Date: August 1, 2008

To: Interested Persons

Re: Treasury Encourages the Development of Covered Bonds in the U.S. and Issues "Best Practices"

As has been widely discussed in the financial press, on July 28, 2008, Treasury Secretary Henry Paulson announced the Treasury Department's support for covered bonds as "a promising financial vehicle" for U.S. mortgage funding and overall market stability. His remarks accompanied the release of a set of detailed Treasury Department (the "**Treasury**") guidelines titled "Best Practices for Residential Covered Bonds" (the "**Best Practices**").[1] The Best Practices are intended to be a standard-setting tool "providing homogeneity and simplicity" to the nascent U.S. covered bond market.

The importance that the U.S. government is placing on this initiative is evidenced by the fact that Secretary Paulson was joined by the heads of the four major federal banking regulatory agencies and representatives of four major banks (Bank of America, Citigroup, JPMorgan Chase and Wells Fargo). In a move likely to lend greater momentum to the U.S. covered bond market, the four banks in a joint press release expressed their support for the government's initiative and announced that they "look forward to being leading issuers as the U.S. covered bond market develops."[2]

Covered bonds are debt securities secured by a collateral pool (the "**cover pool**") of high-quality mortgages or other assets kept on the issuing depository institution's balance sheet. The cover pool is "self-correcting," in that assets that no longer satisfy the stringent quality criteria must be replaced with other assets

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[1] The Best Practices are available at http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf. See also the Fact Sheet accompanying the Best Practices release, available at http://www.ustreas.gov/press/releases/reports/factsheet.pdf; the transcript of Secretary Paulson's remarks, available a*t* http://www.ustreas.gov/press/releases/hp1101.htm; and the press release accompanying Secretary Paulson's remarks, available at http://www.ustreas.gov/press/releases/hp1102.htm.

[2] The banks' joint press release is available at http://newsroom.bankofamerica.com/index.php?s=press_releases&item=8214. Potential investors have also expressed their support. For instance, TIAA-CREF, the largest private pension system in the U.S., issued a press release expressing support for the U.S. Treasury Best Practices. The Best Practices "can help create transparency for investors while helping bolster liquidity in underserved areas of the housing market," said Sanjeev Handa, Head of Global Markets. Press Release, TIAA-CREF (July 28, 2008), http://www.tiaacref.org/about/press/about_us/releases/pressrelease257.html.

that do, and typically also provides for "overcollateralization," in that the asset value counted towards the cover pool must exceed the notional value of the covered bonds secured by it. The cover pool management is typically supervised by a public or other independent entity. In the event of an issuer default, holders of covered bonds have dual recourse, in that they share ratably in the proceeds of liquidation of the cover pool, but also retain an unsecured claim against the issuer should the cover pool assets prove insufficient to satisfy their claim. [3] Importantly, covered bond regimes have generally been designed to allow covered bonds to remain outstanding when the issuer becomes insolvent.

With covered bonds, the U.S. regulators and financial market participants have imported a traditionally European financial product.[4] While relatively unknown in the U.S., with only two issuers to date, covered bonds are a cornerstone of European mortgage and public sector funding. In particular in its "benchmark" segment,[5] the European market is highly liquid and, with its high credit quality and yield pick-up compared to government-issued bonds, attracts investments by credit institutions, investment funds, central banks and agencies, insurance companies and pension funds. In most European countries, as well as in the European Union as a whole,[6] covered bonds are subject to detailed

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3 Covered bonds are therefore quite different from traditional U.S. asset-backed securities under the originate-to-distribute model, where the loans leave the balance sheet of the lending institution and investors' recourse is only against the predefined pool of assets.

