

FREQUENTLY ASKED QUESTIONS ABOUT COVERED BONDS

Background

What are covered bonds?

Covered bonds are debt obligations that have recourse either to the issuing entity or to an affiliated group to which the issuing entity belongs, or both. Upon an issuer default, bondholders also have recourse to a pool of collateral (known as the “cover pool”), separate from the issuer’s other assets.

What type of assets can make up the cover pool?

The cover pool usually consists of high quality assets, including residential mortgages, public debt, or ship loans. Cash, or cash equivalents, also may serve as cover pool collateral.

Are covered bonds a new product?

Although relatively new to the United States, covered bonds are not a new product. Covered bonds have been used to raise capital in Europe since 1769, when the first covered bond was issued in Prussia to finance agriculture. Germany, France, and Spain have large covered bond markets aided by specific legislation that prescribes a framework for the issuance of covered bonds. The United Kingdom’s participation in the market has been rapidly expanding with the recent passage of legislation bolstering its popularity. See “Covered Bond Structure in Europe.” At year-end 2007, there were

U.S. \$2.75 trillion in outstanding covered bonds in Europe.

How are covered bonds issued?

Covered bonds can be issued as a single issuance or as a program. Under the Securities Act of 1933, covered bonds are regulated as securities and must be registered under the Securities Act or exempt from registration. U.S. covered bond programs often rely on the Rule 144A exemption.

What type of bond is issued?

Covered bonds generally are fixed rate bonds with a maturity of no less than one year and no more than 30 years. The bonds are low risk yield-bearing products having long maturities.

Who invests in covered bonds?

Central banks, pension funds, insurance companies, asset managers, bank treasuries, and other institutional investors seeking a low risk yield-bearing product with a long maturity invest in covered bonds

What factors are considered when rating agencies rate covered bonds?

Rating agencies treat covered bonds as a hybrid instrument. The ratings analysis is based in part on the credit and rating of the sponsor entity and in part on the collateral (or cover pool).

In evaluating the cover pool in covered bond issuances, rating agencies consider the following factors:

- the effective segregation of the cover assets from the claims of other creditors of the issuer;
- the immunity of excess over-collateralization against the claims of other creditors of the issuer;
- the bankruptcy-remoteness of the collateral posted by swap counterparties;
- provisions against the risk that the cover pool's cash flows could be commingled with other revenues of the insolvent issuer and might not reach the covered bond holders; and
- protection against borrowers' attempts to set off their debt against any receivable they have against the issuer.

Covered Bond Structure in the United States

How are covered bonds structured?

There are two ways to structure covered bonds. The depository institution can issue the covered bonds directly, or a special purpose vehicle (SPV) can be established to act as issuer. See “How are covered bonds structured when the depository institution issues the covered bonds directly?” and “How are covered bonds structured when a SPV is established to issue the covered bonds?”

Regardless of structure, there are three general principles of all covered bonds. The covered bonds must be secured by high quality assets; management of the cover pool must be supervised; and investors

are first in priority upon an issuer's insolvency. Whether contractual or statutory, there must be a framework in place that protects the cover pool from unsecured creditor claims and directs payments to covered bond holders upon a bankruptcy.

Who holds the collateral and protects the investors under the U.S. covered bond structure?

There are two trustees under the U.S. covered bond structure. The mortgage bond indenture trustee is an independent trustee designated by the mortgage bond issuer. This trustee represents the interests of the mortgage bond holder and enforces its rights if the mortgage bond issuer defaults. The covered bond indenture trustee is an independent trustee designated by the covered bond issuer who represents the interests of investors and enforces the investors' rights if the covered bond issuer defaults. See “How are covered bonds structured when a SPV is established to issue the covered bonds?” for an explanation of the roles of the mortgage bond issuer and the covered bond issuer and their respective obligations.

How are investors protected under the U.S. covered bond structure?

In the event of a mortgage bond issuer default, the covered bond indenture trustee, on behalf of covered bond holders, will deposit all mortgage bond payments and related proceeds into a guaranteed investment contract (GIC), or other arrangement whereby the proceeds of the cover pool are invested with, or by, one or more financially sound counterparties. The purpose of entering into a GIC is to ensure continued timely payments to the covered bond holders and avoid acceleration of payment

under the covered bonds. Mortgage bond issuer events of default include failure to make timely payment of interest and principal, failure to satisfy the asset coverage test, and the occurrence of certain insolvency events.

