



VIA ELECTRONIC MAIL

June 23, 2008

Mr. Robert E. Feldman  
Executive Secretary  
Attention: Comments  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

Re: Covered Bond Policy Statement  
73 *Federal Register* 21949, April 23, 2008

Dear Mr. Feldman:

The American Bankers Association (ABA) and the ABA Securities Association (collectively the Associations) are responding to the request by the Federal Deposit Insurance Corporation (FDIC) for comments on its interim final policy statement (policy statement) on the treatment of covered bonds in a conservatorship or receivership<sup>1</sup>. Our members are actively involved in both mortgage origination and the securitization of mortgages and are participating or may participate in the development of a market for covered bonds in the United States.

The interim policy statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds in a receivership or a conservatorship, after the FDIC makes a determination whether to terminate or continue the transaction. Currently, under the FDIC's special powers as a conservator or receiver, a secured party must obtain the FDIC's consent to seize the collateral during the 45-day period after the agency is named conservator, or during the 90-day period after it is named receiver. In addition, the FDIC, as conservator or receiver, has the right to repudiate the bank's agreement to support the covered bonds through additional asset transfers to the trust. The policy statement establishes a framework under which the FDIC will grant covered bond holders the right to seize the collateral within ten business days after an insured depository institution (IDI) defaults on monetary payments, or after the effective date of an FDIC repudiation of the covered bond obligation.

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<sup>1</sup> ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.3 trillion in assets and employ more than two million men and women. ABASA is a separately chartered affiliate of the ABA representing those holding company members of the ABA actively engaged in capital markets, investment banking and broker-dealer activities.

At the outset, the Associations commend FDIC for taking this initial action to promote a market for covered bonds in the U.S, a goal shared with the U.S. Treasury Department. A covered bond market could provide a significant long-term funding source (complementing other funding sources, such as short-term Federal Home Loan Bank (FHLBank) advances) to help U.S. banks fund consumer mortgages. At the same time, because covered bonds are obligations of the issuing bank that remain on the bank's balance sheet, this product could provide both lenders as well as regulators greater opportunities to assess more accurately the risks in their portfolios.

The European market for covered bonds is well developed, with an estimated \$2.75 trillion of bonds currently outstanding, and serves as a primary source of mortgage funding in Europe. Of particular interest for today's economic conditions, in the first three weeks of 2008, European banks were able to issue approximately \$20 billion in covered bonds, despite worldwide concerns about the international credit freeze.

Because risk-averse covered bond investors generally are seeking "rates products" (similar to Treasury and agency debt) that are structured to ensure continued timely payment of principal and interest, issuer failure notwithstanding, any uncertainty about U.S. laws or regulations that impact those payment streams are viewed negatively. As a result, on the few occasions when U.S. banks have issued covered bonds, the pricing has been comparable to mortgage-backed securities, rather than agency debt, despite the fact that they are, at their core, obligations of the bank.

A key concern investors have about U.S. covered bonds is whether payments of principle and interest would be interrupted in the event that FDIC is named as conservator or receiver of a failed U.S. bank. While the Associations support FDIC's policy statement, because we believe it will help foster investors' confidence that their covered bonds will not be impaired in the event an IDI fails, we remain concerned that the proposed definition of "eligible mortgage" may serve to unduly delay the development of a robust covered bonds market in the U.S. Accordingly, although we recognize FDIC's decision to limit the scope of its interim policy statement to gain experience in this important new market, we urge FDIC to provide more flexibility in its final policy statement so that IDIs will have an incentive to become active in this nascent market. In addition, we strongly urge FDIC to make clear in the final policy that the eligibility criteria may be further expanded in the near term, consistent with experience gathered.

Our specific comments follow.

## **Background**

### **1. General Description of Covered Bond Transactions**

Covered bonds are general obligation bonds of the issuing IDI secured by a pledge of loans that remain on the IDI's balance sheet. They are typically sold to risk-averse investors seeking "rates products" and are structured to assure the continued, timely payment of principal and interest, even if the issuing IDI should fail. For this market to work efficiently, these investors must be confident that, in the event of a failure of the IDI, they will be able to seize the collateral rather than become unsecured creditors.

