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THE PROPOSED UNITED STATES COVERED BOND ACT OF 2010

MICHAEL DURRER, THERESA KRADJIAN, JOSEPH McLAUGHLIN, AND
DANIEL ROSSNER

Recently, the United States Covered Bond Act of 2010 was proposed in Congress. The Act would create a comprehensive statutory regime for the issuance of covered bonds by banks, bank holding companies, and certain other eligible issuers similar to that which exists for issuers in many European jurisdictions. The authors explain the important provisions of the Act, and conclude it is a meaningful step forward in the development of a U.S. covered bond market.

Representative Scott Garrett (R-NJ) recently introduced into the United States House of Representatives the proposed United States Covered Bond Act of 2010 (the “Act”). The Act would create a comprehensive United States statutory regime for the issuance of covered bonds by banks, bank holding companies and certain other eligible issuers similar to that which exists for issuers in many European jurisdictions.¹ Although the Federal Deposit Insurance Corporation (“FDIC”) and the United States Department of the Treasury previously issued regulatory guidance intended to facilitate the issuance of U.S. covered bonds, the absence of a statutory regime has been widely viewed as impeding the development of a robust market for such bonds.² Indeed, to date, only two covered bond programs have been established by U.S. issuers — one by Washington Mutual Bank in 2006 and

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one by Bank of America in 2007 — both relying on structural features intended to replicate the features of European statutory covered bond schemes.

The Act would facilitate the issuance of U.S. covered bonds by providing greater clarity and certainty (similar to that which exists under European statutory covered bond programs) with respect to the rights of investors following the insolvency of issuers or other events of default and providing a comprehensive scheme of government oversight and regulation of U.S. covered bond programs similar to that which exists for such statutory programs. In introducing the Act, Representative Garrett stated “Covered bonds have been used in Europe to help provide additional funding options for the issuing institutions and are a major source of liquidity for many European nations’ mortgage markets. The Garrett-Kanjorski-Bachus legislation is a thorough framework that seeks to provide the same benefits to the U.S. market.”³

BACKGROUND

The Act has its origin in much more limited bills proposed by Representative Garrett in July of 2008,⁴ entitled the Equal Treatment of Covered Bonds Act of 2008, and in June of 2009, entitled the Equal Treatment of Covered Bonds Act of 2009.⁵ In November of 2009, Representatives Garrett and Kanjorski submitted a new covered bond bill as a proposed amendment to the omnibus financial reform legislation which was then pending before the House of Representatives (the “Amendment”).⁶ The Amendment received substantial attention within the U.S. covered bond community and from Moody’s Investors Service, which stated it would have provided strong protections for covered bond investors.⁷ In December 2009, the Amendment was withdrawn from consideration based on the promise of Representative Barney Frank (D-MA), Chairman of the House Financial Services Committee, to further vet the Amendment at a Committee hearing. The hearing took place on December 15, 2009.⁸

SUMMARY OF THE ACT

The Act covers four main areas:

1. Provision of regulatory oversight of covered bond programs under the supervision of the Department of the Treasury;
2. Setting basic parameters for covered bond programs including definitions of eligible issuers, eligible cover pool assets and core structural features;
3. Mapping the post-issuer insolvency treatment of a covered bond program, including the creation of a post-insolvency estate to assume the assets and liabilities of a failed issuer; and
4. Supporting provisions regarding the treatment of covered bonds under the federal securities laws and tax code.

The Act contains several revisions to the Amendment previously circulated.

Regulatory Regime

The Secretary of the Treasury or any officer of Treasury designated by the Secretary is to be the “covered bond regulator” (the “Regulator”). The Regulator has general authority to make regulations affecting covered bond programs “consistent with the Act and with safe and sound banking practices.”⁹ Each new program must be approved by the Regulator in consultation with the issuer’s primary federal regulator¹⁰ and the Regulator will maintain a public, Web-based registry of all approved programs, which includes information on all outstanding covered bonds issued under such programs. Further, the Regulator is empowered to establish minimum overcollateralization levels for covered bond programs.

