April 8, 2008

MEMORANDUM TO: The Board of Directors

THROUGH: Sara A Kelsey
General Counsel

FROM: Richard T. Aboussie
Associate General Counsel
Litigation Branch

Charles A. Fulton
Counsel

SUBJECT: Interim Final Covered Bond Policy Statement

Recommendation

That the Board of Directors approve for publication in the Federal Register an interim final Covered Bond Policy Statement ("Policy Statement"), with a request for comments. The Policy Statement would provide 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 will provide guidance to facilitate the prudent and incremental development of the U.S. covered bond market while the FDIC and other regulators evaluate the benefits and risks of these products in the U.S. mortgage market. The reason for publishing the Policy statement as "interim final" is to provide immediate guidance to covered bond issuers, but with a view to possible later amendment in response to comments received.

Background

The FDIC has received questions from interested parties about how covered bond transactions will be treated in a conservatorship or receivership of an insured depository institution ("IDI"). Currently, there are no statutory or regulatory prohibitions on the issuance of covered bonds by U.S. banks. Interested parties assert that if the FDIC were to issue a policy statement providing guidance on the availability of expedited access to collateral pledged for certain covered bonds, in a conservatorship or a receivership, it would reduce market uncertainty and the additional costs of U.S. covered bond transactions. As discussed below, these costs are created by the 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 after the FDIC decides 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 access pledged covered bond collateral.

Covered bonds are general 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. The 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"). 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.

FDIC staff agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and 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 diversified sources of liquidity and the benefits that accrue from additional on balance sheet alternatives to securitization for financing mortgage lending. The Policy Statement seeks to balance these considerations by clarifying the circumstances and the specific covered bond transactions for which the FDIC will grant consent to access pledged covered bond collateral. Staff believes that the prudential limitations identified 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. As a result, FDIC staff recommends publication in the Federal Register of the interim final Covered Bond Policy Statement with a request for comments.

Discussion

Under the Federal Deposit Insurance Act, 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. During this period, the FDIC must still comply with otherwise enforceable provisions of the contract. The FDIC also may terminate or repudiate any agreement of the IDI within a reasonable time after 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. The questions 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.

The Policy Statement provides that the consent of the FDIC as conservator or receiver is promised to covered bond obligees in covered bond transactions conforming to the Policy Statement to obtain collateral ten (10) business days after a monetary default on an IDI's obligation to the covered bond obligee, or after the effective date of repudiation as provided in written notice by the conservator or receiver.

To provide guidance to potential covered bond issuers and investors, while allowing the FDIC to evaluate the potential benefits and risks that these 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:

- Covered bonds comprise no more than 4% of an issuing financial institution's total liabilities after issuance.
- Covered bonds must be secured by perfected security interests under applicable state and federal law
  - on performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income in accordance with FDIC and interagency guidance on the underwriting of residential mortgages in effect at issuance (defined as "eligible mortgages) ; or
  - AAA-rated mortgage-backed securities backed solely by eligible mortgages that are made in compliance with standards defined above. Such mortgage-backed securities may comprise no more than 10% of the collateral for any covered bond issuance or series.

Comment is also invited on the following issues: whether the policy should be limited to the currently defined structures or open to future innovations in how covered bond transactions may be structured in the U.S. and, if so, how any future policy should be applied to such innovative elements; whether issuances of covered bonds should increase an institution's insurance assessment rate or be included in an institution's assessment base; if so, whether such

assessment rate increases or inclusion in assessment base should only apply when an institution's covered bond liability exceeds 4% of its total liabilities; whether an institution's percentage of secured liabilities to total liabilities should be factored into an institution's insurance assessment rate or whether the total secured liabilities should be included in the assessment base; and, whether there should be an overall cap for secured liabilities.

Contacts:

If you have any questions concerning this case, please call Michael Krimminger, Special Advisor for Policy (202) 898-8950, Richard T. Aboussie, Associate General Counsel, Legal Division (703) 562-2452, or Charles A. Fulton, Counsel, (703) 562-2424.