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I. FRAMEWORK¹

US covered bond legislation: review & outlook

Past attempts to create a market in the US

The US does not yet have covered bond legislation. The first US covered bond was issued by Washington Mutual Bank in September 2006 and between then and June 2007, Bank of America and Washington Mutual Bank priced a total of seven covered bonds. As the crisis unfolded, the growth of the US covered bond market was put on hold. Since June 2007, we have not seen a new issue of a US lender. In September 2008, after Washington Mutual Bank's closure, JPMorgan Chase acquired the assets and most of the liabilities, including covered bonds and secured debt, of Washington Mutual Bank from the Federal Deposit Insurance Corporation (FDIC) as receiver for Washington Mutual Bank. Claims by equity, subordinated and senior unsecured debt holders were not acquired.

In the absence of covered bond legislation, Bank of America and Washington Mutual Bank developed structures independently. Both structures operate a two-tier approach: the covered bonds are issued by special purpose vehicles, rather than by US lenders. They are secured by a related mortgage bond series launched by a lender. The mortgage bond series is backed by collateral that remains on the lender's balance sheet. This structure is not only disfavoured by investors, but also more cumbersome, complex and costly than direct issuance – i.e., where the covered bonds are launched by a lender and the covered bond collateral remains on its balance sheet.

In 2008, the US Treasury and the FDIC worked together and released the Best Practices for Residential Covered Bonds statement (Best Practices Guide) and the final Covered Bond Policy Statement, respectively. The hope was that these statements would provide clarity and allay investor concerns about the treatment of the product in the event of lender default and support growth of a standardised US covered bond market. Since their release, it has become apparent that statements alone are insufficient to promote the development of a robust covered bond market populated by domestic and foreign investors.

Necessity is the mother of invention

After several years of investigation, covered bonds are increasingly being touted in the US as another source of liquidity for lenders. This is due not only to a growing recognition of the benefits that could be reaped from a vibrant domestic covered bond market, but also to the resurgence of a USD-denominated (benchmark) covered bond market that to date has mainly advantaged non-US lenders. A robust US covered bond market is likely to bring private capital into the national lending market and contribute to a less volatile asset finance and origination system in the US.

There is a political dimension to the development of a special-law-based US covered bond market. The take-off of such market may depend on the resolution of the broader issues associated with the US housing finance market reform, the fate of Freddie Mac and Fannie Mae, and the future role of the Federal

¹ The description of the US framework is merely a summary of aspects of the (proposed) legislation. As a summary, it is not complete. For details refer to the respective (draft) legislation, regulations, statements and base prospectuses. This summary does not constitute legal advice by the author.

Home Loan Banks. We see covered bonds as a viable alternative to funding assets off-balance sheet. However, on-balance sheet funding instruments cannot replace the multi-trillion securitisation market in the US, in our view. We see covered bonds as a source of complementary liquidity.

There is again an active effort under way to introduce covered bond legislation in the US. We believe that the US authorities' active engagement in the development of a domestic covered bond market significantly increases the likelihood of the introduction of covered bond legislation and the creation of a sustainable covered bond market in the US. In June 2011, the House Committee on Financial Services approved H.R. 940, the United States Covered Bond Act of 2011. This is the first step in the legislative process.

Bills go first to committees that deliberate, investigate and change them before they go to general debate. H.R. 940 is now eligible for a vote by the full House of Representatives. A bill needs to be passed by both the Senate and the House of Representatives and then be signed by the President before it becomes law. Be it enacted, the United States Covered Bond Act would lay the foundation for a special-law-based US covered bond market. The content of the proposed United States Covered Bond Act may be further amended as it makes its way through the legislative process.

Good things finally come to those who wait

The legal framework could consist of three layers. Once primary and secondary legislation is introduced, lenders could start developing individualised programmes tailored to their needs. We view H.R. 940 as a good basis for building a legal framework for US covered bonds. Although there are still lingering issues that require attention and hurdles that need to be taken, H.R. 940 addresses some of the past problems restricting the acceptance and use of the US product.

H.R. 940 seems comprehensive. Nevertheless, market stakeholders, including investors and credit rating agencies, may look for even further improvements – i.e., stricter eligibility criteria, tighter asset-liability matching requirements, higher minimum over-collateralisation levels, more details on the rights and duties of the administrator or servicer of the separate estate and of the asset monitor, and more details on the reporting requirements and other features tailored to a lender's credit risk profile.

Improvements on H.R. 940 may be addressed during the legislative process or in future regulations and should enhance the marketability and investor acceptance of the future US product. We believe that the cultivation of a domestic investor base and the attraction of foreign investors are additional challenges that should be addressed.

Where there is a will, there is a way

We think that the question is not whether, but how, a US covered bond market will take shape. Market stakeholders are approaching this question with deliberate care. Because of their divergent interests, a workable compromise is the likely outcome. The compromise is likely to be a balance between investor protection and issuer flexibility, between innovation and standardisation, between the rights of regulatory authorities and the rights of investors, and the lenders' need for viable funding instruments.