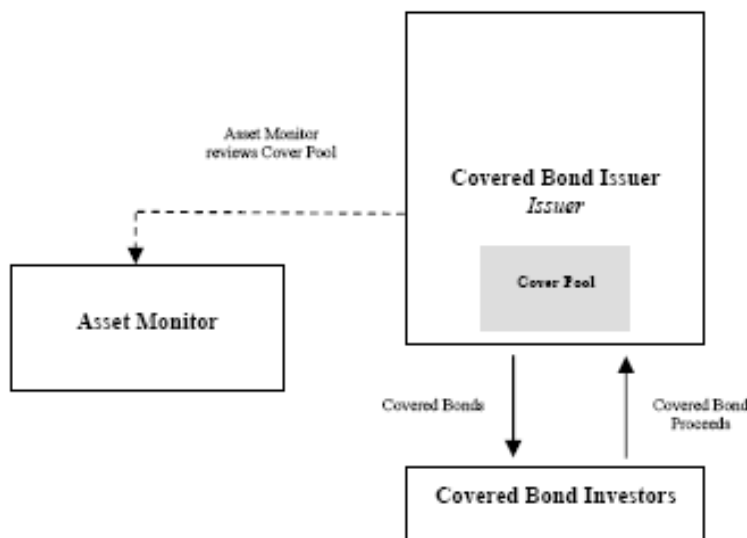
The covered bond indenture trustee performs a monthly proceeds compliance test to ensure there are adequate proceeds available to make timely payments on the covered bonds. See What is a proceeds compliance test? Failure to satisfy the proceeds compliance test results in an event of default that would trigger acceleration of the covered bonds. Additional events of default include interest and principal payment failures and the occurrence of certain insolvency events. If the covered bonds are accelerated, the covered bond indenture trustee can cause the covered bond issuer to liquidate the collateral to make payments due under the covered bond. See “What happens to payment flows if there

is a mortgage bond acceleration?” and “What happens to payment flows if there is a covered bond acceleration?”

How are covered bonds structured when the depository institution issues the covered bonds directly?

Direct issuance is used in European countries with specific covered bond legislation. These transactions are structured so that the depository institution originating the mortgage loans making up the cover pool is also the issuer of the covered bonds. Legislation in some European countries provides exceptions for covered bonds in the event of bankruptcy. Specifically, in the event of an issuer insolvency, covered bond holders have priority rights over the cover pool assets.

Below is a diagram of the direct issuance structure where the depository institution issues the covered bonds.



