MEMORANDUM TO: The Board of Directors

THROUGH: Sara A Kelsey
General Counsel

FROM: Richard T. Aboussie
Associate General Counsel
Litigation Branch

SUBJECT: Final Covered Bond Policy Statement

Recommendation

That the Board of Directors approve for publication in the Federal Register the final Covered Bond Policy Statement ("Policy Statement") which adopts certain limited revisions and clarifications to the Interim Final Policy Statement published on April 23, 2008.[1] 73 FR 21949 (April 23, 2008). The Policy Statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds, in a receivership or conservatorship, after the FDIC decides whether to terminate or continue the transaction. In order to be accorded such expedited access to collateral, the covered bonds must be structured consistent with the Policy Statement. The Policy Statement provides guidance to facilitate the prudent and incremental development of the U.S. covered bond market while the FDIC and other regulators evaluate the

[1] For ease of reference, the Interim Final Covered Bond Policy Statement, published on April 23, 2008, will be referred to as the Interim Policy Statement. The Final Covered Bond Policy Statement will be referred to as the Policy Statement.

benefits and risks of these products in the U.S. mortgage market. The policy statement is being published as final, but the staff may recommend subsequent amendments for the Board's consideration as the covered bond market develops in the U.S.

I. Background

Currently, there are no statutory or regulatory prohibitions on the issuance of covered bonds by U.S. banks. Therefore, to reduce market uncertainty and clarify the application of the FDIC's statutory authorities for U.S. covered bond transactions, the FDIC issued an Interim Policy Statement to provide guidance on the availability of expedited access to collateral pledged for certain covered bonds by insured depository institutions ("IDIs") in a conservatorship or a receivership. As discussed below, under section 11(e)(13)(C) of the Federal Deposit Insurance Act ("FDIA"), any liquidation of collateral of an IDI placed into conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Consequently, issuers of covered bonds have incurred additional costs from maintaining additional liquidity needed to insure continued payment on outstanding bonds if the FDIC as conservator or receiver fails to make payment or provide access to the pledged collateral during these periods after any decision by the FDIC to terminate the covered bond transaction. The Policy Statement does not impose any new obligations on the FDIC, as conservator or receiver, but does define the circumstances and the specific covered bond transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral.

Covered bonds are general, non-deposit, obligation bonds of the issuing bank secured by a pledge of loans that remain on the bank's balance sheet. Covered bonds originated in Europe, where they are subject to extensive statutory and supervisory regulation designed to protect the interests of covered bond investors from the risks of insolvency of the issuing bank. By contrast, covered bonds are a relatively new innovation in the U.S. with only two issuers to date: Bank of America, N.A. and Washington Mutual. These initial U.S. covered bonds were issued in September 2006.

In the covered bond transactions initiated in the U.S. to date, an IDI sells mortgage bonds, secured by mortgages, to a trust or similar entity ("special purpose vehicle" or "SPV").[2] The pledged mortgages remain on the IDI's balance sheet, securing the IDI's obligation to make payments on the debt, and the SPV sells covered bonds, secured by the mortgage bonds, to investors. In the event of a default by the IDI, the mortgage bond trustee takes possession of the pledged mortgages and continues to make payments to the SPV to service the covered bonds. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base.

The FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and within the parameters set forth in the Policy Statement. While covered bonds, like other secured liabilities, could increase the costs to the deposit insurance fund in a receivership, these potential costs must be balanced with diversification of sources of liquidity and the benefits that accrue from additional on-balance

[2] The FDIC understands that certain potential issuers may propose a different structure that does not involve the use of an SPV. The FDIC expresses no opinion about the appropriateness of SPV or so-called "direct issuance" covered bond structures, although both may comply with this Statement of Policy.

sheet alternatives to securitization for financing mortgage lending. The Policy Statement seeks to balance these considerations by clarifying the conditions and circumstances under which the FDIC will grant automatic consent to access pledged covered bond collateral. The FDIC believes that the prudential limitations set forth in the Policy Statement permit the incremental development of the covered bond market, while allowing the FDIC, and other regulators, the opportunity to evaluate these transactions within the U.S. mortgage market. In fulfillment of its responsibilities as deposit insurer and receiver for failed IDIs, the FDIC will continue to review the development of the covered bond marketplace in the U.S. and abroad to gain further insight into the appropriate role of covered bonds in IDI funding and the U.S. mortgage market, and their potential consequences for the deposit insurance fund. (For ease of reference, throughout this discussion, when we refer to "covered bond obligation," we are referring to the part of the covered bond transaction comprising the IDI's debt obligation, whether to the SPV, mortgage bond trustee, or other parties; and "covered bond obligee" is the entity to which the IDI is indebted.)

