U.S. COVERED BOND LEGISLATION EDGES FORWARD:

A STATUTORY FRAMEWORK FOR U.S. COVERED BONDS IS INTRODUCED TO THE U.S. HOUSE OF REPRESENTATIVES

By Howard Goldwasser[1]

On Thursday, March 18, 2010, a bill (the "Bill") providing for the "United States Covered Bonds Act of 2010" (the "Act") was introduced to the United States House of Representatives. If the bill is enacted into law, it would implement a statutory framework and program for the regulatory oversight of the issuance of covered bonds by U.S. issuers.[2]

The Bill contemplates the creation of a fairly comprehensive statutory framework under which U.S. issuers could structure covered bond programs. Most importantly, the Bill directly addresses some of the legal impediments (in particular, those arising under the Federal Deposit Insurance Act) that have complicated, and added legal uncertainties and significant transactional costs to, the structures used in U.S. covered bond issuances to date.[3] It does so, in part by clearly providing for the creation of an over-collateralized cover-pool "estate" that would independently survive a default by, or insolvency of, the issuer of the covered bond, and be fully segregated and held separate and apart from the other property of the issuer in the context of its receivership, conservatorship or insolvency. A noteworthy feature of the Bill is the central role that the U.S. Treasury Department (the "Treasury Department") would play under the Act. As currently drafted, the Treasury Department is designated as the primary "covered bond regulator" – a designation that confers upon the Treasury Department the authority to approve, and thereby authorize, covered bond programs for issuers that are eligible under the Act; and, as such, the Treasury Department is also directed to act as "the trustee of any [cover-pool] estate" created after the default or insolvency of the issuer, with the power to appoint and supervise private-sector servicers or administrators of the estate.

Another key feature of the Bill is its ambitious scope. The Bill contemplates that the Act would enable covered bond programs to be structured across a wide array of prescribed "eligible asset classes." These include residential mortgages, home-equity loans and commercial mortgage loans; public-sector obligations, such as municipal and state bonds, loans to states and municipalities and federally guaranteed loans and securities; auto loans and leases; student loans; credit-card receivables; small business loans; and "other eligible asset classes designated by the [Treasury Department]" over time.

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[1] Howard Goldwasser is a Finance Group Partner, based in Curtis' New York office. Before joining Curtis in late 2009, Howard was a partner at another major international law firm where, as counsel to various issuers and arrangers, he helped structure what were among the first U.S. and Canadian covered bond programs, as well as covered bond programs for issuers in Mexico and Brazil.

[2] The bill was introduced by Representative Scott Garrett of New Jersey, a ranking member of the House Capital Markets Subcommittee, with the support of Representative Paul Kanjorski of Pennsylvania, the Chairman of the House Capital Markets Subcommittee, and Representative Spencer Bachus of Alabama, also a ranking member of the House Capital Markets Subcommittee.

[3] So far, only two issuers in the United States have come to the market with covered bonds: Washington Mutual in late 2006 and then Bank of America in early 2007. Other issuers are known to have taken steps toward implementing a covered bond program but, in large part due to the complexity of the structures that have developed under existing law, have not taken their programs forward.

KEY PROVISIONS OF THE ACT

- **What is a "covered bond"?**

Using the terms defined by the Act, the Act would provide for the issuance of "covered bonds" under "covered bond programs" that have been pre-approved by the Treasury Department. The Act defines a covered bond as "any senior recourse debt obligation of an eligible issuer that . . . has an original term to maturity of not less than 1 year [and] is secured directly or indirectly by a perfected security interest in a cover pool which is owned directly or indirectly by the issuer of the obligation . . . ." The Act's definition of a "cover pool" is discussed below.

- **Who can issue covered bonds?**

Under the Act, a covered bond program may be established by an FDIC-insured depositary institution or a subsidiary, a bank holding company registered under the Bank Holding Company Act or a savings and loan holding company contemplated under the Home Owner's Loan Act. The Act also permits smaller issuers to pool together through a single "issuing entity" to issue covered bonds on a pooled basis. This is an important provision, and something that would make it more likely that smaller, regional banks would be able to turn to covered-bond issuances for funding and liquidity.

- **What kinds of "cover pools" are contemplated by the Act?**

The Act defines a permitted "cover pool" as "a dynamic" – that is, actively managed – "pool of assets that is comprised of . . . 1 or more eligible assets from a single eligible asset class . . . ." Eligible asset classes, in turn, include a broad swath of asset classes, the financing of which has been adversely impacted by the still-diminished U.S. securitization market:

  - residential mortgages and home-equity loans
  - commercial mortgage loans
  - public-sector obligations, such as municipal and state bonds, loans to states and municipalities and federally guaranteed loans and securities
  - auto loans and leases
  - student loans
  - credit-card receivables
  - small business loans made under a (guaranteed or non-guaranteed) program established by the Small Business Administration (SBA)
  - "other eligible asset classes" later designated by the Treasury Department

For all of the mortgage and consumer asset classes, as well as the small-business-loan asset class, the Act permits cover pools to include a "bucket" of related mortgage-backed securities, asset-backed securities or SBA-loan-backed securities, as long as the securities are AAA-rated and, in the aggregate, do not account for more than 20% of the principal balance of all of the assets in the cover pool.

