

U.S. Structured Finance Newsletter

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FDIC'S STATEMENT MAY PEEL BACK THE COVER ON COVERED BONDS

The recent interim policy statement¹ announced by the Federal Deposit Insurance Corporation (FDIC) may be a potential catalyst to resuming covered bond issuance in the United States. The statement by the FDIC, as a federal regulator of insured depository institutions (IDIs), is another example of concerted U.S. government efforts to promote liquidity in the debt capital markets and confidence in the federal banking system. The interim policy statement provides guidance on the treatment of a covered bond in the event of insolvency of an issuing bank. As the U.S. covered bond market is in its nascency,² market participants have begun to seek guidance by federal regulators on the priority of covered bond investors in the event of insolvency of an issuing bank. Market participants may now have fewer uncertainties after reading the FDIC's recent statement, which establishes preferential claim of covered bond investors to the underlying assets that collateralize a covered bond in the event of an issuing bank insolvency.

A covered bond is an on-balance sheet financing of a loan portfolio or "cover pool," which may include mortgages, AAA-rated RMBS and public debt. A covered bond may provide cost-effective funding through the issuance of highly-rated securities supported by a bank's corporate solvency and the credit quality of the cover pool. The cover pool differs in several key aspects from the underlying collateral of a mortgage securitization; 1) the underlying assets/collateral in the cover pool are dynamic and may be replaced at the discretion of the issuing bank, and 2) the cover pool is pledged to a special purpose vehicle whilst remaining on an issuing bank's balance sheet. Given the accounting recognition of a cover pool as an asset of an issuing bank, a covered bond has come to be regarded more as a senior corporate debt obligation than an asset-backed debt security. However, a covered bond issuance may be rated higher than the bank issuer's senior corporate debt rating – something only achievable when issued as an asset-backed debt security.

In the event of a bank's insolvency, the FDIC is (in most cases) appointed as receiver and charged with resolving the failed IDI. In so doing, the receiver must fulfill all obligations to senior creditors and depositors of the IDI and may cause to liquidate all assets. The FDIC's interim policy statement establishes covered bond investors as having preferential claim to the cover pool in the event an IDI covered bond issuer falls into receivership, provided that the covered bond meets FDIC criteria. The criteria described in the FDIC's interim policy statement requires a covered bond issuer to have: 1) the permission of the IDI's federal regulator to proceed with the cover bond issuance; 2) the total issuance of the covered bond may not exceed 4% of the total liabilities of the IDI; 3) the cover pool must contain performing mortgages underwritten in accordance with interagency guidance principles; 4) no more than 10% of all underlying collateral may consist of AAA-rated RMBS.

As a full recourse debt obligation, a covered bond issuance conveys investors the right to be repaid by the liquidation of the cover pool and, if necessary, by other assets of the issuing bank. DBRS believes that the covered bond market will stimulate liquidity in the traditional mortgage market, which is represented by conservatively underwritten loans with full documentation of income and verification of an ability to pay at the fully indexed rate.

For questions or comments, please contact Bernard Maas at bmaas@dbrs.com.

¹ www.fdic.gov/news/board/08Apr15SOPmemo.pdf.

² There have only been two U.S. covered bonds issuances since September 2006. While the European covered bond market traces back over 200 years, a European structured covered bond market is only five years old.