[4] The discussion around covered bonds represents a new and significant stage in the interaction of the U.S. financial markets with the European financial markets, with the import of a major financial product from Europe to the United States. Like all imports across regulatory and social environments, adjustments will need to be made. The U.S. banking regulators' willingness to look to Europe for ideas and solutions, and to discuss its ideas with European regulators, also comes at a time when U.S. and European regulators increasingly cooperate on financial regulatory matters. See, for example, the ongoing EU-U.S. Financial Markets Regulatory Dialogue, begun in 2002.

[5] The "benchmark" covered bond market is the second most liquid bond market in Europe, after government bonds. About 40% of all covered bonds are issued as benchmark covered bonds, which entails Euro denomination, bullet maturity, defined minimum outstanding volume of €1 billion, market making by at least five market makers at narrow two-way prices, and the availability of electronic trading. It should be noted that as a result of widening spreads during the ongoing credit turmoil, inter-bank market making in Europe suffered interruptions.

[6] Article 22(4) of the Directive of the European Parliament and of the Council on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), Council Directive 85/611/EEC, as amended by Directive 2001/108/EC provides a baseline definition and allows certain investment funds to invest up to 25% of their assets (instead of just 5%) in covered bonds under applicable prudential investment limits. The Capital Requirements Directive, Directive 2006/48/EC, implementing Basel II standards, offers favorable capital treatment for covered bonds meeting certain criteria (including compliance with UCITS standards). See also Third Life Insurance Directive, Council Directive 92/96/EEC; Third Non-Life Insurance Directive, Council Directive 92/49/EEC.

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regulation, covering such topics as issuance standards, insolvency treatment and benefits derived by investors holding this asset class. By contrast, in the U.S., regulation has thus far been limited to a policy statement (the "**FDIC Policy Statement**") by the Federal Deposit Insurance Corporation (the "**FDIC**") clarifying the actions the FDIC will take during an insolvency or receivership of an issuing insured depository institution (a "**depository institution**").[7] While further regulation in specific areas is to be expected (see section 3 below for some of the initiatives underway), the Best Practices are evidence of the Treasury's view, in the words of Secretary Paulson, that, over all, "this market can grow in the United States absent federal legislative action." Others are not so certain. On July 30, 2008, Representative Scott Garrett introduced H.R. 6659, the Equal Treatment for Covered Bonds Act.[8]

The Treasury's release of the Best Practices comes at a time of continuing bad news for the housing sector, which is plagued by rising foreclosures and a paralyzed private-label securitization market, and increasingly relies on a very limited set of funding strategies, including Fannie Mae- and Freddie Mac-sponsored securitizations. The hope is to establish an "additional, complementary funding source" for the $11 trillion U.S. residential mortgage market. In order to further that goal, and to keep the product simple from investors' point of view, the Treasury has limited the asset classes eligible for inclusion in the cover pool to high-quality residential mortgages while acknowledging that, as the covered bond market develops over time, it may include "other asset classes." Since cover pool assets remain on the balance sheet of the issuing depository institution, the hope is that covered bond issuance will also help to counter the moral hazards inherent in the originate-to-distribute business model underlying securitization and some other funding techniques. There is no expectation that other funding techniques will be replaced fully, not least because both the Best Practices and the FDIC Policy Statement impose a four percent limit on the liabilities that covered bonds can represent for any one U.S. issuer.

[7] On April 23, 2008, the FDIC published an Interim Final Policy Statement indicating how it would treat certain qualifying U.S. covered bonds in the event of the conservatorship or receivership of an insured depository institution (bank or thrift). On July 15, 2008, after a comment period, the FDIC adopted the Final Covered Bond Policy Statement containing only slight changes to the Interim Final Policy Statement. Both the Interim and Final Policy Statements provide "guidance to facilitate the prudent and incremental development of the U.S. covered bond market while the FDIC, and other regulators, evaluate the benefits and risks of these products in the U.S. mortgage market." The Best Practices contain the full text of the FDIC's Final Covered Bond Policy Statement, also available at http://www.fdic.gov/news/news/press/2008/pr08060a.html.