Under the FDIA, when the FDIC is appointed conservator or receiver of an IDI, contracting parties cannot terminate agreements with the IDI because of the insolvency itself or the appointment of the conservator or receiver. In addition, contracting parties must obtain the FDIC's consent during the forty-five day period after appointment of FDIC as conservator, or during the ninety day period after appointment of FDIC as receiver before, among other things, terminating any contract or liquidating any collateral pledged for a secured transaction.[3] During this period, the FDIC must still comply with otherwise enforceable provisions of the contract. The FDIC also may terminate or repudiate any contract of the IDI within a reasonable time after

[3] See 12 U.S.C. § 1821(e)(13)(C).

the FDIC's appointment as conservator or receiver if the conservator or receiver determines that the agreement is burdensome and that the repudiation will promote the orderly administration of the IDI's affairs.[4]

As conservator or receiver for an IDI, the FDIC has three options in responding to a properly structured covered bond transaction of the IDI: 1) continue to perform on the covered bond transaction under its terms; 2) pay-off the covered bonds in cash up to the value of the pledged collateral; or 3) allow liquidation of the pledged collateral to pay-off the covered bonds. If the FDIC adopts the first option, it would continue to make the covered bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the covered bonds plus interest accrued to the date of appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral. If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the FDIA. On the other hand, if there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.

While the FDIC can repudiate the underlying contract, and thereby terminate any continuing obligations under that contract, the FDIA prohibits the FDIC, as conservator or receiver, from avoiding any legally enforceable or perfected security interest in the assets of the IDI unless the interest was taken in contemplation of the IDI's insolvency or with the intent to hinder, delay, or

[4] See 12 U.S.C. §§ 1821(e)(3) and (13). These provisions do not apply in the manner stated to "qualified financial contracts" as defined in Section 11(e) of the FDI Act. See 12 U.S.C. § 1821(e)(8).

defraud the IDI or its creditors.[5] This statutory provision ensures protection for the valid claims of secured creditors up to the value of the pledged collateral. After a default or repudiation, the FDIC as conservator or receiver may either pay resulting damages in cash up to the value of the collateral or turn over the collateral to the secured party for liquidation. In liquidating any collateral for a covered bond transaction, it would be essential that the secured party liquidate the collateral in a commercially reasonable and expeditious manner taking into account the then-existing market conditions.

As noted above, existing covered bond transactions by U.S. issuers have used SPVs. However, nothing in the Policy Statement requires the use of an SPV. Some questions have been posed about the treatment of a subsidiary or SPV after appointment of the FDIC as conservator or receiver. The FDIC applies well-defined standards to determine whether to treat such entities as "separate" from the IDI. If a subsidiary or SPV, in fact, has fulfilled all requirements for treatment as a "separate" entity under applicable law, the FDIC as conservator or receiver will not apply its statutory powers to repudiate the subsidiary's or SPV's contracts with third parties. While the determination of whether a subsidiary or SPV has been organized and maintained as a separate entity from the IDI must be determined based on the specific facts and circumstances, the standards for such decisions are set forth in generally applicable judicial decisions and in the FDIC's regulation governing subsidiaries of insured state banks, 12 C.F.R. § 362.4.

The requests to the FDIC for guidance have focused principally on the conditions under which the FDIC would grant consent to obtain collateral for a covered bond transaction before the expiration of the forty-five day period after appointment of a conservator or the ninety day period after appointment of a receiver. IDIs interested in issuing covered bonds have expressed

[5] See 12 U.S.C. §1821(e) (12).

concern that the requirement to seek the FDIC's consent before exercising on the collateral after a breach could interrupt payments to the covered bond obligee for as long as 90 days. IDIs can provide for additional liquidity or other hedges to accommodate this potential risk to the continuity of covered bond payments but at an additional cost to the transaction. Interested parties requested that the FDIC provide clarification about how FDIC would apply the consent requirement with respect to covered bonds. Accordingly, the FDIC issued an Interim Final Covered Bond Policy Statement in order to provide covered bond issuers with guidance on how the FDIC will treat covered bonds in a conservatorship or receivership and requested comment thereon.

II. Overview of the Comments Received

The FDIC received approximately 130 comment letters on the Interim Policy Statement; these included comments from national banks, Federal Home Loan Banks, industry groups and individuals.

Most commenters encouraged the FDIC to adopt the Policy Statement to clarify how the FDIC would treat covered bonds in the case of a conservatorship or receivership and, thereby, facilitate the development of the U.S. covered bond market. The more detailed comments focused on one or more of the following categories of issues: (1) the FDIC's discretion regarding covered bonds that do not comply with the Policy Statement; (2) application to covered bonds completed prior to the Policy Statement; (3) the limitation of the Policy Statement to covered bonds not exceeding 4 percent of liabilities; (4) the eligible collateral for the cover pools; (5) the measure

of damages provided in the event of default or repudiation; (6) the covered bond term limit; and (7) federal home loan bank advances and assessments.

