News Bulletin

June 30, 2008

Something to Talk About

When the Federal Deposit Insurance Corporation (the "FDIC") issued its Interim Final Covered Bond Policy Statement on April 15, 2008, they gave the market something to talk about, and talk they did. While applauding the FDIC for its effort to provide greater certainty for covered bonds in the United States, commentators generally believe the policy statement falls short of what's needed in order for a vibrant market to develop.

Compensatory Damages

Commentators stress the need for the FDIC to provide a definitive statement regarding the actual compensatory damages the FDIC will pay holders if it is acting as conservator or receiver for the covered bond issuer. Under the Federal Deposit Insurance Act, as conservator or receiver of an FDIC-insured institution, the FDIC has the power to repudiate contracts. Under the existing regime, uncertainly exists as to what damages the FDIC may pay, leaving the risk that investors may lose a portion of their principal. Commentators encourage the FDIC to confirm that actual direct compensatory damages upon repudiation or liquidation will equal outstanding principal amounts plus accrued and unpaid interest on covered bonds. The American Securitization Forum, or ASF, suggests that the FDIC also clarify that damages include costs associated with investing the proceeds of the cover pool. Confirmation from the FDIC would bring U.S. covered bondholders in line with European covered bondholders who are entitled to receive payment in full upon an issuer insolvency and also participate in the proceeds of the cover pool.

Eligible Mortgages

Many requested that the FDIC amend the narrow definition of eligible mortgage. The policy statement defines "eligible mortgages" to include only performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income. Eligible mortgages also must be underwritten in accordance with existing supervisory guidance governing the underwriting of residential mortgages. Commentators note that this definition is unclear – for instance, is it required that supervisory guidance be in place at the time the loan is underwritten or at the time of the policy statement? Is this an attempt, on the FDIC's part, to regulate the standards pursuant to which loans are originated?

The mortgages underlying existing U.S. issued covered bonds would not qualify as "eligible mortgages" and, as a general matter, few existing mortgages would meet the FDIC's standard. In addition to suggesting that the FDIC grandfather existing covered bond programs, some commentators suggest that the criteria for determining "eligible mortgages" be based on LTV, delinquency and negative amortization.

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Cover Pool

The policy statement permits a covered bond to be secured by residential mortgage loans and by AAA-rated mortgage bonds, not exceeding ten percent of the collateral. Commentators suggest that the FDIC broaden the types of assets that may be included in cover pools, such as permitting inclusion of multi-family residential loans, home equity lines of credit, second-lien home equity loans, commercial mortgage loans, public sector loans, government and agency securities, agency mortgage backed securities, student loans, highly rated money market securities and credit card receivables.

Flexibility

Comments stressed that the FDIC should encourage innovation in order for the covered bond market in the U.S. to gain some momentum. Along these lines, many objected to the limitation on maturities, noting that market demand and existing bank regulations should dictate the tenor of covered bonds. The ASF and Bank of America further noted that European covered bonds are not subject to similar restrictions and maturities there are often 15 years and even as long as 50 years. Commentators also objected to the FDIC's 4% hard cap on issuances, instead favoring either a system that requires regulatory approval for issuances in excess of a stated cap or doing away with the cap and requiring that issuances be made in compliance with existing regulations regarding safe and sound practices. Those in favor of modified limitations favored issuance limits based on assets, not liabilities, as is more typical in other jurisdictions. Commentators objected to the FDIC's requirement that an issuer obtain the consent of its primary regulator prior to each issuance.

Conclusion

In addition to the concerns discussed above, participants made a number of other suggestions intended to provide certainty to, and greater flexibility for, the U.S. covered bond market. For example, one commentator recommended that the FDIC explicitly state that it will not consolidate a special purpose entity used solely to issue or guarantee a bank's covered bonds upon a bank insolvency. This would enable U.S. banks to use an issuance structure more similar to that used in Europe. The ASF also recommended that the FDIC permit the SPV issuer to hold the assets in the cover pool rather than engage in a fire sale of assets upon appointment of a receivership or conservatorship in order to preserve the value of the cover pool and avoid a loss of principal for the covered bondholders. To facilitate this, the FDIC must recognize the separate existence of the SPV and refrain from seeking to reclaim or recover the cover pool until such time as a liquidation that maximizes the value of the cover pool can occur.

Contacts

Anna Pinedo
(212) 468-8179
apinedo@mofo.com

Oliver Ireland
(202) 77 8-1614
oireland@mofo.com

Mara Goldsmith
(212) 336-8472
mgoldsmith@mofo.com

Kenneth Kohler
(213) 892-5815
kkohler@mofo.com

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