Core Terms

The Act defines certain key roles and features for all covered bond programs. Among them are the following:

“Eligible Issuer:” any FDIC-insured bank or other FDIC insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act), any subsidiary of an FDIC-insured depository institution, any bank holding company (as defined in the Bank Holding Company Act of 1956),

any savings and loan holding company (as defined in the Home Owners Loan Act), or a special purpose entity sponsored by one or more of the foregoing for the purpose of issuing covered bonds on a pooled basis.¹¹

“Eligible Asset Classes”: the types of financial assets that may be included in a cover pool that secures covered bonds. Only assets from a single eligible asset class may be included in a given cover pool.¹² These include:

- Residential mortgage loans;
- Home equity loans;
- Commercial mortgage loans;
- Public sector securities and loans (*e.g.*, municipal bonds and obligations backed by the full faith and credit of the United States);
- Auto loans;
- Student loans;
- Credit card receivables;
- Small business loans (made or guaranteed by the Small Business Administration);
- Other classes as designated by the Regulator;
- Substitute Assets
 - Cash
 - Direct obligations of the United States or obligations backed by the full faith and credit of the United States
 - Securities issued or guaranteed by government sponsored enterprises and of the highest investment grade; and
- Ancillary Assets
 - Interest or currency swaps
 - Credit enhancements or liquidity arrangements
 - Other contractual rights supporting cover pool assets.

The Act sets forth specific criteria for the assets in each eligible asset class. As a general matter, all eligible assets must comply with relevant supervisory guidance at the time they were originated. In addition, asset-backed securities (ABS) of eligible assets qualify as eligible assets provided that such ABS are “of the highest investment grade” and do not comprise more than 20 percent of the outstanding principal amount of the assets in the relevant cover pool. Further, an asset does not qualify as an eligible asset while, if it is a loan, it is delinquent for more than 60 days and, if it is a security, it does not meet the Act’s investment grade requirement.

Post-Default Provisions

A central component of any covered bond program is the protection of bondholders’ scheduled payments following the insolvency of or other material default by the issuer. This requires putting cover pool assets beyond the reach of an issuer’s creditors or conservator, receiver, liquidating agent or trustee, including, in the case of an insolvent bank, the FDIC as conservator or receiver of such bank. The Act accomplishes this by providing that a separate legal entity — referred to simply as an “estate” — will be created automatically following an uncured issuer default on its covered bonds including, subject to limited rights of the FDIC, the conservatorship, receivership, liquidation or bankruptcy of an issuer. This estate (a “CB Estate”) is to be created “by operation of law” and will “exist separate and apart from [the issuer] or any subsequent conservatorship, receivership, liquidating agency or estate in bankruptcy.”¹³

If a CB Estate is created following an issuer default but before a conservatorship, receivership, liquidation or bankruptcy, then the cover pool assets securing the issuer’s program are automatically released to the CB Estate. The released assets are to be “free and clear of any right, title, interest or claim of the issuer or any conservator, receiver, liquidating agent or trustee in bankruptcy” and the CB Estate assumes full liability on all covered bonds (and related obligations such as derivatives in the cover pool) secured by that cover pool.

If the FDIC is appointed conservator or receiver for an issuer before a default causes the creation of a CB Estate, it has 15 days from the date of ap-

pointment to transfer the cover pool assets and the associated covered bonds to another eligible issuer. During this 15-day period the FDIC is required to make any payments that fall due on the covered bonds as well as to fulfill any non-monetary obligations of the issuer under the program. If the FDIC completes a transfer within the 15-day period, the transferee thereupon acquires ownership of the cover pool assets and becomes fully liable for the obligations of the issuer under the covered bond program. If the FDIC does not transfer a covered bond program within the permitted 15-day period, or a conservator, receiver, liquidity agent or trustee in bankruptcy other than the FDIC is appointed for a defaulting issuer, then a CB Estate is created automatically by operation of law.

Following the creation of a CB Estate, covered bondholders retain an unsecured claim against the issuer for any deficiency in amounts due under the covered bonds. Similarly, a swap provider or other counterparty to an obligation secured by the cover pool retains a deficiency claim against the issuer. An innovative element in the Act provides for the creation of a security representing the residual interest in any CB Estate. The holder of this residual interest is entitled to receive any assets remaining in a CB Estate after the related covered bonds and other obligations under the program are satisfied. This residual security will be issued to the issuer or, if the FDIC or another conservator, receiver, liquidating agent or trustee has been appointed for the issuer, the residual security will be issued to such appointed entity.