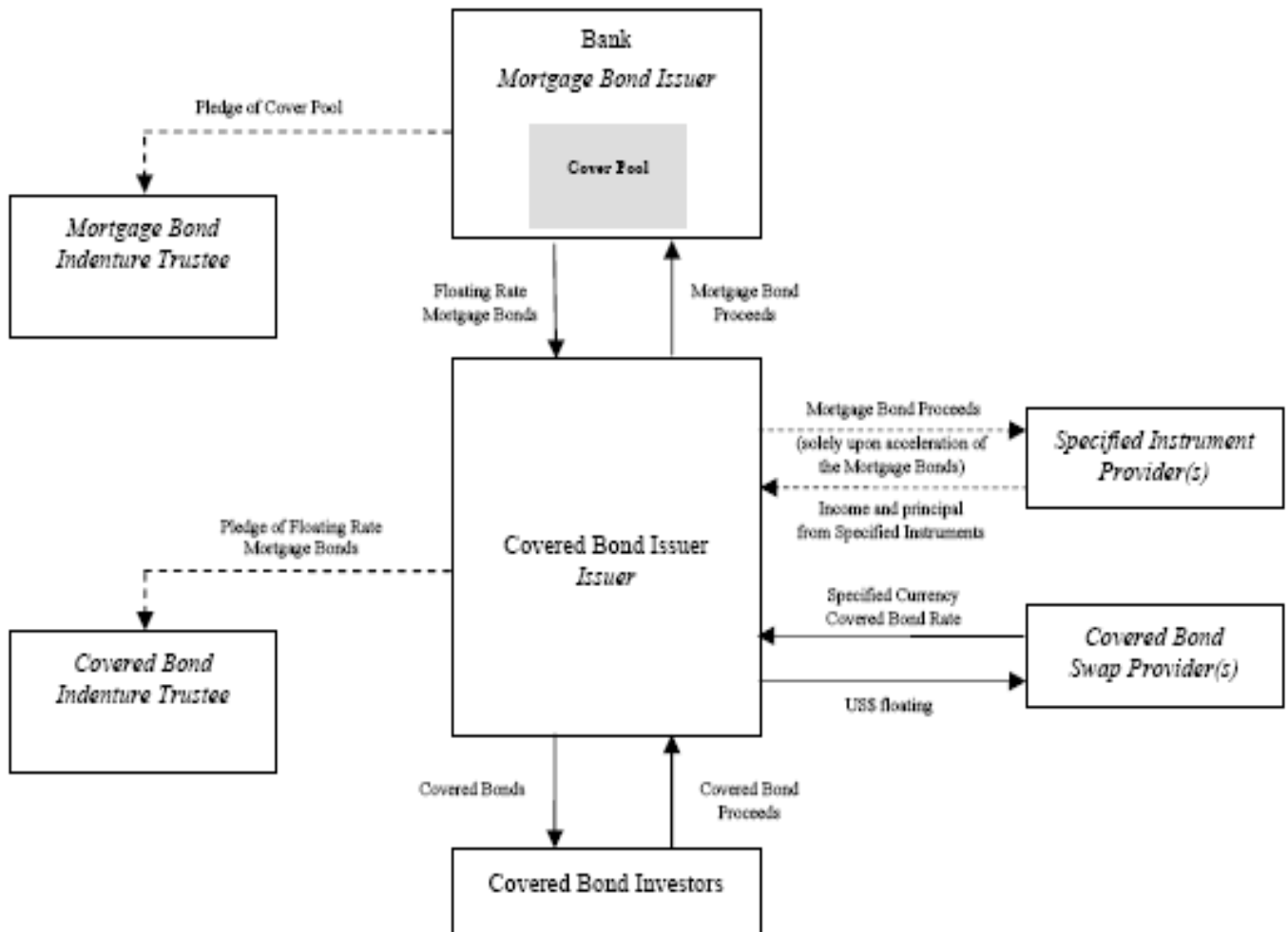
How are covered bonds structured when a SPV is established to issue the covered bonds?

The two-tier system used until recently in the United Kingdom (prior to the passage of legislation for covered bonds) and the only structure used in the United States provides for the depository institution originating the mortgage loans to sell mortgage bonds to a SPV established to act as issuer of the covered bonds. This two-tier structure provides the

bankruptcy protection granted by statute in the EU for U.S. covered bond holders.

The proceeds from selling covered bonds are used by the covered bond issuer to purchase the mortgage bonds, which are secured as a separate pool of mortgages on the bank's balance sheet. The covered bond issuer, as the holder of the mortgage bonds, has a perfected security interest in the mortgage pool.

Below is a diagram of the two-tier structure where a SPV is established to issue covered bonds.



Covered Bond Structure in Europe

What is the European regulatory framework for covered bond issuances?

France, Germany, Italy, Spain, Portugal, Sweden, Denmark, Norway, Finland, and recently the UK have adopted covered bond legislation. The regulatory framework for a European covered bond is a direct issuance structure. Although legislation varies in each jurisdiction, there are two key factors that enable a covered bond market to flourish in Europe: legislation providing for special treatment under bankruptcy law in the event of an issuer insolvency for the benefit of covered bond holders; and special treatment under the banking laws that provide favorable risk weighting in comparison to the issuer's unsecured debt for the benefit of covered bond issuers.

How are covered bonds treated under the EU's Undertakings for Collective Investment and Transferable Securities Directive?