There is bi-partisan support for H.R. 940 in the House of Representatives, though there is some tension and disagreement. There was close voting at the mark-up hearing in June 2011 on amendments offered by Barney Frank (D-MA) on behalf of the FDIC dealing with the resolution mechanism and the covered bond regulatory oversight programme.

- > Disagreements about the proposed rights, powers and responsibilities of the regulatory authorities, and as to who creates the covered bond regulatory oversight programme. According to the FDIC, the banking agencies should promulgate regulations affecting covered bonds.
- > Disagreements about the proposed resolution scheme, in particular the FDIC's rights and powers in a conservatorship, receivership, liquidation or bankruptcy of a lender, and the content and the strictness of the covered bond regulatory oversight programme.
- > H.R. 940 is meant to provide an opportunity for smaller-sized US lenders to use covered bonds. There are, however, concerns that the proposed legislation may lead to a further concentration of the banking industry. We argue that the pooling of funding needs is a challenge that needs to be addressed.

The FDIC expressed concerns that the proposed legislation would increase the risk of losses or actual losses to the Deposit Insurance Fund or the receivership of a lender by limiting the FDIC's authorities and ability to maximise recoveries on assets in resolution. According to the FDIC, any covered bond legislation should not restrict its ability to recover losses the Deposit Insurance Fund incurs in resolving a lender and should not grant rights to investors that are superior to any other secured creditor.

Some creditors of US lenders – i.e., the Federal Home Loan Banks and qualified financial contract counterparties – already enjoy rights similar to those investors in covered bonds would be granted under H.R. 940. Covered bonds are a funding alternative for lenders that implies structural subordination of unsecured creditors, including depositors. It is unlikely that the FDIC will endorse covered bonds given its mission to maintain stability and public confidence in the financial system by insuring deposits.

The FDIC expressed its willingness to support a vibrant covered bond market that would increase liquidity to lenders and enable sustainable asset origination. Where there is a will, there is likely to be a way, in our view. For example, to address the FDIC's concerns about asset encumbrance for the benefit of covered bond investors and its ability to recover any potential depositor losses, consideration may be given to lower over-collateralisation and offsetting the negative effect with improved liquidity facilities in the event of lender default.

Not only covered bonds, but also other instruments, including Federal Home Loan Bank advances and qualified financial contracts, result in the encumbrance of assets and imply structural subordination. We think that this issue should be addressed by regulators in a holistic way across the different funding instruments for lenders – potentially as part of the regulators' monitoring process of lenders' controls and risk management processes – rather than by singling out covered bonds for disparate treatment.

H.R. 940 is now eligible for a vote by the full House of Representatives. A next step would be the introduction of a bill into the Senate. Chuck Schumer (D-NY) expressed interest in sponsoring a covered bond bill in the Senate. Bob Corker (R-TN) may be co-sponsor. The prospects for bi-partisan support in the House of Representatives and the Senate are promising, in our view. If the House of Representatives and the Senate pass inconsistent versions of a bill, the differences need to be resolved in a conference committee.

In February 2011, the report, *Reforming America's Housing Finance Market*, was released to Congress by the Obama administration. This fuelled hopes of developing a US covered bond market because the Obama administration said that it will work with Congress on alternatives to funding mortgages, potentially including the development of a covered bond market. We believe that covered bonds could be part of the US housing finance market reform.

We believe that the prospects for approval of H.R. 940 by the House of Representatives are better than those for moving a covered bond bill quickly through the Senate. As the US housing finance market reform is likely to have a negative impact on the housing market, it is unlikely that comprehensive legislation will be passed before the 2012 elections. Due to the tight congressional calendar, there is uncertainty as to when covered bond legislation will be passed by the Senate and House of Representatives in the 112th Congress. The 112th Congress convened on 3 January 2011 and will end on 3 January 2013.

Primary legislation is a necessary but not sufficient condition for the development of a US covered bond market. Covered bond issuance by US lenders is likely to take even longer because it also depends on the establishment and introduction of secondary legislation. In addition, if tax related provisions are not in the final legislation, there is uncertainty until the Internal Revenue Service takes a position on tax related questions.

Proposed United States Covered Bond Act

In June 2011, the House Committee on Financial Services approved H.R. 940, the United States Covered Bond Act of 2011. H.R. 940 was introduced by Scott Garrett (R-NJ) and Carolyn Maloney (D-NY) in March 2011. The proposed United States Covered Bond Act is similar to H.R. 290 introduced in 2011, and H.R. 5823 and H.R. 4884 introduced by Scott Garrett (R-NJ), Paul E. Kanjorski (D-PA) and Spencer Bachus (R-AL) in 2010, and Scott Garrett's (R-NJ) proposed amendment to the Wall Street Reform and Consumer Protection Act of 2009 that was introduced in 2009, but later withdrawn at the request of Barney Frank (D-MA). It is more comprehensive than H.R. 2896, the Equal Treatment of Covered Bonds Act of 2009, and H.R. 6659, the Equal Treatment of Covered Bonds Act of 2008.

