News Bulletin

July 29, 2008

Treasury Announces Best Practices for Covered Bonds

On July 28, 2008 Treasury Secretary Paulson announced the publication of a Best Practices guide for U.S. covered bonds, intended to promote covered bond issuances. Flanked by regulators, including the Chair of the FDIC, the OCC Comptroller, the Governor of the Federal Reserve, and representatives from large financial institutions, Paulson stated that "covered bonds have the potential to increase mortgage financing, improve underwriting standards, and strengthen U.S. financial institutions by providing a new funding source that will diversify their overall portfolio." The Best Practices are intended as a complement to the FDIC's Final Covered Bond Policy Statement issued on July 15, 2008[1]. In connection with Paulson's announcement, four financial institutions, Bank of America, Citigroup, JP Morgan and Wells Fargo announced plans to issue covered bonds.

The Best Practices establish a template for U.S. covered bond issuances and outline additional standards for covered bonds that will bolster investor confidence in these instruments. We summarize below the principal standards enumerated in the Best Practices.

Cover Pool

In order to be eligible for inclusion in the cover pool, collateral must have a maximum loan-to-value ("LTV") of 80% at the time of inclusion. No single Metro Statistical Area may make up more than 20% of the cover pool. Negative amortization mortgages are not eligible for inclusion in the cover pool. Mortgages in the cover pool must be first lien only. The Best Practices recommend that an issuer maintain an overcollateralization value of at least 5% of the outstanding principal amount of the covered bonds at all times. For purposes of calculating the minimum overcollateralization required, only the 80% portion of the LTV will be credited.

Payments

The Best Practices recommend that at the time of issuance, the covered bond issuer enter into one or more swap agreements to: (1) provide scheduled interest payments in case the issuer becomes insolvent and (2) to mitigate timing mismatches between interest payments and interest income, if applicable. This is consistent with the covered bond issuance structure that has been used in the U.S. If covered bonds are denominated in a currency other than U.S. dollars, the Best Practices suggest that a currency swap also be entered into at issuance. Also, consistent with the current covered bond issuance programs, the Best Practices recommend that the covered bond issuer enter into a deposit agreement – a guaranteed investment contract, or other arrangement (a Specified Investment), whereby the proceeds of the cover pool assets are invested at the time of issuance with one or by one or more financially sound counterparties. The Specified Investment should pay ongoing scheduled interest and principal payments after a default or repudiation by the FDIC, so long as the Specified Investment provider receives proceeds from the cover pool assets at least equal to the par value of the covered bonds.

[1] Please see our client alert on the FDIC's Final Covered Bond Policy Statement at http://www.mofo.com/news/updates/files/080716FDIC.pdf

Disclosure

The issuer must make available to investors descriptive information about the cover pool at the time of issuance (when the investment decision is made) and on a monthly basis thereafter. If more than 10% of the cover pool is substituted within any month, or more than 20% within any quarter, the issuer should provide updated information on the cover pool to investors. The issuer must perform a monthly asset coverage test on the cover pool to ensure collateral quality and the proper level of overcollateralization, and for necessary substitutions. The results of each asset coverage test must be made available to investors. In addition, the depository institution and the SPV (if one is used) should disclose any other information that an investor might view as material to its investment decision.

Defaults

The same cover pool may be applied to multiple covered bond issuances. In the event of a default, any losses must be allocated pro rata across the cover bond issuances that rely on the same cover pool. If the asset coverage test is breached, the issuer has one month to correct the breach. If it is not corrected, the trustee may terminate the covered bond program and principal and accrued interest will be returned to investors.

Other details

The Best Practices specifically contemplate covered bond issuances either through a newly created, bankruptcy-remote SPV or directly by the depository institution and/or a wholly-owned subsidiary. Under the direct issuance approach, the issuing institution must designate a pool of residential mortgages that will constitute the cover pool. The Best Practices also specify that covered bonds may be issued either as registered securities or pursuant to an exemption from the registration requirements of the Securities Act.

Conclusion

With the publication of the Best Practices, the Treasury Department has taken another step toward facilitating the development of a U.S. covered bond market. As Treasury Secretary Paulson indicated in his remarks, the Best Practices may serve “as a starting-point for the market” and bring to the U.S. market the “homogeneity and simplicity” offered by the regulatory framework in European jurisdictions.

For more on covered bonds, please see our prior client alerts:
http://www.mofo.com/news/updates/files/080716FDIC.pdf
http://www.mofo.com/docs/pdf/080630SomethingTalk.pdf
http://www.mofo.com/docs/pdf/CoveredBondsUSregulator.pdf

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We are thought leaders in covered bonds in both the United States and the United Kingdom. Our knowledge of bank regulatory issues, financial institutions and financing techniques makes us the first call for covered bond issuances by financial institutions. Our innovative work in covered bonds received recognition recently from IFLR, which selected us as Securitization Team of the Year (2008). With more than 1000 lawyers in 17 offices worldwide, we offer clients comprehensive, global legal services.

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