United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220


Dear Sir or Madam:

The press release issued by the Department of the Treasury on June 26, 2014, requested comment on “facilitating the development of market practices and standards that would be necessary to support a safe and sustainable PLS housing finance channel of significant scale and liquidity to improve the overall efficiency of the U.S. housing finance system.”

While many commentators will focus on restoring the private RMBS market, that would appear to be a complicated and lengthy process. Although restoration of a vibrant private RMBS market is desirable, it would also seem prudent based on recent experience to establish additional channels for financing residential mortgage loans with private funds.

The financial crisis, particularly the role played by mortgage securitization, has brought critical focus to how residential mortgage loans should be financed. As a result, there is broad agreement on some of the key attributes that a safe and sustainable channel for private financing of residential mortgage loans should have:

[1] an alignment of interests between investors, issuers and servicers;
[2] the use of quality underwriting standards by originators of mortgage loans;
[3] flexibility to modify mortgage loans to assist borrowers having difficulty meeting their loan payments;
[4] the ability of borrowers to continue to deal with the same institution in connection with their mortgage loans;
[5] the presence of a trustee with fiduciary obligations to investors;
[6] a simple investment without complex payment characteristics;
[7] transparency for regulators so that the exposure of the bank is readily apparent;

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2 The items in the list are identified throughout the letter by number.
additional diversification of the investor base;
active review and oversight of the financing activity;
clearly defined roles for all the transaction parties; and
a resilient market capable of performing throughout a crisis.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 sought, in part, to achieve these goals through the reformation of securitization and tighter regulation of mortgage origination and servicing. Four years later, we are still in the process of implementing these Dodd-Frank Act provisions due to the complexities of securitization.

An Available Private Funding Solution
Many of the attributes listed above for a private funding channel could be met by implementing a framework for covered bonds in the United States. Covered bonds are a financing technique used broadly outside the United States. The covered bond market has existed in Europe for more than 200 years without ever experiencing a default. The market in Europe is currently about $3 trillion of outstanding covered bonds. This suggests that covered bonds could provide a significant source of funding for U.S. banks.

The Nature of Covered Bonds
Unlike RMBS, covered bonds are not designed to transfer underwriting risk on mortgage loans to third parties. Instead, covered bonds are used for portfolio financing for those loans that a bank wishes to retain for its own account. In this sense, covered bonds are similar to auto loan and credit card financing, which are designed to provide financing, not risk transfer.

Covered bonds are dual-recourse instruments, providing investors with a claim on the bank issuing a covered bond, and, if the bank fails, a preferential claim on the assets in the cover pool securing the covered bond. This dual-recourse feature creates a conservative instrument attractive to investors who favor sovereign debt or sovereign agency bonds and who view the risk profile of covered bonds as similar.

A key feature of covered bonds is that the bonds remain outstanding and paid in accordance with their schedule if the issuing bank becomes insolvent. As long as the issuing bank is solvent, the obligation to pay the bonds is a senior obligation of the issuing bank. In the event the issuing bank defaults or becomes insolvent, cash proceeds from assets in the cover pool are used to pay the bonds as scheduled, through their scheduled maturity dates.

Covered bonds are issued in single classes, without tranching. The bonds may be fixed rate or floating rate and will have a bullet maturity, i.e., there is no principal amortization -- the principal is all due at maturity. From time to time, additional series of bonds may be issued against the same cover pool so long as there are sufficient loans in the cover pool.
Alignment of Interests - Investor Protection

The nature of covered bonds provides many desirable protections for investors:

- covered bonds are issued by financial institutions subject to regulation by banking authorities [9];
- an asset monitor, usually an accounting firm, is appointed for each covered bond program and the asset monitor is responsible for reviewing at least annually the issuing bank’s calculation of the asset coverage test, which is a test of the sufficiency of the cover pool to repay the bonds in accordance with their terms;
- seriously delinquent and defaulted assets in the cover pool must be replaced by the issuing bank with performing loans. This means that at all times prior to insolvency of the issuing bank, investors have the benefit of fully performing loans in the cover pool;
- covered bonds are issued under classic trust indentures, which provide for fiduciary duties on the part of the indenture trustee [5];
- assets in the cover pool continue to be owned by the issuing bank, which means that the issuing bank has 100% “skin-in-the-game.” This also means that the issuing bank continues to hold capital against the assets in the cover pool; covered bonds are not used to achieve capital relief;
- establishment and operation of covered bond programs are subject to the oversight of a covered bond regulator [9], who sets standards for covered bonds by regulation;
- covered bond frameworks are established by statute, defining eligible issuers, eligible assets, asset quality, minimum over-collateralization levels in cover pools and the authority of the covered bond regulator.

These features of covered bonds tend to align the interests of investors, issuing banks, servicers and regulators [1] to a degree not achievable with securitization.

Regulatory Benefits of Covered Bonds

As a financing tool, covered bonds provide some important regulatory policy benefits. Unlike RMBS, the mortgage loans backing covered bonds are not sold, but instead remain on the balance sheet of the issuing bank. Because a loan is not sold, a bank retains control of the loan and is better able to make changes to loan terms to accommodate borrowers [3] who are experiencing difficulties in meeting their payment obligations. It also means that borrowers continue to deal with the same institution throughout the life of their loans [4]. Retention of ownership also facilitates a bank complying with consent orders related to servicing or underwriting practices.