Investors are protected from decreases in the value of the collateral pool because the IDI has a continuing obligation to transfer additional performing assets to the pool in the event the market value or income stream from the assets falls below pre-determined thresholds. In addition, rating agencies may require changes in the collateralization level to ensure that the modeled liquidation value is above the par value of the covered bonds.

If the issuing IDI fails, the covered bond holders are protected by their interest in the pool of assets backing the bonds, *so long as they can seize the collateral quickly and liquidate it at current market values.*

**European market.** Covered bonds are well established in European markets and have been authorized either through specific legislation or regulatory agreement. The market developed after legislation was enacted in a number of European countries ensuring that if the sponsoring bank were to become insolvent, the cover pool would be maintained apart from the insolvency proceedings until all of the covered bonds were paid as required by their terms. Importantly, under European law, no acceleration of the covered bonds can occur unless the collateral pool in the end proves insufficient to pay the bonds in full. In light of this high level of investor protection, based both on the pool of mortgages serving as collateral and on the bank's obligation to maintain the collateral at prescribed levels, European covered bonds receive the highest credit rating possible and trade akin to Treasury or agency obligations in the U.S. markets.

**U.S. market.** While the Uniform Commercial Code and existing FDIC regulations provide protections quite similar to European law, the lack of legal certainty in the U.S. in the event of an IDI failure is an extraordinarily important factor for investors in the covered bond markets. In particular, covered bond holders are concerned that they would not be able to seize the collateral quickly enough to avoid the potential market risk that the value of the collateral would decline or that payments to investors could be interrupted. However, if investors could seize the collateral very soon after an IDI failed, there would be less concern, because at that point in time the market value of the assets in the pool would be more than adequate to protect the covered bond holders fully. Investors are similarly concerned that if FDIC were to repudiate the agreement, the IDI would no longer be required to transfer additional assets into the collateral pool.

Without such legislative or regulatory assurances for investors, U.S. banks issuing covered bonds have had to structure their transactions in a more costly and complex manner to diminish the probability that covered bonds would be accelerated if the IDI were to become insolvent. In those covered bond transactions initiated in the U.S., the IDI sold mortgage bonds, secured by mortgages, to a special purpose vehicle (SPV). The pledged mortgages remained on the IDI's balance sheet, securing the IDI's obligation to make payments on the debt, and the SPV sold covered bonds, secured by the mortgage bonds, to investors.

If the IDI were to become insolvent, the mortgage bond trustee would take possession of the pledged mortgages and continue to make payments to the SPV to service the covered bonds. Only if the pool were insufficient to support payment in full would the covered bonds be accelerated. If FDIC repudiated the IDI's mortgage bonds, the trustee would invest all of the damages paid by the agency in an income-generating instrument, which income would be used to pay interest on the covered bonds until maturity. A swap is also built into the structure to cover shortfalls in interest that may occur in the time between the appointment of FDIC and the receipt of damages or other proceeds.

## **2. FDIC Interim Final Policy Statement**

FDIC's policy statement is intended to address the uncertainty described above that currently exists in the U.S. in the absence of covered bond legislation. The policy statement provides that FDIC will grant access to the collateral supporting a covered bond within ten business days after the insured depository institution defaults, or after the effective date of an FDIC repudiation of the covered bond obligation so long as the following conditions are satisfied:

- The covered bond issuance must be made with the consent of the bank's primary federal regulator;
- The term of the covered bond must be greater than one year but no more than ten years;
- After issuance, the covered bonds must comprise no more than four percent of an issuing financial institution's total liabilities; and

- The collateral securing the bonds must consist of:
  - Perfected security interests on performing mortgages on one- to four-family residential properties, underwritten in accordance with existing supervisory guidance at the fully indexed rate and relying on documented income (eligible mortgages); or,
  - AAA-rated mortgage-backed securities backed solely by eligible mortgages. Such mortgage-backed securities may comprise no more than ten percent of the collateral for any covered bond issuance or series.

Covered bonds that do not meet these standards would remain subject to the 45- or 90-day stay under FDIC regulations.