[8] See http://garrett.house.gov/News/DocumentSingle.aspx?DocumentID=99123. The bill would add covered bonds to several sections of the Federal Deposit Insurance Act, including the definition of "qualified financial contract." The bill would also give joint rulemaking authority to the Treasury, the Federal Reserve, FDIC, OCC and OTS.

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We view the Treasury's Best Practices as a significant step in the development of a domestic U.S. covered bond market, which may also open U.S. investors to covered bond issuances by European issuers. The ultimate success of a U.S. covered bond market will depend in large part on the price at which investors and issuers will be willing to enter the market. Price, in turn, will in part depend on the efficiency and characteristics of covered bond programs, on investors' willingness to accept the Best Practices in the absence of dedicated legislation, on the availability of a liquid secondary market and on benefits investors can derive from holding covered bonds (such as beneficial capital treatment or classification of covered bonds within the universe of eligible collateral under the Federal Reserve's liquidity and support operations).

This memorandum describes salient terms of the Best Practices and analyzes how covered bonds might work in the United States.

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1. The Best Practices define covered bonds and address cover pool asset characteristics, monitoring and disclosure.

The definition of covered bonds in the Best Practices (see Table 1) is in line with the basic features of most covered bond regimes found across Europe. However, the Best Practices' definition is somewhat more restrictive in that, at least for now, only residential mortgage-backed covered bonds qualify, while in several European countries, other asset classes, such as commercial mortgages and public sector debt, are equally permitted as collateral.

Table 1
A Covered Bond – U.S. Treasury Definition

- A debt instrument secured by a perfected security interest in a specific pool of collateral called a cover pool
- Covered bond must have a maturity of more than a year and less than 30 years
- A covered bond provides funding for a depository institution, and may not account for more than 4% of its liabilities after issuance
- The cover pool is limited to residential mortgage loans that meet certain quality characteristics (see Table 2)
- Substitution collateral can include cash, U.S. Treasury and agency securities
- The mortgages remain on the balance sheet of the depository institution
- Interest payments are made from the general cash flows of the issuing depository institution
- The cover pool is actively managed to maintain the quality required and non-performing assets are replaced with performing assets
- Overcollateralization (see Table 2)
- Multiple issuances can use a common cover pool
- In default, investors look first to the cover pool. If the cover pool is inadequate, investors have an unsecured claim against the depository institution *pari passu* with other unsecured investors

Table 2
Mortgage Quality and Overcollateralization

- Loan-to-value (LTV) of mortgages must be 80% at the time of inclusion in the cover pool
- First-lien perfected performing residential mortgages only
- Documented borrower income
- Underwritten at the fully indexed rate
- Mortgages in a single Metro Statistical Area may not make up more than 20% of the cover pool
- Negative amortization mortgages may not be included
- The cover pool must at all times provide 5% overcollateralization for the covered bonds
- LTV assumptions updated quarterly

The mortgages in the cover pool must share certain basic characteristics, several of which are listed in Table 2. These characteristics can be seen as a response to substandard underwriting practices that have contributed to the U.S. subprime crisis, and are also designed to meet typical rating agency criteria. For example, only performing one- to four-family residential mortgages underwritten at the fully indexed rate qualify for the cover pool. The mortgages must have been underwritten with documented income, and all supervisory guidance as to underwriting practices applicable at the time of origination must have been met.

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All mortgages in the cover pool must have a loan-to-value (LTV) of 80% at the time of inclusion in the cover pool, and the cover pool must provide for an overcollateralization of the outstanding principal balance of covered bonds by at least 5% at all times. Mortgages with an LTV that increases above 80% while in the cover pool do not become ineligible to satisfy the overcollateralization requirement, but only the 80% LTV portion of each mortgage loan will be credited as the collateral value. The assumptions underlying the LTV calculation must be updated quarterly using "a nationally-recognized, regional housing price index or other comparable measurement."

