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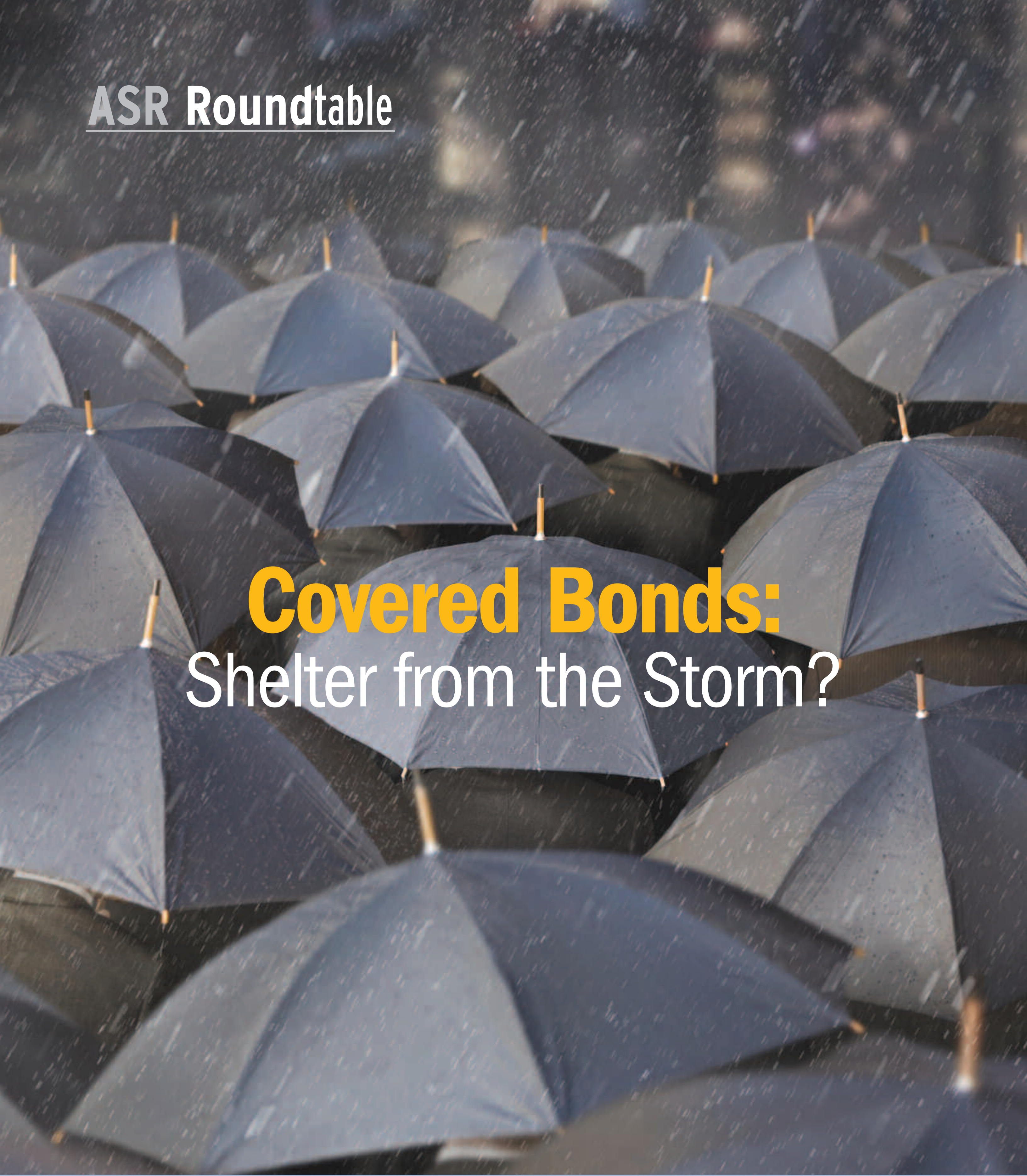

ASR Roundtable

Covered Bonds:
Shelter from the Storm?

