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United States Covered Bond Act of 2010 Introduced in the House of Representatives

Covered bonds have been singled out in recent months for their capacity to bring a stabilizing influence to the broader financial system and to supply meaningful credit to consumers, small businesses, and State and local governments throughout the United States.

Covered bonds are a form of high-grade senior debt that is issued by a bank or other regulated financial institution and that is secured – or "covered" – by a dynamic cover pool of financial assets which is continually replenished. What distinguishes covered bonds from other secured debt is a mechanism for managing (rather than immediately liquidating) the cover pool upon the issuer's default or insolvency and continuing scheduled (rather than accelerated) payments. Covered bonds have a 240-year history in Europe, and today, almost 30 countries there have adopted national legislation to govern them.

Covered bonds create an effective bridge between the capital markets and households, small businesses, and public-sector borrowers for several reasons:

- With maturities that range from 2 to 10 years or more, covered bonds can infuse stable, longer term liquidity into the credit markets and reduce refinancing risks.

- By providing more cost-effective funding for lenders, covered bonds can produce less expensive and more available credit for borrowers of all kinds.

- Covered bonds can mitigate systemic risk by enabling financial institutions to draw liquidity from a separate investor base that would not otherwise make funds available through the unsecured-debt or securitization markets.

- Covered bonds can deliver funding from the private sector even in distressed market conditions without relying on U.S. taxpayers for support.

- Because covered-bond issuers continue to own the assets in their cover pools and have 100% "skin in the game," incentives relating to loan underwriting, performance, and modification can be strongly aligned.

- As a straightforward financial instrument, covered bonds can increase transparency and uniformity in the capital markets.

To function effectively, however, a U.S. covered-bond market must be deep and highly liquid, and that requires the kind of legal certainty that only comprehensive federal legislation can provide.

CONTACTS

If you have any questions about the Act or want to discuss covered bonds generally, please contact:

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Today, Representative Scott Garrett (Ranking Member of the House Capital Markets Subcommittee) acted to provide this legal certainty by introducing the United States Covered Bond Act of 2010. Joining him as leading co-sponsors were Representatives Paul Kanjorski (Chairman of the House Capital Markets Subcommittee) and Spencer Bachus (Ranking Member of the House Financial Services Committee).

The Garrett-Kanjorski-Bachus United States Covered Bond Act includes the following core elements:

- *Public Supervision by the Treasury Department* – The Secretary of the Treasury or another Treasury official designated by the Secretary is appointed to serve as the covered bond regulator and is directed to issue regulations establishing a covered bond regulatory oversight program. The covered bond regulator, acting in consultation with any primary federal regulator of an eligible issuer, has authority over whether to approve that issuer's covered bond programs. A public registry of all approved covered bond programs is required to be maintained by the covered bond regulator.

- *Eligible Issuers* – Eligible issuers of covered bonds consist of (1) FDIC-insured depository institutions and their subsidiaries, (2) bank holding companies and savings and loan holding companies, and (3) issuing entities that are sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis.

- *Covered Bonds* – A covered bond is defined as a senior recourse debt obligation of an eligible issuer that (1) has an original term to maturity of not less than one year, (2) is secured directly or indirectly by a perfected security interest in a cover pool which is owned directly or indirectly by the issuer, (3) is issued under a covered bond program that has been approved by the covered bond regulator and is identified in the registry of covered bonds maintained by the covered bond regulator, and (4) is not a deposit.

- *Cover Pool* – A cover pool is defined as a dynamic pool of assets that is comprised of (1) one or more eligible assets from a single eligible asset class, (2) substitute assets (such as cash and cash equivalents) without limitation, and (3) ancillary assets (such as swaps, credit enhancement, and liquidity arrangements) without limitation. No cover pool can include eligible assets from more than one eligible asset class. A loan does not qualify as an eligible asset while delinquent for more than 60 consecutive days, and a security does not qualify as an eligible asset while any investment-grade requirement is not met. Each issuer is required to clearly identify the assets that comprise a cover pool in its books and records and to deliver to the indenture trustee, on at least a monthly basis, a schedule of all eligible assets and substitute assets in the cover pool.

- *Eligible Asset Classes* – The eligible asset classes consist of (1) the residential mortgage asset class, (2) the home equity asset class, (3) the commercial mortgage (including multifamily) asset class, (4) the public sector asset class, (5) the auto asset class, (6) the student loan asset class, (7) the credit or charge card asset class, (8) the small business asset class, and (9) other asset classes designated by the covered bond regulator.

- *Over-collateralization, Asset-Coverage Test, and Independent Asset Monitor* – The covered bond regulator is directed to establish minimum over-collateralization requirements for covered bonds backed by each of the different eligible asset classes based on credit, collection, and interest-rate risks but not liquidity risks. Each cover pool securing covered bonds must satisfy, at all times, an asset-coverage test that measures whether the eligible assets and the substitute assets meet the minimum over-collateralization requirements. Each issuer is required to perform the asset-coverage test monthly on each of its cover pools and to report the results to applicable covered bondholders and regulators. Each issuer also is obligated to appoint the indenture trustee for its covered bonds or another unaffiliated entity as an independent asset monitor, which will verify the results of the asset-coverage test on an annual or more frequent basis and provide reports to applicable covered bondholders and regulators.

- *Separate Resolution Process for Covered Bond Programs* – A separate estate is created for a covered bond program if the issuer defaults or enters conservatorship, receivership, liquidation, or bankruptcy, unless the FDIC is able to transfer the covered bond program to another eligible issuer within 15 days of its appointment as conservator or receiver for the issuer. Deficiency claims against the issuer or its insolvency estate are preserved, and a residual interest representing the right to any surplus from the cover pool is created for the issuer or its insolvency estate.

  The covered bond regulator is appointed to serve as the trustee for an estate that is created for a covered bond program and is required to engage a servicer or administrator to manage and realize on the cover pool and to use the funds and other proceeds received to make all remaining payments on the covered bonds and other liabilities of the estate at the scheduled times. The servicer or administrator also is authorized to borrow or otherwise procure funds for the benefit of the estate on a secured or unsecured basis.

- *Other Provisions* – The application of securities and tax laws to covered bond programs is clarified, and the SEC is directed to develop a streamlined registration scheme for covered bonds that do not fall within an exemption provided under the Act or otherwise. SMMEA is expanded to encompass covered bonds, and covered bonds that are backed by the residential mortgage asset class, the home equity asset class, or the commercial mortgage asset class are treated as qualified mortgages for REMICs.

If you have any questions about the Garrett-Kanjorski-Bachus United States Covered Bond Act or want to discuss covered bonds generally, please contact Scott Stengel (202.339.8484 or sstengel@orrick.com). Scott is a member of the Steering Committee for the U.S. Covered Bond Council and testified before the House Financial Services Committee in December on the unique role for covered bonds in the United States.