The creation of such a residual security both formalizes the rights of a defaulting issuer or its conservator or receiver in the surplus value in a cover pool and provides a means for that value to be sold or pledged. This feature of the Act addresses — at least in part — the criticism that a covered bond program locks up a disproportionate amount of an issuer's assets because of the need to over-collateralize covered bonds.

The Act requires a defaulting issuer to cooperate in the transfer of all books, records and other materials to the CB Estate and to continue servicing the cover pool assets for 120 days for a fair market fee. The Regulator is responsible for acting as trustee of a CB Estate and also for appointing one or more servicers or administrators. A servicer or administrator manages the cover pool assets so as to make timely payments of interest and principal on the outstanding covered bonds. The servicer or administrator is responsible

for making collections and may liquidate or borrow against cover pool assets. The Act also charges the servicer or administrator with funding “private market alternatives” to supply liquidity that may be necessary to repay maturing series of covered bonds because of timing mismatches between cover pool assets and liabilities. The Act does not distinguish between the roles of servicer and administrator.

Securities Laws and Taxation

The Act aims to streamline the applicability of federal securities laws to covered bond programs. Covered bonds “offered and sold to the public” by “banks” (or subsidiaries of banks) will be exempt from federal securities laws, other than anti-fraud rules, and will instead be subject only to the securities regulations of their primary federal regulator.¹⁴ Because Sections 3(a)(2) of the Securities Act of 1933 (the “’33 Act”) already exempts securities issued by federally and state chartered banks from the registration and disclosure requirements of the ’33 Act this may, in the case of bank issuers, seem like the same result as would obtain without the Act. Certain features of a covered bond program, however, make the availability of such exemption unclear. The Act’s federal securities laws exemption also appears to be aimed at exempting banks (to the extent not already exempted by Section 304(a)(4) of the Trust Indenture Act of 1939) and their subsidiaries from having to qualify a covered bond indenture under the Trust Indenture Act of 1939 and, possibly (to the extent not already exempted by Section 3(c)(3) of the Investment Company Act of 1940), from having to register, or have CB Estates created pursuant to the Act register, as an investment company under the Investment Company Act of 1940. It would be desirable to clarify these exemptions in any final legislation. Special purpose vehicle issuers under multibank covered bond programs will be treated like bank-issued programs. Issuers that are not banks or subsidiaries of banks do not receive an exemption from the federal securities laws under the Act. The Act does, however, state that the Securities and Exchange Commission “shall develop a streamlined registration scheme” for covered bonds issued by such entities. A CB Estate created after the failure of an issuer will be entitled to the same securities law exemptions as that issuer.

The Act amends the Secondary Mortgage Market Enhancement Act of 1984 to apply to covered bonds issued under the Act's regime. Similarly, the Act broadens Section 860G(a)(3) of the Internal Revenue Code of 1986, as amended (the "Code") to include covered bonds within the definition of a real estate mortgage investment conduit. Finally, the Act provides that: (i) a CB Estate is not taxable as a separate entity; (ii) transfers of assets or liabilities by an issuer to a CB Estate are not taxable events to covered bondholders; and (iii) the acquisition of a covered bond will be treated as an acquisition of a security, and not as an interest in a loan, for purposes of applying rules under the Code relating to U.S. trade or business activities.

COMMENT

The Act is similar to the Amendment which Representative Garrett proposed in late 2009. It does, however, contain a few noteworthy additions and omissions. Perhaps the most significant difference is the removal of provisions in the Amendment which permitted the servicer or administrator of a CB Estate to borrow from the Federal Financing Bank to the extent necessary to make required payments on the covered bonds, using cover pool assets as collateral on terms no less favorable than available for discount window borrowings from the Federal Reserve. This feature had significant value in that it provided a certain source of liquidity to a CB Estate with which to repay maturing series of covered bonds during difficult market conditions. The rating agencies in particular have identified the possibility of liquidity shortfalls due to the need to sell all or a large portion of a covered pool into an illiquid market in a short period of time as a key credit concern for U.S. covered bonds. The availability of liquidity from the Federal Financing Bank was viewed by Moody's and other commentators as satisfactorily addressing this concern. It may be that Representative Garrett removed the Federal Financing Bank borrowing facility provision in anticipation of objections from some legislators that it could be viewed as an implicit federal government guarantee.