This retention of ownership of the mortgage loans encourages banks to employ more conservative underwriting criteria [2]. As a result, the mortgage loan pools for covered bonds tend to hold high quality mortgage loans, which, when combined with the dual-recourse nature of the instrument, leads investors to view covered bonds as having a risk profile similar to high

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3 See, Seizing the Opportunity, IFLR July/August 2014 at 64, attached as Appendix A.
quality sovereign debt. Accordingly, covered bonds provide very attractive financing rates for
issuing banks.

Because covered bond investors generally do not purchase corporate debt or private RMBS,
covered bonds open up a new investor base for banks, providing critically important funding
diversification [8]. In a crisis, this diversification can provide continued funding when other
funding channels are closed. In Europe, the covered bond markets continued to provide
European banks with funding throughout the crisis [11].

Analytically Simpler for Investors
Covered bonds provide simplicity for an investor. In contrast, a securitization presents a
considerably more complex investment decision. Securitizations typically involve complex
security class structures that result in complex payment provisions. An RMBS offering may
involve 20 or 25 classes of securities supported from a single pool of loans. And the class
structures and payment mechanisms are very seldom the same on consecutive offerings.
Accordingly, on each offering an investor must commit significant resources to analyzing the
precise terms of the proposed investment, in addition to analyzing the performance risks of the
collateral pool, which will be unique for each offering. And finally, the risk of early or delayed
principal repayment must be analyzed, which risk can be critical to assessing the value of each
class of securities.

Covered bonds, on the other hand, provide a simpler investment proposition for the investor [6].
A covered bond is a senior debt offering of a regulated financial institution. The institution is
usually reviewed by several investment industry credit analysts, files extensive financial
statements with regulators and exchanges, and has listed common stock that has a long history of
public pricing. The institution is audited regularly by independent auditors and supervised by
regulators. Moreover the senior debt of the institution is rated by rating agencies and traded in
the secondary market, providing important pricing transparency and indications of continuing
credit evaluations.

Only if the issuing institution defaults on its covered bond debt does the strength of the cover
pool become important. Until then the issuing institution is bound to continually refresh the
cover pool with new loans to replace delinquent, defaulted or matured loans. At all times prior
to the default or insolvency of the institution, the cover pool should consist of fully performing
loans.

All series of covered bonds in a program are issued against the same cover pool, which
simplifies the analysis of the collateral for an investor. This enables an investor to build on the
up front analysis of a covered bond program by making successive investments in the same
program, unlike a securitization in which the collateral pool changes with each offering.
Moreover, covered bonds are not tranchable, so there is no complex class structure and payment mechanism [6]. And, because covered bonds are bullet pay securities, there is no prepayment risk to analyze. Covered bonds are primarily a payment obligation of the issuing institution, so the credit analysis is primarily an analysis of the credit worthiness of the issuing institution. This is a risk that is publicly reviewed by other analysts and supervised by regulatory authorities.

**Analytically Simpler for Rating Agencies**

The simpler structure of a covered bond also eases the task of the rating agencies in providing a rating. There are no complex rules governing how a multitude of bond classes are paid, since covered bonds have only a single class. Also prepayment rates on the mortgage loans are not a factor in when bonds are paid, since payments on the mortgage loans are used to acquire new mortgage loans in order to keep the cover pool replenished. As a result there is less “over reliance” on ratings.

**Regulatory Transparency**

From a regulator’s perspective, a bank’s exposure on its covered bonds is simpler to analyze than its securitization exposure. As the numerous recent litigation settlements by banks have shown, securitization exposes banks to significant costs that are not apparent in the financial statements or other disclosures of the banks. The aggregate settlement amount to date in the U.S. for the banking industry is estimated to exceed $100 billion and there is more to come. This exposure was not apparent to regulators pre-crisis. Securitization had been viewed by banks and regulators as a transfer of risk on the assets to investors, relieving the banks of exposure to the assets.

Covered bonds do not present this hidden risk to regulators [7] because the assets in the cover pool remain on the balance sheet of the issuing institution. The nature and performance of the assets is a constant audit and financial reporting item, readily apparent to the supervising agencies. Because the issuing institution retains 100% of the risk on the assets, it has a strong incentive to monitor and maintain high origination standards. This incentive tends to align the interests of the banks and the regulators in a way that securitization never will.

Cover pools provide dynamic coverage for covered bonds; i.e., the cover pool is tested monthly for its ability to pay the covered bonds in the event the issuing bank becomes insolvent. Loans must be replaced by the issuing bank as loans pay down or default. An abnormal level of replacement activity provides an early warning signal about the bank’s health, particularly the health of its residential mortgage sector.

**Relative Pricing**

The conservative nature of covered bonds leads to very attractive pricing for issuing banks. Most recently, Toronto-Dominion Bank issued €1.750 billion of 5-year covered bonds at 0.625%. This offering was priced at 7 basis points over mid-swaps, a very attractive rate relative to sovereign bonds which are viewed by investors as comparable risk.
Establishing a Covered Bond Framework
Many of the elements necessary for U.S. banks to issue covered bonds are in place or well developed. There is a substantial European market for covered bonds, there is a significant and growing U.S. investor base for covered bonds, the disclosure and reporting framework for covered bond is established, and legislation for covered bonds is well developed.