H.R. 940 is meant to establish standards for covered bond programmes and a covered bond regulatory oversight programme, and provide a funding alternative for a broad range of assets. The content of the proposed United States Covered Bond Act may be further amended as it makes its way through the legislative process. H.R. 940 addresses some of the uncertainties restricting the acceptance of US covered bonds, and covers the following points:

- > **Issuers:** Eligible issuers would be insured depository institutions, savings and loan holding companies, bank holding companies, non-bank financial companies and their subsidiaries. Pooled covered bond issuance by entities sponsored by eligible issuers would be permitted. This would provide an opportunity for smaller-sized lenders to use the product. Regulators could approve existing programmes. Eligible issuers would be allowed to have more than one covered bond programme.
- > **Collateral:** A cover pool would be defined as a dynamic asset pool and would consist of eligible assets from a single eligible asset class, substitute assets² and ancillary assets³. Eligible asset classes would initially be residential mortgages, commercial mortgages, public-sector debt, auto loans or leases, student loans, credit or charge card loans and small business loans. Loans must not be delinquent for more than 60 consecutive days. Issuers would have to clearly mark collateral in their books and records. Collateral that would not comply with the eligibility criteria could not be taken into account in the Asset Coverage Test (ACT).

2 Substitute assets would be cash, obligations of the US government or a triple-A rated US government corporation or government-sponsored enterprise, and any overnight investments in federal funds.

3 Ancillary assets would be currency swaps, interest rate swaps, credit enhancements, liquidity arrangements associated with, any obligation supporting the payment or performance of, and proceeds of collateral in a cover pool.

- > **Supervision:** Covered bond regulators may be the appropriate banking agency⁴ or the Secretary. The Secretary and regulators would have to set up a covered bond regulatory oversight programme within 180 days after the enactment of the act. Programmes would require approval by the respective regulator. The Secretary would maintain a publicly available registry of approved programmes and the covered bonds drawn under them. Regulators may direct issuers to cease issuing covered bonds if programmes are not maintained in line with the law and the oversight programme.
- > **Coverage:** The Secretary and regulators would define minimum OC levels for covered bonds backed by each of the eligible asset classes based on their credit, collection and interest rate risks, but not liquidity risk. To verify compliance with the OC requirement, issuers would have to perform an ACT. Each month, issuers would have to submit the test outcome to the Secretary, the regulator, the indenture trustee, the asset monitor and bondholders. Bonds issued under an approved programme would remain special-law-based even if the OC requirement is not met. An uncured failure of the OC requirement within a set time would constitute a default on covered bonds.
- > **Limit:** Based on safety and soundness considerations and the financial condition of an issuer, the regulator would set a covered bond issuance limit as a percentage of total assets. A regulator could alter this limit as often as quarterly and if safety and soundness considerations or the issuer's financial condition would change. A cut of the limit would not affect an issuer's outstanding covered bonds.
- > **Monitoring:** Issuers would have to appoint an independent asset monitor that verifies and reports at least annually to the Secretary, the regulator, the indenture trustee and bondholders whether a pool meets the OC requirement. At least monthly, issuers would have to deliver a list of the eligible and substitute assets in the pool to the independent asset monitor and indenture trustee.
- > **Reporting:** Each regulator would be required to adopt a separate scheme of disclosure, registration and reporting obligations and exemptions for covered bonds. These different schemes should be as uniform and consistent as possible. Once a year, the regulators would have to submit a joint report to the Congress describing the state of the covered bond market in the US and testify on the state of this market before the House and Senate.
- > **Default:** There are two scenarios: default on covered bonds before and after the issuer entering conservatorship, receivership, liquidation or bankruptcy (issuer default). Issuer default would not necessarily cause an acceleration of outstanding covered bonds.
 - > **Default on covered bonds before issuer default:** The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.
 - > **Default of the issuer (without FDIC involvement):** The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.
 - > **Default of the issuer (with FDIC involvement):** The FDIC would have the right to transfer the cover pool and the related covered bonds to another eligible issuer within a one-year period. Until the transfer is made or the FDIC ceases further performance, the FDIC would meet an issuer's obligations under the covered bonds. If the FDIC would not complete the transfer within

⁴ Under the Federal Deposit Insurance Act, the term appropriate federal banking agency means the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation or the Board of Governors of the Federal Reserve System.

one year, ceases further performance or fails to meet an issuer's obligations under the covered bonds, the cover pool and covered bonds would be automatically transferred to a newly created separate estate.

The transferee would become liable for the covered bonds and related obligations of the issuer secured by the cover pool. The cover pool would be held by the transferee free and clear of any right, title, interest or claim of the issuer or any conservator, receiver, liquidating agent or bankruptcy trustee. Investors would retain a claim against the issuer for any deficiency with respect to the covered bonds. The issuer, conservator, receiver, liquidating agent or bankruptcy trustee would retain a residual interest in the separate estate. The issuer would have to transfer to the estate all property of the estate that is in its possession or under its control, and may be required to continue servicing the cover pool for 120 days.

The regulator would give the Secretary, indenture trustee, residual interest holder and bondholders written notice of the creation of the estate. It would appoint a trustee for the estate and servicers or administrators for the pool. The servicers or administrators would actively manage the pool and would be required to maximise the proceeds and the value of a cover pool in resolution. They would be allowed to dispose of assets and raise funds on a secured or unsecured basis and on a priority, *pari passu*, or subordinated basis. The regulator would supervise the trustee and any servicer or administrator. It may remove or replace the trustee or any administrator or servicer and require reports from a servicer or administrator. The trustee would close the estate after it has been fully administered.

