Client Alert.

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Covered Bond Legislation Passed by the House Financial Services Committee

By Jerry R. Marlatt

On July 28, 2010, the Financial Services Committee of the U.S. House of Representatives voted to send a covered bond bill to the full House. This is a significant step in the legislative process. The starting point for the Committee deliberations was legislation[1] introduced by Representative Scott Garrett (R-NJ) on July 22, 2010. This was the fifth time that Rep. Garrett has introduced legislation to establish a statutory framework for U.S. banks to issue covered bonds.[2] The legislation is similar to legislation Rep. Garrett introduced in March, with some changes to accommodate concerns that were raised during the Joint Congressional Hearings on the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] At a markup hearing on July 28 before the House Financial Services Committee, there were a number of amendments to the bill that made some additional significant changes.

THE CHANGES IN THE NEW GARRETT BILL.

As you might expect, the basic provisions of the bill introduced by Mr. Garrett remain unchanged from the prior version. The bill continues to utilize an issuance structure that would be familiar to many European investors because it is similar to the issuance structure used in many European jurisdictions that have covered bond statutes: (i) the bonds are issued directly into the capital markets by a bank or other approved issuer and are secured by a cover pool of approved assets that are held on the issuer's balance sheet; (ii) in the event of the default or insolvency of the issuer, the cover pool is separated from the estate of the issuer and administered by the covered bond regulator for the benefit of the bond holders through the scheduled maturity of the related covered bonds; and (iii) covered bond programs must be approved by the covered bond regulator and listed in a public registry maintained by the regulation.

The bill also continues to provide that a residual certificate representing the remainder interest in a separated cover pool be issued to the FDIC or other receiver of an insolvent issuer.

However, under the broad structural provisions, there have been changes made to many of the details.

- Reported protestations from the Treasury Department apparently prompted a change in the covered bond

[1] H.R. 5823, United States Covered Bond Act of 2010, which can be found at http://financialservices.house.gov/Media/file/markups/Bills/H_R_%205823.pdf.

[2] *See* some of our earlier client alerts at: http://www.mofo.com/files/Uploads/Images/100401FourthTime.pdf; http://www.mofo.com/files/Uploads/Documents/091215Hearing_on_Covered_Bond_Legislation.pdf; U.S. Covered Bond Legislation Introduced in Congress and http://www.mofo.com/files/Uploads/Documents/090401CoveredBonds.pdf.

[3] A modified version of H.R. 4884, the bill introduced by Representative. Garrett in March, was included as part of the House amendment to the legislation that eventually became the Dodd-Frank Act. See the discussion in the client alert at http://www.mofo.com//files//Uploads/Images/100624Reconciliation.pdf.

regulator from the Secretary of the Treasury to the Office of the Comptroller of the Currency, the agency that regulates national banks.

- The definition of "eligible assets" was narrowed by eliminating securitized forms of eligible assets. No longer, for example, can 20 percent of a cover pool of residential mortgage loans consist of RMBS. Otherwise, the types of assets defined as eligible assets remains the same: residential mortgage loans, home equity loans, commercial mortgage loans, any state or municipal security or loan, auto loans or leases, student loans, credit or charge card receivables, Small Business Administration loans, and any other asset type approved by the covered bond regulator by rule.

  The bill continues to provide that a cover pool may consist only of a single class of eligible assets. So, for example, a cover pool might consist solely of residential mortgage loans. The bill now expressly provides that no asset may be subject to a prior pledge; this addresses the concern raised by some regarding FHLB blanket liens.

- The rulemaking authority of the covered bond regulator under the bill now requires consultation with the applicable "primary financial regulatory agency"[4] for eligible issuers.

- The term "eligible issuer" was expanded, to include any "nonbank financial company"[5] that is approved by the primary financial regulatory agency and the covered bond regulator.

- The definition of "substitute asset" is unchanged except that references to ratings were dropped and U.S. agency obligations are how limited to 20 percent of the cover pool.

- Rulemaking by the covered bond regulator to establish a covered bond regulatory oversight program must now be accomplished within 180 days of passage of the bill. Previously there was no deadline. This provision now expressly calls for rules defining eligibility standards for eligible assets.

- Instead of the previous 15-day period, the FDIC as conservator or receiver of a failed bank issuer now has 180 days to transfer the covered bond obligations and the cover pool to an assuming bank. As before, the failure of the FDIC to continue to make payments on the covered bonds during this period would automatically lead to the creation of a separate estate by separation of the cover pool from the estate of the failed bank. The new bill now additionally provides that a repudiation[6] by the FDIC would also lead to the creation of a separate estate.

- The separate estate created by the separation of the cover pool was authorized under the previous bill to borrow to meet liquidity. H.R. 5823 now adds that the borrowing can be on a priority, *pari passu*, or subordinated basis.