Existing U.S. Covered Bond Market
While as noted there is a very substantial market for covered bonds in Europe, there is also an existing covered bond market in the United States. There were some occasional issuances of U.S. dollar denominated covered bonds prior to 2010 when significant growth began. Today there are approximately $150 billion of U.S. dollar denominated covered bonds outstanding. Nearly all of this issuance has come from foreign banks financing foreign mortgage loans in the United States when funding rates are attractive or cross-currency swap costs are favorable. While Washington Mutual and Bank of America issued covered bonds in 2006 and 2007, no U.S. bank since then has issued covered bonds, due in part to the absence of a statutory framework. The structured technique used by Washington Mutual and Bank of America is no longer feasible in a post-crisis environment. Accordingly, although U.S. investors have found covered bonds very attractive, U.S. banks are unable to access this investor base, creating an uneven playing field.

Existing Disclosure Framework - SEC Registered Covered Bonds
The covered bond registration statements of three Canadian banks have now been approved by the Securities and Exchange Commission. This action has established standards for disclosure for covered bonds and for periodic reporting to bondholders. The issuance of registered covered bonds has further expanded the investor base for covered bonds in the United States and has led to tighter pricing. It is expected that other foreign banks that are currently registered with the SEC for their senior debt programs will file registration statements for covered bonds.

Need for a Statutory Framework
For U.S. banks to access the existing market for covered bonds requires a statutory framework. The key feature of a covered bond is the segregation of the cover pool in the event of the insolvency of an issuing bank. While this can be achieved using structured financing techniques, investors strongly prefer a statutory framework for covered bonds. A statutory framework provides for certainty of treatment in the event of the failure of a bank, standards for the establishment of covered bonds programs including defining eligible assets and minimum over-collateralization levels for the cover pool, a regulator to register covered bond programs and establish standards of issuance and reporting, and creation of an estate for the cover pool to be administered separate and apart from the insolvency estate of the issuing bank.

4 A list of covered bonds denominated in U.S. dollars since 2010 is attached as Appendix C.
6 See, e.g., H.R.940 (112th Congress).
Development of Legislation
In 2008, Secretary Paulson initiated an effort to establish a framework for the issuance of covered bonds by banks in the United States. As part of this effort the Department published a document defining best practices for issuing covered bonds. In 2011, the Treasury again looked to establishing a covered bond framework in the United States.

Since 2008, a number of legislative proposals have been introduced in Congress to establish a statutory framework for covered bonds in the United States, but no proposal has survived the crowded legislative agenda. However, covered bond legislation has received bi-partisan support, which suggests that enactment of covered bond legislation may be achievable even in the current Congress.

The legislation that advanced the furthest was H.R.940, which was introduced in 2011 by Representative Scott Garrett. After hearings before the House Financial Services Committee, the bill was approved by the committee by a vote of 44-7, evidencing very strong bi-partisan support. The House Ways and Means Committee, however, continued a jurisdictional hold on the bill through the remainder of the congressional session, and consequently the bill was not voted on by the full House. The companion bill in the Senate, S.1835, which had bi-partisan sponsorship, was never voted on by the Senate Banking Committee.

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9 “We will also work with Congress to consider additional means to advance funding for mortgage credit, including potentially the development of a covered bond market.” Reforming America’s Housing Finance Market, February 2011 at p.14, available at http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf.
Beneficiaries of Covered Bond Legislation

Some concern has been expressed that covered bond legislation would benefit only money center banks. The covered bond market in Germany, which has the oldest covered bond market in Europe, suggests a very different picture. Residential mortgage loan origination in Germany is predominately from smaller, regional banks and it is these banks who are the primary issuers into the domestic covered bond market in Germany. While this market does not draw large international investors, it has very strong support from domestic institutions as purchasers. As a result, during the financial crisis this domestic market continued to function and to provide funding [11] to the regional banks in Germany. If covered bond legislation is enacted in the United States, the prime beneficiaries should be the regional banks, as covered bonds would provide them with access to the capital markets using a very conservative funding instrument that should appeal to domestic institutions with knowledge of regional banks and regional economies as purchasers.

Concerns about Covered Bonds

Some, including the FDIC, have raised concerns about asset encumbrance levels at banks that issue covered bonds. While that concern cannot be dismissed, it must be recognized that asset encumbrance at banks arises from many activities, including central bank funding, FHLB funding, repo funding, securities lending, hedging activity such as derivatives and securitization. Securitization is not normally viewed as creating asset encumbrance, but in substance it is very similar because the assets securitized are dedicated to paying the securities issued and are no longer available to meet demands of depositors. Some of these activities, such as repos and other short term funding, tend to aggravate the condition of a struggling bank because collateral requirements tend to escalate as the bank’s condition deteriorates. Covered bonds, however, are typically issued with five- to ten-year maturities, providing nearly matched funding for the assets in the cover pool and bridging short term market or financial difficulties faced by a bank.

In the policy statement it issued on covered bonds, the FDIC included a limit on ability of banks to issue covered bonds. Some other jurisdictions, such as England and Canada, have started their covered bond markets with limits on the issuance of covered bonds. While a one-size-fits-all limit such as the FDIC proposes may lack precision, perhaps it is not an unreasonable beginning.

Resources on Covered Bonds

A list of resources on covered bonds that may be useful for research purposes is attached as Appendix D. We would be pleased to supplement this submission with additional materials or to discuss in more detail any aspect of covered bonds.