Issuers must perform monthly asset coverage tests, including tests designed to ensure collateral quality, establish when collateral substitutions are required[9] and maintain mandated overcollateralization levels. An independent asset monitor must be designated to periodically assess compliance of the issuer with those asset coverage tests. Unlike in several European jurisdictions, the asset monitor, while independent, need not be a statutorily created entity. The Best Practices do not specify who shall serve as the asset monitor.

If the issuer is not in compliance with the asset coverage tests and does not rectify the situation within a month, the covered bonds may be terminated and unwound by the trustee on behalf of the bond holders.

The Best Practices also promote oversight by requiring disclosure in excess of current standards. Depository institutions must not only monitor the quality of their cover pool, but also disclose certain information affirmatively. "Descriptive information" about the cover pool must also be disclosed at the time of issuance, and then on a monthly basis,[10] as well as when a specified percentage of the cover pool is substituted.[11] Furthermore, the Best Practices impose a general duty to disclose "information regarding [the depository institution's] financial profile and other relevant information that an investor would find

[9] The Best Practices allow for substitution of cash, U.S. Treasury securities and agency securities "as necessary to prudently manage the Cover Pool." The FDIC Policy Statement further specifies that any mortgage-backed securities in the cover pool must be AAA-rated, secured by eligible mortgages and limited to no more than 10% of the cover pool.

[10] A requirement that cover pool information be released monthly is more frequent than is the custom in Europe, and even in the U.S. asset-backed securities market. As U.S. disclosure practices have, in the past, affected the overseas Rule 144A/Regulation S market and disclosure practices, European banks that are considering selling their own covered bonds into the U.S. under Rule 144A may find that the developing U.S. disclosure practices are imported back into their own Rule 144A documentation.

[11] Disclosure is triggered if 10% of the cover pool is replaced within any month, or if 20% of the cover pool is replaced within any quarter.

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material."[12] This duty also applies to an SPV issuing covered bonds on behalf of a depository institution (see Section 2 below). Finally, any reviews by the asset monitor, as well as the results of asset coverage tests, must be made available to the public.

2. The Best Practices limit the use of covered bonds to depository institutions, and allow for two different issuance structures designed to address peculiarities of the U.S. bank insolvency regime.

The Best Practices, like the FDIC Policy Statement before it, are limited to issuers that are depository institutions or wholly owned subsidiaries of such depository institutions, as well as certain special purpose vehicles ("**SPVs**") set up by one or more such depository institutions.[13] Only well-capitalized[14] depository institutions should issue covered bonds according to the Best Practices, and those institutions must receive prior approval from their primary federal regulator to issue covered bonds or set up a covered bond program.

The Best Practices set forth two possible issuance structures. In the direct-issuance structure, the depository institution issues covered bonds directly to the market. In the SPV structure, the depository institution sells mortgage bonds collateralized by the cover pool assets to an SPV, which holds those mortgage

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[12] It is unclear at the moment whether this general duty is meant to impose obligations stricter than those already imposed under the U.S. securities laws. As a practical matter, for those banks that are subsidiaries of publicly listed bank holding companies and are willing or able to rely on such disclosure for their covered bond issuances, this disclosure requirement should add nothing new to the ongoing obligations of the bank holding company under the Securities Act and the Securities Exchange Act, if one assumes that such bank holding companies face virtually continuous disclosure obligations as a practical matter in today's markets. Those covered bond issuers using the direct-issuance route (described below in Section 2), and who are neither willing nor able to rely on bank holding company disclosure, may have to consider the extent to which separate bank financials would be advisable or necessary. Notably, the UK Financial Services Authority is moving in the opposite direction after its experience with Northern Rock, and is considering implementing regulations that would permit a bank to withhold, for a very short time, confidential information about its receipt of liquidity support. See Financial Services Authority, Disclosure of Liquidity Support (July 2008), available at http://www.fsa.gov.uk/pubs/cp/cp08_13.pdf.

