

UNITED STATES COVERED BOND ACT OF 2011

SUMMARY AND SECTION-BY-SECTION ANALYSIS

Summary

The purpose of the United States Covered Bond Act of 2011 is the creation of a legislative framework for U.S. covered bonds.¹

This framework will enable credit to flow more readily from the capital markets to households, small businesses, and State and local governments in a way that enhances the stability of the broader financial system.

With this framework in place, covered bonds (1) can infuse stable, longer term liquidity into the credit markets and reduce refinancing risks, (2) can generate less expensive and more available credit for borrowers of all kinds, (3) can mitigate systemic risk by enabling financial institutions to draw liquidity from a separate investor base that would not otherwise make funds available through the unsecured-debt or securitization markets, (4) can supply private-sector funding even in distressed market conditions without relying on U.S. taxpayers for support, (5) can align incentives relating to loan underwriting, performance, and modification because of the issuer's retention of 100% "skin in the game," and (6) can increase transparency and uniformity in the capital markets with their straightforward structure.

The core elements of the legislative framework are legal certainty for covered bond programs and public supervision by federal regulators.

The legal status of covered bonds is established by specifying the categories of eligible issuers and eligible cover-pool assets, mandating an asset coverage test for cover pools and audits by an independent asset monitor, and clarifying applicable securities and tax matters. Most important, since covered bonds are distinguished from other forms of secured debt by a mechanism for managing (rather than liquidating) the cover pool upon the issuer's default or insolvency and continuing scheduled (rather than accelerated) payments, the framework creates a separate resolution process for covered bond programs.

Public supervision designed to protect covered bondholders is supplied by requiring a regulatory oversight program. The oversight program is created by the Secretary of the Treasury in consultation with applicable prudential regulators, which are designated under the

¹ A covered bond is a form of high-grade senior debt that is issued by a regulated financial institution and that is secured – or “covered” – by a dynamic cover pool of financial assets which is continually replenished. Today, almost 30 countries across Europe have adopted national legislation to govern covered bonds. These include Germany, France, the United Kingdom, the Netherlands, Spain, Italy, Russia, Denmark, Ireland, Portugal, the Czech Republic, the Slovak Republic, Austria, Hungary, Slovenia, Switzerland, Luxembourg, Sweden, Finland, Norway, Poland, Latvia, Lithuania, Ukraine, Romania, Bulgaria, Greece, Armenia, and Turkey.

Act as covered bond regulators. For each eligible issuer, the oversight program is administered by the applicable covered bond regulator.

Section-by-Section Analysis

Section 1. Short Title.

Section 2. Definitions.

Contains various definitions used in the Act, including those for “covered bonds,” “eligible issuers,” “eligible assets,” and “covered bond regulators.”

Section 3. Regulatory Oversight of Covered Bond Programs Established.

Directs the Secretary of the Treasury, in consultation with the covered bond regulators, to issue regulations establishing a covered bond regulatory oversight program. Provides each covered bond regulator with authority to approve the covered bond programs of eligible issuers under its primary supervision. Requires the Secretary to maintain a public registry of approved covered bond programs. Authorizes each covered bond regulator to levy fees on the covered bond issuers under its primary supervision in order to cover the costs of administering the oversight program.

Directs the Secretary, in consultation with the covered bond regulators, to establish minimum over-collateralization requirements for covered bonds backed by each of the different eligible asset classes. Requires each cover pool securing covered bonds to satisfy an asset coverage test that assesses whether the minimum over-collateralization requirements are met, and obligates the issuer and an independent asset monitor to confirm on a periodic basis whether the asset coverage test is satisfied. Specifies eligibility criteria for cover pools and recordkeeping obligations of eligible issuers.

Section 4. Resolution upon Default or Insolvency.