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10 See the statistics provided by the Pfandbrief Association at http://www.hypverband.de/cms/ internet.nsf/0/57DC4ADF9BFE0274C1257CE500293E0C/$FILE/2003_2013_public_vs_private_placement.pdf?OpenElement
11 See, A battle over collateral, IFLR March 2013 at 46, attached as Appendix B.
Covered bonds provide an opportunity for the Department of the Treasury to establish a significant new channel for financing residential mortgage loans for U.S. banks that would satisfy many of the key attributes of a desirable private funding regime. The legislation for a covered bond framework is well developed after the hearings on H.R.940 and the investor base has been developing strongly on the issuance of covered bonds by foreign banks into the United States. The SEC has developed a disclosure framework for covered bonds and the necessary periodic reporting to investors. The advanced state of these conditions means that there is an opportunity to achieve some fundamental changes rather quickly without the need to wait for investors to regain confidence in a previously toxic sector of the market. The active support of the Department of the Treasury for covered bond legislation would hasten the development of an important alternative channel for private funding of residential mortgage loans.

Sincerely,

Oliver I. Ireland

Jerry R. Marlatt

Anna T. Pinedo
Seizing the opportunity

Anna Pinedo and Jerry Marlatt of Morrison & Foerster examine the opportunity for US regulators to adopt a framework to encourage the issuance of covered bonds by US banks

The European Central Bank (ECB) and the Bank of England are seeking to reinvigorate securitisation in the hope of stimulating the European economy. In the US, Congress is debating how to bring private money back to the mortgage market and the US Treasury has announced an effort to encourage private funding. Perhaps while Europe looks to a US product for help, the US can look to a European product: covered bonds. Covered bonds have proven to be a successful approach to provide private funding for mortgage loans in Europe.

Also, covered bonds have a number of useful attributes for regulatory purposes. The implementation of Basel III capital standards in the US provides an opportunity to consider whether regulations can be formulated in a way that will facilitate the use of covered bonds to achieve significant policy goals.

Diversity of funding

The covered bond market in Europe is about $3 trillion of outstanding bonds, all of which represents private funding. This suggests that covered bonds could provide a significant funding instrument for banks in the US. Residential mortgage loans are the most common asset for cover pools, and while no one would expect covered bonds to entirely fund residential mortgage loans in the US, given the historic role of the federal government in the market, covered bonds could serve an important function. The combination of covered bonds, residential mortgage-backed securities, federal home loan bank system loans and government-sponsored enterprise sales would provide banks with improved diversity of funding. Covered bonds could help restore private funding of residential mortgage loans.

High quality assets

Covered bonds are high quality assets. The dual recourse nature of covered bonds enhances the obligation of the issuing bank and provides a covered bond with a risk profile closer to that of a sovereign obligation than any other non-sovereign instrument. Additionally, the dynamic cover pool distinguishes covered bonds from securitisations and extends the semi-sovereign character of the instrument. Accordingly, there is a solid basis for giving special treatment to covered bonds as part of the rulemaking efforts. As an asset held by a bank, covered bonds would serve to promote stability.

Better transparency

As a funding instrument, a bank’s exposure on its covered bonds is simpler to analyse than its securitisation exposure. As the numerous recent litigation settlements by banks in the US have shown, securitisation exposes banks to significant cost that is not apparent in the financial statements or other bank disclosures. The aggregate settlement amount to date in the US for the banking industry is estimated to exceed $100 billion, and there is more to come. This exposure was not apparent to lenders pre-crisis. Securitisation had been viewed by banks and regulators as a transfer of risk on the assets to investors, relieving the banks of exposure to the assets. Covered bonds do not present this hidden risk because the assets in the cover pool remain on the balance sheet of the issuing institution. The nature and performance of the assets is a constant audit and financial reporting item, so supervising agencies have greater transparency. Because the issuing institution retains 100% of the risk on the assets, it has a strong incentive to monitor and maintain high origination standards. This incentive tends to align the interests of the banks and the regulators in a way that securitisation never will. Covered bonds will tend to simplify the complicated liability structure of a bank.

Assistance to borrowers

Borrowers were hard hit by the financial crisis. Foreclosures on residential properties surged to levels not seen since the Great Depression. A variety of schemes to assist troubled borrowers were impeded by the complexity of securitisations. Covered bonds provide desirable flexibility for addressing borrowers with temporary difficulty in meeting their payment obligations.

In a securitisation, the securitisation entity acquires the right to make any and all decisions with respect to granting payment rescheduling or other relief to a borrower in financial difficulty or foreclosing on property securing a loan. Securitisation entities are bound typically by a trust agreement or pooling agreement that spells out all actions the entity may take with respect to the loans. These provisions generally do not provide for discretion to be exercised by the securitisation entity to work with borrowers to avoid default and foreclosure.

The transfer of a loan to the securitisation entity often means that a borrower can no longer discuss with his lender alternatives to avoid default, and the lender no longer has the power to effect any relief for a deserving borrower. That power has been transferred to a securitisation entity, which is bound by agreements that limit its ability to provide such relief.

Additionally, the borrower often has difficulty determining who may have some ability to grant relief. The borrower’s loan may have been transferred through several entities before reaching the securitisation entity. Further, all actions of securitisation entities are performed under contract by third parties, including trustees and loan servicers.

