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DEAL PIPELINE

TAKE COVER

BY JOHN ARNHOLZ AND KEN MARIN

Amid possibly the worst financial crisis since the Great Depression – caused in part by huge losses on mortgage-backed securities – how can Americans realize the dream of home ownership?

Primary issuances of mortgage-backed securities – which fueled the housing expansion – have dried up. Washington Mutual Inc. was seized by regulators and its banking assets sold overnight to J.P. Morgan Chase & Co. Fannie Mae and Freddie Mac are under conservatorship and must dramatically reduce their mortgage portfolios starting in 2010. Lehman Brothers Holdings Inc. and Bear Stearns Cos. – both big issuers of mortgage-backed securities – are gone. Virtually every standalone mortgage finance company has disappeared or merged in the past 18 months.

The time may be ripe for a U.S. covered-bond market. Covered bonds, a funding source tapped by banks to finance mortgage loans on balance sheets, have been widely used in Europe for centuries but only recently emerged in the United States. In the past six months, through a formal policy statement by the Federal Deposit Insurance Corp. and a release of recommended best practices by the Treasury Department, the U.S. government has promoted covered bonds as a way to increase the availability of credit for homebuyers and to promote sound underwriting by financial institutions. The FDIC policy statement was designed to clarify to prospective covered-bond investors how it would treat the liquidation of residential mortgage loans securing covered bonds if a bank issuer became insolvent. The guidelines encourage high-quality mortgage underwriting for residential covered bond programs.

Investors should take comfort from the FDIC's confirmation that Washington Mutual's covered-bond program will pass along to J.P. Morgan intact. Covered bonds have traditionally been a bank product, and the FDIC's and Treasury Department's pronouncements are limited to banks subject to regulatory oversight by the FDIC. The addition of two prominent institutions to the banking world – Goldman Sachs Group Inc. and Morgan Stanley – may be an additional boost to the covered-bond market.

Covered bonds proliferated in Europe due partly to an established legal and regulatory framework, which allows investors direct access to the cover pool in the event of a bank issuer's insolvency. In contrast, before its pronouncement, the FDIC as sole conservator or receiver of an FDIC-insured bank had the power to stay for 45 days (as conservator) or 90 days (as receiver) the exercise of remedies against an insolvent covered-bond issuer. Therefore, U.S. covered-bond investors were exposed to the risk that payments on the covered bonds could be suspended for up to 90 days.

The FDIC's policy statement reduces the maximum automatic stay period from 90 business days to 10 business days for certain covered-bond programs. If the FDIC, as receiver or conservator, fails to make required payments under the covered bond or if it repudiates the covered bond obligation and fails to pay damages, investors may after 10 business days exercise their contractual remedies. The FDIC will not, however, pay accrued interest after its appointment.

Only covered bonds secured by performing first-lien residential mortgage loans that are fully documented may qualify for favorable treatment under the Federal Deposit Insurance Corp.'s policy statement. Other eligibility requirements under the FDIC's and Treasury Department's guidelines include a maximum 80% mortgage loan-to-value ratio and no negative amortization loans, and an inclusion of AAA-rated mortgage-backed securities backed by eligible mortgage loans, not to exceed 10%.

Additionally, the issuer must maintain overcollateralization of at least 5% of the principal balance of the covered bonds, and the size of a bank's covered-bond program may not exceed 4% of its total liabilities. An investment contract, in which cover-pool proceeds would be invested after the insolvent bank's default, is required to prevent early repayment of the covered bonds.

Guidance from the FDIC and Treasury Department may provide greater certainty in this expanding market, but it remains to be seen whether the U.S. covered-bond market will become a significant financing source for residential mortgage finance in the United States to the same extent as in Europe.

John Arnholz and Ken Marin are partners at McKee Nelson LLP, based in Washington and New York, respectively.

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