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WITH THE **FEDERAL DEPOSIT INSURANCE CORP.**'S (FDIC) RELEASE OF A COVERED BOND POLICY STATEMENT AND TREASURY SECRETARY **HENRY PAULSON**'S PUBLIC SUPPORT FOR THE CREATION OF A U.S. MARKET FOR THESE TRADITIONALLY EUROPEAN SECURITIES, *ASR* BROUGHT TOGETHER A GROUP OF EXPERTS FOR A DISCUSSION OF HOW COVERED BONDS WORK AND TRADE, HOW THEY WILL BE TREATED BY REGULATORS AND THEIR POTENTIAL FOR GROWTH AND DEVELOPMENT IN THE U.S. THE DISCUSSION WAS MODERATED BY **CHRISTOPHER O'LEARY**.

ASR: Let's open by ensuring that everyone is on the same page. What is a covered bond, and how does it work?

ARNHOLZ: Very simply, a covered bond is a security issued by a bank. It is a general obligation of the bank, but it also is secured by a pledge of a separate pool of mortgage loans. A covered bond really is a hybrid obligation-part conventional debt security, part securitized instrument. While covered bond investors don't rely primarily on the cash flow from the pledged assets as in a securitized offering, they have the benefit of the mortgage pool as security in the event of the bank's failure.

MARIN: Covered bonds are similar to securitized products in that they are structured to insulate investors from the risk of the issuing bank's insolvency. They are different from securitized products in that the bank can freely substitute collateral and is required by the governing agreements to replenish the collateral if the value deteriorates. Also these bonds are typically structured with a bullet maturity of five or ten years, and the collateral cash flow is not matched to the bond's payments.

Covered bonds have proliferated in Europe, especially in countries with legislation that protects investors from the risk of insolvency or receivership of the issuing bank. These programs place a "ring fence" around the collateral, enabling investors to access the collateral in the event of a default.

KRIMMINGER: You can overstate the differences and the similarities between the U.S. and European laws on insolvency. In the U.S. there is a greater opportunity to avoid accelerating obligations because the FDIC's typical role is to be appointed receiver for a failed insured institution and then transfer operations as much as possible to another bank. In contrast, under European law one of the reasons special laws for covered bonds were required was that you really only have two options in an insolvency — the government either bails out the institution or institutes liquidation proceedings. While European authorities have more flexibility than they used to, the liquidation process is generally controlled by a court.

FREILINGER: There are some additional factors in the European market for mortgage loans that don't necessarily apply to the U.S. market. In particular, in a number of European regimes there are barriers to the transfer or sale of a loan without the borrower's consent. And so it's enormously difficult in an insolvency to dispose of loans. The European market for whole loans, as compared to the U.S. market, remains very limited. Here, the agencies exist to provide liquidity, in broad measure, to the mortgage market.

MARIN: There have been concerns in the U.S. about delays in payment of accrued interest on the bonds — whether investors would have to pay up for liquidity to cover any potential period during which interest wouldn't be paid on the bonds. I think the FDIC policy statement has alleviated that concern somewhat. We're all hoping it will be a boost for the covered bond market.

What also might cause more investor confidence in covered bonds is that investors have expressed their dismay with the job that rating agencies have done.

— John Arnholz

KRIMMINGER: We certainly wanted to provide some clarification as to how our law would apply, consistent with the 45-day period in the case of conservatorship or the 90-day period in the case of receivership. And, just to clarify, it's not the same type of stay you have under bankruptcy. It really is a time period during which you have to get the consent of the FDIC to take action with regard to collateral or terminate a contract and such.

ARNHOLZ: What was the motivation for the FDIC to take this action? Was there a consensus that these securities might be particularly helpful in providing liquidity and moving the markets forward?

KRIMMINGER: There were two motivations. First, as the consent period was adopted into law a couple of years ago, we felt we should provide guidance as to what would be an appropriate period of time for someone to have access to the collateral. Second, we are trying to balance the positive features of covered bonds, which include perhaps lower cost of funding and the ability to access new sources of liquidity, with the potential downside from the perspective of a deposit insurer.

