Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

23 June 2008

Dear Mr. Feldman,

Merrill Lynch is pleased to submit some comments on the Interim Final Covered Bond Policy Statement published by the Federal Deposit Insurance Corporation (FDIC) on 23 April 2008.

We strongly believe that the Covered Bond is an asset class that merits the serious attention of the various US authorities that regulate financial institutions and the bond markets. Every effort should be made to facilitate the establishment of a vibrant market for this asset class in the US. The market potentially offers US financial institutions an opportunity of raising cost effective, term funding using on balance-sheet assets, while attracting new groups of investors and enhancing their liquidity. The Covered Bond will, however, flourish only if investors can be certain of its inherent quality and liquidity. The European experience has reinforced our belief that the Covered Bond requires the support of a strong domestic investor base in order to gain wider international acceptance.

We note that international investors are generally less familiar with US insolvency practices and recent secondary market activity indicates that US covered bonds are not favoured by traditional European covered bond investors. Recent rating agency action has served to further increase investor concerns. In order to establish a vibrant US covered bond market, international investors need to gain confidence in the product and domestic investors need to be encouraged to buy into the funding concept. This will have many benefits.

We believe that the FDIC should provide greater support for the issuance of covered bonds in the US in such a way as to encourage broad participation in this sector by major domestic funds. We recognise that there is some tension between the role of the FDIC as a receiver or conservator of an insured depository institution protecting the deposit insurance fund, and the nature of the Covered Bond that offers specific high quality security to one specific group of creditors. We hope that a balance can be achieved, which recognises the interest of all parties, including the benefits of the asset class for US banks and their depositors, and lays a solid foundation for future market growth and development.

<u>The ASF Letter</u>

We support the various specific technical comments made by the American Securitization Forum (ASF), of whose working group we are a member. We wish nevertheless to make some general comments on the need to increase confidence in the US covered bond product. We welcome the principle of issuing a Covered Bond Policy Statement to clarify the FDIC's position on covered bonds and their treatment in a conservatorship or receivership of a sponsor bank. The overall hope, as also expressed in the ASF letter, is that the reach of the Covered Bond Policy Statement should be broadened to make US covered bonds truly competitive and attractive to a wide community of domestic and international investors.

Specific measures should include confirming in a clear and categorical manner that the *actual direct compensatory damages* will equate to at least the payment of principal and accrued interest. Indeed, we might even suggest that the FDIC considers treating cover pools in the same way as assets pledged to the Federal Home Loan Banks.

One of the principles that has successfully underpinned the growth of the covered bond market in other jurisdictions and reinforced the credit quality of the product has been the ability to successfully segregate a cover pool including over-collateralization and the related covered bonds from the balance sheet of the insolvency estate of an issuer, allowing the cover pool to service the covered bonds until maturity. The existing arrangements whereby the FDIC has extensive rights over a failed financial institution's balance sheets, including the cover pool, result in uncertainty and may compromise the ability to service any outstanding covered bonds in full and cause an impairment to their ratings and the credit quality of the instrument.

<u>Covered Bond Issuance Threshold and Cover Pool Assets</u>

It is recognised that the encumbrance of prime assets of a financial institution leads to structural subordination of unsecured creditors, including depositors, and results in a regulatory pressure to limit the amount, up to which a financial institution might fund eligible on-balance sheet collateral via the issuance of covered bonds. Nevertheless, we consider the indicated 4% issuance threshold to be excessively tight and suggest a far higher limit to be adopted. Work done in other jurisdictions suggests that there is a direct benefit for unsecured creditors of and other stakeholders in a financial institution accruing from lower financing costs, diversification of funding sources and longer maturities available. These benefits – at least partly – outweigh any structural subordination effects. Note that the UK has adopted covered bond issuance thresholds of 4% and 20% of the total assets of an issuer and that such thresholds are not hard issuance limits but trigger points at which an issuer has to engage in discussions with the UK Financial Services Authority. We would urge the FDIC to adopt a similar approach, particularly since no limit exists on any other form of secured borrowing by US banks. This would provide the respective primary federal regulator and the FDIC flexibility to negotiate issuance thresholds with an insured depository institution on a case by case basis.

We firmly support a relaxing of the definition of eligible mortgages. For example, loans secured by a mortgage on commercial property, public sector debt, student loans, mortgage-backed securities and substitute collateral and derivatives – all subject to strict criteria for eligibility – should be permitted to be included in the cover pool. We recognise that the immediate focus is a facilitation of residential mortgage finance, but we urge the FDIC to expand its current eligibility criteria and allow additional assets – eligible as collateral in other jurisdictions – to be included in the cover pool in order to avoid anti-competitive consequences. This should be encouraged at an early stage in the evolution of a fully fledged US covered bond market. Generally, as shown in the European experience, there needs to be a mechanism that allows potential product evolution and development, as the market is unlikely to remain static.

Other Market Measures

The successful growth of a covered bond market is only partly dependent on the quality and reliability of the instrument itself. It must be emphasised that this initiative must be undertaken as one aspect of the establishment of the asset class. Issuers will need to commit to using the market, provided there are sensible incentives for them to do this. The trading community is responsible for supporting the instrument and we will work to put in place the necessary elements for a successful secondary market performance and sufficient liquidity to provide comfort to investors. These measures include a variety of initiatives, such as an agreement over an electronic trading platform and an advantageous repo treatment (i.e., covered bonds should be considered eligible collateral at the Fed's Discount Window), which should form the basis for future market liquidity.

It is also important to have in place a specific independent asset monitor that reports to the financial institution's primary federal regulator and/or the FDIC and verifies the institution's compliance with obligations or requirements imposed on it under the Policy Statement and other guidelines. Clear and timely reporting is in the FDIC's and investors' interests. In addition, a financial institution's compliance with the Policy Statement and other guidelines should be effectively monitored. Monitoring and disclosure of cover pool statistics and information should be timely (monthly) and offer a high standard of transparency.

In summary, Merrill Lynch welcomes the opportunity to comment on this proposal. We warmly welcome the work being done to invigorate this market and believe that there is the potential for the Covered Bond to establish itself as an important asset class in the US. However, the product requires clear leadership and unambiguous support from the FDIC and other interested US regulatory authorities, and industry to be successful. We therefore welcome also the Department of the Treasury's initiative to bring interested parties together in order to create a consensus for future action.

The team at Merrill Lynch remains at your disposal for further consultation both in the context of the work done on our behalf by the ASF and in our own name directly.

Yours truly,

Tim Skeet
Managing director
Head of Covered Bonds
Merrill Lynch Covered Bond Team