The Act also embraces the need for cover pools to include swaps designed to mitigate the impact of interest-rate or currency mismatches that may exist between the eligible assets included in the cover pool and the covered bonds sold to investors, as well as credit and liquidity enhancements and a limited amount of "substitute assets" such as cash, U.S. government securities and other U.S. government-insured or guaranteed assets.

- **Over-collateralization would be enabled – and required – by the Act.**

A major impediment to structuring covered bonds for U.S. issuers has been the inability to effectively over-collateralize covered bonds issued by issuers subject to the supervision of the FDIC. Common wisdom is that, under existing law and the existing structures, the FDIC's appointment as receiver or conservator for an issuer would result in the loss of any over-collateralization maintained in the cover pool prior to the FDIC's appointment.

According to the Act, over-collateralization would be mandatory and would survive the default or insolvency of the issuer and the creation of the cover-pool estate, from which debt service on the issuer's outstanding covered bonds would then be paid on a scheduled, rather than an accelerated, basis. The Act would obligate the Treasury Department "from time to time [to] establish minimum over-collateralization requirements for covered bonds backed by each of the eligible asset classes based on the credit, collection, and interest-rate risks, but not the liquidity risks, associated with [it]." The statute also would require any failure of the statutory over-collateralization requirements that is not cured within the time period prescribed by the program's transaction documents to give rise to an event of the default and the automatic creation of an estate from which covered bonds would thereafter receive their payment.

- **A cover pool that secures a covered-bond issuance would be segregated from an issuer's insolvency estate. (That's a big deal.)**

The most radical provision of the Bill is a provision that, generally speaking, would segregate cover-pool assets from the insolvency estate of a covered-bond issuer. To date, the powers conferred upon the FDIC in the context of an issuer's receivership or conservatorship have been the most challenging obstacles to overcome in devising an efficient U.S.-covered-bond program structure. As previously mentioned, these powers introduced complexity, inefficiency and transaction cost to the structures of the only two U.S. programs that are in the market today.

Under the Act, if the FDIC were to be appointed as the conservator or receiver for an issuer of covered bonds, the FDIC would have 15 days from the date of its appointment to transfer the cover pool, together with the liabilities of the issuer under the covered-bond program, to another eligible (that is, Treasury-approved) issuer. If the FDIC were not to do that within the 15-day period, the Act would automatically provide for the creation of what it refers to as "an estate" -- for which the Treasury Department would act as the trustee – which estate would "exist separate and apart from the issuer and the conservatorship, receivership . . . or estate in bankruptcy for [the] issuer or any of its other assets." Elsewhere, the Act clearly provides that the separate estate would be comprised of the cover pool, "which shall be automatically released to and held by such estate free and clear of any right, title, interest or claim of the issuer or any conservator, receiver, liquidating agent or trustee in bankruptcy for the issuer or any of its other assets." That's a lot of words, but, if those words were to become law, they would immunize the cover pool from any risk associated with the insolvency of the issuer, and, following an issuer's insolvency, allow the estate – under the supervision of the Treasury Department – to function much like the asset pool in a securitization and, accordingly, to service the covered bonds until their maturity or earlier acceleration according to their stated terms. To anyone who has been monitoring the development of covered bonds in the U.S., that really is a big deal. The Bill, no doubt, will be watched closely as it moves through the legislative process.

IF YOU HAVE ANY QUESTIONS ABOUT THE BILL, OR COVERED BONDS GENERALLY, PLEASE CONTACT:

HOWARD GOLDWASSER, PARTNER
E-MAIL: HGOLDWASSER@CURTIS.COM
TEL: +1 (212) 696-6150

Mr. Goldwasser is a partner in the Corporate group. His practice centers around high-value, complex financial transactions, with a primary focus on structured finance and securitization; CDOs and CLOs; covered bonds; credit derivatives and structured-credit products; general debt capital markets matters; and a broad array of commercial lending work including syndicated and bilateral lending, asset-based lending, LBO finance and project finance. More recently, he has also advised clients regarding the U.S. federal rescue programs directed at reviving the securitization markets, such as the Term Asset-Backed Securities Loan Facility (TALF) administered by the Federal Reserve Bank of New York and the Public-Private Investment Program (PPIP) jointly administered by the FDIC and the U.S. Department of Treasury.

Mr. Goldwasser is one of a handful of U.S. lawyers who led the development of covered bond programs for issuers based in Canada, Mexico and Brazil and to have introduced them to the U.S. capital markets. His clients have included many of the world's leading investment banks, commercial banks and other non-bank lenders, including hedge funds and investment managers. He has structured transactions for clients based in the United States, Europe, Turkey, Latin America, Japan, Korea and Taiwan.

Mr. Goldwasser practiced in New York from 1991 to 2001 and again from 2006 to the present. He was based in Tokyo from 2001 to 2006 where he led the Asian finance practices and the Tokyo office for a major international law firm.

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