[13] In a footnote, the Best Practices discuss the possibility for several depository institutions to utilize a joint SPV in order to pool assets, a practice similar to one used in Spain. It will be interesting to see whether a pooling arrangement will allow community and regional banks to access the covered bond market. As of now, the separate requirement that issuances of covered bonds be limited to 4% of an insured depository institution's liabilities seems to be a roadblock for sufficiently large (and thereby liquid) pooled issuances by community and regional banks.

[14] Existing regulatory definitions of "well-capitalized" include a total risk-based capital ratio of at least 10%, and require that the institution not be subject to any corrective orders or compliance agreements. See 12 C.F.R. §§ 325.103(b)(1) (FDIC), 208.43(b)(1) (Federal Reserve), 6.4(b)(1) (OCC), 565.4(b)(1) (OTS).

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bonds as its primary assets and uses them as collateral to issue covered bonds to investors.

In either structure, issuers may also enter into an interest payment swap (the "**Swap**"), and must enter into a deposit agreement (which may take the form of a guaranteed investment contract) (the "**Specified Investment Contract**"), each with a financially sound counterparty. The Swap serves chiefly to provide, in the event the issuer becomes insolvent or is placed into receivership or conservatorship, short-term liquidity to maintain scheduled interest payments and to mitigate timing mismatches between interest income and interest payments. The Specified Investment Contract allows for the reinvestment of an unscheduled receipt of proceeds in the event of a receivership or conservatorship of a depository institution (as further described below) equal to the principal amount of the covered bonds. Upon reinvestment of those moneys, the Specified Investment Contract should pay ongoing scheduled interest and principal payments. The Swap and Specified Investment Contract, if they can be structured to avoid repudiation in connection with an issuing, or affiliated, depository institution's receivership or conservatorship, can play an important role in mitigating risks resulting from an insolvency regime that does not, unlike many European covered bond regimes, guarantee that the entire cover pool (including excess collateral) continues to secure the covered bonds until they mature, regardless of a depository institution's insolvency.[15]

Under the Federal Deposit Insurance Act (FDIA), depository institutions can be placed in receivership or conservatorship by their primary federal

[15] A U.S. regime is conceivable in which, if the FDIC takes over an institution, all of the assets and liabilities related to the covered bonds (including excess collateral in the cover pool) would have to be transferred to another institution, enabling the covered bonds to remain outstanding. Under current law, however, the FDIC, in its role as the receiver for a failed depository institution, has a statutory obligation generally to maximize the return on the sale or disposition of the receivership estate's assets for the benefit of the failed institution's creditors, including, importantly, the FDIC itself in its capacity as federal deposit insurer. Under current law, then, it is hard to imagine that the FDIC could bind itself to give preapproval to the cover pool assets' wholesale removal from the failed institution's estate. Not surprisingly, Michael Krimminger, special advisor to the FDIC, recently did not rule out that a transfer of the covered bonds and cover pool might *de facto* be the course of action taken by the FDIC in any particular receivership, but refused to give up the flexibility that the FDIC currently enjoys. Mr. Krimminger expressed concern that adopting such a covered bond regime would change the public policy of U.S. insured bank regulation, shifting it from its current focus of providing protection to insured depositors to one designed to focus on the risk to individual investors, rather than the overall financial system. See *Covered Bonds: Shelter from the Storm?*, Asset Securitization Report, May 26, 2008, at 12, 14–15. Judging from Mr. Krimminger's reaction, and, even more pertinently, from the FDIC's definition of "actual direct compensatory damages" payable by the FDIC if it repudiates a failed bank's obligations under covered bonds, the FDIC is opposed to any overcollateralization leaving the bank's estate, even temporarily (presumably because it could take years until the covered bonds unwind and the excess collateral would be returned, via a claim for the residual value, to the estate).