Covered bonds do not create this obfuscation. Each loan continues to be owned by the originating lender, who retains all rights to amend the loan or the
paymen

terms or otherwise accommodate a borrower to preserve a performing loan. It is possible that the loan may cease to be qualified to be included in a cover pool, but in that case, the lender simply substitutes another loan for the loan being worked out. From the borrower’s perspective, the borrower always deals solely with the lender that the borrower originally chose to borrow from and should have little difficulty identifying who in the organisation might be able to provide relief.

Early warning
As cover pools have a dynamic coverage requirement, covered bond programmes tend to act as an early warning of deteriorating bank health, especially in the asset sector that makes up the cover pool. The assets in the cover pool are usually tested monthly to confirm that there are a required amount of non-defaulted assets. The rate of replacement of loans in the cover pool will reflect deteriorating loan quality, as will an increase in the over-collateralisation percentage. This deterioration may result from general economic conditions or from weakening underwriting standards at the bank. In either case, monitoring these changes can provide important regulatory early warning benefits.

Risk Weight
Institutions subject to the Capital Requirements Regulation in Europe enjoy favourable capital treatment on their holdings of covered bonds compared to their holdings of unsecured senior debt or asset-backed and mortgage-backed securities. This makes sense because of the dual recourse nature of the bond, the support provided to the bond by the cover pool, and by the dynamic nature of the cover pool. A secured obligation should attract less capital than an unsecured obligation. Covered bonds, for example, are assigned a risk weight of 10% if the senior unsecured obligations of the issuing institution are assigned a 20% risk weighting.

The aggregate settlement amount to date in the US for the banking industry is estimated to exceed $100 billion

There is no comparable treatment of covered bonds under US regulatory capital rules. While the rules recognise certain collateralised transactions for which relief is provided, covered bonds and particularly residential mortgage loans are not recognised. Accordingly, the US regulatory capital rules do not provide an incentive to US banks to acquire covered bonds. The attractive regulatory attributes of covered bonds may warrant a change in US regulatory capital rules.

Liquidity Coverage Ratio
A similar result holds under the proposed rule for implementing a liquidity coverage ratio in the US. In October 2013, the federal banking agencies published a proposal setting out liquidity requirements for large domestic bank holding companies, savings and loan holding companies, depositary institutions and non-bank financial companies. The proposal applies a liquidity coverage ratio for internationally active depositary institutions, depositary institution holding companies and depositary institution subsidiaries that have
Unlike in Europe, where covered bonds are eligible as high quality liquid assets (HQLA) for the liquidity coverage ratio under the Capital Requirement Directive, covered bonds would not be eligible assets under the proposed US rule.

Under the proposal, eligible assets for HQLA expressly exclude any obligations of financial institutions or any consolidated subsidiary. Foreign banks are included in the prohibition. Accordingly, covered bonds issued by a foreign bank would not qualify as eligible assets for HQLA.

Moreover, in the proposal the agencies state that:

The proposed rule likely would not permit covered bonds and securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including US states and municipalities) to qualify as HQLA at this time. While these assets are assigned a 20 percent risk weight under the standardized approach for risk-weighted assets in the agencies' regulatory capital rules, the agencies believe that, at this time, these assets are not liquid and readily-marketable in US markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule.

This leaves US banks with little regulatory incentive to buy covered bonds. Not only would covered bonds not qualify for HQLA, but they do not have the benefit of the favourable capital treatment for bank investors that is provided in Europe.

Central Bank Eligibility

The third prong of regulatory incentives for covered bonds would be central bank eligibility. In Europe, covered bonds are eligible collateral at the European Central Bank and generally at the central bank of the home jurisdiction of the issuing bank. Only covered bonds offered by issuers organised in two countries are eligible for the Federal Reserve discount window: the US and Germany. It is curious why German jumbo Pfandbriefe are eligible as the sole foreign jurisdiction.

Note, however, that unsecured debt securities of the same bank issuer (from countries in addition to the US and Germany) will be eligible at the discount window. The odd result is that what is effectively secured debt of the same issuer is not eligible. Although issuers from other countries have expressed an interest in having their covered bonds added to the list, the Federal Reserve staff has indicated that there are other regulatory matters that must be addressed first. In particular, the Dodd-Frank Reform Act requires the banking authorities to dispense with the use of ratings in their regulations. The alternative to ratings developed by the Federal Reserve will be a key element in determining the discount to be applied to securities delivered to the discount window, including covered bonds. Accordingly, Federal Reserve staff is not inclined to expand the list of securities acceptable at the discount window until this regulatory requirement is addressed.

This leaves covered bonds in the US with none of the regulatory supports that exist in Europe: favourable capital treatment, eligibility as HQLA for liquidity coverage ratio purposes, and eligibility as collateral at the central bank. With the legislative polarisation in the US and the failure to provide any regulatory support, it is not surprising that the market for covered bonds in the US is developing slowly.

Encumbrance issues

Although covered bonds have attractive regulatory attributes, they do raise some regulatory concerns. Covered bonds have become a favoured investment for investors seeking both safety and yield because of the dual recourse nature of the instrument. If the issuing financial institution fails, investors have preferred access over all other creditors of the institution to the cash flow and proceeds of the cover pool. This has led banks to increase their reliance on covered bond funding during stressful times. Increased use of covered bonds means more bank assets dedicated to the cover pool. This has led to a growing concern among regulators about the level of encumbrance of assets by banks issuing covered bonds. The regulators are concerned that the encumbrance represented by cover pools can significantly reduce the availability of quality assets to support depositors and that the priority claim on the assets by covered bond holders in effect subordinates depositors. Similar concerns have been raised by the Federal Deposit Insurance Corporation (FDIC) about the proposed US covered bond legislation and a 4% limit was included in the FDIC policy statement on covered bonds for this reason.