The European Central Bank, or ECB, classifies securities for repo purposes. Banks, which comprise a significant portion of the covered bond investor base, tend to hold covered bonds as collateral for their repo activities. For these purposes, the ECB follows the covered bond definition used in the EU's Undertakings for Collective Investment and Transferable Securities (UCITS) Directive for collective investment vehicles. In order to have an EU-recognized "covered bond" regime, a country must implement the requirements of Article 22(4) of the UCITS Directive, which essentially includes covered bonds issued under statutes imposing special

bankruptcy protection for covered bond holders. For repo purposes, covered bonds are discounted at 1%-7.5%, depending on maturity; bank debt is discounted at 1.5%-9%; and securitizations are discounted at 2%-12%.

How are covered bonds treated under the EU Capital Requirements Directive?

The Capital Requirements Directive (CRD) also makes it more attractive for credit institutions to invest in legislative covered bonds. The CRD, which effects the changes prescribed by the BASEL II framework, requires European credit institutions to hold a certain amount of eligible capital depending on the risk weighting of their assets. Covered bonds meeting the UCITS Article 22(4) criteria benefit from a 10% risk weighting, which is half of the capital charge allocated to unsecured debt from the same issuing financial entity or group. By contrast, covered bonds that are not legally based are subject to a 20% risk weighting.

U.S. Regulatory Framework for Covered Bonds

What is the U.S. regulatory framework for covered bond issuances?

The United States does not have any legislation for covered bonds. Therefore, market participants in the United States have developed a synthetic two-tier structure to replicate the protections afforded by legislation in certain European countries. See "Covered Bond Structure in the United States."

Why hasn't the covered bond market developed in the United States the way it has in Europe?

The U.S. covered bond market has lagged behind the European market due to a lack of legislation. One of the reasons that covered bond legislation has not been lobbied for in the United States is that, until the recent market turmoil, banks had alternative means for obtaining mortgage funding that were not available to their European counterparts.

One example of such funding is government-sponsored enterprises, or GSEs. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) were chartered as GSEs, partly to correct perceived deficiencies in the U.S. mortgage market. In return for a GSE charter, Fannie Mae and Freddie Mac developed a strong secondary market for mortgages by integrating the mortgage markets with the capital markets to make funds more readily available to mortgage borrowers. Fannie Mae and Freddie Mac, with the implicit backing of the U.S. government, could issue debt at lower interest rates than other issuers, and could securitize qualifying mortgages without providing or purchasing credit enhancements. Private companies later used this securitization structure to securitize mortgages, such as jumbo mortgages, that did not qualify under the GSE program.

Another example of alternative funding in the United States is the Federal Home Loan Banks (FHLB). The FHLB are 12 banks set up under a government charter in the early 1930s to provide support to the housing market by advancing funds to over 8000 member banks that make mortgages. The

FHLB system was modernized in 1999 under the Gramm Leach Bliley Act.

Unlike GSEs, which raise capital by selling mortgages in the secondary market, the FHLB system issues debt to raise capital to advance funding to loan originators. Specifically, the FHLB banks sell consolidated obligations to institutional investors. Because the system has a standalone AAA credit rating and enjoys GSE status, it can raise debt at rates only slightly higher than Treasury securities. Additionally, the FHLB banks advance funds to their member financial institutions at interest rates that are lower than those in the commercial market, particularly on longer-term funds. Loans are priced at small spreads over comparable Treasury obligations.

To be eligible to join the FHLB, a financial institution must:

- be duly organized under the laws of any state or of the United States;
- be subject to inspection and regulation under the banking laws, or similar state or federal laws;
- make long-term mortgage loans;
- be financially stable enough that the FHLB bank can lend to it safely; and
- have character of management and a home financing policy consistent with sound and economical home financing.

The general rule that a member must maintain 10 percent of its assets in mortgages is eliminated for institutions defined as “community financial institutions,” which can post new forms of collateral

such as small business loans and farm loans for advances.

Given the existence of funding by government-sponsored entities and the FHLB, why are U.S. regulators now interested in the covered bond market?