The potential downside is that if a bank does fail, the greater the amount of secured liabilities the bank has, the lower the amount of assets available for us to sell to protect depositors and recover losses to the insurance fund. We think that setting up criteria will help provide clarity with regard to the limits to the percentage of liabilities that might be available for use with covered bonds. Then we'll see where the market goes and where adjustments should be made going forward. And we have asked for comments to help us think through the process.

MARIN: One question issuers might have is 'Why only residential mortgage collateral?' Why not other highly liquid assets like Treasuries that a financial institution would often post as collateral? What is the role of these types of assets in a cover pool?

> *One question issuers might have is 'Why only residential mortgage collateral?' Why not other highly liquid assets like Treasuries that a financial institution would often post as collateral?*
>
> *— Kenneth Marin*

KRIMMINGER: Initially we were looking at covered bonds as a vehicle for expanding liquidity for the mortgage markets, particular for the residential mortgage markets. The part of a covered bond structure that could prove challenging to institutions during times of stress is meeting the cover test. That could be difficult if the mortgage or other assets pledged to the covered bond are deteriorating in value, so that you have to sweep additional assets into the cover pool and take them out of that unpledged category that we could sell off, if needed.

ASR: *In the FDIC policy statement there is a reference to a "prudent and incremental development for the U.S. covered bond market." What would a "prudent" expansion of the market entail?*

KRIMMINGER: What we were getting at is that in the U.S. mortgage securitization market, we have played a role in providing guidance for how the bank insolvency laws would deal with securitizations. And so we thought it was appropriate to see how the covered bond market would develop in the U.S., and to make sure that we can provide clarification that would be consistent with our responsibilities as a regulator, a receiver for failed banks and a deposit insurer.

PLANK: I think one of the challenges in financing mortgage loans is acceleration risk — it's a serious problem solved in the covered bond structure with some relatively complicated mechanisms. It would help if the law could provide that if the FDIC took over an institution, it would transfer all of the assets and liabilities to another institution, enabling the covered bonds to remain outstanding. Then you wouldn't need to do anything else to solve the acceleration risk issue.

KRIMMINGER: Let me comment on that. One of the differences between the U.S and European banking markets is that here we have a public policy of providing clear protection to insured depositors, and one way is to give the FDIC flexibility in deciding what the resolution structures for different institutions are. I think if you were to take the more European-style approach of having the ring fence for covered bonds, and taking it basically out of the bank completely, you are essentially changing the whole public policy of U.S. insured bank regulation to one that is much more designed to focus on the risk to investors, rather than the risk to the overall financial system. That, for me, raises some troubling issues.

PLANK: I think that could be addressed, though, because if you look at mortgage originators who filed for bankruptcy, a substantial number of them have held residual interests in securitization trusts, and the bankruptcy trustees for these companies never tried to accelerate the mortgage pools and get the mortgage loans back because they realized securitization creates value. So while your concern is absolutely understandable, it could be addressed if some comfort were provided so that by keeping the covered bond outstanding you would create a mechanism for making sure that that residual value could be realized for the benefit of the deposit holders and the FDIC insurance fund.

KRIMMINGER: That, in fact, is one of the reasons that the structures put in place for the **WaMu** and the **Bank of America** covered bond transactions were designed as they were, which was to allow the FDIC, if the issuing institution closed, to be able to access the excess collateral over that necessary to protect the covered bond investors' interest. And I think fairly central to the concerns of the FDIC, in its role as ultimate receiver for a failed institution, is to make sure that the over-collateralization is not necessary to pay the covered bond obligations.

ASR: *To turn to the longer-term picture now: given Secretary Paulson's recent comments encouraging the growth of the covered bond market, it seems the stage is set for covered bonds to make headway in the U.S. Are there still factors that could slow down growth? Will it be a long process to build the U.S. market?*

LAROCCA: The current challenge to the growth of the U.S. covered bond market is the ongoing dislocation in the mortgage-backed securities market. Until there is stability in that market, it is difficult to imagine that a new product makes headway. To date, the U.S. covered bond market has been limited. Two U.S. issuers have issued covered bonds, WaMu and Bank of America. Bank of America is the only U.S. financial institution that has issued dollar-denominated covered bonds. The WaMu deal was issued in euros. Peter, how many of your bonds were placed with U.S. investors?