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regulator, in which case the FDIC is appointed receiver or conservator.[16] Under the FDIA, the FDIC has the power to enforce any contract, including any covered bond obligation, despite any *ipso facto* clause that purports to accelerate the bonds, or to transfer the bonds and the cover pool to any trustee, upon any depository institution issuer being placed in receivership or conservatorship. Thus, the holders of any covered bonds would not have the right to treat an obligation to repay principal on any covered bonds as being accelerated, to liquidate any collateral to satisfy such accelerated obligation, or to have the covered bond structure transferred to a third party simply by virtue of the depository institution issuer being placed in receivership or conservatorship, even if the terms of the covered bonds purport to give them that right. In contrast, the FDIC has the power to disaffirm or repudiate any contract that it finds "burdensome," including any covered bond obligation, but only if it does so within a "reasonable period" of time after being appointed receiver or conservator.[17] If the FDIC disaffirms or repudiates any contract, it must pay "actual direct compensatory damages." In effect, this puts the FDIC in charge of whether to accelerate the covered bonds, but only for a reasonable period after being appointed as conservator or receiver. The FDIC Policy Statement provides that in the case of a repudiated covered bond the recoverable damages would be limited to principal and accrued interest through the date of the FDIC's appointment as conservator or receiver.[18]

Under the FDIA, the holders of any covered bonds would also be stayed from liquidating any collateral to satisfy any obligations that become due and payable during the initial 45 days or 90 days after the FDIC's appointment as

[16] In the U.S., the FDIC acts as the receiver or conservator for all insured depository institutions. Under the FDIA, the appropriate federal banking regulator for any nationally chartered bank or federal savings association *must* appoint the FDIC as receiver or conservator if it makes certain determinations about the financial condition of the bank or savings association. Although the relevant state banking regulator for any state-chartered insured depository institution nominally has the choice to appoint the FDIC or some other authority as conservator or receiver, many state laws require the relevant state regulator to appoint the FDIC. In addition, the FDIC has the power under the FDIA to appoint itself as conservator or receiver for any state-chartered insured depository institution, and it invariably does so if the relevant state bank regulator does not do so. Thus, the insolvency regime described here applies to all insured U.S. banks and savings associations.

[17] The statute does not define a "reasonable period" of time, but at least one court has held that four months was a reasonable period under the particular circumstances. *Union Bank v. Warrenton Farms*, 724 F. Supp. 468 (E.D. Ky. 1989). Another court held that nine months was unreasonable. *Reckler Partnership v. Resolution Trust Corporation*, No. 90-3091 (D.N.J. Sept. 4, 1990).

[18] If covered bonds were added to the definition of "qualified financial contract" by statutory amendment, the FDIC would be required to pay principal and accrued interest through the date of repudiation. The holders of the covered bonds would also enjoy the various other special rights and protections available to the counterparties to a qualified financial contract.

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conservator or receiver, respectively, including any obligation by the FDIC to pay damages on any covered bond obligations that it repudiates, unless the FDIC otherwise consents. The FDIC Policy Statement is designed to allow collateral to be liquidated to satisfy any payment obligations that became due and payable during the 45-day or 90-day stay period. In essence, the Policy Statement provides that the FDIC will be deemed to have consented to the exercise of contractual rights because of a monetary default, including liquidation of collateral to satisfy the relevant obligation, if the default continues for 10 business days after the FDIC has obtained a written request to consent to such exercise of contractual rights. Under the Policy Statement, The FDIC will also be deemed to have consented to the exercise of contractual rights in response to any failure by the FDIC to pay damages within 10 business days of the date of repudiation of a covered bond obligation.

The Swap and Specified Investment Contract are intended to ensure one of the elements that characterize a covered bond: the ability for the bonds to remain outstanding when the issuer becomes insolvent. This assumes, of course, that they are (and can be) structured to avoid FDIC repudiation themselves, which may be easier to achieve in an SPV structure than in a direct-issuance structure.[19] Even then, they will add additional layers of costs to the structure, which may impact the competitiveness of U.S. covered bond structures *vis-à-vis* some of their European counterparts.