- > **Borrowings:** The Comptroller General of the United States would have to conduct a study whether a separate estate should have access to funds from the Federal Reserve Banks. The Comptroller General of the United States would have to submit a report to the Senate and the House of Representatives on the results of this study not later than six months after the enactment of the United States Covered Bond Act.
- > **Actions:** No court may take any action to restrain or affect the resolution of a separate estate, except at the request of the applicable covered bond regulator. In addition, no person, including bondholders, could bring a judicial or administrative action against the estate, except to compel the release of funds.

Covered Bond Policy Statement & Best Practices Guide

On 9 July 2008, the FDIC approved the final Covered Bond Policy Statement, clarifying its position on the treatment of qualifying covered bonds in a receivership or conservatorship. On 29 July 2008, the US Treasury released its Best Practices Guide with the support of the FDIC, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Federal Reserve and the Securities and Exchange Commission. The Best Practices Guide introduces guidelines to promote the development of a standardised covered bond market. In July 2008, Bank of America, Citigroup, JPMorgan Chase Bank and Wells Fargo expressed their support for the FDIC and the US Treasury statements. They have shown interest in setting up programmes in accordance with or in aligning existing programmes to these statements (although this has not been completed).

FDIC: Final Covered Bond Policy Statement

The policy statement provides guidance on the availability of expedited access to collateral in the cover pool in a receivership or conservatorship, after the FDIC decides whether to continue or to terminate

the transaction. Its focus is to seek a way around the temporary automatic stay of execution rule imposed under the FDIA. Under the FDIA, the FDIC can request a stay of up to 45 days (as conservator) or 90 days (as receiver). For covered bonds structured in accordance with the final Covered Bond Policy Statement, the stay can be shortened to ten days. The policy statement applies to bonds meeting the following criteria.

- > **Features:** The policy statement applies to securities that are non-deposit, recourse debt obligations of insured depository institutions (IDI) with a term greater than one year, and no more than 30 years, that are secured, directly or indirectly, by perfected security interests under applicable state and federal law on collateral held and owned by the IDI.
- > **Limit:** The policy statement applies to covered bonds issued with the consent of an IDI's primary federal regulator. It is limited to covered bonds that comprise no more than 4% of an IDI's total liabilities after issuance.
- > **Collateral:** Performing mortgages compliant with the existing supervisory guidance on the underwriting of residential mortgages, on one-to-four family residential properties, underwritten with documented income and at the fully indexed rate are eligible. MBS collateralised by eligible mortgages must not exceed 10% of the collateral. Substitution collateral may be cash, US Treasury and agency securities. The loan-to-value (LTV) for the mortgages in the cover pool needs to be disclosed.

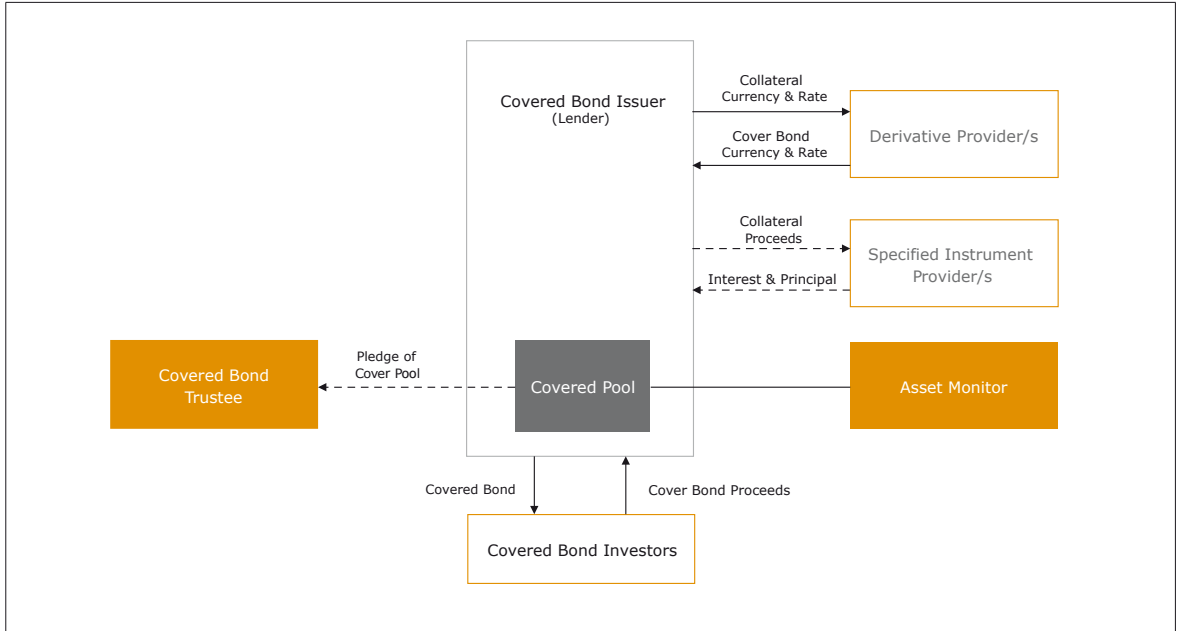
The policy statement must not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC. Neither does it impose new responsibilities on the FDIC as conservator or receiver. The FDIC may consider changes to the policy statement as the US covered bond market develops. It can repeal the policy statement after 30 days notice in the Federal Register. In this event, securities launched before repeal, but in compliance with the policy statement, will be grandfathered.

