issuers must maintain sufficient liquidity to continue payments on the outstanding bonds during this period, unless the FDIC allows access to the collateral or makes the payments, creating a huge expense for issuers. The Final Statement of Policy addresses this problem for issuers, and states the conditions under which the FDIC will reduce this period to 10 days, after which the issuer may liquidate pledged collateral without FDIC consent.

The Final Statement of Policy also discussed the ramifications for those covered bond issuances that do not comply with its requirements. The FDIC indicated that pursuant to the FDIA, with regards to those covered bonds that do not comply with the Final Statement of Policy, "the FDIC retains discretion to grant consent prior to expiration of the 45 or 90 day period on a case-by-case basis." Furthermore, the FDIC stated that it would not allow "grandfathering" of any covered bonds issued before the Final Statement of Policy, as to do so would allow potentially fragile covered bonds the protection that is reserved for "stable and resilient" covered bonds, and would also be contrary to the policy of consistency set forth in the Final Statement of Policy.

Also on July 28, 2008, the Department of the Treasury issued "Best Practices for Residential Covered Bonds" (Best Practices) in an attempt to standardize the U.S. market for covered bonds, much like the legislative framework in place in many European countries. This document, along with the Final Statement of Policy, may serve as a "starting-point" for those institutions seeking to issue covered bonds. However, beyond these documents, there is no formal regulation of covered bonds in the United States.
Best Practices sets forth a template for institutions seeking to establish a covered bond program in the United States. The Treasury, however, indicates that Best Practices does not “imply a government guarantee of any kind,” nor does it “attempt to address requirements arising from federal securities laws or any other legal framework.” The criteria set forth in Best Practices are not requirements, but recommendations posed by the Treasury to aid the growth of the U.S. covered bond market. Best Practices incorporates some provisions of the FDIC’s Final Statement of Policy as well, but warns that “[m]arket participants should independently review the FDIC’s statement to ensure conformity with all provisions.” The template provides for two distinct covered bond program structures, the “SPV Structure” and the “Direct Issuance Structure.” The covered bond programs allow banks to “issue multiple series of covered bonds, and the entire program is supported by the cover pool.”

Under the SPV Structure, the issuer is “[a] newly created, bankruptcy-remote SPV.” The SPV’s “primary assets must be a mortgage bond purchased from a depository institution,” that is “secured at the depository institution by a dynamic pool of residential mortgages.” Both Bank of America and Washington Mutual Bank, the only two U.S. institutions that have issued covered bonds thus far, have used a SPV structure.

The issuer under the Direct Issuance Structure is “[a] depository institution and/or a wholly-owned subsidiary of a depository institution.” Here, “the issuing institution must designate a [c]over [p]ool of residential mortgages as the collateral

40. DEP’T OF THE TREASURY, supra note 4, at 10.
41. Id.
43. DEP’T OF THE TREASURY, supra note 4, at 11.
44. Id.
45. DEUTSCHE BANK, supra note 10, at 3.
46. DEP’T OF THE TREASURY, supra note 4, at 11.
47. Id.
48. E.g., FITCH RATINGS, supra note 4, at 6.
49. DEP’T OF THE TREASURY, supra note 4, at 11.
for the Covered Bond, which remains on the balance sheet of the depository institution.\textsuperscript{50}

Under either structure, the issuing institution “must provide a first priority claim on the assets in the cover pool to bond holders, and the assets in the cover pool must not be encumbered by any other lien.”\textsuperscript{51} In addition, Best Practices sets forth a standard for the overcollateralization of the cover pool, requiring “an overcollateralization value at all times of at least 5% of the outstanding principal balance of the cover bond.”\textsuperscript{52}

Furthermore, Best Practices sets forth a list of criteria that the underlying mortgages in the cover pool should meet invariably to be consistent with the template.\textsuperscript{53} These criteria are all aimed at ensuring repayment by the mortgagor and reducing the default risk for the bond issuers.\textsuperscript{54} These criteria include some provisions from the FDIC Final Statement of Policy and some additional requirements, all of which are designed to allow only highly rated, performing mortgages in the cover pool.\textsuperscript{55}

