Time for a US alternative

Jerry Marlatt and Anna Pinedo of Morrison & Foerster ask whether it is time to stop waiting for a US statute

Seven years ago, Washington Mutual issued the first covered bonds by a US financial institution. Bank of America followed shortly after with its own covered bonds. These were structured covered bonds, not statutory covered bonds, since there was no US statute.

The structure used for these covered bonds, however, was unique and expensive. Under this structure, the banks issued bonds secured by a pool of mortgage loans to a trust (see diagram A). The trust in turn issued covered bonds to investors. Amounts paid on the secured bonds were used by the trust to make payments on the covered bonds. If the issuing bank became insolvent, the secured bonds accelerated, resulting in the full principal and accrued interest on the bonds being paid to the trust. The trust would invest the funds received in a guaranteed investment contract until needed to make payments on the covered bonds.

It was uncertain under the Federal Deposit Insurance Act what action the Federal Deposit Insurance Corporation (FDIC) would take as receiver of an insolvent bank with outstanding covered bonds. The FDIC could (i) repudiate the secured bonds and pay principal and interest accrued up to the date of insolvency to the trust, (ii) transfer the obligation on the secured bonds and the pool of mortgage loans to an assuming bank, or (iii) permit the indenture trustee for the secured bonds to liquidate the pool of mortgage loans and pay the trust principal plus accrued interest up to the date of payment. There was no certainty under the statute which course the FDIC would choose or the timing of its actions. To deal with this uncertainty, the trust held swaps that were designed, among other things, to ensure that the covered bonds continued to be paid while the FDIC determined what course of action to take.

In April 2008, as the financial crisis began to envelop the markets, the FDIC issued its Covered Bond Policy Statement, as an interim final order, to provide some immediate guidance. The statement sought to clarify the treatment of covered bonds in the event of the FDIC becoming the receiver of a failed issuing bank. The statement was limited to covered bonds that satisfied certain mortgage loan requirements and did not exceed 4% of the issuing bank's liabilities. In July 2008 the FDIC issued its Final Policy Statement on Covered Bonds.

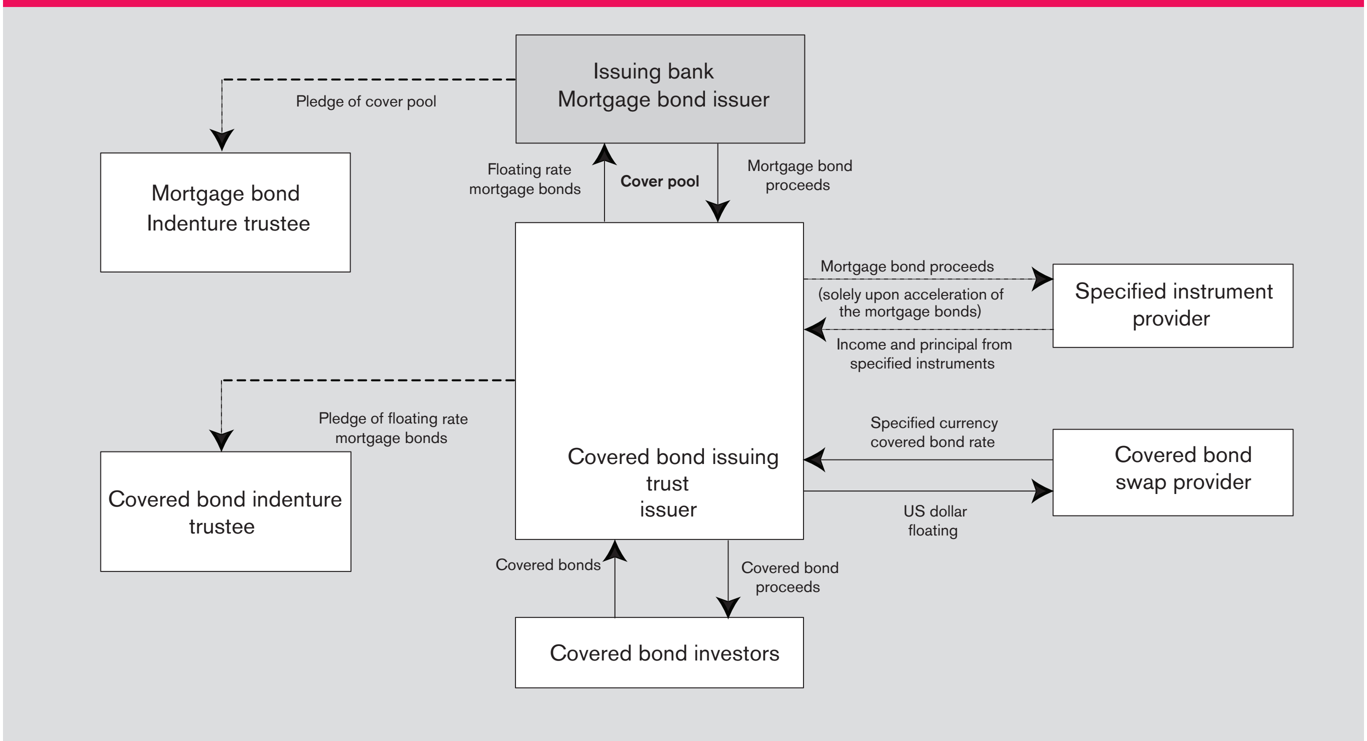
In June 2008, the US Department of the Treasury called a meeting of bankers, issuers, regulators and other participants in an effort to jump start the covered bond market in the US and to promote the development of a regulatory regime and market practices to enable the issuance of covered bonds in the country. In July 2008, the Treasury released its Best Practices for Residential Covered Bonds. This document was intended to expand on the standards for covered bonds and to complement the FDIC's Final Policy Statement.