US Treasury: Best Practices Guide

The Best Practices Guide is a complement to the FDIC's policy statement and presents a standardised model for covered bonds issued by US lenders in the absence of dedicated legislation. It outlines two structures: SPV Issuance and Direct Issuance. To be consistent with the Best Practices Guide, a programme has to meet the following criteria.

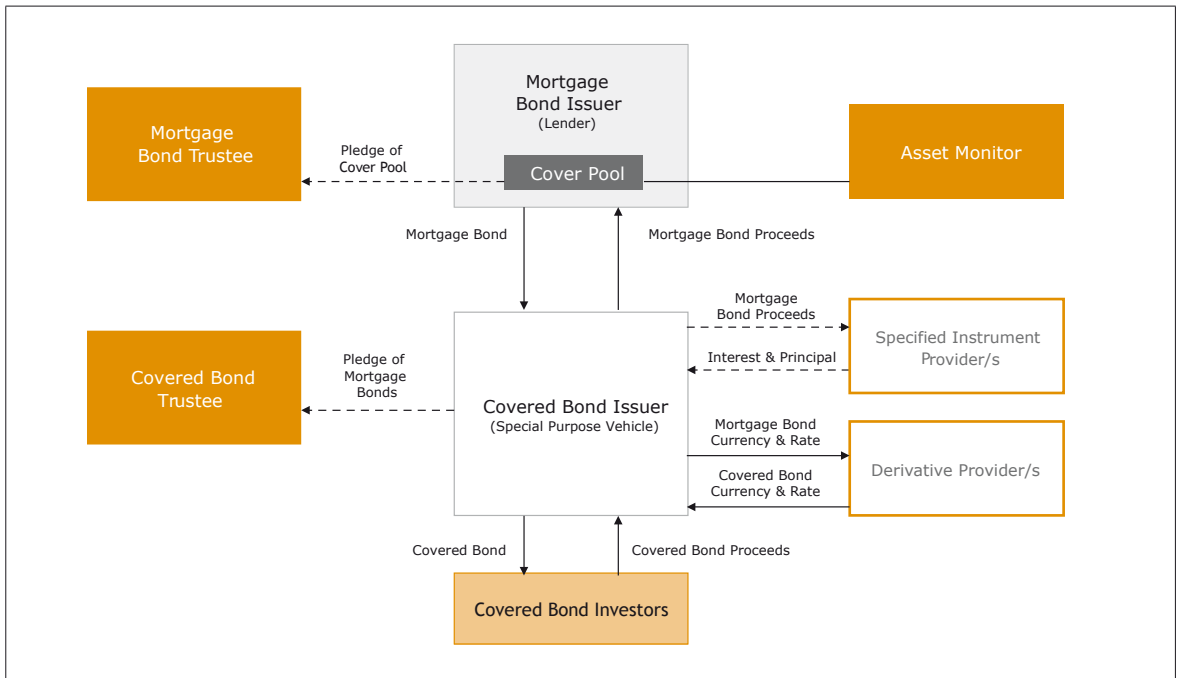
- **Issuer:** Issuers may be depository institutions and their subsidiaries, and bankruptcy-remote SPV. Pooled issuance is possible – i.e., multiple depository institutions could use a joint SPV to pool assets. The collateral has to be owned by the depository institution. Only well-capitalised entities should issue covered bonds.
- **Features:** The maturity for covered bonds has to be greater than one year, but no more than 30 years. Covered bonds may be issued in any currency and may be registered or non-registered with the SEC. They may either be fixed or floating rate instruments.
- **Limit:** An issuer requires approval by its respective primary regulator to launch covered bonds. Covered bonds may account for no more than 4% of an issuer's total liabilities after issuance.
- **Security:** Issuers need to grant a first priority perfected security interest in the collateral for the benefit of the bondholders. Issuers have to clearly mark the collateral, liabilities and the security pledge in their books and records. Multiple series can be backed by a common cover pool.