The FDIC stipulates that only “performing mortgages on one-to-four family residential properties,” that are “underwritten with documented income” “at the fully-indexed rate” shall be eligible.\textsuperscript{56} Requiring that the mortgages be “underwritten with documented income” is a very important feature of any covered bond program.\textsuperscript{57} This helps to ensure that mortgagors make timely payments and that the mortgages, in turn, will perform, thereby protecting both the investors as well as the issuers.\textsuperscript{58} The mortgages must also “comply with existing supervisory guidance

\textsuperscript{50.} Id.
\textsuperscript{51.} Id.
\textsuperscript{52.} Id. at 12.
\textsuperscript{53.} See id.
\textsuperscript{54.} See id.
\textsuperscript{55.} DEPT OF THE TREASURY, supra note 4, at 7 ("This [c]over [p]ool consists of a portfolio of performing residential mortgage loans that meet specified underwriting criteria and are actively managed by the issuer to meet certain characteristics.") (emphasis added).
\textsuperscript{56.} Id. at 12.
\textsuperscript{58.} See id.
governing the underwriting of residential mortgages." The Treasury adds that only current, first lien mortgages with a "maximum loan-to-value ... of 80% at the time of inclusion" may be eligible. This guarantees that the mortgagor has equity at risk. The value of the home may decrease by up to 20% and the homeowner won't owe more than the home is worth, helping to ensure that the mortgagor will not be persuaded to default on the loan. In addition, "[a] single Metro Statistical Area cannot make up more than 20% of the [c]over [p]ool." A "Metro Statistical Area" is a geographic area with a population of 50,000 or more. The purpose of this requirement is to ensure diversification. If one Metro Statistical Area has a large drop in home values or a major employer in the area lays off most of their workers, this requirement will protect the entire loan pool.

Best Practices also excludes negative amortization mortgages from the cover pool. A negative amortization mortgage is one in which the principal on the mortgage actually increases over time because the monthly payments are inadequate to cover the interest accrued. The mortgages must be "performing," which means that the mortgagor is current on all mortgage payments when the mortgage is added to the pool.

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59. DEPT OF THE TREASURY, supra note 4, at 12 (This includes "the Interagency Guidance on Non-Traditional Mortgage Products, Oct. 5, 2006, an the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination.").
60. Id.
62. See id.
63. DEPT OF THE TREASURY, supra note 4, at 12.
64. U.S. Census Bureau, http://www.census.gov/population/www/metroareas/metroarea.html (last visited Oct. 6, 2008) ("A metro area contains a core urban area of 50,000 or more population.").
66. See id. (Discussing the different factors that "drive delinquency rates.").
67. DEPT OF THE TREASURY, supra note 4, at 12 ("Negative amortization mortgages are not eligible for the [c]over [p]ool.").
68. BLACK'S LAW DICTIONARY 93 (8th ed. 2004) ("Negative amortization" is "an increase in a loan's principal balance caused by monthly payments insufficient to pay accruing interest.").
69. See DEPT OF THE TREASURY, supra note 4, at 12.
mortgagor on a loan in the pool becomes more than 60-days delinquent in payments, that nonperforming mortgage must be replaced with a performing mortgage.70 There is also a requirement that the issuers enter into a “specified investment contract” at the time of issuance for further protection of investors against prepayment risk in the case of a default.71 Under such a contract, the “proceeds of [c]over [p]ool assets are invested . . . at the time of issuance with or by one or more financially sound counterparties.”72 This investment will continue to pay principal and interest payments should an issuer default or the FDIC repudiate the transaction as conservator or receiver, provided that the “[s]pecified [i]nvestment provider receives proceeds of the [c]over [p]ool assets at least equal to the par value of the [c]overed [b]onds.”73

Best Practices also sets forth guidelines for the issuer.74 These include disclosure of information about the cover pool to investors,75 testing to “ensure collateral quality,” also called the “Asset Coverage Test,” and the appointment of an “Asset Monitor” and a Trustee.76 Issuers must disclose to potential investors “descriptive information” about the cover pool, and must disclose the same information to actual investors “on a monthly basis after issuance.”77 The issuer must also “disclose information regarding its financial profile and other relevant information that an investor would find material.”78 “The issuer must perform an Asset Coverage Test on a monthly basis to ensure collateral quality and the proper level of overcollateralization and to make any substitutions that are necessary to meet the provisions of this template.”79 The Asset Monitor is appointed to ensure that the issuer is in compliance with the Asset Coverage Test.80 The