Also in 2008, Congressman Scott Garrett (R-NJ) introduced a bill related to covered bonds. No action was taken on the bill.

When the financial crisis overtook the markets, Washington Mutual failed and was taken over by the FDIC, as receiver. The FDIC transferred the cover pool and the obligation on the mortgage bonds to JP Morgan Chase, which continued to make payments on the bonds.

Despite the success of Washington Mutual and Bank of America with this structure, it became clear that the existing structure for issuing US covered bonds was too expensive to replicate and too complicated for investors. Unusual, securitisation-type structures became disfavoured by investors. Also, the

Diagram A: structure used by Washington Mutual and Bank of America



swaps, which provided partial credit enhancement to the structure (as noted above), were one of a kind, off-market swaps that were quite expensive.

In 2009, Congressman Garrett introduced another bill on covered bonds, which was not acted on by Congress. In 2010, there was a failed attempt to add covered bond provisions to the Dodd-Frank Wall Street Reform and Consumer Protection Act. In 2011, Congressman Garrett introduced HR 940 in the House of Representatives. The bill was assigned to the Financial Services Committee and the Ways and Means Committee. After hearings on the bill, the Financial Services Committee approved the bill 44-7, a strong bi-partisan showing. The bill, however, was hung up in the Ways and Means Committee until late December 2012 and, accordingly, was never voted on by the full House of Representatives.

In November 2011, s.1835 was introduced in the Senate, co-sponsored by Senators Hagan (D-NC), Schumer (D-NY), Crapo (R-ID) and Corker (R-TN), and assigned to the Committee on Housing, Banking and Urban Affairs. No hearings were held on the bill and no further action was taken on the bill. In the spring of 2012, there was a failed effort in the Senate to add covered bond provisions to the Jobs Act.

With the start of 2013, a new Congress began. Any bills unfinished by the old Congress must be reintroduced in the new Congress if action is to be taken on them. To date, no covered bond bill has been introduced in the Senate or the House of Representatives.

We are now in the sixth year of efforts to enact a covered bond statute. And the legislative agenda is again crowded, this year with immigration reform, deficit spending limitations, tax reform, GSE wind down bills, telephone and internet surveillance hearings and a host of other matters. Perhaps it is time to try an alternative, to try to restart covered bond issuance by US banks in the absence of a statute.

The housing market is clearly recovering strongly and the need for private sector funding of residential mortgage loans is growing. Government-sponsored enterprises (GSEs) have funded approximately 95% of new mortgage loans since the crisis, but now efforts are emerging to address the losses in GSEs and reduce their role in financing new mortgage loans. There is legislation in the Senate to dissolve the GSEs and establish a new mortgage insurance corporation as an agency of the government.

The securitisation of mortgage loans has yet to recover in the United States. As a result of the enormous settlements for representation and warranty violations entered into by the banks that funded their origination of mortgage loans through FNMA or FHLMC or through private sector securitisation, banks are now trying to put specific time limits on their representation and warranty exposure, so far only with wary acceptance by investors.

Perhaps it is worth trying to develop an alternative means for US banks to issue covered bonds. Covered bonds provide a more policy-friendly means of residential mortgage finance. Because mortgage loans remain on the bank's books, the bank's interests are better aligned with those of investors. The bank has an incentive to maintain strong underwriting standards and, for borrowers who get into difficulties, the bank retains the flexibility to assist borrowers in working out loans because it continues to own the loans. From an investor's perspective, covered bonds create additional confidence because they are dual recourse instruments, providing recourse both to the issuing bank and to a pool of collateral in the event of a bank failure or default. Finally, the issuance of covered bonds by financial institutions are subject to continued regulation and oversight by banking authorities.