- Unlike the prior bill, covered bonds would no longer be exempt from the federal securites laws. Instead the new bill provides that a covered bond issued by a bank is a security issued under Section 3(a)(2) of the Securities Act. Also, the bill provides that a covered bond issued by a bank is not an asset-backed security. No reference is

[4] The term is given the same meaning as the term defined in the Dodd-Frank Act.

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[6] Basically, a repudiation is a notice by the FDIC that it does not intend to make scheduled payments on the covered bonds.

made to the federal securities law treatment of covered bonds issued by non-bank entities. The separate estate and any residual interest in the separate estate would be exempt from all securities laws.

- A significant new provision was added that prohibits any person from bringing a judicial or administrative action against the separate estate, except to compel a permitted release of funds. No court may issue an attachment or execution on the assets of an estate. And no court may take any action to restrain or affect the resolution of an estate, except at the request of the covered bond regulator.
- All of the tax-related provisions were stripped out of the bill. The previous bill had provided that the separate was not a taxable entity, that disposition of assets by the separate was not a taxable event, and that acquisition of a covered bond should be treated as an acquisition of a security and not as an interest in a loan or a lending transaction for purposes of determining any related trade or business activity of the acquirer. If these or similar tax provisions continue to be omitted from the bill going forward it will raise some uncertainty until the Internal Revenue Service expressly takes a position (hopefully favorable) on the questions.

THE COMMITTEE MARKUP PROCESS.

At the Committee markup hearing on July 28, a Manager's Amendment was introduced by Representative Paul Kanjorski (D-PA).[7] The amendment was adopted as introduced. The amendment made the following notable changes: (i) home equity loans, student loans, and credit and charge card receivables were eliminated as eligible assets; and (ii) eligible issuers was expanded to include any subsidiary of a bank holding company or a savings and loan holding company.

The Kanjorski amendment was followed by an amendment introduced by Representative Melissa Bean (D-IL); this amendment was also adopted as introduced. The amendment provided that: (i) the covered bond regulator should be the issuer's "primary Federal financial regulator" [8] and rulemaking should be undertaken by the covered bond regulators jointly; (ii) the 180-day period for the FDIC to act should instead be a one-year period; and (iii) prior to taking any regulatory action a covered bond regulator should confirm to the FDIC that the action, would not increase the risk of loss to the deposit insurance fund.

Rep. Garrett then introduced an amendment to amend the Bean amendment to change the one-year period back to a 180-day period. This amendment was accepted.

Finally, Rep. Bean introduced a second amendment that provided that: (i) if the FDIC is appointed conservator or receiver within 30 days of a default by an issuer that led to the creation of a separate estate, the FDIC would have the power to cure the default and dissolve the separate estate; and (ii) during the 180-day period (A) the FDIC shall commit that it will not repudiate the covered bonds and will perform all obligations on the covered bonds or (B) repudiate the covered bonds and release the cover pool to a separate estate. This amendment was withdrawn by Ms. Bean with the understanding that there would be further discussion of the points and thus was not acted on by the Committee.

[7] Mr. Kanjorski is Chairman of the Capital Markets subcommittee.

[8] This is defined to be (i) the OCC with respect to a national bank or a federal savings association, (ii) the FDIC with respect to a state chartered non-member bank, (iii) the Federal Reserve Board with respect to Federal Reserve System member banks and bank and savings association holding companies, and (iii) the SEC with respect to any other institution.

Chairman Frank noted that a letter had been submitted by Chairman Bair of the FDIC that raised a concern that the FDIC was required under the bill to transfer the over collateralized portion of the cover pool without compensation and that the issue had not been addressed. Chairman Frank indicated that the concern might be addressed later in the legislation process and then called the matter to a vote. H.R. 5823, as amended, was approved.

WHERE TO FROM HERE?

Congress is now in recess and will not resume until September 14. It is expected that the full House will take up the bill in the fall prior to the November elections. When the bill is taken up by the full House, there may be additional amendments from the floor, some of which may seek to address the concern raised by Chairman Bair's letter. It is also possible that the bill could be referred to another committee of the House that may exercise jurisdiction over the bill, such as the Ways and Means Committee, for any tax-related provisions. Accordingly, while having a covered bond bill voted out of committee is a significant development, there is still uncertainty as to the form of the final bill to be voted upon by the House.

Additionally, for legislation to become law, it must also be passed by the United States Senate. No bill for the establishment of a covered bond statute has been introduced in the Senate and no hearings have been held. While Chairman Dodd of the Senate Banking Committee committed during the Joint Committee deliberation on the Dodd-Frank Act to hold hearings on a covered bond bill in the fall, no hearings have been scheduled at this writing. This lack of development in the Senate means there is uncertainty about whether a covered bond bill will be addressed in the Senate in this session of Congress.

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