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COVERED BOND GROUP

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United States Department of Treasury Releases Best Practices for Residential Covered Bonds

On July 28, 2008, The United States Department of Treasury released "Best Practices for Residental Covered Bonds" to provide guidelines for issuers of Covered Bonds in the United States. The guidelines, together with the July 15, 2008 publication of the Federal Deposit Insurance Corporation, "Final Covered Bond Policy Statement," are intended to provide greater certainty as to the treatment of Covered Bonds issued in the United States. Although the guidelines are limited to Covered Bonds backed by residential mortgages and, to a limited extent, AAA-rated residential mortgage-backed securities, the guidelines specifically state that it is expected that additional asset classes will back Covered Bonds as the market develops.

In general, Covered Bond structures involve the issuance of a non-deposit, recourse debt obligation of an insured depository institution (an "IDI"). Such debt obligation is directly or indirectly secured by a perfected security interest in the underlying pool of collateral (referred to as the "Cover Pool"). In some cases, however, that debt obligation will be deposited into a special-purpose trust or similar entity (a "special purpose entity" or "SPV"), which will issue the securities that are sold to investors.

In contrast to most current mortgage-backed securities transactions, a Cover Pool will remain on the balance sheet of the subject IDI. The primary repayment obligation for any Covered Bonds rests with the issuer. In the event of a default by the issuer to repay the principal and interest on the Covered Bonds, investors have recourse to the Cover Pool. The Cover Pool is actively managed at all times to maintain its credit quality and levels of overcollateralization. In the event that the Cover Pool is liquidated and the proceeds of such liquidation are insufficient to cover required principal and interest payments, the investors will retain a general unsecured claim against the issuer for the amount of the deficiency.

Covered Bonds have had a long and successful history in Europe in providing liquidity to the mortgage market (importantly, in particular, due to the absence in Europe of government-sponsored entities equivalent to Fannie Mae, Freddie Mac and the Federal Home Loan Banks). In many European jurisdictions, a legal and regulatory framework has been established for the issuance and operation of Covered Bond programs. Such legal and regulatory framework does not exist in the United States, and accordingly, to date, only two United States institutions have issued Covered Bonds: one solely in Euros, and the other in Euros and U.S. Dollars. To that end, the guidelines state that their purpose is to present a "standardized model for Covered Bonds issued in the United States in the absence of dedicated legislation."

The guidelines specify that for a Covered Bond program to be consistent with the "Best Practices Template," it must exhibit certain specified characteristics both at the time of issuance and throughout the life of the program. These characteristics include:

- Each Covered Bond issued under the program must have a maturity between one and 30 years;

- Issuers of Covered Bonds must provide a first priority security interest in the Cover Pool for the benefit of investors, and the Cover Pool must be otherwise unencumbered by any other lien;

- All collateral in the Cover Pool must satisfy certain eligibility requirements (including the requirement that each mortgage was underwritten at the fully indexed rate and in reliance upon documented income) and concentration limits (including geographically-based limits);

- Issuers must maintain a Cover Pool that, at all times, has an overcollateralization value of not less than 5% of the outstanding principal balance of the Covered Bonds;

- For purposes of calculating the minimum required overcollateralization with respect to the Covered Bonds, the portion of each mortgage loan in the Cover Pool that will be credited will equal the lesser of (i) the full outstanding principal balance of that mortgage loan and (ii) 80% of the updated value of the underlying mortgaged property;

- Compliance with monthly asset coverage tests (including periodic independent third-party monitoring of the asset coverage) and monthly disclosure requirements, together with substitution obligations with respect to non-performing assets;

- Issuers may invest proceeds of Cover Pool assets into a guaranteed investment contract or other arrangement for the purposes of paying scheduled interest and principal payments (to avoid acceleration upon an issuer insolvency);

- Appointment of an independent trustee for the Covered Bonds (who should, among other things, represent the investors' interests and enforce the investors' rights in an issuer insolvency);

- An IDI must receive consent from its primary federal regulator; and

- Covered Bonds must not account for more than 4% of an IDI's liabilities (although the FDIC has indicated that this level may be re-evaluated as the United States market develops).

The guidelines, and to a greater extent, the FDIC's "Final Covered Bond Policy Statement" set out procedures that the FDIC would follow in the event of an issuer insolvency or receivership. These procedures may include the FDIC continuing to perform the issuer's obligations under the Covered Bond program, paying off the Covered Bonds in cash (up to the value of the Cover Pool) or allowing the liquidation of the Cover Pool to pay off the Covered Bonds. Any shortfall in repayment of a Covered Bond would be an unsecured claim in the receivership of the issuer. Prior to publishing the Policy Statement, the consent of the FDIC was required in respect of any liquidation of collateral pledged by an IDI to secure Covered Bonds during the 45-day period beginning on the date of the appointment of the FDIC as conservator (or 90-day period if appointed as receiver). The Policy Statement effectively permits liquidation of a Cover Pool if a monetary default continues for ten business days after written notice to the FDIC, even during the 45-day (or 90-day) period, thus, providing faster access to the collateral.

The guidelines (including a copy of the Policy Statement) can be downloaded from the Department of Treasury website at:

http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf

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