> EXHIBIT A: SIMPLIFIED DIRECT ISSUANCE



Source: Best Practices Guide, Credit Suisse

> EXHIBIT B: SIMPLIFIED SPV ISSUANCE



Source: Best Practices Guide, Credit Suisse

- **Coverage:** At all times, issuers must maintain an OC of at least 5% of the outstanding principal balance of the covered bonds. When calculating OC, for each loan, up to 80% of the property's value can be taken into account. If more than 10% or 20% of the collateral is substituted in any month or quarter, respectively, issuers must disclose updated collateral information to investors.
- **Test:** Issuers need to conduct a monthly ACT. The results of the ACT and of any reviews by the asset monitor must be made available to investors. If an ACT is failed, issuers may not launch a new series while such a breach exists. If an ACT is failed, and the breach is not remedied within one month, the trustee may terminate the covered bond programme and principal and accrued interest must be paid to investors.
- **Collateral:** Performing first-lien mortgages on one-to-four family residential properties, meeting the existing supervisory guidance on the underwriting of residential mortgages, underwritten with documented income and at the fully indexed rate are eligible. Ineligible are negative amortisation mortgages. Mortgages over 60 days in arrears must be replaced. At the time of inclusion in the cover pool, mortgages need to have a maximum LTV of 80%. The LTV needs to be updated quarterly using a nationally recognised, regional housing price index or other comparable measurement. A single Metro Statistical Area cannot make up over 20% of the cover pool. Substitution collateral may be cash, US Treasury and agency securities.
- **Derivatives:** At issuance of a series, issuers may enter into derivative agreements for the series to hedge risks arising from any timing and currency discrepancies. Derivative agreements need to be with financially sound counterparties and the identity of those counterparties has to be disclosed to investors.
- **Investment:** At issuance of a series, issuers need to enter into a specified investment agreement for the series with financially sound counterparties. Following issuer default or repudiation by the FDIC as conservator or receiver, proceeds from the collateral must flow into the specified investment. Scheduled payments are paid out of this investment as long as the investment provider receives proceeds in an amount at least equal to the amount falling due. If the proceeds are insufficient to meet a payment, the series would become immediately due and payable (payment acceleration).
- **Disclosure:** At the time an investment decision is made, and monthly after issuance, descriptive information on the collateral must be disclosed to investors no later than 30 days after the end of each month. The depository institutions and SPV need to disclose information relating to their financial profile and other material information.
- **Monitoring:** The primary regulators monitor an issuer's controls and risk management processes. Issuers must designate an independent asset monitor and an independent trustee. An asset monitor has to determine compliance with the ACT. A trustee needs to represent bondholder interests and enforce their rights in the collateral in the event of issuer insolvency.
- **Default:** As receiver or conservator for an IDI, the FDIC has three options in responding to a covered bond: the FDIC affirms the bond and meets the obligations of the IDI under the bond, it pays off the bond in cash up to the collateral value, or it allows liquidation of the collateral to pay off the bond. The second and third options are triggered if the FDIC repudiates the bond or if default occurs. In each case, an amount equal to actual direct compensatory damages is paid in full up to the collateral value. If the collateral value exceeds the actual direct compensatory damages, the excess

amount is returned to the FDIC as conservator or receiver for the IDI. If investor claims are not met (i.e., the actual direct compensatory damages exceed the collateral value), any unsatisfied claims are unsecured claims in the receivership or conservatorship. Any losses must be allocated pro rata across series backed by a common cover pool, irrespective of the maturity of the individual series.

The Best Practices Guide serves as a template for market participants and must not be construed to be dedicated legislation. Neither does it attempt to address any requirements imposed by other applicable US legislation, or provide or imply a government guarantee. The US Treasury expects the structure, collateral and other key terms of the product to evolve with the growth of this market in the US.

US lenders: SPV Issuance currently in practice

Importance of first priority perfected security interests

To date, US lenders use SPV Issuance. The existing programmes of Bank of America and JPMorgan Chase Bank are governed by, and construed in accordance with, the laws of the State of New York and the State of Delaware. There are other federal legislations and regulations implicated, including the Uniform Commercial Code, the Securities Act and the FDIA. The Uniform Commercial Code provides the basis to pledge collateral by creation of a first priority perfected security interest. Pledged collateral remains on the balance sheet of the entity granting the first priority perfected security interest.

- > **Sponsor:** A sponsor issues USD-denominated floating-rate mortgage bonds in series. Each series is a direct, unconditional and senior secured obligation of a sponsor ranking pari passu, pro rata, and without priority among themselves. A mortgage bond is backed by a cover pool that remains on a sponsor's balance sheet. The cover pool is revolving. A sponsor grants to a Mortgage Bond Indenture Trustee (MBIT) a first priority perfected security interest in the cover pool for the benefit of the mortgage bond holders.
- > **SPV:** The sole purpose of a bankruptcy-remote SPV is to launch a covered bond series and to use the proceeds to purchase a related mortgage bond series. The SPV grants a first priority perfected security interest in the covered bond collateral to a Covered Bond Indenture Trustee (CBIT) for the benefit of the secured creditors. The CBIT on behalf of the SPV holds each mortgage bond series as collateral for a covered bond series.
- > **Bonds:** The existing covered bonds are limited recourse obligations of the SPV ranking pro rata and without priority among themselves. Investors have no further claim against the SPV or sponsor if the proceeds from the enforcement of the first priority perfected security interest in the covered bond collateral are insufficient to meet their claims. The two statutory trusts organised under the laws of the State of Delaware with outstanding covered bonds are BA Covered Bond Issuer and WM Covered Bond Program.
- > **Monitoring:** Bank of America and JPMorgan Chase Bank are supervised by the OCC. The Bank of New York Mellon was appointed independent asset monitor to verify the arithmetic accuracy of the ACT calculations of both lenders yearly. If the sponsor was downgraded to or below a minimum level, the asset monitor would have to verify the ACT calculation monthly until the necessary credit ratings have been reinstated.