Some of the risks associated with receivership or conservatorship remain unaddressed by both the FDIC Policy Statement and the structural features described in the Best Practices. Most importantly, even if the FDIC chooses to leave a covered bond in place, it may use its powers to obtain any excess collateral to satisfy the claims of other creditors (including itself in its role as deposit insurer) rather than leave it in place to over-collateralize the claims of covered bondholders. Furthermore, the FDIC has the power to repudiate the depository institution's obligation to service the cover pool, and can refuse to grant consent to a successor pool administrator assuming its role. These and other shortcomings are likely to be focal points in the debate as to whether the U.S. legal framework is sufficiently robust to sustain a deep and broad covered bond market.

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[19] Under the SPV structure, the goal is easier to accomplish so long as the SPV is structured to be treated as "separate" from the insured depository institution. As the FDIC itself noted in the Policy Statement, "[i]f a subsidiary or SPV, in fact, has fulfilled all requirements for treatment as a "separate" entity under applicable law, the FDIC as conservator or receiver has not applied its statutory powers to the subsidiary's or SPV's contracts with third parties." It should be noted that the covered bond programs established by Bank of America and Washington Mutual, the only U.S. banks to have issued covered bonds to date, used a variation of the SPV structure. The direct-issuance structure, by contrast, has not yet been market-tested in the U.S.

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Both structures should achieve comparable results under the Investment Company Act of 1940, as amended,[20] and the direct-issuance structure should offer benefits in terms of greater structural clarity, with associated cost savings,[21] and should make available certain exemptions under the Securities Act of 1933, as amended (the "**Securities Act**").

While not attempting to address the requirements arising from federal securities laws, the Best Practices note that covered bonds may be issued as securities registered with the U.S. Securities and Exchange Commission or may be exempt from registration under the U.S. securities laws. Both of the existing programs have been sold as private and offshore placements under the exemption provided by Rule 144A and Regulation S under the Securities Act, respectively. European banks that are eligible to do so have also used Rule 144A to sell covered bonds into the U.S.[22] However, the Rule 144A market is of course a private market available only to institutions, and it is conceivable that a public market in covered bonds will develop, especially for use by those depository institutions whose parents are "well-known seasoned issuers" eligible to file automatic shelf registration statements, or by institutions who decide to register directly with their primary federal banking regulator or otherwise take advantage of exemptions from registration under the Securities Act.

[20] For the purposes of the exemptions under the Investment Company Act (the "1940 Act"), the first structure would be exempt because the issuer is a "bank" as defined in the 1940 Act and the second structure would meet the asset-backed issuer exemption and the real estate exemption. European banks who use entities that are not eligible for these exemptions face a more complex situation under the 1940 Act. In a recent letter, the SEC recommended that no action be taken against Dexia Municipal Agency, a subsidiary of a French commercial bank seeking to make private offerings of covered bonds in the U.S. without registering under the 1940 Act. No-Action Letter from SEC to Nora M. Jordan, Davis Polk & Wardwell (Dec. 26, 2007), available at http://www.sec.gov/divisions/investment/noaction/2007/dexia122607.pdf.

[21] It should be noted, however, that in the direct-issuance structure as currently envisioned, a taxable event to the investors will occur where the par value (plus accrued interest) is paid prematurely in a receivership or conservatorship, even if reinvested in a Specified Investment Contract. Whether the SPV structure will have the same tax result will depend on the specific terms of the structure.