70. Id.
71. Id. at 13.
72. Id.
73. Id.
74. Id. at 11.
75. DEP’T OF THE TREASURY, supra note 4, at 14.
76. Id.
77. Id.
78. Id.
79. Id.
80. Id. Deutsche Bank Trust Company Americas, New York was appointed asset
Trustee generally “represent[s] the interest of investors” and is charged with enforcing the “investors’ rights in the collateral in the event of an issuer’s insolvency.”

Best Practices requires issuers to “receive consent to issue [c]overed [b]onds from their primary federal regulator,” and limits covered bonds to a maximum of “four percent of an issuers’ liabilities.” The FDIC may increase this percentage, but has refused to do so thus far while it assesses the covered bonds market in the United States. The template also allows both a “currency swap” and an “interest payment swap.” A “currency swap” is only necessary in the instance that “a [c]overed [b]ond is issued in a different currency than the underlying [c]over [p]ool.”

“The purpose of [interest payment swap] agreements” are “[t]o provide scheduled interest payments on a temporary basis in the event the issuer becomes insolvent” and “[t]o mitigate any timing mismatch, to the extent applicable, between interest payments and interest income.”

Best Practices also lays out the protocol in the event of an issuer’s default. Should an issuer default, the losses sustained by the cover pool backing that bond will be shared equally among all bondholders whose investments are backed by that cover pool, regardless of when a bondholder purchased their covered bond. Should the Asset Coverage Test be breached, “the issuer has one month to correct such breach,” at which time, if “the breach remains, the Trustee may terminate the [c]overed [b]ond program

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81. DEP’T OF THE TREASURY, supra note 4, at 14.
82. Id. at 15.
83. Id.
85. DEP’T OF THE TREASURY, supra note 4, at 13 (“If a Covered Bond is issued in a different currency than the underlying [c]over [p]ool (or Mortgage Bond, if applicable), the issuer shall employ a currency swap.”).
86. Id.
87. Id.
88. Id.
89. Id. at 15.
90. Id.
and principal and accrued interest [on the amount invested by the bondholders] will be returned to investors.\(^9\)

Lastly, Best Practices sets forth the “insolvency procedures” for the FDIC in the event that an IDI becomes insolvent.\(^\text{92}\) These are taken from the Final Statement of Policy and allow “three options in responding to a properly structured covered bond transaction of the IDI.”\(^\text{93}\) The FDIC may “(1) continue to perform on the covered bond transaction under its terms; (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.”\(^\text{94}\) The Final Statement of Policy explains the situation in which each of these options would be necessary and how the FDIC would go forward under each option.\(^\text{95}\)

If the FDIC adopts the first option, it would continue to make the covered bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the covered bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral. If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the [Federal Deposit Insurance Act]. On the other hand, if there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the

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91. DEP’T OF THE TREASURY, supra note 4, at 15.
92. Id. at 16.
94. Id.
95. Id.
claims in excess of the pledged collateral would be unsecured claims in the receivership.\textsuperscript{96}

III. COMPARED TO MORTGAGE-BACKED SECURITIES

Covered bonds are similar to mortgage-backed securities (MBS) in that they are both secured by a “pool” of home mortgages and pay the investor a fixed interest rate.\textsuperscript{97} In general, MBS “are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property.”\textsuperscript{98} MBS may be issued by private institutions or governmental entities that have bought the mortgage loans from the originators of the loans and securitized them.\textsuperscript{99}