However, covered bonds are not the only means of bank financing that isolates assets and makes them unavailable to meet deposit obligations. Repurchase agreements also have collateral requirements which tend to increase sharply as a bank approaches insolvency. At the same time, the maturities available to a bank for refinancing a repo tend to shorten dramatically as a bank's credit condition deteriorates. Any other secured borrowing, such as borrowing from a central bank, also involves the dedication of assets to repayment of the borrowing. Swap agreements provide for collateralisation of the swap obligation by high-grade assets (often treasuries in the local jurisdiction), and these requirements often increase sharply as a bank's credit rating deteriorates. In the US, borrowings by a bank from a Federal Home Loan Bank are collateralised.

Securitisations can also create a situation for a regulator similar to the encumbrance concern described above. Often, the market demands that if a bank securitises its assets, it retain a significant (usually subordinated) interest in the securitisation, to give comfort to the market on the quality of the assets being securitised. Moreover, recent legislation in both the US and Europe requires banks to have a significant retained interest in assets that are securitised. In both cases, the bank will need to finance the retained portion with deposits or senior debt or other sources. Securitisations dedicate a pool of assets to the repayment of the asset-backed securities in preference to depositors and reduce the assets available to regulators to support deposit obligations of the banks.

There is a risk from funding long-term assets with short-term liabilities. As the liabilities are renewed at rollover, the interest rates can increase in adverse markets and in extreme cases the funding simply may not be available. Covered bonds can approximate matched funding for mortgage loans. Nevertheless, some limit on the issuance

The attractive regulatory attributes of covered bonds may warrant a change in US regulatory capital rules.
Don’t go around in circles.

Morrison & Foerster has one of the most well-regarded financial services regulatory practices in the world. Many large financial institutions count on us, and Chambers USA notes that our “extensive regulatory team handles a high volume of work across the financial services sector.” So there is no need to go around in circles when confronted by complex regulatory issues. Let us help you find a way forward.

Learn more at mofo.com/resources/regulatory-reform/.
of covered bonds may be advisable. The former general counsel of the FDIC has reported that, before his departure, the agency had agreed internally that the risk from encumbrance would be addressed by an 8% cap on issuance of covered bonds. Although a one-size-fits-all limit may not be appropriate, perhaps it is a workable starting point.

Single counterparty exposures
Over exposure to a single covered bond issuer could also be a concern. In March 2013, the Basel Committee published a consultative proposal to revise the supervisory framework for measuring and controlling large counterparty exposures of systemically important financial institutions. The proposal would limit a banking organisation’s exposure to a single counterparty or connected counterparties, and define a large exposure as five percent or more of a bank’s eligible capital. The Basel Committee proposes an aggregate large exposure limit of 25% of common equity Tier 1 capital. Additionally, for global systemically important banks (G-SIBs), the proposal would apply an exposure limit of between 10% and 15% of common equity Tier 1 capital for exposures to other G-SIBs.

The Basel Committee calls for full implementation of the framework by January 1 2019. When implemented, the framework may be expected to apply to covered bond holdings of banks together with other exposures.

Lack of clarity
The development of the bail-in concept for senior bank debt in Europe in the resolution of a failing bank has led to the protection of covered bonds from bail-in under the Bank Recovery and Resolution Directive, subject to the adequacy of the cover pool. This has raised some questions regarding whether there are similar protections from bail-in for covered bonds under US resolution schemes. It is important to note that the relevant resolution regime is that in place in the home jurisdiction of the issuer of covered bonds.

The US resolution regime is only relevant if the issuing bank is a US bank. Under the Federal Deposit Insurance Act, in the event of the failure of a US bank, the FDIC is appointed as receiver or conservator and the resolution of the bank is carried out under the provisions of the FDIA. Under the FDIA, there is no express protection of covered bonds, largely because there is no covered bond legislation in effect in the US. However, secured obligations are expressly recognised and, to the extent of the adequacy of the collateral securing an obligation, the obligation is protected from loss or write down in the receivership. This protection was one of the key elements in the structure that was developed for the issuance of covered bonds by Washington Mutual and Bank of America.

New regulations implementing the orderly liquidation authority (OLA) provisions of the Dodd-Frank Reform Act do not contain any express protection for covered bonds. However, similar to the FDIA, the OLA regulations provide specific protection from bail-in to secured obligations. The OLA regulations apply to certain financial companies other than insured depository institutions. Thus, the OLA regulations would not apply to covered bonds issued by a US bank as an insured depository institution.

Volcker and covered bonds
Section 619 of the Dodd-Frank enacted a prohibition on investments by banks in hedge funds and private equity funds and proprietary trading by banks. Section 619 is implemented by regulations that became effective April 1 2014, and that are referred to as the Volcker Rule.

Covered bonds are well outside the scope of hedge funds and private equity funds, and some covered bonds are expressly exempted from the definition of covered fund. The exemption, however, leaves out many covered bonds. In light of their attractive regulatory attributes and their usefulness in achieving some important regulatory goals, perhaps a broader exemption is warranted.

A more detailed discussion of the Volcker Rule provisions and their application to covered bonds may be found at www.mofo.com/covered-bond-services.