### **Discussion**

The Associations support FDIC's policy statement as an important first step in the development of a covered bond market in the U.S. The effect of this expedited consent provision will be to provide greater assurance to covered bond investors that they will not be required to wait for the expiration of the 45-day period after appointment of a conservator or the 90-day period after appointment of a receiver before the covered bond trustee exercises its contractual rights over the collateral. However, we remain concerned that while the policy statement may allay investor concerns, the conditions therein may serve as a deterrent to IDI entry into the market. Given the potential beneficial impact of a robust covered bond market in the U.S., The Associations believe that providing greater flexibility in those terms would permit more IDIs to enter this market. The development of a thriving covered bond market in the U.S. could foster important national policy objectives, particularly given the current credit and liquidity conditions. For example:

- Covered bond transactions may offer additional sources of liquidity to mortgage originators. Currently, many banks rely on FHLB advances as their short-term mortgage funding source. Covered bonds could serve to diversify mortgage funding options as a long-term source of liquidity for this important market. Moreover, because they are collateralized, covered bonds can provide a lower cost of funding than issuing senior unsecured debt.
- As investors gain confidence in the security of their U.S. covered bonds, U.S. issuers, who until now have relied upon more complex structures involving SPVs, may be able to substitute less costly direct issuance of their own bank bonds in the covered bond structure.
- A covered bond market would serve to increase the portfolio lending market. Portfolio lenders are typically more conservative in credit underwriting, because the loans stay on their balance sheets. In addition, because they remain in an IDI's portfolio, such loans are also subject to more continual regulatory oversight.
- As mentioned, covered bond transactions can provide a source of long-term financing. In addition, the dynamic cover pool means that the maturity of the covered bonds need not be linked to the maturities of the initial pledged assets.
- The covered bond structure does not face the same costs and accounting and regulatory issues as does the mortgage-backed securities market.

## **1. Associations' Specific Comments**

The goal of the policy statement is to assure covered bond investors that there will be an uninterrupted payment stream and that the collateral supporting their bonds is secure. The importance of obtaining expedited access to the collateral in the event an IDI fails fosters this necessary assurance. However, the policy statement does not address the impact of receivership on the payment stream in the ten-day period before the expedited access provision becomes effective. To address this gap, the Associations strongly recommend that the policy statement explicitly state that upon appointment as receiver FDIC will either (1) pay par plus accrued interest up to the date of repudiation or (2) allow the collateral to be seized with *no* stay period. The Associations believe that the policy statement must be specific on this point to allay investor concerns about the continuity of the payment stream.

The Associations believe that insured institutions may have loans on their balance sheets that pre-date the supervisory guidance specified in the interim policy statement. As a result, many institutions may not have sufficient "eligible mortgages" on their books to warrant entry into the covered bond market. Moreover, because there is no industry-wide agreement as to what constitutes a mortgage "underwritten at the fully indexed rate relying on documented income," it may be impossible to determine which pre-guidance mortgages meet the eligibility requirements. To allow insured institutions to benefit from and support a U.S. covered bond market, the Associations strongly recommend that "eligible mortgages" should include mortgages issued in accordance with supervisory guidance in effect at the time the mortgages were issued.

FDIC's policy statement clearly limits eligibility for the expedited seizure process to loans that conform to the requirements set out in the statement. However, the Associations believe this should not preclude FDIC from authorizing, on a case-by-case basis, an IDI whose covered bond collateral pool includes nonconforming assets, to use the expedited procedure. Accordingly, we urge FDIC to state this clearly in its final policy statement.

With respect to the requirement that loans in the collateral pool be "performing mortgages," the Associations believe that this determination should be made at the time of issuance rather than when a conservator or receiver is appointed. There may be situations where loans that are performing mortgages at issuance may become non-performing at the time of the appointment of the conservator or receiver. In such cases, the Associations believe that the policy statement should provide a reasonable grace period during which the IDI could substitute performing mortgages.

The Associations believe that investors generally lack an accurate understanding of FDIC's battle-tested resolution processes. Accordingly, we believe that a clear description of those processes in an authoritative document, such as the policy statement, would further alleviate investor concerns about the impact of an IDI failure. Accordingly, the Associations recommend that FDIC include in the revised final policy statement a summary describing generally the receivership or conservatorship procedures, and how those proceedings would, under the final policy statement, address covered bond obligations of an IDI, including the timing for that process and specific examples of the possible outcomes.