Notwithstanding the similarities of covered bonds and MBS, the differences between the two mortgage financing vehicles may make covered bonds a more appealing alternative.\textsuperscript{100} Perhaps most importantly, “covered bond investors have full recourse to the issuing bank as well as the cover pool,” whereas “[i]nvestors in [MBS . . . ] only have recourse to the underlying mortgage assets.”\textsuperscript{101} In the event of an issuer default, the covered bondholder’s investment is protected first by the cover pool and then by the issuer, if the cover pool’s assets are insufficient to cover payments.\textsuperscript{102} Investors in MBS are protected only to the extent that the underlying assets are performing.\textsuperscript{103}

\begin{footnotesize}
\textsuperscript{96} Id.
\textsuperscript{97} Peter Coy, Covered Bonds, Exposed Taxpayers, \textsc{Bus. Wk.}, Aug. 11, 2008, at 25, \textit{available at} \url{http://www.businessweek.com/magazine/content/08_32/b4095000911375.htm?chan=magazine+channel_top+stories} (note that the Internet article is titled \textit{Are Covered Bonds a Safe Way to Finance Mortgages? Not Likely}, however the content of both articles is identical).
\textsuperscript{98} U.S. SEC. AND EXCH. COMM’N, MORTGAGE-BACKED SECURITIES, \url{http://www.sec.gov/answers/mortgagesecurities.htm} (last visited Oct. 6, 2008).
\textsuperscript{99} Id.
\textsuperscript{100} See infra notes 101-121 and accompanying text.
\textsuperscript{101} \textsc{Fitch Ratings}, supra note 4, at 2.
\textsuperscript{102} DEP’T OF THE TREASURY, \textit{supra} note 4, at 8 (“In the event that the Covered Bonds do accelerate and repay investors at an amount less than the principal and accrued interest, investors retain an unsecured claim on the issuer.”).
\textsuperscript{103} Id.
\end{footnotesize}
"repayment at an amount less than the principal and interest owed," MBS investors generally have no recourse to the issuer.\textsuperscript{104}

Additionally, “[t]he collateral underlying [c]overed [b]onds is dynamic [in that] non-performing (or prepaying) assets within the [c]over [p]ool must be [replaced] with performing mortgages,” unlike the “mortgages underlying MBS” which are “static and remain in each MBS until maturity” or payment.\textsuperscript{105} This creates “prepayment risk” as well as a default risk to MBS investors.\textsuperscript{106} Generally, a mortgage will be prepaid when interest rates are falling and the homeowner can refinance at a lower rate and repay the old mortgage.\textsuperscript{107} Because the mortgages underlying the MBS are static, a prepaid mortgage would mean a loss to a MBS investor of the future interest payments on the prepaid principal.\textsuperscript{108} Additionally, if a mortgagor were to default on a mortgage underlying MBS, the MBS investor would be at a loss.\textsuperscript{109} But because covered bonds are backed by a “dynamic” cover pool, any underlying mortgage that is prepaid or in danger of default is removed from the cover pool and replaced with a performing mortgage, thereby eradicating both risks for covered bond investors.\textsuperscript{110} Covered bonds are structured to ensure that the investor is paid the scheduled interest and principal payments through the date of maturity, whereas a MBS investor has no such guarantee.\textsuperscript{111} By requiring issuers to enter into the specified investment contracts discussed above, and allowing interest payment swaps, the Treasury can protect the investor from

\textsuperscript{104} Id.
\textsuperscript{105} Id.; see also Fitch Ratings, supra note 4, at 3 (“[C]overed bonds enable the issuer to actively manage the underlying assets in the cover pool.”).
\textsuperscript{106} See Dep’t of the Treasury, supra note 4, at 8.
\textsuperscript{108} Id.
\textsuperscript{109} Id. (“Ginnie Mae, Fannie Mae and Freddie Mac offer guarantees against default risk. Private sector issuers may obtain direct insurance against default, but often they structure their MBSs to allocate default risk toward parties willing to bear it.”).
\textsuperscript{110} Dep’t of the Treasury, supra note 4, at 8.
\textsuperscript{111} Id.
payment prior to the date of maturity in the case of issuer insolvency.112

Another important distinction is that the "[m]ortgages that secure a [c]overed [b]ond remain on the issuer’s balance sheet," whereas those underlying mortgages in a MBS are securitized and sold to a SPV that assumes those mortgages on its balance sheet.113 Although a covered bond issuance may flow through a SPV as well, "[t]he pledged mortgages remain on the IDI’s balance sheet, securing the IDI’s obligation to make payments on the debt, and the SPV sells covered bonds, secured by the mortgage bonds, to investors."
114 This feature keeps the risk of prepayment with the issuing institution, rather than transferring that risk “at the time of securitization.”115 Furthermore, "[b]ecause the banks retain the credit risk, they have an incentive to make sure the underlying loans can be repaid.”116 This would also encourage better initial loan underwriting by the bank originating the loan.117 Additionally, “all covered bonds are issued in series and rank pari passu and without priority among themselves, whereas . . . MBS are generally issued in a form of senior and subordinated tranches.”118 This means that all of the covered bonds issued from one cover pool will “have equal rights to payment.”119 Therefore, one might argue that an investor would be better off investing in a senior tranche of a MBS, which is supported by and protected from losses by all of the subordinate tranches of the MBS.120