A golden opportunity
The attractive regulatory attributes of covered bonds could prove useful to the US. During the implementation of the Basel III capital standards in the US, there is an opportunity to adopt regulations that encourage the holding and issuance of covered bonds by US banks, which could assist in achieving some important policy goals. The regulations should apply to both the covered bonds issued by US banks and by foreign banks. A covered bond statute in the US should not be viewed as a predicate condition to adopting such regulations. Although a covered bond statute in the US would be desirable, US banks should be able to issue covered bonds in the absence of a statute.
A battle over collateral

If regulators are worried about over-encumbered bank assets, they must look beyond just covered bonds

Covered bonds’ dual recourse nature makes them a favoured instrument for investors seeking both safety and yield. If the issuing financial institution fails, investors have preferred access — over all other creditors — to the cash flow and proceeds of the cover pool.

This often means that when market conditions are volatile or difficult, investors are more likely to buy covered bonds than a bank’s unsecured senior debt. Not surprisingly, it follows that issuers tend to rely more heavily on covered bonds over senior debt funding in difficult times. The result is that significantly more of an issuer’s assets become dedicated to covered bond investors.

This has led to a growing concern among regulators about the level of encumbered assets held by banks issuing covered bonds. Some of the concern appears misplaced as it relates to apparently very high overcollateralisation levels in some European covered bond programmes.

This, however, is not the result of programme requirements, but rather the issuer’s structure as a special purpose covered bond issuer, all of whose assets are available to support its covered bonds.

In other cases, some banks’ heavy reliance on covered bonds, particularly at a time of difficulty for senior debt markets, has worried regulators. They are concerned that the encumbrance represented by cover pools can significantly reduce the availability of quality assets to support depositors, and that the preference for covered bondholders in effect subordinates depositors.

At the same time, changing rating agency requirements have led to downgrades and higher overcollateralisation levels for some issuers. In addition, the euro crisis and the difficulties often faced by banks issuing senior debt have made them more reliant on covered bonds rather than a bank’s unsecured senior debt.

The appropriate balance of secured and unsecured funding is likely to vary from bank to bank

Not an isolated problem

What seems to be missing in these discussions, however, is any recognition of other bank financing alternatives that would be expected to raise similar concerns. Covered bonds are not the only form of bank financing that isolates assets and makes them unavailable to meet deposit obligations.

We saw this happen during the financial crisis with the failure of SIVs that funded long-term assets with commercial paper

The US savings and loan crisis of the 1980s and the failure of structured investment vehicles (SIVs) that funded long-term assets with commercial paper in the 2007-2009 crisis are examples of comparable situations.

Securitisation can create similar situations to the covered bond encumbrance issues concerning regulators. If a bank securitises its assets, the market often demands that it retain a significant — and usually subordinated — interest in the instrument. This is to provide comfort to the market on the quality of the underlying assets. In fact, recent legislation in both the US and Europe now require banks to hold a significant retained interest in securitised assets. In both cases, the bank will need to finance the retained portion with deposits, senior debt or other sources. Securitisations dedicate a pool of assets to the repayment of the asset-backed securities in preference to depositors, reducing the assets available to support banks’ deposit obligations.

Learning from mistakes

However, the appropriate balance of secured and unsecured funding is likely to vary from bank to bank. The asset mix of a bank must be taken into consideration in this regard.

Funding long-term assets with short-term liabilities presents risks. As the liabilities are renewed at rollover, the interest rates can increase in adverse markets and in extreme cases the funding simply may not be available.

We saw this happen during the financial crisis with the failure of structured investment vehicles (SIVs) that funded long-term assets with commercial paper. The US savings and loan crisis of a...
The inability to meet growing demands for collateral on its repo financings was the immediate cause of the Lehman bankruptcy. This concern about asset-liability mismatches is reflected in Basel III by the adoption of the net stable funding ratio (NSFR), which requires banks to reduce the mismatch in maturities between long-term assets and their funding.

Also, in many jurisdictions the deposit base of a bank is simply inadequate to fund some or much of a bank’s lending, so banks turn to other means of financing. When funding long-term assets, the more attractive interest rates available from secured financings suggest that relying entirely on senior debt financing is not sensible. Accordingly, some form of securitisation or covered bonds is used to obtain a better balance of funding costs.

It is likely that every institution is different when determining the appropriate balance of funding. The mix of long-term and short-term assets is different, and the balance between deposit base and other available financings is different.

The capital markets’ view of banks will make different types of financing available to banks based on their different circumstances. The balance of types of financings used by a bank will be very dependent on the institution’s particular circumstances.

With this understanding, it is unlikely that a single limit on the percentage of assets that can be used for covered bond financing is appropriate. The limit instead should depend on each bank’s circumstances and address all forms of secured bank financing.

The focus on covered bonds to the exclusion of securitisation, repo financing and other transactions that encumber asset will tend to encourage the use of securitisation and repo financing over covered bonds. The wisdom of this policy choice is questionable.