The structure used by Washington Mutual and Bank of America for issuing covered bonds is still not usable, however, due to its expense and complexity. But perhaps it is worth attempting to obtain approval for issuing covered bonds under the structure used by Canadian and English banks prior to the passage of statutes in those countries and still used today under a statutory scheme.

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Anna Pinedo's practice is focused on securities and derivatives. She represents issuers, investment banks and financial intermediaries, and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

Pinedo works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing expertise in working with technology-based, telecommunications, and healthcare, companies, and with financial institutions, REITs and consumer finance companies. Pinedo has worked closely with foreign private issuers in their securities offerings in the US and in the Euro markets. She has also worked with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium-term note and commercial paper programmes. She is the co-author of *Covered Bonds Handbook*, published by Practising Law Institute (2010).

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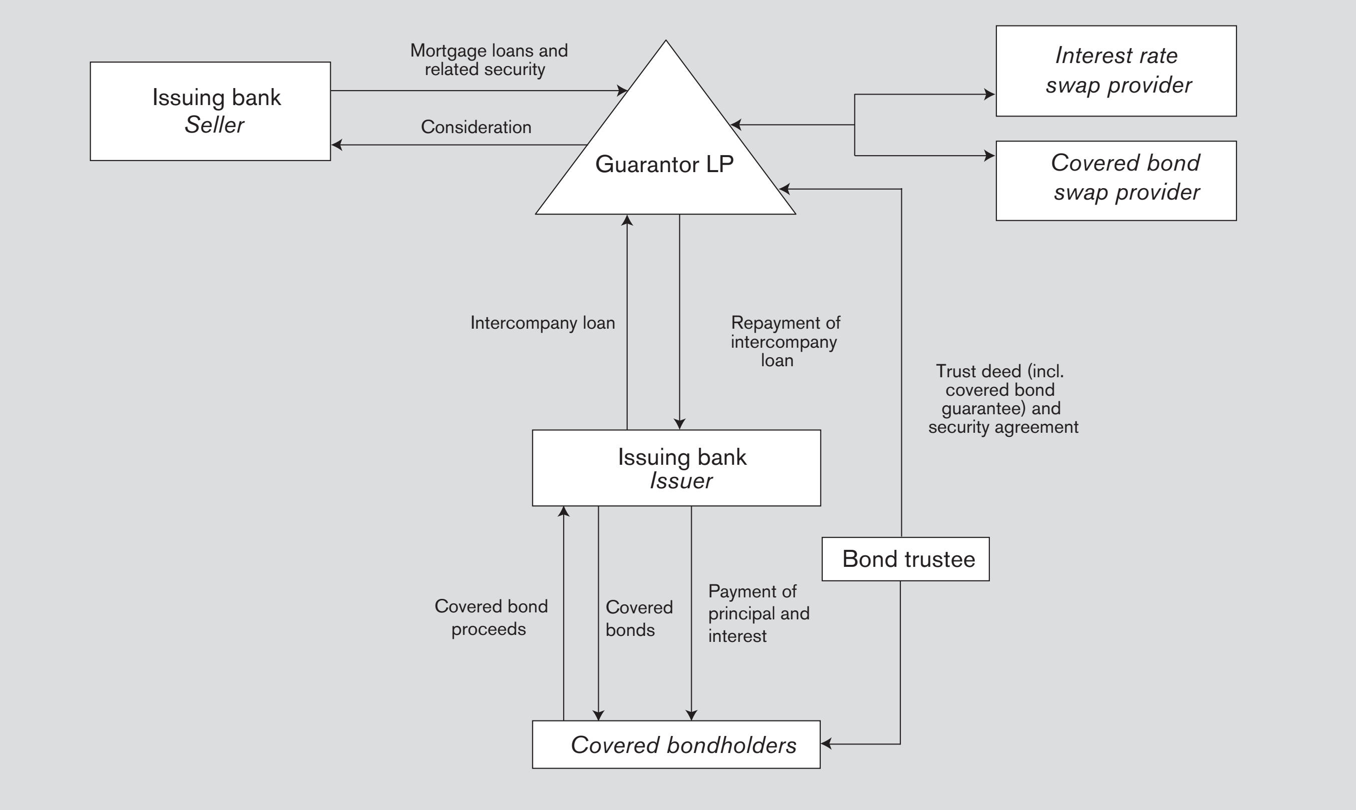
Jerry Marlatt represents issuers, underwriters and placement agents in public and private offerings of debt, covered bonds, surplus notes, securities of structured investment and specialised operating vehicles, and securities repackagings. Example transactions involve the first covered bond by a US financial institution, the first covered bond programme for a Canadian bank, surplus notes and common stock for a US monoline insurance company, eurobond offerings by US issuers and securities offerings for a variety of structured vehicles, including CBOs, SIVs, CDOs, derivative product companies, ABCP conduits and credit-linked investments. Marlatt is co-author of *Considerations for Foreign Banks Financing in the US*, published by International Financial Law Review (2012), is a contributor to *Covered Bonds Handbook*, published by Practising Law Institute (2010) and a charter member of the United States Covered Bonds Council. He was named Dealmaker of the Year by *The American Lawyer* for his work as issuer's counsel on the first covered bond deal ever registered with the Securities and Exchange Commission. Marlatt is recommended as a leading lawyer by *Chambers USA* 2013, *Legal 500 US* 2013 and *IFLR1000 2013*.