FREILINGER: None really. There are U.S.-based investors who bought bonds out of WaMu accounts for their European managed accounts, but as it was a euro-denominated product; we didn't really see interest from U.S. dollar accounts.

LAROCCA: Even more challenging is the concern that European investors have about the U.S. housing markets, which adds another layer of complication.

The covered bond market in Europe is very established. There are regulatory regimes, financial institutions and asset classes that investors are comfortable with.

— Prue Larocca

FREILINGER: Over the long term, we think covered bonds are a meaningful tool to help us manage our asset liability mix as well as our investor and liability diversification efforts. It gives us an on-balance sheet management tool that, historically, we would not have had. The securitization market has gone through periods where it has been popular and then less popular, and accounting rules change, etc. But on-balance-sheet financing is always going to be a part of our bank's core mission. We now have, with covered bonds, the ability and the technology to create a much higher-rated secured structure that will help us manage our liabilities more successfully.

ARNHOLZ: Given the FDIC statement, do you think other banks will now view covered bonds as a useful alternative on-balance sheet financing tool? Is it something that you would expect to see more issuer interest in, leaving aside current spotty investor demand? I imagine you are not going to see real investor demand until the secondary market picks up.

FREILINGER: That's exactly right. We are not fooling ourselves that investor demand will return until some of these secondary market issues get resolved. The FDIC's policy approach is a great first step. I think it does a lot for investors to let them know that, from a policy perspective, the key regulatory constituents in the U.S. have seen value in the product and understand that it needs its own set of clarifying statements. So now investors can feel like this isn't just some lawyers and structurers sitting together in a room and coming up with the next new thing.

LAROCCA: The covered bond market in Europe is very established. There are regulatory regimes, financial institutions and asset classes that investors are comfortable with. I agree with Peter that the FDIC's policy statement will help to build confidence in the European investor community in the regulatory structure. Over time confidence in the U.S. housing market will rebound.

ARNHOLZ: It is a much more transparent product in that sense.

LAROCCA: It is.

ARNHOLZ: You sell it as a general obligation but you have the collateral behind it as well.

LAROCCA: The collateral in the cover pool is a backup for the general obligation of the financial institution. The primary focus of the investors' analysis is the credit quality of the financial institution.

ARNHOLZ: Do investors care more about the fact that these obligations stay on balance sheet? What do investors feel these days about an originator that keeps skin in the game and doesn't sell securities or sell the loans? Is that an important aspect of these transactions?

HITZMANN: It becomes more like a corporate issue when you start to introduce the institution. If you are going to look at the issuing entity, it becomes a bit more like a corporate bond at that point, because you are looking through the bond to the issuer's rating, for instance, the triple-B rating at WaMu. The advantage of a covered bond (versus a corporate bond) is the recourse to the underlying assets that secures or "covers" the bond if the originator/bank becomes insolvent. Under an insolvency scenario, investors are going to look through to the underlying mortgages which may be located in regions experiencing declining property values, which is a whole other issue that you have to address. I think lifting the loan limits for the GSEs from around $417,000 to $730,000 has basically re-opened a broader segment of the mortgage market to doing business again.

LAROCCA: But I don't know that the investors in covered bonds spend that much time doing a mortgage analysis. They typically look at highlights and descriptors for pools.

HITZMANN: Most lenders are not currently originating loans to portfolio their production, but rather making sure such originations can be delivered directly to **Fannie Mae**, **Freddie Mac** or **FHA**. Since the non-agency market is in turmoil, I think any new initiative for a U.S. residential mortgage loan covered bond program would need to address an exit for the underlying loans eligible in the cover pool.

ARNHOLZ: So in terms of the investor's credit analysis, it's the corporate credit that seems to be more important?

LAROCCA: Correct, the corporate credit is more important. I don't want to lead you to believe that investors don't want some detail about the mortgage loans and some high-level detail about the origination process, but that's not the primary focus of their analysis. Think about it from the investors' perspective: as long as the bank is solvent, they are really looking to the bank to pay the obligation on the covered bonds. They're not looking to the cover pool.