Certain banks and industry associations sought clarification about the treatment of covered bonds that do not comply with the Policy Statement by the FDIC as conservator or receiver. Specifically, commenters asked the FDIC to clarify that if a covered bond issuance is not in conformance with the Policy Statement, the FDIC retains discretion to grant consent prior to expiration of the 45 or 90 day period on a case-by-case basis. Under Section 11(e)(13)(C) of the FDIA, the exercise of any right or power to terminate, accelerate, declare a default, or otherwise affect any contract of the IDI, or to take possession of any property of the IDI, requires the consent of the conservator or receiver, as appropriate, during the 45-day period or 90-day period after the date of the appointment of the conservator or receiver, as applicable. By the statutory terms, the conservator or receiver retains the discretion to give consent on a case-by-case basis after evaluation by the FDIC upon the failure of the issuer.

Comments from banks who issued covered bonds prior to the Policy Statement requested either 'grandfathering' of preexisting covered bonds or an advance determination by the FDIC before any appointment of a conservator or receiver that specific preexisting covered bonds qualified under the Policy Statement. After carefully considering the comments, the FDIC has determined that to "grandfather" or otherwise permit mortgages or other collateral that does not meet the specific requirements of the Policy Statement to support covered bonds would not promote stable and resilient covered bonds as encompassed within the Policy Statement. If preexisting covered bonds, and their collateral, otherwise qualify under the standards specified in the Policy

Statement, those covered bonds would be eligible for the expedited access to collateral provided by the Policy Statement.

A number of commenters requested that the limitation of eligible covered bonds to no more than 4 percent of an IDI's total liabilities should be removed or increased. Commenters also noted that other countries applying a cap have based the limitation on assets, not liabilities. The Policy Statement applies to covered bond issuances that comprise no more than 4 percent of an institution's total liabilities since, in part, as the proportion of secured liabilities increases the unpledged assets available to satisfy the claims of the Deposit Insurance Fund, uninsured depositors and other creditors decrease. As a result, the FDIC must focus on the share of an IDI's liabilities that are secured by collateral and balance the additional potential losses in the failure of an IDI against the benefits of increased liquidity for open institutions. The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the U.S., which differs in many respects from that in other countries deploying covered bonds. Consequently, while changes may be considered to this limitation as the covered bond market develops, the staff does not recommend any change at this time.

A number of commenters sought expansion of the mortgages defined as "eligible mortgages" and the expansion of collateral for cover pools to include other assets, such as second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt, and student loans. Other commenters requested that "eligible mortgages" should be defined solely by their loan-to-value (LTV) ratios. After considering these comments, the staff believes that the FDIC's interests in efficient resolution of IDIs, as well as in

the initial development of a resilient covered bond market that can provide reliable liquidity for well-underwritten mortgages, support retention of the limitations on collateral for qualifying covered bonds in the Interim Policy Statement. Recent market experience demonstrates that many mortgages that would not qualify under the Policy Statement, such as low documentation mortgages, have declined sharply in value as credit conditions have deteriorated. Some of the other assets proposed are subject to substantial volatility as well, while others would not specifically support additional liquidity for well-underwritten residential mortgages. As noted above, certain provisions of the Policy Statement may be reviewed and reconsidered as the U.S. covered bond market develops.

With regard to the comments that LTV be used as a guide to determine an "eligible mortgage," the staff does not believe that LTV can substitute for strong underwriting criteria to ensure sustainable mortgages. In response to the comments, and the important role that LTV plays in mortgage analysis, the staff recommends that the Policy Statement urge issuers to disclose LTV for mortgages in the cover pool to enhance transparency for the covered bond market and promote stable cover pools. However, no specific LTV limitation should be imposed.

Two commenters suggested that the Policy Statement should be clarified to permit the substitution of cash as cover pool collateral. The Policy Statement has been modified to allow for the substitution of cash and Treasury and agency securities. The substitution of such collateral does not impair the strength of the cover pool and may be an important tool to limit short-term strains on issuing IDIs if eligible mortgages or AAA-rated mortgage securities must be withdrawn from the cover pool.

A number of commenters requested guidance on the calculation of damages the receiver will pay to holders of covered bonds in the case of repudiation or default. Under 12 USC § 1821(e)(3), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract is limited to "actual direct compensatory damages" and determined as of the date of appointment of the conservator or receiver. In the repudiation of contracts, such damages generally are defined by the amount due under the contract repudiated, but excluding any amounts for lost profits or opportunities, other indirect or contingent claims, pain and suffering, and exemplary or punitive damages. Under the Policy Statement, the FDIC agrees that "actual direct compensatory damages" due to bondholders, or their representative(s), for repudiation of covered bonds will be limited to the par value of the bonds plus accrued interest as of the date of appointment of the FDIC as conservator or receiver. The FDIC anticipates that IDIs issuing covered bonds, like other obligations bearing interest rate or other risks, will undertake prudent hedging strategies for such risks as part of their risk management program.

