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Update Regarding the United States Covered Bond Act

Representative Scott Garrett (R-NJ) and Representative Carolyn Maloney (D-NY) on March 8, 2011 introduced the United States Covered Bond Act of 2011 ("Act"), legislation targeted at establishing a regulatory framework to encourage the creation of a U.S. covered bond market. See our *DechertOnPoint*, Reform for the Covered Bond Industry on the Horizon. Covered bonds are similar to mortgage-backed securities; however, the loans underlying the securities remain on the balance sheet of the issuing bank, and the pool of loans is actively managed. The proposed legislation defines the issuers and asset classes that would be eligible to participate in covered bond programs, establishes a framework for a federal regulatory oversight program for covered bonds, and creates a default and insolvency resolution process in the event that an issuer fails.

The U.S. covered bond market envisioned in the bill would differ from its European counterpart, which has existed for over two centuries and is primarily backed by residential mortgages. The proposed legislation would expand the type of cover-pool assets that are eligible to back covered bonds in the United States, allowing assets such as residential and commercial mortgages, government-guaranteed small business loans, student loans, auto loans, and credit card accounts to be pooled into debt securities. This *DechertOnPoint* summarizes the progress of the bill in committee thus far, including the addition of three amendments to the initial legislation, and the continuing concerns of the Federal Deposit Insurance Corporation ("FDIC") with the proposed legislation.

Passage by the House Financial Services Committee

The Act was approved by the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises on May 3, 2011. On June 22, 2011, the House Financial Services Committee voted 44-7 to approve the Act with the inclusion of three amendments. The significant margin reflects bipartisan support for the pending legislation.

Rep. Maloney proposed an amendment that extended the amount of time that the FDIC would have after taking over an insolvent institution to market and sell covered bond programs from the failed bank to a new, healthier institution. The amendment extends the time period from 180 days to one calendar year.

An amendment introduced by Representative John Campbell (R-CA) required covered bond regulators to establish a limit on the amount of assets that can be pledged to a covered bond program, a measure that aims to protect the FDIC's Deposit Insurance Fund ("DIF") in the event that the FDIC takes over an issuer. The cap would be subject to the discretion of the appropriate regulator and would be based on a

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percentage of the issuer's total assets, consistent with safety and soundness considerations and the financial condition of the issuer. A covered bond regulator would have the authority to increase or decrease the percentage cap for a particular issuer on a quarterly basis in light of safety and soundness considerations or changes in the financial condition of the eligible issuer.

Rep. Garrett presented an amendment that would narrow the type of nonbank financial companies that can qualify as eligible issuers under the bill from any nonbank financial company as defined in the Dodd-Frank Act that is approved by its covered bond regulator and any subsidiary of such company to any nonbank financial company that is designated as a systemically important financial institution ("SIFI") under section 113 of the Dodd-Frank Act and any subsidiary thereof, including any intermediate holding company supervised as a nonbank financial company.

The amendment also would remove language permitting the regulator to serve as the trustee for a covered bond estate. The regulator would now only be authorized to assign a third party trustee. In addition, the amendment strengthens language dealing with securities law disclosures. It provides a uniform requirement for disclosure and reporting regulations for offers or sales of covered bonds by banks or other eligible issuers. It also requires the adoption of a separate scheme of registration, disclosure, and reporting obligations and exemptions for covered bond programs as part of the securities regulation of the covered bond issuer.

Failed Amendments

Additionally, two amendments were introduced by Representative Barney Frank (D-MA) and were rejected by the committee. The first amendment, which was co-authored by Rep. Campbell, proposed significant revisions to the section of the bill detailing the resolution scheme for failed issuers. The second amendment would have granted the covered bond regulators greater authority to establish a covered bond regulatory oversight and standards-setting program. The program imagined by the amendment would have granted regulators the power to promulgate rules concerning covered bond program limits, eligibility standards for issuers and asset classes, structural and cover pool related requirements, asset coverage tests, maximum over-collateralization amounts, limits on the amount of substitute assets in a cover pool, and issuance standards, including disclosure requirements. As the bill currently stands, the Secretary of the Treasury is authorized, in consultation with the covered bond regulators, to establish an oversight program.

Continuing Concern on the Part of the FDIC

Both rejected amendments reflected concern on the part of the FDIC, which continues to express strong reservations about several aspects of the bill. As Rep. Frank explained, "The FDIC has concerns not with the concept [of a covered-bond market] but with the extent to which the FDIC will be protected."[1] The FDIC would like the DIF to have priority over covered bond investors in the event of a bank failure.[2]

The FDIC has also expressed more specific concerns with the proposed bill. In a statement made by the agency to the House Subcommittee on Capital Markets and Government Sponsored Enterprises in March 2011, the FDIC objected to the Treasury acting as the primary rule-writer.[3] As the proposed legislation currently stands, the Department of Treasury is authorized to promulgate the rules in consultation with regulating institutions. The FDIC prefers that the primary federal banking regulators write the rules jointly with the Treasury, to preserve federal bank regulators independence from the Treasury in establishing prudential banking policies for insured depository institutions, since the Treasury is not considered a "safety and soundness" regulator.

However, Rep. Garrett has expressed concern that extending the FDIC's oversight functions to such a degree would subject investors to prepayment risks that do not belong in the definition of a working covered

1 Jon Prior, *House Committee Clears Framework for Covered Bonds*, HOUSING WIRE (June 22, 2011), http://www.housingwire.com/tag/federal-deposit-insurance-corp.

2 Maya Jackson Randall, *Lawmakers Back Covered Bonds*, THE WALL ST. J. (June 22, 2011), http://online.wsj.com/article/SB10001424052702303970604576402350724592040.html.

3 *Legislative Proposals to Create a Covered Bond Market in the United States: Hearing on H.R. 940 Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 141-145 (2011) (statement of The Federal Deposit Insurance Corporation).

bond market.[4] Industry participants also expressed concern that overly restrictive legislation would hinder the development of a U.S. covered bond market and thereby prevent the creation of an additional credit funding tool for U.S. financial institutions.

While Rep. Garrett has recently stated that establishing a strong covered bond market in the U.S. could be a positive development for credit markets while also leveling the playing field for U.S. financial firms competing with foreign firms, critics also argue that only the nation's largest banks are likely to issue covered bonds, which would put small lending institutions at a disadvantage.[5] The amendment introduced by Rep. Garrett, which would limit eligible nonbank issuers to SIFIs, would also favor larger lending institutions.

Conclusion

The proposed covered bond legislation has advanced through the House Financial Services Committee and must now be adopted by the House in a floor vote. While Rep. Garrett expressed his desire for the bill to receive consideration on the House floor as soon as possible,[6] and industry groups such as the National Association of Realtors and the Mortgage Bankers Association have submitted letters of support for the bill, it is not clear when the leadership in the House will introduce the bill for debate. Prior to the legislation being considered and voted on, the House Ways and Means Committee must comment on the tax provisions in the bill, which clarify the tax treatment of a covered bond estate that is established when a covered bond issuer fails. Moreover, while Senator Charles Schumer expressed interest in the prospects of a covered bond market in the United States,[7] no companion bill has been introduced in the Senate.

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4 Jon Prior, *House Committee Clears Framework for Covered Bonds*, HOUSING WIRE (June 22, 2011), http://www.housingwire.com/tag/federal-deposit-insurance-corp.

5 *Id.*

6 *Id.*

7 *The Administration's Report to Congress: Reforming America's Housing Finance Market Before the United States Senate Comm. on Banking, Housing and Urban Affairs,* 112th Cong. (2011) (statement of Sen. Charles Schumer, Chairman S. Rules Comm.).

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