Another change from the Amendment is the omission of non-depository institution affiliated entities from the definition of eligible issuers. The Amendment had included "any regulated financial institution that is approved [by the Regulator] and determined to be systemically important."

This would have opened the door for certain securities firms, insurance companies and other potential issuers not affiliated with an insured depository institution to issue covered bonds. The Act adds language that appears to permit the Regulator to approve existing U.S. covered bond programs under the statutory regime.¹⁵ Other additions comprise technical features common to most covered bond programs, including requirements for an asset monitor, an asset coverage test and authority for the Regulator to set minimum overcollateralization levels for cover pools.

The Act would bring the present U.S. covered bond product more closely in line with the market in Europe. The regime outlined by the Act embodies many of the requirements for covered bond programs under the European Union supervisory framework of the Capital Requirements Directive, which implements the capital standards of Basel II.¹⁶ As a result, some market participants hope that, in addition to facilitating the development of a covered bond market in the United States, the Act will open up the European investor base to U.S. covered bond issuers. The Act's terms differ from most European statutory regimes in that they permit a wide variety of asset classes, whereas European programs generally are permitted only to use mortgage loans and public sector loans as cover pool assets.

Overall, then, the Act is a meaningful step forward in the development of a U.S. covered bond market. Potential issuers and investors will disagree on a number of specifics, for example who is an "eligible issuer," what is an "eligible asset" or whether federally-sponsored liquidity should be provided to covered bond programs. No doubt the text of the Act will be further amended as it makes its way through the legislative process. Should the legislation be passed, supplemental regulations will be needed from the Regulator to flesh out specifics. Nonetheless, the Act sets out most of the fundamentals that are needed to create U.S. covered bonds more efficiently and on terms acceptable to global investors.

NOTES

¹ H.R. 4884, 111th Cong., 2d Session (2010), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4884ih.txt.pdf. The Act is co-sponsored by Representative Paul Kanjorski (D-PA) and Representative

Spencer Bachus (R-AL), Ranking Member of the House Financial Services Committee. A section by section analysis of the Act, prepared by the sponsors, is available at <http://www.scribd.com/doc/28709304/The-US-Covered-Bond-Act-Section-by-Section-Analysis>.

² FDIC Covered Bond Policy Statement, Final Statement of Policy (July 15, 2008), available at <http://edocket.access.gpo.gov/2008/pdf/E8-17168.pdf>; U.S. Department of the Treasury, Best Practices for Residential Covered Bonds (July 2008), available at <http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf>.

³ The full text of Representative Garrett's press release relating to the introduction of the Act is available at <http://garrett.house.gov/News/DocumentSingle.aspx?DocumentID=176991>.

⁴ H.R. 6659, 110th Cong., 2d Session (2008).

⁵ H.R. 2896, 111th Cong., 1st Session (2009).

⁶ H.R. 3996, 111th Cong., 1st Session (2009).

⁷ Moody's Structured Finance, U.S. Covered Bonds: Industry Gears Up to Propose Comprehensive Legislative Framework; Banks to Benefit (December 2009).

⁸ An archived Web cast of the hearing is available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/fchr_121509.shtml.

⁹ Section 3(a)(i).

¹⁰ Although not entirely clear, Section 3(a)(2)(A) of the Act suggests that existing covered bond programs may also be approved by the Regulator if they otherwise satisfy the requirements of the Act and any regulations thereunder.

¹¹ Section 2(9). "Insured depository institution" is defined in Section 3 of the Federal Deposit Insurance Act to include not only FDIC-insured federally- and state-chartered banks and thrift institutions, but also any FDIC-insured branch of a foreign bank. In addition, the Act does not require that bank holding companies, savings and loan holding companies and other eligible issuers be organized under the laws of the United States or a state. In the case of non-U.S. issuers, consideration would have to be given to the interplay of the Act and home country law (including home country insolvency law).

¹² Section 2(9).

¹³ Sections 4(a)(i) and 4(b)(2)(B).

¹⁴ The Act does not define "bank" for this purpose. Presumably "bank" is intended to cover all insured depository institutions that are eligible to be issuers under the Act, but this is not entirely clear, and hopefully will be further elucidated in any final legislation.

¹⁵ Section 3(a)(2)(A).

¹⁶ Article 22(4) of the Directive 2001/108/EC relating to undertakings for collective investment in transferable securities.