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## EUR Liquid Credit Update

# FDIC on US Covered Bonds

### Regulatory Policy

#### Research Analyst

**Bernd Volk, CFA**Strategist  
(+49) 69 910-31967  
bernd.volk@db.com

Moody's has given Washington Mutual covered bonds the second worst of all possible Timely Payment indicators ('improbable') and rates the covered bonds A2 with review uncertain. Against this backdrop, we briefly review the FDIC Policy Statement on US covered bonds and comment on it. An A1 rating at Moody's would have been possible given a Timely Payment Indicator of 'improbable'. Moody's has not provided reasons for not giving a A1 rating.

The FDIC Policy statement was published on April 8, 2008 (as 'interim final') in order to provide immediate guidance with the possibility of introducing amendments later.

In its policy statement the FDIC allows a covered bond holder to exercise certain rights. They could request the FDIC not to assert the rights to repudiate contracts and to request a stay as conservator – or as receiver. In both relevant cases, if the appointed conservator or receiver fails to make payments on the respective covered bond obligations over 10 business days or in case of repudiation, if the FDIC fails to pay the respective damages within 10 business days, the FDIC authorizes the respective covered bond holder to exercise the respective contractual rights. The FDIC policy statement creates an exception to general insolvency procedures with respect to U.S. insured depository institutions (IDI) for the benefit of covered bond holders.

The Policy Statement is limited to covered bonds meeting the following standards:

- A covered bond is defined as a recourse debt obligation of an insured depository institution with a term greater than one year and no more than ten years.
- Covered bonds comprise no more than 4% of an issuing financial institution's total liabilities after issuance.
- 'Eligible mortgages are performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income in accordance with existing supervisory guidance governing the underwriting of residential mortgages only, 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 other guidance applicable at the time such covered bonds are issued by any insured depository institution.
- AAA-rated mortgage-backed securities backed solely by eligible mortgages are also eligible. Such mortgage backed securities may comprise no more than 10% of the collateral.

**The FDIC Policy Statement is an important step in clarifying the regulatory treatment.**

It could strongly mitigate concerns about the timeliness of payments. We have the following comments:

- Other regulators like the British FSA referred the issuance limit to total assets instead of total liabilities. In our view, a limit regarding the issuance of covered bonds is useful. Otherwise, if a bank makes too much use of covered bonds as a funding tool, political pressure might arise against actually enforcing the preferential claim of covered bond holders in case of issuer insolvency.
- According to our understanding, a covered bond once issued inside the stipulated maturity range will not fall out of the regulation when the remaining life is below one year.
- AAA mortgage backed securities can be allowed up to 20% of the cover pool without breaching the limit set by CRD (certainly, CRD is not relevant for US covered bonds).
- We understand that the FDIC's consent to repudiate contracts and to request a stay as conservator or as receiver may not necessarily be visible before the 11th day following a monetary default or a non-payment of the respective damages. In order to make it transparent whether individual covered bond programs would qualify for a beneficial treatment, the FDIC could publicly declare whether the respective covered bonds would fall under the respective protections or not, following the examination of a request for consent.
- The Policy Statement does not stipulate a specific structure, even though *covered bonds must be secured by perfected security interests under applicable state and federal law*. In our view, the Policy Statement should be open to other structures and not only cover the current structure of US covered bonds. Even more so, as the current structure of US covered bonds is different to most other covered bond concepts where covered bonds are issued by banks and not by special purpose vehicles. The possibility of Insured Depository Institutions issuing covered bonds without the use of a SPV as an intermediary would simplify the structure.
- The Policy Statement defines that a covered bond is a recourse debt instrument of a depository institution. A further clarification that holders of US covered bonds, under the current structure, in fact have full recourse to the issuer of the mortgage bonds would be helpful, i.e. that covered bond holders, on top of the preferential claim against the collateral in the cover pool, rank pari passu to unsecured credit in case their claims are not fully satisfied by the collateral in the cover pool.
- The Policy Statement says: *The FDIC as conservator or receiver consents to a covered bond obligee's exercise of the rights and powers listed in 12 U.S.C §1821(e)(13)(C), and will not assert any rights to which it may be entitled pursuant to 12 U.S.C. §1821(e)(13)(C), after expiration of the specified amount of time, and the occurrence of the following events: .....(2) If the FDIC as conservator or receiver of an insured depository institution provides a written notice of repudiation of a contract to a covered bond obligee, and the FDIC does not pay the damages pursuant to 12 U.S.C. §1821(e)(13)(C) by reason of such repudiation with ten (10) business days after the effective date of the notice, the FDIC hereby consents pursuant to 12 U.S.C. §1821(e)(13)(C) for the covered bond obligee's exercise of any of its contractual rights, including liquidation of property pledged collateral by commercially reasonable methods, provided no involvement of the receiver or conservator is required.* A further clarification that in case of the FDIC paying compensatory damages, compensatory will either amount to the par value of the bonds or consent to access to collateral making up for the difference will have to be granted would be helpful.
- Generally, the Policy Statement lacks valuation calculations and does not contain any specific loan to value limit.

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