Creates, if covered bonds default before the issuer enters conservatorship, receivership, liquidation, or bankruptcy, a separate estate that is comprised of the applicable cover pool and that assumes liability for the covered bonds and any related obligations secured by that cover pool. Preserves deficiency claims against the issuer. Creates for the issuer a residual interest that represents the right to any surplus from the cover pool. Obligates the issuer to transfer applicable books, records, files, and other documents to the trustee of the estate or a designee of the trustee and, at the election of the trustee, to continue servicing the cover pool for 120 days.

If the FDIC is appointed as conservator or receiver for an issuer before a default on its covered bonds results in the creation of an estate, provides the FDIC with an exclusive right for 180 days to transfer the issuer’s covered bond program to another eligible issuer. Requires the FDIC as conservator or receiver, during the 180-day period, to perform all monetary and nonmonetary obligations of the issuer until the FDIC completes the transfer of the covered bond program, the FDIC affirmatively elects to cease further performance, or the FDIC fails to perform or cure any default (other than the issuer’s conservatorship or receivership).

Creates a separate estate if another conservator, receiver, liquidator, or bankruptcy trustee is appointed for an issuer before a default on its covered bonds results in the creation of an estate or if the FDIC as conservator or receiver does not timely effect a transfer of the covered bond program to another eligible issuer, affirmatively elects to cease further performance, or fails to perform or cure any default. Causes the estate to be comprised of the applicable cover pool and to assume liability for the covered bonds and any related obligations secured by that cover pool. Requires the conservator, receiver, liquidating agent, or bankruptcy court to estimate and allow any contingent deficiency claim against the issuer. Creates for the conservator, receiver, liquidating agent, or bankruptcy trustee a residual interest that represents the right to any surplus from the cover pool. Obligates the conservator, receiver, liquidating agent, or bankruptcy trustee to transfer applicable books, records, files, and other documents to the trustee of the estate or a designee of the trustee and, at the election of the trustee, to continue servicing the cover pool for 120 days.

Provides for the applicable covered bond regulator to act as or appoint the trustee of the estate. Directs the covered bond regulator to appoint and supervise a servicer or administrator for the cover pool held by the estate. Requires the trustee to administer the estate. Requires the servicer or administrator to collect, realize on, and manage the cover pool and to invest the proceeds. Allows the covered bond regulator to remove and replace any trustee, servicer, or administrator. Limits judicial, administrative, and other actions that may be brought against the estate or that would affect its resolution.

Authorizes the servicer or administrator to borrow funds or otherwise obtain credit for the benefit of the estate on a secured or unsecured basis and on a priority, *pari passu*, or subordinated basis. Requires a study by the Government Accountability Office on whether estates should be authorized to borrow from a Federal Reserve Bank to manage liquidity (though not credit) risks and, if so, on what conditions.

Provides for distributions by the estate to make required payments on the covered bonds and to satisfy other liabilities of the estate. Provides for distributions by the estate on the residual interest. Requires the trustee to close the estate once fully administered. Makes clear that taxpayers will not bear any loss from the resolution of an estate.

Section 5. Securities Law Provisions.

Clarifies that covered bonds are securities but not asset-backed securities. Creates exemptions for estates and residual interests.

Section 6. Miscellaneous Provisions.

Expands the Secondary Mortgage Market Enhancement Act of 1984 to encompass covered bonds.

Specifies that an estate is not a taxable entity and that no transfer of assets or liabilities to an estate is a taxable event under the Internal Revenue Code and, to the extent provided by the Secretary, under State and local income-tax laws.

Provides for covered bonds that are backed by the residential mortgage asset class, the home equity asset class, or the commercial mortgage asset class to be qualified mortgages for Real Estate Mortgage Investment Conduits (REMICs) and, to the extent provided by the Secretary of the Treasury, to be treated as real estate assets in the same manner as REMIC regular interests.

Clarifies that the acquisition of a covered bond is treated as the acquisition of an investment security, and not as a lending transaction, under the Internal Revenue Code.

Confirms that other bankruptcy or insolvency laws may not be construed or applied to interfere with the operation of the Act.