Diagram B: structure used in the UK and Canada



This structure has been welcome in the market and does not entail the expense and complexity of the Washington Mutual structure.

It is a simple structure. The issuing bank establishes a subsidiary to which it sells the mortgage loans that will constitute the cover pool. A loan from the bank to the subsidiary provides the financing for the purchase of the loans. The bank issues covered bonds to investors, guaranteed by the subsidiary. The guarantee is secured by the pledge of the mortgage loans owned by the subsidiary. (see diagram B). If the bank fails, it will be taken into receivership by the FDIC. The subsidiary then becomes obligated under its guarantee to continue making scheduled payments on the covered bonds using proceeds from the mortgage loans. This issuance structure has now become well accepted by US investors as almost half of the $120 billion of dollar covered bonds outstanding have been issued under this structure.

The legislative initiatives discussed above contemplate a direct issuance structure that is similar to many European structures. Mortgage loans in the collateral pool would be ringfenced on the balance sheet of the issuing bank and covered bonds would be issued directly to investors by the bank. Only upon the insolvency of the bank (or upon a pre-insolvency event of default) would the mortgage loans be separated from the bank and used to pay the covered bonds as scheduled. Such a structure would be preferable for its simplicity, but in the absence of a statute the Canadian or English structure is probably the best alternative and has the benefit of market acceptance.

Whether this structure would be approved by US regulators, particularly the FDIC, is an open question. In order for the structure to work, the FDIC would need to treat the transfer of mortgage loans to the subsidiary as a sale when the FDIC is acting as a receiver for the failed bank. Because the mortgage loans would be transferred in whole to the subsidiary, with no retained interest held by the bank, such sale treatment should be obtainable. Regulatory approval would also be needed to establish a bank subsidiary. Because the subsidiary would be engaged in the business of investing in mortgage loans, a business the bank itself is authorised to engage in, approval for establishment of the subsidiary seems likely. Such regulatory approval may be conditioned on the bank not issuing covered bonds in excess of an specific percentage of it liabilities to address any FDIC concern about excessive encumbrance of assets.

The effect of this structure is to convert a debt obligation of the issuing bank, upon its failure, into a simple securitisation with a fresh collateral pool that has no defaults at the time of the conversion. The impact on depositors and other creditors of the bank should be similar to that of the bank effecting a securitisation immediately before its failure.

This structure was not used by Washington Mutual and Bank of America to issue their covered bonds. There has been some suggestion that there was some regulatory hostility at the time to this structure. However, there has never been a definitive response from the regulators to using this structure. Moreover, in the aftermath of the financial crisis, caused at least in part by US mortgage securitisation, perhaps the regulatory response would be different today.

As in the Canadian and English covered bond programmes, if a bank were limited in the percentage of its assets that it could transfer to its subsidiary, perhaps the FDIC could be convinced that covered bonds issued under this structure would provide an attractive alternative to securitisation of mortgage loans. Securitisation comes with massive hidden contingent liabilities for breaches of representations and warranties, with inherent conflicts of interest and a mix of complicated Dodd-Frank rulemaking. By comparison, covered bonds simplify the regulators' assessment of a bank because of improved transparency, and foster a better environment for borrowers and improved bank underwriting standards. At a time when it would be beneficial to restore a high level of private sector funding for residential mortgage loans without the risks presented by securitisation, maybe we should look at this alternative to enacting a covered bond statute, and get on with the business of financing residential housing. A statute would follow if we develop significant issuance.