Covered Bond Legislation: Is the Fourth Time the Charm?

On March 18, 2010, Representative Scott Garrett (R-NJ) introduced a covered bond bill for the fourth time since the start of the financial crisis. The latest bill, entitled the United States Covered Bond Act of 2010 (the “Covered Bond Act”), was co-sponsored by Representative Paul Kanjorski (D-PA) and Representative Spencer Bachus (R-AL). The Covered Bond Act is similar to the draft amendment to the Wall Street Reform and Consumer Protection Act of 2009 (the “Amendment”) that Representative Garrett submitted in November 2009 but subsequently withdrew at the request of the House of Representatives’ Financial Services Committee Chairman Barney Frank, and is more complete than the Equal Treatment for Covered Bonds Act that Representative Garrett first introduced in 2008 and reintroduced with Representative Kanjorski’s support in June 2009. A copy of the Covered Bond Act is available at http://cmbs.informz.net/cmbs/data/images/garrett-kanjorski-bachus.pdf. A copy of the Amendment is available at http://www.coveredbondinvestor.com/sites/default/files/Covered%20Bond%20Amendment.pdf and a copy of the June 2009 Equal Treatment for Covered Bonds Act is available at http://www.coveredbondinvestor.com/sites/default/files/ETCBA%202009.pdf.

The Covered Bond Act adopts a statutory structure for covered bonds issued by U.S. institutions similar to the structure successfully used in the European covered bond market by European financial institutions. The key elements of the Covered Bond Act that would establish a structure similar to the European structure are: (1) requirement that an independent asset monitor be appointed and that an asset coverage test be satisfied, (2) separation of the cover pool from the issuer in the event of the insolvency or default of an issuer or transfer of the cover pool and the obligation on the covered bonds to an assuming bank in the event of the insolvency of an issuing bank, and (3) designation of a covered bond regulator (in this instance, the Secretary of the Treasury) as the trustee of the separated cover pool to act for the benefit of the covered bondholders.

Additional elements of the Covered Bond Act include (1) the authority of the separate cover pool to borrow on a secured or unsecured basis from the private markets in order to obtain liquidity to make required payments on the covered bonds, (2) a residual interest in the cover pool to be issued to the FDIC or other receiver, which will receive any remaining value in the cover pool after payment in full of the covered bonds, (3) a variety of eligible asset classes for the cover pool, and (4) a mechanism for registering existing covered bond programs. These elements are discussed in more detail below.

In addition, the Covered Bond Act exempts covered bonds issued by a bank or a subsidiary of a bank or an entity sponsored by one or more banks from the federal securities law other than regulations issued by the issuer’s primary federal regulator and applicable anti-fraud rules. Covered bonds issued by other eligible issuers would be subject to a streamlined registration scheme to be adopted by the Securities and Exchange Commission.
Separation of the Cover Pool from Estate of Failed Issuer

The Covered Bond Act sets forth a procedure for separating and transferring a cover pool in the event that the issuer has failed or defaulted on its covered bonds. If the FDIC is not appointed as a receiver, the cover pool is separated immediately from the estate of the issuer. This may be the case for a non-bank issuer or for a bank issuer that has defaulted prior to an appointment of the FDIC as receiver. If the FDIC is appointed as conservator or receiver of a failed institution prior to a default on the covered bonds, the Covered Bond Act provides a 15 day period for the FDIC to transfer the cover pool and the covered bond obligations to an assuming institution. If the cover pool and the covered bonds are not transferred to an assuming institution within the 15 day period, then the cover pool will be separated from the estate of the failed institution and treated as a separate estate.

Once a separate estate is established, the Secretary of the Treasury, as covered bond regulator, is appointed as the trustee, and the covered bond regulator has the authority to appoint and supervise a servicer and administrator. The bill permits the servicer or administrator to borrow on a secured or unsecured basis for the benefit of the estate to manage any liquidity constraints caused by a timing mismatch among the assets and liabilities of the estate. The bill directs the trustee, conservator, receiver or bankruptcy court to estimate and allow any contingent deficiency claim against the issuer.