Criteria to ensure sustained collateral quality

The existing programmes provide the sponsors with considerable flexibility with regard to the composition of the cover pool. The eligibility criteria can be altered subject to approval of the credit rating agency then rating the outstanding covered bonds. Eligible as collateral are currently first-lien or second-lien residential mortgages and home equity lines of credit originated or acquired by the sponsor. In the case of BA Covered Bond Issuer, loans in arrears for over 60 days must be excluded from the ACT calculation. For each loan, up to 75% of the property's value can be considered in the ACT calculation. A property's value is the value given to the property by the sponsor adjusted for changes by the Office of Federal Housing Enterprise Oversight House Price Index. Index declines are fully reflected in the reassessment of the mortgaged property's value, but only 85% of an index increase can be taken into account. Substitution collateral may be cash, debt issued or guaranteed by 0% risk-weighted public sector entities, exposures to 10% or 20% risk-weighted entities, and triple-A rated, USD-denominated RMBS. RMBS must not account for more than 10% of the total principal amount of the outstanding covered bonds. Substitution collateral is limited to up to 10% of the cover pool.

Monthly tests to ensure adequate collateralisation

A mismatch between a mortgage bond's coupon and the yield on the collateral in a cover pool is unhedged. The principal and core terms of a covered bond series match those of the related mortgage bond series. An SPV enters into derivative agreements with eligible counterparties to address risks arising from interest, currency and timing discrepancies between the mortgage bond and covered bond series. Derivative counterparties need to make payments to the SPV if and to the extent they receive payments. If the SPV fails to meet a scheduled payment, for example, if the FDIC as receiver or conservator does not authorise an interest payment on a sponsor's mortgage bond, the derivative counterparty needs to cover limited amounts of interest. Depending on the final terms of a series, the series is repaid in full on its maturity date or, if the SPV fails to repay the series in full on this date, repayment can be deferred. In accordance with the programme terms, a deferral can be up to 60 days. Payment deferral does not constitute an event of SPV default. The individual programme terms provide for an ACT and a Proceeds Compliance Test (PCT).

- > **ACT:** The sponsor performs this monthly test and ensures that the adjusted total loan amount is at least equal to the total unpaid principal amount of all outstanding mortgage bonds. The adjusted total loan amount is multiplied by an asset percentage, which is at least 96% for BA Covered Bond Issuer and 93% for WM Covered Bond Program, and refers to a minimum OC of 4.2% and 7.5%, respectively. An ACT is also carried out if collateral is removed from the cover pool or prior to the issuance of a new covered bond series. If the test is failed, the sponsor has to top up the cover pool to ensure that the ACT is passed again at the next calculation date. Consecutive failure of this test results in an event of sponsor default.
- > **PCT:** Upon an event of sponsor default and declaration of acceleration of the mortgage bonds by the MBIT but before an event of SPV default, the CBIT performs this monthly test. The CBIT assesses whether the sum of the total amounts deposited in, or credited to, the specified instrument for each covered bond series less any accrued interest, and the total unpaid principal amounts of each mortgage bond series is at least equal to the total principal amount of all outstanding covered bonds. A failure of the PCT constitutes an event of SPV default.

Procedures upon an event of sponsor and/or SPV default

For example, if a sponsor becomes insolvent or is in an unsound condition, the applicable bureau of the US Treasury has the right to appoint the FDIC as conservator or receiver for the sponsor. In the event of sponsor default, the cover pool turns static and the MBIT may declare the principal of all mortgage bonds and any accrued and unpaid interest thereon through the acceleration date to be due and payable (Mortgage Bond Acceleration). The cover pool and mortgage bonds would not be segregated from the estate of the sponsor. The FDIC, as receiver or conservator for a sponsor, currently has the following options in responding to covered bonds: the FDIC affirms the bonds and meets the obligations of the sponsor under the mortgage bonds and/or seeks to transfer any of the sponsor's assets and liabilities to a new obligor, or it repudiates the covered bonds.

If the FDIC repudiates the covered bonds, the mortgage bonds become due and payable and an amount equal to actual direct compensatory damages has to be paid in full up to the value of the collateral. If the collateral were insufficient to fully back any recognised claim of the MBIT under the mortgage bonds, the MBIT would be an unsecured creditor of the sponsor as regards the portion of the claim that is unsecured. If, after its appointment, the conservator or receiver for the sponsor remains in default for a set period, or if the FDIC as conservator or receiver for the sponsor repudiates the covered bonds, but does not pay the actual direct compensatory damages within a set period, the MBIT may exercise self-help remedies and enforce its security interest over the collateral. The exercise of self-help remedies is subject to approval by the FDIC.

Upon an event of sponsor default, the CBIT on behalf of the SPV has to deposit the cash from the liquidation of or the proceeds from the collateral in the cover pool into a specified instrument for each covered bond series. Reserves on each specified instrument have to be swapped to provide the funds needed to meet scheduled payments under the covered bonds. Funds standing to the credit of each specified instrument must not be commingled with a sponsor's other funds and assets. As long as the reserves on a specified instrument are sufficient to meet scheduled payments under the respective covered bond series, the covered bonds do not accelerate.