[22] European banks' issuances into the U.S. market have been limited both by a lack of U.S. domestic knowledge of the product as well as the fact that some European banks have difficulties under the 1940 Act. With the development of a U.S. covered bond market, market knowledge will increase, U.S. investor familiarity will increase, and depending on the circumstances, European banks may find it easier to approach the SEC staff for no-action relief. One foreign bank has already done so. See No-Action Letter from SEC to Nora M. Jordan, Davis Polk & Wardwell (Dec. 26, 2007), available at http://www.sec.gov/divisions/investment/noaction/2007/dexia122607.pdf.

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3. U.S. covered bonds will be affected both by the Best Practices and by future developments.

The Best Practices are not intended as a comprehensive treatment of covered bonds. They do not address any issues under the U.S. securities laws or any other laws. Further developments under the U.S. securities laws and regulations—and in the market itself—will help determine the attractiveness of U.S. covered bonds to a variety of important constituencies. These constituencies include investors and underwriters.

Depository Institutions and Broker-Dealers as Investors

For institutions that borrow cash and securities through the Federal Reserve's liquidity and support operations, regulators must clarify the potential treatment of covered bonds as collateral. Following Secretary Paulson's remarks, Federal Reserve Governor Kevin Warsh stated that "[h]ighly rated, high-quality covered bonds would generally fall within [the] range" of collateral accepted at the Fed's discount window.[23] However, neither the Treasury Department nor the Federal Reserve has to date specified exactly which programs will accept covered bonds, or the margins by which the lendable value of covered bonds will be calculated.

Broker-dealers are subject to minimum net capital requirements under Rule 15c3-1 under the Securities Exchange Act of 1934, as amended.[24] Similarly, banks are subject to risk-based capital requirements by their respective regulator. The treatment of covered bonds under these requirements has yet to be determined.

Private measures to promote a liquid market are also under development. Tradeweb, an online marketplace partially owned by 10 dealers, announced the formation of an online covered bond marketplace for institutional investors.

Also following the U.S. Treasury's announcement, Bank of New York Mellon announced that it would accept covered bonds in its tri-party repo program. Further developments will clarify the role of covered bonds in such programs, which allow broker-dealers to raise money from one another.

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[23] A transcript of Federal Reserve Governor Warsh's remarks is available at http://www.federalreserve.gov/newsevents/speech/warsh20080728a.htm.

[24] The criteria by which broker-dealers determine compliance with net capital requirements are currently the subject of an SEC rule proposal. *See* SEC Release No. 34-58070 (July 1, 2008).

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Finally, the Securities Industry and Financial Markets Association announced the formation of the U.S. Covered Bonds Traders Committee. The Committee plans to provide research and price information on covered bonds, and the 13 member firms have each pledged to appoint a dedicated trader for the U.S. covered bond market.

Underwriters

For underwriters, who face liability under Sections 11 and 12 of the Securities Act,[25] the development of a mature U.S. covered bond market will entail the development of issuance disclosure norms and transaction practices, as well as periodic disclosures. As noted, the Best Practices' requirement of "descriptive information" disclosed on a monthly basis goes beyond what issuers must provide under existing market norms. In addition to Best Practices-directed disclosure, disclosure standards for the cover pool[26] and risk factors will need to be developed and standardized across the market, and customs for comfort letters and disclosure opinions will need to develop, if such opinions are desired. In purely European deals, many covered bond issuances are done as medium term notes or other programs and each takedown is done with a minimum of documentation and no disclosure opinions. By contrast, in the Rule 144A market for European banks, the current market standard is for there to be comfort letters, disclosure opinions and risk factors about the covered bonds as well as the legislative or structural regime behind them.[27] Underwriters and issuers in the United States will need to determine the market practices that are acceptable in light of the different legal regime in the United States. It is to be expected that such practices will be worked out in the coming months.

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[25] This is of particular note as the covered bond market expands from Europe to the U.S., as underwriters do not face Section 11 or 12-type liability under European laws.

[26] Some of the pool-level disclosure will borrow from Regulation AB.

[27] Some of these risk factors are extensive and point out that the legal regime behind covered bonds has not been tested in an insolvency situation.

This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.