## **2. FDIC Questions for Comment**

***Future innovation.*** FDIC seeks comment on whether this policy statement should be limited to the currently defined structures or open to future innovations in how covered bond transactions may be structured in the U.S. As stated above, the Associations believe the policy statement is a first and important step in the development of the covered bond market in the U.S. Accordingly, the Associations urge FDIC to ensure that the final policy statement clearly remains open to prompt remain open to prompt liberalization of the policy statement so as to permit and promote growth and innovation of this market in the U.S.

**Assessments and secured liabilities.** FDIC seeks comment on whether covered bond issuances should increase an institution's insurance assessment rate or should be included in an institution's assessment base. If so, should such assessment rate increases or inclusion in assessment base only apply when an institution's covered bond liability exceeds four percent of its total liabilities?

FDIC further seeks comment on whether (1) an IDI's percentage of secured liabilities to total liabilities should be factored into its insurance assessment rate; (2) an IDI's secured liabilities should be included in its assessment base; or (3) this policy statement should incorporate an overall cap for secured liabilities.

While we recognize FDIC's concern that covered bonds and secured liabilities may decrease the assets available to FDIC in the event of a failure, the Associations believe that it is wholly inappropriate to address these issues in the much narrower context of providing guidance regarding covered bonds. Rather, we believe it imperative that should the FDIC determine that it is necessary to address these issues that they are taken up in a rulemaking *separate* from the covered bond issue and denominated appropriately so that notice is given to all insured institutions that might be affected by such changes.

**FHLBank advances.** The potential impact on FHLBank advances of FDIC's questions on secured liabilities demonstrates the broad reach of interim final rule. Because FDIC deems FHLBank advances to be secured liabilities, these advances would be negatively impacted by FDIC efforts to address the effect of secured liabilities on assets available in a resolution. The Associations strongly oppose incorporating FHLBank advances into assessment calculations or imposing an arbitrary cap, because we believe such actions would discourage community banks, in particular, from using these advances.

Importantly, we believe such actions serve neither current policy goals nor the best interests of FHLB member banks. Indeed, the increase in 2007 FHLBank advances by over 36 percent indicates that these advances are playing a key role in providing liquidity to the mortgage market. Given the current economic circumstances, it should be clear that any action that decreases either the availability of or incentives to use FHLBank advances is contrary to the efforts by the Administration, Congress, and financial regulators to restore liquidity and bolster confidence in the housing market.

FHLBank advances serve as an especially stable, reliable source of liquidity that reduces funding risk for FHLBank members. Larger banks typically use advances as a short-term source of funding, while community banks may use advances more broadly. If the FDIC were to include FHLBank advances in the calculation of an institution's premium assessments, thereby discouraging borrowing from FHLBanks, it would be counterproductive to improving liquidity resources for insured depository institutions and would actually increase risk. Borrowers frequently use FHLBank advances for liquidity purposes and to manage interest-rate risk, as well as to fund loan growth. Curtailing the use of FHLBank advances would force institutions to look to alternative, often more costly wholesale funding sources that are considerably more volatile, therefore reducing profitability and increasing liquidity risk. Penalizing FHLBank members for using advances would not only limit their use of a valuable liquidity source, but also make them less competitive and limit the availability of credit in the communities they serve.

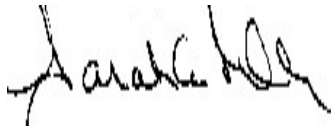
Finally, when FDIC is concerned about the safety and soundness of an insured institution, an arrangement is already in place whereby FDIC and the relevant FHLBank are to engage in collaborative efforts to ensure that an institution has adequate liquidity while minimizing losses to the FDIC.

**Conclusion**

In conclusion, the Associations support FDIC's policy statement as an important first step in the development of a U.S. covered bond market. As the FDIC gains experience in this market, we believe that FDIC should commit to an early review of the policy with the goal of more closely mirroring the European covered bond market. Please do not hesitate to contact the undersigned or Cristeena Naser at 202-663-5332, should you wish to discuss this matter further.

Sincerely,

Sarah A. Miller

A handwritten signature in black ink, appearing to read "Sarah A. Miller". The signature is fluid and cursive, with the first name being the most prominent.

Senior Vice President  
ABA Center for Securities, Trust & Investment

General Counsel  
ABA Securities Association