



One Minute Memo[®]

Update on Covered Bonds

On Wednesday, June 22, 2011, the full House Financial Services Committee approved, by a 44-7 vote, a bill known as H.R. 940 for the purpose of establishing a comprehensive statutory framework for the issuance of covered bonds in the U.S., which includes giving the Treasury Department oversight of a covered bond market.

Covered bonds are debt instruments issued by financial institutions and secured by a pool of assets, with full recourse by investors against the issuing financial institution for amounts not paid. The cover pool could consist of mortgages, auto loans, credit card receivables, student loans, and other asset classes and the designated assets in the cover pool could change from time to time to maintain minimum over-collateralization requirements. H.R. 940 would provide investors with legal and regulatory certainty as to how covered bonds would be treated in the event of default and insolvency of a financial institution. Without a definitive legal framework which allows investors to identify the risks of investing in covered bonds issued by U.S. financial institutions, there will continue to be too much market uncertainty for the creation and maintenance of a strong covered bond market in the U.S.

Further, in order to become law, the full House and Senate must pass the bill, and then the President must sign it. Reuters has reported that the White House supports the bill, but there may be strong opposition in the Senate. Currently, there is no companion bill in the Senate, although Senator Charles Schumer (D-N.Y.) is expected to introduce similar legislation in the Senate later this year. Although it is anticipated that the Republican-controlled House will pass the legislation, there is significant opposition in the Democrat-controlled Senate and, thus, it may not get to the President's desk for some time.

Although some industry participants believe that Congress will enact some form of covered bond legislation by the end of the year, the Federal Deposit Insurance Corporation has voiced concerns over the priority given to covered bond investors in a bank failure, arguing that this will make the FDIC a "de facto" guarantor of the debt instruments. Two amendments were offered and accepted as part of the vote on H.R. 940 as an attempt to alleviate some of the FDIC concerns. One amendment extends the time from 180 days to one year for the FDIC to locate an alternative financial institution to whom it could transfer the asset pool securing the bonds and the related obligations, and the other amendment requires the regulators to set a maximum of the amount of covered bonds a financial institution could issue as a percentage of an issuer's total assets. Some have suggested that this maximum percentage be 4% or 5% of total assets. In addition, other supporters of a covered bond market have pointed to the fact that legislation would require that the cover pool be overcollateralized. Although this overcollateralization will provide further protection to investors, the FDIC will be entitled to any unused excess for general creditors.

Representative Scott Garrett (R-N.J.), the sponsor and strongest proponent of the bill, has been working with House and Senate legislators for over two years to pass legislation to create a U.S. covered bond structure in the U.S. During the first half of 2011, over \$17 billion of covered bonds have been marketed in the U.S. by foreign banks to U.S. investors. Covered bonds have been used in Europe for over 200 years and are one of the primary methods used to finance mortgages. Supporters of a covered bond market believe that it could help to restore liquidity to the U.S. credit markets and encourage investment of private capital.

About the author: Shirley E. Curfman served as legal counsel to the mortgage bond trustee in the sale by Washington Mutual of EUR 4.0 billion of euro-denominated covered bonds in September 2006. WaMu was the first US-based bank to complete a transaction in the European covered bond market. Ms. Curfman is a partner at Seyfarth Shaw LLP.

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