112. See id.
113. Id. at 7; see also AM. BANKER, Banker’s Glossary, http://www.americanbanker.com/glossary.html?alpha=S (last visited Nov. 11, 2008) (“GAAP accounting rules may permit the assets and liabilities of the SPV to be unconsolidated and therefore off the balance sheet of the entity that generated the assets.”).
115. FITCH RATINGS, supra note 4, at 2-3.
118. FITCH RATINGS, supra note 4, at 3.
However, covered bond investors, as a whole, are better off than the MBS investors, as a whole.121

There are several advantages for investors in choosing covered bonds over MBS.122 Covered bond investors have recourse to the cover pool as well as the issuing institution,123 and because the assets underlying the investment are kept on the issuer’s balance sheet, investors are largely benefited by smart lending practices.124 While covered bonds can by no means fix the subprime mortgage crisis, they may be a helpful tool in changing the tides of the U.S. mortgage market.125

Despite the advantages of covered bonds over MBS, the FDIC stated in its Final Statement of Policy that certain MBS might be allowed as collateral for covered bonds.126 Specifically, “AAA-rated mortgage-backed securities secured by eligible mortgages” are allowed, so long as they do not exceed “ten percent of the collateral for any covered bond issuance or series.”127 Lastly, MBS should not be totally discredited. It has been argued that while covered bonds are an attractive alternative to MBS, “[n]ew and improved mortgage securitization practices – with more transparency, simpler structures, better diligence and underwriting, and improved ratings processes – also should be a major part of U.S. mortgage finance.”128

IV. EXPOSURE OF THE FDIC

Some economists argue that although covered bonds may be a safe investment for bondholders, these debt instruments could create some risk for U.S. taxpayers.129 Because of the structure of

121. See supra notes 100-120 and accompanying text.
122. See supra notes 100-121 and accompanying text.
123. See supra notes 101-104 and accompanying text.
124. See supra notes 113-1147 and accompanying text.
125. See supra notes 100-124 and accompanying text.
127. Id.
129. Coy, supra note 97, at 25.
the covered bond programs, if an issuer defaults, the bondholders will be paid before the FDIC.\textsuperscript{130} This could mean that the FDIC would have to use its insurance fund to pay the remainder, if any, of what is owed to bondholders and then pay the insured depositors to the extent the issuing bank’s remaining assets are not sufficient.\textsuperscript{131} If this happens and “the insurance fund runs low, taxpayers have to ante up.”\textsuperscript{132} Those who cite this risk argue that “[p]romoting covered bonds is really a way to compartmentalize and shift risk to the FDIC and uninsured depositors.”\textsuperscript{133}

The FDIC recognizes this risk, and as a result has set a cap on the percentage of a bank’s liabilities that may be comprised of covered bond obligations.\textsuperscript{134} The FDIC’s Final Statement of Policy only applies to those covered bond issuances “in which the IDI’s total covered bond obligation as a result of such issuance comprises no more than 4 percent of an IDI’s total liabilities.”\textsuperscript{135} Although this measure is in place to protect the insurance fund, and in turn the U.S. taxpayers, “arguments for a higher ceiling are already being made.”\textsuperscript{136} The problem with the low ceiling is that it “prevents covered bonds from making a meaningful contribution to mortgage availability.”\textsuperscript{137} “[B]anks can raise money less expensively when they pledge mortgages as collateral,” thereby “increas[ing] their profitability.”\textsuperscript{138}

Despite these concerns, the FDIC also notes that covered bonds “could increase the costs to the deposit insurance fund in a receivership,” but that “these potential costs must be balanced with diversification of sources of liquidity and the benefits that accrue from additional on-balance sheet alternatives to securitization for financing mortgage lending.”\textsuperscript{139} The FDIC took several comments and suggestions into consideration in their

\begin{itemize}
\item \textsuperscript{130} \textit{Id.}
\item \textsuperscript{131} \textit{Id.}
\item \textsuperscript{132} \textit{Id.}
\item \textsuperscript{133} \textit{Id.}
\item \textsuperscript{134} \textit{Id.}
\item \textsuperscript{135} Fed. Deposit Ins. Corp., \textit{supra} note 3, at 43758.
\item \textsuperscript{136} Coy, \textit{supra} note 97, at 25.
\item \textsuperscript{137} \textit{Id.}
\item \textsuperscript{138} \textit{Id.}
\item \textsuperscript{139} Fed. Deposit Ins. Corp., \textit{supra} note 3, at 43754.
\end{itemize}
Covered Bonds

Revision of the "Final Statement of Policy," some of which could increase risk to the insurance fund.\textsuperscript{140} Rather importantly, "[r]esponding to requests from market participants, the FDIC increased the term limit for covered bonds from 10 to 30 years."\textsuperscript{141} The FDIC reasoned that "longer-term [C]overed [B]onds should not pose a significant, additional risk and may avoid short-term funding volatility."\textsuperscript{142} In response to the push to increase the four percent cap, the FDIC noted that "it may, in the future, change the limitation on issuances as the market develops."\textsuperscript{143} In addition, the "Final Statement of Policy" permits "[s]ubstitution collateral" that "may include cash and Treasury and agency securities as necessary to prudently manage the [c]over [p]ool."\textsuperscript{144} "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.'"\textsuperscript{145}

V. Proposal for the U.S. Market

As previously noted, the market for covered bonds has been in existence in Europe for over two centuries.\textsuperscript{146} Germany, Spain, France, Luxembourg, Ireland, Sweden, Portugal, Italy, Norway, Denmark, Turkey, the U.K, Greece and Ukraine all have legal frameworks dedicated to covered bonds.\textsuperscript{147} The "dedicated legal frameworks" that exist in many of the European countries "govern[] the issuance of covered bonds, specify[] the type of institutions allowed to issue covered bonds, defin[e] assets eligible for covered bonds funding and set[] the priority rights of covered bondholders against the cover pool assets in the event the issuer

\textsuperscript{141} Id. at 2.
\textsuperscript{142} Fed. Deposit Ins. Corp., supra note 3, at 43756.
\textsuperscript{143} MORRISON \& FOERSTER, supra note 140, at 2.
\textsuperscript{144} Fed. Deposit Ins. Corp., supra note 3, at 43757.
\textsuperscript{145} MORRISON \& FOERSTER, supra note 140, at 2.
\textsuperscript{146} DEP’T OF THE TREASURY, supra note 4, at 9.
\textsuperscript{147} FITCH RATINGS, supra note 4, at 11.
becomes insolvent." These "dedicated legal frameworks" have helped to prevent any European covered bonds from defaulting "since their modern form was adopted in 1899." Unlike these European countries, the U.S. "operates under a framework resting on contractual undertakings," meaning that there is no specific legislation to control the actions of covered bond issuers or investors, rather, all covered bond transactions in the U.S. are subject to contract law. Although "no specific covered bond legislation exists, . . . the Uniform Commercial Code (UCC) provides the legal background to pledge assets through the creation of a first-priority perfected security interest." And while the European covered bond market flourishes, only two U.S. institutions have issued covered bonds to date.

While the Best Practices and the FDIC's Final Statement of Policy may serve as guidelines for institutions seeking to issue covered bonds, the lack of formal legislation may be part of the reason for the small market in the U.S. Federal Reserve Chairman Ben Bernanke noted that one of the reasons why covered bonds had only been issued by two U.S. institutions was that "the United States does not have the extensive statutory and supervisory regulation designed to protect the interests of covered bond investors that exists in European countries," and referred to the FDIC's Final Statement of Policy and the Best Practices as

148. Id. at 5.
150. FITCH RATINGS, supra note 4, at 5.
151. See id.
152. Id.; see also DEUTSCHE BANK, supra note 10, at 5 ("[A] first-perfected security interest in the cover pool assets is created, as allowed by the Uniform Commercial Code (UCC).")
153. FITCH RATINGS, supra note 4, at 2 ("In 2006, covered bonds were introduced to the U.S. when Washington Mutual Bank became the first U.S. depository institution to issue a Euro-denominated covered bond, followed by Bank of America N.A. in 2007.").
"constructive steps." There is very little certainty surrounding the transaction process for covered bonds and this may be a major reason for investor and issuer inhibitions. It has been said that the FDIC "has still not provided the absolute assurance that the covered bond market needs, . . . investors in covered bonds need to know that no matter what happens to the bank, they will get paid." This fear arises because although the bondholders would be paid before the FDIC in the event of an issuer's default, there is still the possibility that the FDIC will repudiate the covered bond transaction. As noted above, if the transaction was repudiated, the investor would be paid the principal and the interest accrued to the time of the FDIC's appointment as conservator or receiver, "up to the value of the collateral." The value of the collateral may be sufficient, however if it is not, "the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership." It is this uncertainty that worries potential investors.

On July 30, 2008, only two days after the Final Statement of Policy and Best Practices were issued, Representative Scott Garrett of New Jersey introduced H.R. 6659, the Equal Treatment for Covered Bonds Act, proposed legislation that would govern covered bonds in the United States. According to Representative Garrett, the law would "provide more certainty in the marketplace and hopefully fuel investor confidence." Furthermore, "codification of this investment tool will provide greater stability and permanency for covered bonds, in addition to encouraging the use of covered bonds as an alternative to mortgage securitization." It is also argued that the certainty

155. Bernanke, supra note 2, at 5.
156. See infra notes 157-158 and accompanying text.
159. Id.
160. Id.
161. See supra notes 156-160 and accompanying text.
162. Garrett, supra note 154.
163. Id.
164. Id.
provided by statutory language “can lower transaction costs because investors and issuers will not be pricing for uncertainty.”

Representative Garrett’s legislation would classify covered bonds as a “qualified financial contract” under the FDIA. As such, once the FDIC is appointed conservator or receiver of anIDI that has issued covered bonds, there would be “virtually no delay for covered bond holders to exercise their rights.”

In addition, the legislation provides for compensatory damages, payable to the bondholder by the FDIC as conservator or receiver, including “the outstanding principal and interest on the covered bonds” as well as “other costs (including reasonable attorney's fees) relating to the exercise of any right, power or remedy under the covered bonds.” The proposed bill also “[p]rovides for joint rulemaking authority to the Secretary of Treasury, the Federal Reserve, Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS) and FDIC for any new regulations affecting covered bonds.”

In sum, this legislation would provide the legal certainty to covered bond investors and issuers that the Final Statement of Policy and Best Practices do not. And by dictating those agencies responsible for regulating the covered bonds market, the legislation anticipates the need for responsive rulemaking to help conform covered bonds regulations to the ever-changing market, discrediting the argument that formal legislation is too static for such a new and evolving market.

The American Securitization Forum (ASF) issued a Statement on U.S. Covered Bonds on July 28, 2008, also proposing

165. Id.
166. Id.
168. Id.
170. See id.
171. See id.
a "more holistic legal framework" that "plainly recognizes covered bonds as a distinct asset class and a true rate product."173 The ASF visualizes a framework that "would address comprehensively all of the regulatory, insolvency, securities, tax, and other laws that affect covered bonds."174 The Statement also set forth five important characteristics that covered bonds must offer the issuing institutions and "the dealers and investors that acquire and trade them" for the U.S. covered bonds market to "fully develop."175 These "attributes" are that the covered bonds must be "[c]ost-effective," "[c]apital-efficient," "[l]iquidity-positive," "[i]nsolvency-remote" and "[r]egulatory-supported."176 According to the ASF, the claim that U.S. Covered Bonds must be "regulatory-supported," means that the "[c]overed bonds must be entitled to the kind of supportive capital treatment that is found in European jurisdictions under Basel II and to advantageous terms at each Federal Reserve Bank’s Discount Window."177 The ASF stated that the FDIC’s Final Statement of Policy and the Treasury’s Best Practices “are critical first steps toward establishing more standardized and certain market and legal frameworks for U.S. covered bonds that can support a deep and robust market populated by domestic and international investors alike.”178 Additionally, a sound legislative framework for covered bonds may help the United States to access some additional benefits provided by a robust covered bonds market.179 “An entire market for covered bonds backed by public sector debt thrives in Europe alongside its sister mortgage-backed equivalent.”180 The European public sector covered bonds serve to fund infrastructure, a potentially valuable tool for U.S. governments.181 Proponents of this type of covered bond market in the United States suggest that

173. AM. SECURITIZATION FORUM, supra note 149, at 2.
174. Id.
175. Id.
176. Id.
177. Id.
178. Id.
179. See infra notes 180-184 and accompanying text.
180. Crebo-Rediker & Rediker, supra note 117.
181. See infra notes 182-184.
“[c]reating U.S. covered bond legislation that incorporates public sector debt as well as mortgages is one tool in the financial toolbox we can use to both help jump-start the mortgage market and open channels for attracting infrastructure investment through the global capital markets.”\textsuperscript{182} Although U.S. municipal bond markets have financed public infrastructure successfully, “municipal bonds are unable to take advantage of the world’s largest pools of capital that are available for infrastructure financing elsewhere.”\textsuperscript{183} Covered bonds may be able to access this capital and help finance public infrastructure.\textsuperscript{184}

There are other plausible reasons why the U.S. market for covered bonds may be off to a slow start.\textsuperscript{185} Chairman Bernanke highlighted some additional explanations for the lack of U.S. covered bonds issuances in a recent speech.\textsuperscript{186} First, Bernanke noted that Federal Home Loan Banks (FLHB) are generally able to provide more “cost-effective funding for mortgage assets” than covered bonds can.\textsuperscript{187} In addition, Bernanke pointed to the fact that “Fannie Mae and Freddie Mac have traditionally securitized U.S. prime mortgage assets.”\textsuperscript{188} The sheer size of their operations and the fact that both institutions have been backed by the government has “made it difficult for banks to use covered bonds to finance their own prime mortgages.”\textsuperscript{189} However, as both Fannie Mae and Freddie Mac have recently been placed in government conservatorship, it remains to be seen whether or not they will be able to fulfill the demand for funds based on home mortgage collateral.\textsuperscript{190} If Fannie and Freddie are no longer up to the task, it may be that covered bonds could be a valid alternative.\textsuperscript{191} Lastly, Bernanke pointed to the fact that because

\textsuperscript{182} Crebo-Rediker & Rediker, \textit{supra} note 117.
\textsuperscript{183} \textit{Id.}
\textsuperscript{184} \textit{Id.}
\textsuperscript{185} See infra notes 186-192.
\textsuperscript{186} Bernanke, \textit{supra} note 2, at 5.
\textsuperscript{187} \textit{Id.}
\textsuperscript{188} \textit{Id.}
\textsuperscript{189} \textit{Id.}
\textsuperscript{191} See id.
covered bonds require banks to keep the mortgage loans on its books, the bank must have additional capital compared to “securitization through Fannie and Freddie.”

VI. CONCLUSION

For U.S. investors to fully embrace covered bonds, there must be formal legislation that provides clarity, certainty, and assurance. Although Treasury Secretary Paulson has been attributed as saying that the U.S. covered bond “market can grow without legislative action,” there is a plethora of evidence to the contrary. Both Congressman Garrett and Chairman Bernanke have recognized the potential benefits of a thriving covered bond market as well as the importance of legislation to foster the growth of this market. In these especially uncertain times in the U.S. mortgage market, a new source of mortgage funding should be regulated, not only to encourage the growth of the market, but to protect both investors and issuers as well.

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192. Bernanke, supra note 2, at 5.
193. See supra notes 146-192 and accompanying text.
194. Marilyn Alva, New Mortgage Funding Plan Holds Lenders Accountable, INVESTOR’S BUS. DAILY 3 (Aug. 1, 2008) (“Paulson said that unlike many European nations that have covered-bond legislation, the U.S. market can grow without legislative action.”).
195. See supra notes 146-192 and accompanying text.
196. See supra notes 2 and 162-165 and accompanying text.
197. See supra notes 146-192 and accompanying text.