The covered bond regulator has the power to require the issuer or the conservator, receiver, liquidator or bankruptcy court to turn over all the books and records relating to the cover pool and continue servicing the cover pool for 120 days, subject in the event of an insolvency to any right of repudiation or rejection by the FDIC.

Most of these provisions were in the Amendment; however, there are two major differences. First, the Amendment permitted the newly created estate to borrow on a secured basis from the Federal Financing Bank to provide liquidity to meet payment obligations on outstanding covered bonds, whereas the Covered Bond Act only provides for private sector borrowing. Second, the Covered Bond Act revises the Internal Revenue Code to provide that the creation of the estate will not be taxable as a separate entity and the transfer of assets and liabilities to such estate will not be a taxable event, a provision that was not in the Amendment. Also the acquisition of a covered bond will be treated as an acquisition of a security and not an interest in a loan or a lending transaction for the purpose of determining the character of any related trade or business activity of the acquirer or any asset held by such acquirer.

Creation of Residual Interest

In the event that the cover pool is separated from the estate of the issuer, the Covered Bond Act provides for the creation of a residual interest in the cover pool for the benefit of the issuer or the FDIC or third party as receiver. Any remaining value in the cover pool after payment in full of the covered bonds will belong to the issuer or the FDIC or third party as receiver.

Eligible Issuers, Assets and Asset Classes

The Covered Bond Act defines eligible issuers as any insured depository institution or subsidiary thereof, any bank holding company, any savings and loan holding company, or any entity sponsored by one or more eligible issuers. This definition differs from the definition in the Amendment, which also included any regulated financial institution that is approved, and determined to be systemically important.

The bill defines various eligible asset classes to be included in cover pools: residential mortgage loans, home equity loans, commercial mortgage loans, student loans, auto loans, credit card receivables, municipal and state obligations, small business loans and any other asset class designated by the covered bond regulator. Loan assets would be eligible assets only if they are not more than 60 days delinquent.
Although the Covered Bond Act includes a number of eligible asset classes beyond mortgage loans, the Covered Bond Act expressly states that a cover pool for a covered bond program may include only one asset class. An issuer could establish more than one covered bond program in order to issue using other asset classes. Each covered bond program must be approved by the covered bond regulator and the covered bond regulator is required to maintain a public registry listing each approved covered bond program and information on the outstanding covered bonds.

The bill amends the Internal Revenue Code to provide that covered bonds that are secured by eligible assets within the residential mortgage, home equity, and commercial mortgage loan classes be deemed qualified mortgages for real estate mortgage investment conduits, or REMICs. The provision was not included in the Amendment.

Registration of Existing Programs

The Covered Bond Act permits the registration of existing covered bond programs. Existing programs that are approved by the covered bond regulator will be subject to the Covered Bond Act, and therefore exempt from the federal securities laws except for regulations issued by the issuer’s primary federal regulator and applicable anti-fraud rules. This is a new provision that was not in the Amendment.

What Next?

Generally, there has been strong bipartisan support for covered bonds. At the hearing held on December 15, 2009 before the Financial Services Committee of the House of Representatives, a number of Representatives from both parties spoke out in support of covered bonds. The fact that covered bonds have been used extensively in Europe and that the European covered bond market proved resilient in recovering from the financial crisis has been viewed by some as evidence that covered bonds could provide essential liquidity to the U.S. mortgage market. With growing political discord over mounting losses at Fannie Mae and Freddie Mac, many industry participants are hopeful that the bipartisan support will provide the needed momentum to establish an alternative private market for mortgage financing. And the fact that the issuing institution retains ownership of assets in the cover pool is viewed as likely to improve underwriting standards and to make it much easier to make modifications to a borrower’s loan.

While there is generally support for the creation of a statutory structure for covered bonds in the U.S., there was some disagreement at the December hearing about how strict the statutory requirements for collateral should be and whether initially covered bonds should be restricted to longer term assets such as residential and commercial mortgage loans.

Prospects and timing for the bill are difficult to forecast. The strong bipartisan support for the Amendment at the December hearing would suggest the prospects for passage are good if the bill can attract the necessary attention in a very crowded legislative calendar. Attachment of the bill to a major piece of legislation, particularly financial reform legislation, may provide the best prospects for early passage.

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