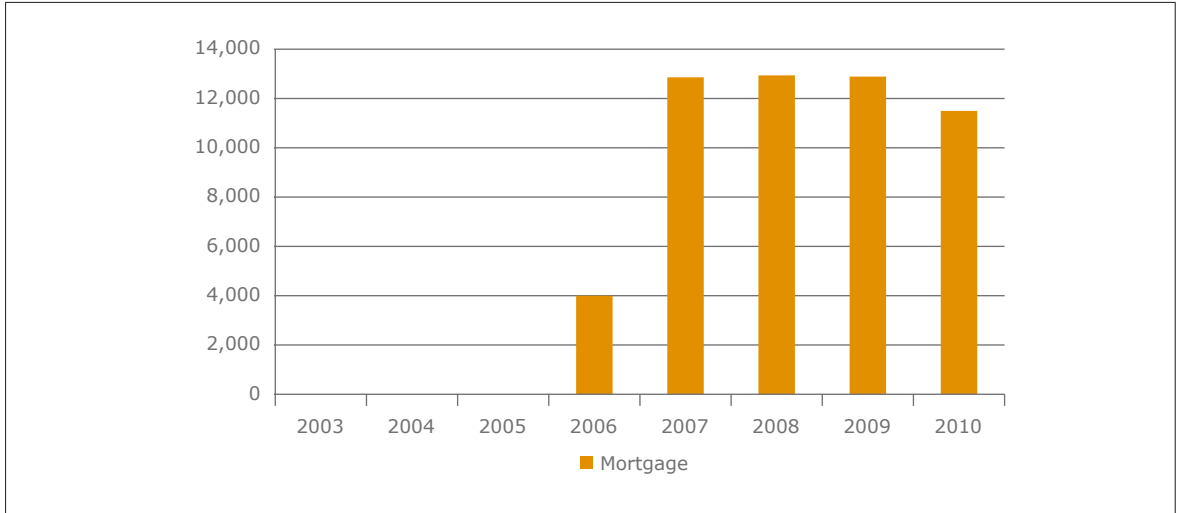
Following an event of SPV default, the CBIT can declare all outstanding covered bonds to be due and payable against the SPV at their early redemption amount plus accrued interest (Covered Bond Acceleration). The CBIT may enforce its security interest over the covered bond collateral, liquidate it and exchange the proceeds with the derivative providers to prepay the covered bonds. No covered bond investor can proceed directly against an SPV unless the CBIT fails to take such action. If the proceeds from the enforcement of the security interest in the covered bond collateral are insufficient to meet the claims of the covered bond holders in full, no other collateral will be available for the payment of the deficiency.

II. RISK WEIGHTING & ECB ELIGIBILITY

The outstanding general-law-based US covered bonds are not compliant with UCITS 52(4) and do not benefit from the higher investment limits because none of the current issuers is a credit institution with its registered office in a EU member state and subject by legislation to special public supervision designed to protect the bondholders. These bonds cannot be CRD compliant without meeting UCITS 52(4). Thus, the bonds cannot benefit from special treatment in terms of risk weight.

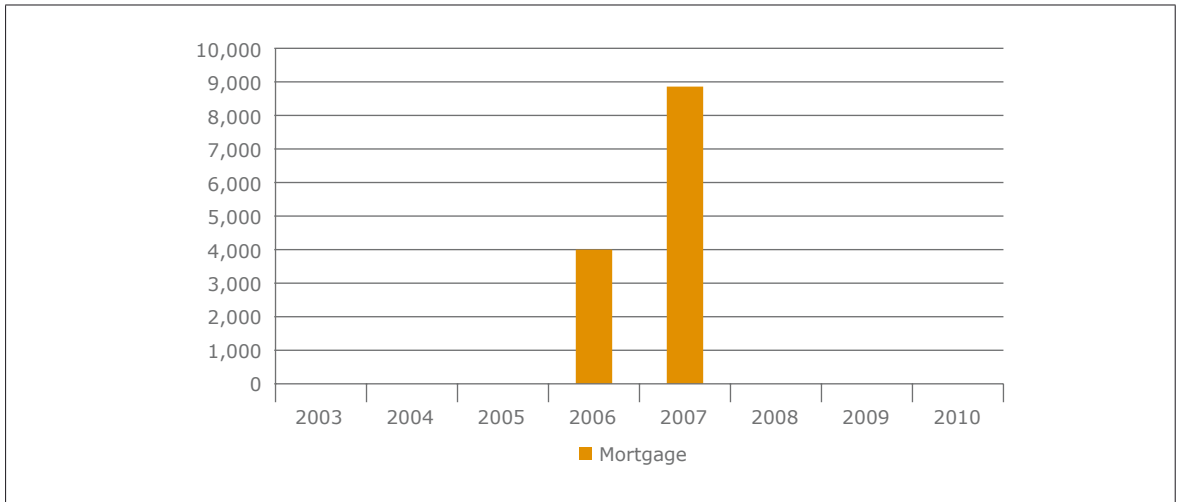
The Eurosystem accepts eligible assets as collateral for its credit operations. At present, outstanding EUR-denominated general-law-based US covered bonds are part of Liquidity Category IV.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC