

CAPITAL MARKETS | BY [DAVID W. FORTI](#) AND [JOSEPH V. GATTI](#)

FDIC action might spur US covered bond growth

Covered bonds are receiving significant attention in the US as a result of the first US structured covered bond issuance, the Federal Deposit Insurance Corporation's (FDIC) approval on 15 April 2008 of the issuance of an interim final covered bond policy statement, and the credit crisis. Although covered bonds are one of the oldest asset financing techniques, they are still relatively unknown in the US.

Covered bonds are securities issued by a bank and backed by a specified pool of loans known as the 'cover pool', to which bondholders have a preferential claim in the event of the issuer's insolvency. If the issuer becomes insolvent, the loans in the cover pool are separated from the issuer's other assets and are made available solely to satisfy the covered bond debt. In other words, covered bonds are a form of on-balance sheet financing for the issuer, which retains control of the loans and remains directly or indirectly liable for payment of the covered bonds.

Most covered bonds are structured to receive AAA ratings based on the credit quality of the assets included in the cover pool, over-collateralisation, and other features. Covered bond transactions require the appointment of an independent asset monitor that is responsible for monitoring the loans in the cover pool on a regular basis, removing loans from the cover pool if they become impaired, and requiring the issuer to supplement the cover pool with additional loans in the event that the current value of the cover pool falls below the transaction's required level of over-collateralisation.

The first US issuance of covered bonds was in September 2006, when Washington Mutual Bank issued a structured covered bond transaction, with a cover pool consisting of US residential mortgage loans. Bank of America followed up with a similar transaction.

Covered bonds allow issuers to obtain large volumes of inexpensive long dated funds. In addition to relatively stable spreads and substantial market liquidity, covered bonds can offer many benefits that other financing tools cannot.

Unlike most European jurisdictions, the US does not have covered bond legislation, so US deals will continue to rely on these structured finance techniques.

Benefits and disadvantages of covered bonds

The covered bond market offers investors an alternative to government securities, unsecured bank debt, and securitised bonds. While there is some evidence of variance in the pricing of covered bonds by nationality of issuer, this appears to be only weakly related to differences in the respective legislative frameworks. Recent history shows covered bonds pricing to be resilient in the face of shocks to issuer credit risk as well as more systemic shocks to the value of cover pools.

Covered bonds allow issuers to obtain large volumes of inexpensive long dated funds. In addition to relatively stable spreads and substantial market liquidity, covered bonds can offer many benefits that other financing tools cannot. Such benefits include: (i) credit ratings higher than the issuer's credit rating, typically AAA, and thus a lower cost of funding; (ii) bullet maturities without exposure to pre-payment or acceleration risk; (iii) dual recourse to a financial institution and to an over-collateralised pool of high quality loans, which ensures that the cover pool is sufficient to repay the covered bonds; (iv) a dynamic pool of assets; and (v) favourable capital treatment in certain jurisdictions.

The cover pool must provide sufficient collateral to satisfy bondholder claims throughout the entire term of the covered bond. While in a typical securitisation, the collateral consists of a fixed pool of mortgages that is constantly amortising and pre-paying, in a covered bond transaction, the pool must be replenished as mortgages are prepaid so that the remaining portfolio is always sufficient to fully back the covered bonds. As a result, the cover pool securing a covered bond will change over the life of the bond, with new loans that meet the eligibility criteria being added on a regular basis. This ability to substitute assets arguably offers more flexibility to the issuer and protection for investors than a static pool. Active management of the cover pool allows the issuer to substitute higher quality loans for those in distress or default, maintaining a higher quality cover pool overall.

Despite the attractiveness of covered bonds, there are some drawbacks that potential issuers must understand. First, the cover pool may only consist of high quality mortgage loans, while a wider variety of mortgage loans, including subprime, high loan to value, and other non-prime mortgage loans, can be effectively securitised. Second, while a typical securitisation transaction is often structured to ensure off-balance sheet treatment of the securitised assets, in a covered bond deal, the cover pool stays on-balance sheet. Finally, there are a variety of limitations on who can issue covered bonds (generally only highly rated financial institutions), while many unrated non-financial entities have completed successful securitisation transactions.

Structure and differences from traditional securitisation

Covered bonds are on-balance sheet transactions in which the issuer ►►

retains the risk of loss on the cover pool. On the other hand, a conventional mortgage securitisation transaction is off-balance sheet. Therefore, in a securitisation the risk is removed from the issuer's balance sheet at the time of issuance of the securities. Covered bond investors have full recourse to the issuer and the cover pool which is constantly monitored and revised whereas investors in residential and commercial mortgage backed securities have recourse to the original pool of securitised assets only.

Covered bonds typically have lower spreads than securitisation bonds. This is partially because, as mentioned above, in terms of collateral, covered bond statutes or contractual provisions in structured covered bond deals only allow the use of high quality, low loan to value mortgages, while assets of varying quality may be included in securitisation transactions.

US covered bonds issuances to date have been structured to have bank issued mortgage bonds backed by a cover pool of residential mortgages that remain on the bank's balance sheet. In the event of the bank's insolvency, the bondholder indirectly receives payments from the cover pool. This model utilises structured finance techniques, including using a special purpose entity as the issuer. The covered bonds constitute limited recourse obligations of the issuer and are secured primarily by the related series of mortgage bonds issued by a bank. To oversimplify, the covered bonds are secured by the mortgage bonds, which are in turn secured by the mortgage loans.

The limitations imposed by the US insolvency regime and the absence of covered bond legislation are fundamental in explaining the use of this structure. In the event of a bank's insolvency, the FDIC is appointed conservator or receiver for the insolvent bank. In such capacity, the FDIC has the power to repudiate a contract entered into by the relevant institution and limit the amount of compensation paid to 'actual direct compensatory damages'. As a result, the special purpose entity that issues the covered bonds is required to invest all of the damages paid by the FDIC in a guaranteed investment contract or similar instrument. The income produced from this instrument can be used by the covered bond issuer to pay interest on the covered bonds until their maturity.

To further support this structure, a swap is entered into to cover shortfalls in interest that may arise between the appointment of the FDIC, as conservator or receiver, and the time that damages/proceeds are received and invested by the covered bond issuer. Furthermore, under current FDIC regulations, there is an automatic stay for as long as 90 days of any attempt to foreclose on a failed bank's property or to affect its rights under contract. As a result, the 90 day delay could cause missed payments on the covered bonds, which forces issuers to enter into third party contracts to cover the risk of non-payment, adding expense to the transaction.

On 15 April 2008, the FDIC issued an interim final policy statement, subject to comments received within 60 days, that removes these impediments for qualifying covered bonds. In the event of the issuing bank's insolvency, the FDIC, in its capacity as conservator or receiver,

would consent to the exercise of rights over the covered bond collateral as soon as 10 business days after a monetary default of the bank on the covered bond obligations or 10 business days after the FDIC repudiates the contract in writing. To qualify for such treatment, the term of the covered bond must be greater than one year but no more than 10 years, the bank's total covered bond obligations at issuance of such covered bonds must not exceed 4 percent of the bank's total liabilities, and the collateral securing the bonds must be limited to performing mortgages on one to four family residential properties, underwritten at the fully indexed rate and in accordance with existing guidance on residential mortgages and relying on documented income (eligible mortgages). Up to 10 percent of the collateral may consist of AAA rated mortgage securities backed by eligible mortgages.

This interim final policy statement should provide comfort to issuers and investors with respect to covered bond transactions that meet the foregoing criteria. It is important to note that at this point neither commercial mortgage loans nor AAA rated commercial mortgage backed securities (CMBS) nor other high quality assets such as government guaranteed students loans qualify as eligible mortgages. As a result, covered bond transactions issued by banks that contain such assets would still be subject to the 90 day stay. The interim final policy statement contemplates possible later changes in response to comments received, and we anticipate there will be industry comments to expand the eligibility criteria to include certain high quality commercial loans, CMBS and other high quality assets.

In recent months, it has become difficult to sell mortgage backed securities, and there is increasing speculation that an emerging covered bond market could help amid the current credit crisis by providing another mechanism for funding mortgage loans. Also, regulators and certain investors appear to believe that covered bonds would encourage more conservative underwriting and risk management than has been the case with securitisation, as the issuing bank would hold the cover pool on its balance sheet.

Covered bonds have played, and will continue to play, an important role in the financial system in Europe and contribute not only to the efficient allocation of capital, but also ultimately to economic growth. Covered bonds manage to offer a hybrid approach between traditional bank lending and securitisation because they allow banks to tap into the capital markets while holding the cover pool on their books. As a result of the long, stable history of the covered bond market in Europe and the many benefits covered bonds provide, it would not be surprising to see the rapid development of a covered bond market in the US as a means to finance mortgage loans and other high quality assets in the post credit crisis world. ■

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David W. Forti is a partner in the finance and real estate group. His practice is focused in the areas of real estate finance and securitization. Mr. Forti is also lead outside counsel to the commercial mortgage securitization group of an international rating agency. Mr. Forti represents various lenders, issuers, master servicers, and special servicers in transactions involving loan origination, mezzanine financing, CMBS securitization, post-closing modifications, work-outs, and foreclosures.

Mr. Forti is active in the Commercial Mortgage Securities Association (CMSA) and the Mortgage Bankers Association (MBA) and has served on numerous CMSA and MBA committees. He is a regular author and speaker on a wide range of issues affecting real estate finance and securitization.

Mr. Forti was among only 61 U.S. lawyers selected for inclusion in the International Who's Who of

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Mr. Gatti has represented issuers and other parties in transactions involving all types of mortgage-related assets, including home equity loans and lines of credit, NIMs, manufactured

housing installment contracts, FHA Title 1 loans, commercial mortgages, resecuritizations of commercial mortgage loans, and multifamily loans. He has also represented parties in transactions involving many other asset types including auto loans, equipment leases, tobacco litigation settlement fees, recreational vehicle contracts, charged off credit cards, whole businesses, health care receivables, entertainment events, and life insurance settlements. In addition, Mr. Gatti has represented originators in the sale of receivables both in whole loan sales and into commercial paper conduits and in the negotiation of warehouse facilities.

Over the past several years, Mr. Gatti has also been actively involved in the securitization bankruptcy and workout process as counsel to creditors' committees, securitization trustees, and bondholders. Significant representations in this area involve having served as special counsel to the official creditors committee in the bankruptcy of a leading manufactured housing company and as special securitization counsel to the creditors' committee in a transaction that challenged the true sale basis underlying the debtor's securitization.