FREILINGER: The way I think investors look at a covered bond first is, 'What's the quality of the underlying bank? Is that bank going to be able to make good on that joint liability?' The second thing, though, is, 'Does this product work in my country?' We never saw legal impediments within the U.S. regulatory framework that would create a problem for this product working or not working here. But I think investors are looking for some quality endorsements for the product. For example, in Europe there is favorable regulatory capital treatment for banks that hold covered bonds compared with traditional bank liabilities or securitizations. That's something potentially the Fed or the FDIC could do, coordinate with the ECB to harmonize treatment of covered bonds between European Central Bank regulations and U.S. central bank regulations. It doesn't affect the FDIC's process or regulatory framework for addressing an insolvent bank, but for existing covered bonds I think it gives them that stamp of approval.

The third element really is the cover pool. Investors do not go into a lot of depth. First and foremost, they are looking at whether the bond works and whether the bank works. If those two goals are met, then it is a price decision.

LAROCCA: The other thing I would add is that investors want to make sure that the institution can't add lower quality assets to the cover pool — they want to see a commitment to maintaining good quality assets in the cover pool.

ARNHOLZ: What also might cause more investor confidence in covered bonds is that investors have expressed their dismay with the job that rating agencies have done. And while these bonds are, of course, issued by rated institutions, it seems to me that investors are putting as much stock in the fact that the banks are regulated institutions and that they maintain a sensible balance sheet.

ASR: *Is it fair to say that, if a market takes off in the U.S. at some point, covered bonds could become a viable alternative to mortgage securities? Or are they going to be seen as part of another market?*

LAROCCA: I think covered bonds will be seen as another market, another financial instrument. But, they are another way for financial institutions to fund their mortgage production and portfolios. It is, from an investor's perspective a different product, more analogous to unsecured bank debt or MTNs. For example, at my company, the covered bonds would be sold from the agency debt desk, not off the mortgage-backed securities desks. Investors in the product are typically looking for bullet maturities, and not looking for convexity or to do a credit analysis.

We think that setting up criteria will help provide clarity with regard to the limits to the percentage of liabilities that might be available for use with covered bonds. Then we'll see where the market goes and where adjustments should be made going forward.

— Michael Krimminger

MARIN: I wonder if they might appeal to the MBS investors, though.

LAROCCA: In the current market, the spreads are too tight to attract mortgage-backed securities investors. We will have to wait and see what the market is like at the time, but I doubt it.

MARIN: What is the pricing differential between mortgage-backed securities and covered bonds?

LAROCCA: Everything has widened out. There was a Swedish covered bond deal that priced recently at Libor plus 17, which in the old days would have been considered a very wide level for a good bank and good assets, but it was now considered to be a very tight spread.

ARNHOLZ: Back to the question of whether or not covered bonds could be an alternative, I think there are aspects of a good covered bond program that really could be competitive with MBS programs, from a funding standpoint. They are efficient, you get to market fast-you really can't do much better. However, you do lose some of the ability to tranche or issue interest-only securities.

LAROCCA: Investors aren't looking for tranching of cash flows. They are looking for a three-year, five-year, seven-year, or a ten-year maturity. There is innovation in the market, but it does not, so far, include tranching of cash flows.

FREILINGER: I think the best analogy is to an MTN program. As the U.S. dollar market evolves, you will see, whether it is our program or BofA's program or other programs, that eventually we will be competing for a credit spread in addition to the classic agency MTN market. The covered bond programs are very flexible and we can write these things very easily. But U.S. mortgage-backed products are usually not designed to be timed like that. They are designed to be forward instruments that go in bullet portfolios.

ASR: *Keeping our eyes on the long term, is there potential for covered bonds to expand into collateral like student loans or auto loans, or is that going too far afield?*

KRIMMINGER: The FDIC's perspective is that we want to see how the market develops, starting with what we would hope to be a more stable type of collateral, one-to- four-family, fully underwritten, residential mortgages. We are not going to say that we wouldn't consider other types of structures in the future. Essentially what we are saying in our policy statement is that we are comfortable providing this fairly short-term consent to liquidation of collateral with these types of covered bonds because we think they will be more stable and easier to deal with at this stage of the market than other types.