Many commenters suggested that the 10-year term limit should be removed to permit longer-term covered bond maturities. After reviewing the comments, the FDIC agrees that longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility. Therefore, the staff recommends revising the Interim Policy Statement by increasing the term limit for covered bonds from 10 years to 30 years.

A number of the Federal Home Loan Banks, and their member institutions, objected to the inclusion of FHLB advances in the definition of "secured liabilities," any imposed cap on such advances, and any change in assessment rates. Under 12 C.F.R. Part 360.2 (Federal Home Loan

Banks as Secured Creditors), secured liabilities include loans from the Federal Reserve Bank discount window, Federal Home Loan Bank (FHLB) advances, repurchase agreements, and public deposits. However, the Policy Statement does not impose a cap on FHLB advances and has no effect on an IDI's ability to obtain FHLB advances or its deposit insurance assessments. The Policy Statement solely addresses covered bonds.

However, as noted above, where an IDI relies very heavily on secured liabilities to finance its lending and other business activities, it does pose a greater risk of loss to the Deposit Insurance Fund in any failure. Should the covered bond market develop as a significant source of funding for IDIs, and should that development create substantial increases in an IDI's reliance on secured funding, it would increase the FDIC's losses in a failure and perhaps outweigh the benefits of improved liquidity. As a result, it is appropriate for the FDIC to consider the risks of such increased losses. Consideration of these risks may occur in a possible future request for comments on secured liabilities, but they are not addressed in this Policy Statement.

III. Final Statement of Policy

For the purposes of this Policy Statement, a "covered bond" is defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by a pool of eligible mortgages or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. The term "covered bond obligee" is the entity to which the IDI is indebted.

To provide guidance to potential covered bond issuers and investors, while allowing the FDIC to evaluate the potential benefits and risks that covered bond transactions may pose to the deposit insurance fund in the U.S. mortgage market, the application of the policy statement is limited to covered bonds that meet the following standards.

This Policy Statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligations at such issuance comprise no more than 4 percent of an IDI's total liabilities. The staff remains concerned that unrestricted growth while the FDIC is evaluating the potential benefits and risks of covered bonds could excessively increase the proportion of secured liabilities to unsecured liabilities. The larger the balance of secured liabilities on the balance sheet, the smaller the value of assets that are available to satisfy depositors and general creditors, and consequently the greater the potential loss to the Deposit Insurance Fund. To address these concerns, the recommended policy statement remains limited to covered bonds that comprise no more than 4 percent of a financial institution's total liabilities after issuance.

In order to limit the risks to the deposit insurance fund, application of the Policy Statement is restricted to covered bond issuances secured by perfected security interests under applicable state and federal law on performing eligible mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income, a limited volume of AAA-rated mortgage securities, and certain substitution collateral. The Policy Statement provides that the mortgages shall be underwritten at the fully indexed rate relying on documented income, and comply with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage

Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. In addition, the Policy Statement requires that the eligible mortgages and other collateral pledged for the covered bonds be held and owned by the IDI. This requirement is designed to protect the FDIC's interests in any over collateralization and avoid structures involving the transfer of the collateral to a subsidiary or SPV at initiation or prior to any IDI default under the covered bond transaction.

The FDIC recognizes that some covered bond programs include mortgage-backed securities in limited quantities. Staff believes that allowing some limited inclusion of AAA-rated mortgage-backed securities as collateral for covered bonds during this interim, evaluation period will support enhanced liquidity for mortgage finance without increasing the risks to the deposit insurance fund. Therefore, covered bonds that include up to 10 percent of their collateral in AAA-rated mortgage securities backed solely by mortgage loans that are made in compliance with guidance referenced above will meet the standards set forth in the Policy Statement. In addition, substitution collateral for the covered bonds may include cash and Treasury and agency securities as necessary to prudently manage the cover pool. Securities backed by tranches in other securities or assets (such as Collateralized Debt Obligations) are not considered to be acceptable collateral.

The Policy Statement provides that the consent of the FDIC, as conservator or receiver, is provided to covered bond obligees to exercise their contractual rights over collateral for covered bond transactions conforming to the Interim Policy Statement no sooner than ten (10) business days after a monetary default on an IDI's obligation to the covered bond obligee, as defined in

the Policy Statement, or ten (10) business days after the effective date of repudiation as provided in written notice by the conservator or receiver.

The staff anticipates that future developments in the marketplace may present interim final covered bond structures and structural elements that are not encompassed within this Policy Statement and therefore the FDIC may consider future amendment (with appropriate notice) of this Policy Statement as the U.S. covered bond market develops.

Contacts:

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