By Jerry Marlatt, partner at Morrison & Foerster in New York
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### USD Covered Bonds 2010 - 2014

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<th>(Sm)</th>
<th>Coupon</th>
<th>Maturity</th>
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<td>3yr</td>
<td>+75</td>
</tr>
<tr>
<td>4/13/2011</td>
<td>Credit Agricole Home Loan SFH</td>
<td>France</td>
<td>1,500</td>
<td>FRN</td>
<td>7/14/2014</td>
<td>3.25yr</td>
<td>+75</td>
</tr>
<tr>
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<td>Sparebanken 1 Boligkreditt</td>
<td>Norway</td>
<td>1,250</td>
<td>2.625</td>
<td>5/27/2016</td>
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<td>+62</td>
</tr>
<tr>
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<td>Switzerland</td>
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<td>2.600</td>
<td>5/27/2016</td>
<td>5yr</td>
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</tr>
<tr>
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<td>LBBW</td>
<td>Germany</td>
<td>550</td>
<td>FRN</td>
<td>6/22/2012</td>
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<td>+22</td>
</tr>
<tr>
<td>6/28/2011</td>
<td>HSBC Bank PLC</td>
<td>United Kingdom</td>
<td>1,250</td>
<td>1.625</td>
<td>7/7/2014</td>
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</tr>
<tr>
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<td>Korea</td>
<td>500</td>
<td>3.500</td>
<td>12/15/2016</td>
<td>5yr</td>
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<td>Canada</td>
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</tr>
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<td>Sweden</td>
<td>1,000</td>
<td>2.125</td>
<td>8/31/2016</td>
<td>5yr</td>
<td>+82</td>
</tr>
<tr>
<td>9/7/2011</td>
<td>Toronto-Dominion Bank</td>
<td>Canada</td>
<td>2,000</td>
<td>0.875</td>
<td>9/12/2014</td>
<td>3yr</td>
<td>+26</td>
</tr>
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<td>Toronto-Dominion Bank</td>
<td>Canada</td>
<td>3,000</td>
<td>1.625</td>
<td>9/14/2016</td>
<td>5yr</td>
<td>+44</td>
</tr>
<tr>
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<td>Canada</td>
<td>2,000</td>
<td>0.900</td>
<td>9/19/2014</td>
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<td>+28</td>
</tr>
<tr>
<td>9/15/2011</td>
<td>Nordea Eiendomskreditt AS</td>
<td>Norway</td>
<td>1,000</td>
<td>2.125</td>
<td>9/22/2016</td>
<td>5yr</td>
<td>+92</td>
</tr>
<tr>
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<td>National Bank of Canada</td>
<td>Canada</td>
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<td>2.200</td>
<td>10/19/2016</td>
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<td>+72</td>
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<td>Canada</td>
<td>2,000</td>
<td>1.300</td>
<td>10/31/2014</td>
<td>3yr</td>
<td>+50</td>
</tr>
<tr>
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<td>Australia</td>
<td>1,250</td>
<td>2.400</td>
<td>11/23/2016</td>
<td>5yr</td>
<td>+115</td>
</tr>
<tr>
<td>11/17/2011</td>
<td>Westpac Banking Corp</td>
<td>Australia</td>
<td>1,000</td>
<td>2.450</td>
<td>11/28/2016</td>
<td>5yr</td>
<td>+115</td>
</tr>
<tr>
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<td>Canadian Imperial Bank of Commerce</td>
<td>Canada</td>
<td>2,000</td>
<td>1.500</td>
<td>12/12/2014</td>
<td>3yr</td>
<td>+68</td>
</tr>
<tr>
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<td>Canada</td>
<td>2,400</td>
<td>2.000</td>
<td>2/4/2013</td>
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<td>+30</td>
</tr>
<tr>
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<td>Canada</td>
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<td>3.125</td>
<td>4/15/2015</td>
<td>5yr</td>
<td>+30</td>
</tr>
<tr>
<td>Date</td>
<td>Issuer</td>
<td>Region</td>
<td>$ (mm)</td>
<td>Coupon</td>
<td>Maturity</td>
<td>Tenor</td>
<td>Spread vs. MS</td>
</tr>
<tr>
<td>------------</td>
<td>---------------------------------------</td>
<td>--------------</td>
<td>--------</td>
<td>--------</td>
<td>----------</td>
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</tr>
<tr>
<td>4/22/2010</td>
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<td>4/22/2013</td>
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<td>+40</td>
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<td>2.600</td>
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<td>+45</td>
</tr>
<tr>
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<td>Cie Financement Foncier</td>
<td>France</td>
<td>1,500</td>
<td>1.625</td>
<td>7/23/2012</td>
<td>2yr</td>
<td>+75</td>
</tr>
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<td>5yr</td>
<td>+85</td>
</tr>
<tr>
<td>9/21/2010</td>
<td>Barclays Bank PLC</td>
<td>United Kingdom</td>
<td>1,000</td>
<td>2.500</td>
<td>9/21/2015</td>
<td>5yr</td>
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</tr>
<tr>
<td>9/30/2010</td>
<td>Stadshypotek AB</td>
<td>Sweden</td>
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</tr>
<tr>
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<td>Norway</td>
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<td>2.100</td>
<td>10/14/2015</td>
<td>5yr</td>
<td>+68</td>
</tr>
<tr>
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<td>Norway</td>
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<td>1.250</td>
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<tr>
<td>11/2/2010</td>
<td>BNP Paribas Home Loan</td>
<td>France</td>
<td>2,000</td>
<td>2.200</td>
<td>11/2/2015</td>
<td>5yr</td>
<td>+70</td>
</tr>
</tbody>
</table>

**Source:** RBC Capital
Resources on Covered Bonds


8. A covered bonds blog at [www.us-covered-bonds.com](http://www.us-covered-bonds.com)