LAROCCA: Certainly, from a rating agency perspective, covered bonds can be created with other types of collateral, and already are in the European market. But when you start a market you always try to start small. It was enough of a stretch to have WaMu and BofA roadshow in Europe and convince investors that they had viable mortgage programs. I don't think European investors would have been ready to entertain some of the more interesting products that either of the institutions might have on their balance sheets.

It becomes more like a corporate issue when you start to introduce the institution. If you are going to look at the issuing entity, it becomes a bit more like a corporate bond at that point, because you are looking through the bond to the issuer's rating, for instance, the triple-B rating at WaMu.

— Michael Hitzmann

FREILINGER: No! (laughs).

LAROCCA: But it is a good funding tool, so some financial institutions might like to use their auto or credit card portfolios as a cover pool.

PLANK: I would think that, in the long run, the fact that covered bonds have a fixed maturity, or a much more fixed maturity than a current mortgage-backed security, and therefore perform more like a corporate bond, would certainly be helpful in terms of future development of the market.

ARNHOLZ: So if the corporate credit behind the security is what really counts to the investor, then, in theory, if investors are comfortable with the credit you could imagine financing an auto pool or a student loan pool.

LAROCCA: You have to remember that spread is important. You can not assume that a covered bond with an auto cover pool is likely to trade at the same spreads as a covered bond with a mortgage cover pool. At a certain point, it may become uneconomical to use cover pools of unusual assets.

FREILINGER: From the investor's perspective, there already has been a lot of innovation in the covered bond markets in the past 10 to 12 years in terms of new domiciles, new structures, all the rest. I think this current investor market is looking really for very strong ratings and certainty of payment. They are not interested in high levels of quick innovation. And I think the U.S., as a regulatory construct and as a domicile, is already a big step for them. So looking at other asset classes beyond residential mortgages probably is pressing the innovation envelope a little bit too much. Eventually, you are right, the legal construct can support just about any type of receivable, but that will probably be more in the five- to ten-year time horizon. It is not going to be a near-term innovation. I think we have to be conscious of and patient with the investor community to let them get used to it.

KRIMMINGER: Looking at it from an outsider's view, it would seem that the focus at this point in the U.S. covered bond market should be on creating an understanding by investors of what the U.S. covered bond market would bring to the table, and for investors to have a level of comfort through high quality assets and perhaps the adoption of industry best practices. A standardized way of bringing the covered bond product to market would help, I think, provide the comfort level that a lot of Europeans are seeking. Branching out in other types of asset categories may not be the way to go at this stage.

ASR: *So, to wrap up, a final question: what will it take to build up a U.S. investor base for covered bonds? Will it require banks to devote years to investor education, to doing road shows, and so on?*

FREILINGER: I think, first off, that the U.S. mortgage market in general needs a little time to calm down. Nothing is going to happen in the near term because of the turmoil and questions regarding the health of the mortgage market in general. But once we get through that-if you look to 2009, which is where I think we will see things normalize in the mortgage markets broadly-then, yes, it is going to take investor education and everyone at this table has a role to play in that. The policy statement from the FDIC is a tremendous step forward.

I think the Street also needs to invest some real time and energy in getting out to the buying community in the U.S., which traditionally has consisted of buyers of bullet agency products and highly-rated bullet corporate products. Those investors, both in the U.S. and externally in dollar products, could see the value of a dual recourse instrument from a regulated depository institution with strong collateral backing it up. But it is going to be an educational effort and it is going to take time. It's probably not worth spending that time right now because there are too many other distractions in the mortgage market. But next year I think the constituencies that have a lot to gain from making this product work should be spending that time.

LAROCCA: Ironically, many of the investment banks in 2007 were out talking hypothetically with investors about a U.S. covered bond market, and were starting to educate investors and the internal sales force about the product. As the mortgage-backed securities market improves, those conversations will continue. ASR