Due to the current credit crisis in the United States, GSEs are facing liquidity crises of their own, while the financial markets continue to show the ill effects of turmoil triggered by mortgage losses. Although FHLB members can borrow at lower rates than they can issue covered bonds, the financial institutions seeking such funding must buy equity in the FHLB equal to 5 percent of their borrowings and post 120-130 percent over-collateralization. There is no equity buy-in cost for covered bonds and the recommended over-collateralization is only 105 percent. Therefore, FHLB funding could cause greater strain on cash-starved financial institutions.

Overall, the economy is underperforming in terms of growth and job creation, and financial institutions are affected by the generalized pullback in liquidity and deteriorating credit quality. Many financial institutions have retreated from certain business lines, limited their participation in markets for some financial products, delevered their balance sheets, and taken other actions aimed at balance sheet repair. With the securitization market closed to financial institutions and other sources of lending either scarce or more expensive, the U.S. government views covered bonds as another funding source that may assist in reviving the lending market.

Have any government agencies issued guidance related to covered bond issuances?

The FDIC released a Covered Bond Policy Statement on July 15, 2008, and the Treasury Department issued Best Practices for Residential Covered Bonds on July 28, 2008. Two days later, U.S. House Representative Scott Garrett of New Jersey proposed the Equal Treatment of Covered Bonds Act (H.R. 6659) to Congress. The bill is still only a proposal and has not yet been enacted. See “The FDIC Covered Bond Policy Statement,” “The Treasury Department Best Practices for Residential Covered Bonds,” and “The Equal Treatment of Covered Bonds Act.”

The FDIC Covered Bond Policy Statement

What uncertainties in the U.S. covered bond market were addressed by the FDIC Covered Bond Policy Statement?

Prior to the release of the Policy Statement, market participants were unsure if the FDIC, in a receivership scenario, would seek to repudiate the covered bond transaction documents. Market participants also were concerned about how long it would take to access the collateral due to the 90-day automatic stay provision in the event of a bank insolvency under the Federal Deposit Insurance Act (FDIA).

What is the scope of the FDIC Policy Statement?

The Policy Statement is applicable to depository institutions insured by the FDIC. Although the Policy Statement provides much sought-after guidance, the scope of transactions the guidance covers is limited. The Policy Statement applies only to (i) recourse debt obligations (ii) of an insured depository institution

(iii) with a term of greater than one year but not exceeding ten years (iv) that are secured directly or indirectly by perfected security interests in a pool of mortgage loans or, not exceeding 10% of the collateral, by AAA-rated mortgage bonds.

For mortgages to be eligible assets for the cover pool, they must be “eligible mortgages.” See “What are “eligible mortgages?”” The protection afforded by the FDIC is only applicable if the covered bonds are issued with the consent of the bank’s primary federal regulator and comprise no more than 4% of the bank’s total liabilities.

What are “eligible mortgages?”

Eligible mortgages are defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate, and relying on documented income.

How will compensatory damages be paid by the FDIC when acting as conservator or receiver?

The FDIC set forth three options for paying compensatory damages when acting as conservator or receiver for a depository institution. The FDIC can:

1. continue to perform on the covered bonds;
2. pay off the covered bonds in cash up to the value of the pledged collateral; or
3. allow liquidation of the pledged collateral to pay off the covered bonds.

Under Scenario 1, payments on the covered bonds would be made as scheduled. Scenarios 2 and 3 would be triggered if the FDIC were to repudiate the transaction or if a monetary default were to occur. In both cases, the FDIC will pay holders of covered bonds the outstanding principal amount plus accrued

and unpaid interest on the bonds to the date of the FDIC’s appointment as conservator or receiver, up to the value of the cover pool. If there is excess collateral, the FDIC will retain the excess for distribution under the Federal Deposit Insurance Act and if there is not enough collateral, it will limit the amount of secured claims up to the collateral value. These statements eliminate the risk that investors may lose a portion of their principal.

How long will investors have to wait before exercising rights in an event of monetary default?

The Policy Statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds in a receivership or conservatorship after a default on a bank’s obligation to the covered bond holder or after the effective date of repudiation. The Policy Statement enables a covered bond holder to exercise its rights to collateral (1) if the bank remains in monetary default for at least ten business days after the investor delivers a written request to the FDIC to exercise its rights, or (2) if the FDIC as conservator or receiver provides written notice of repudiation of a contract to the investor and does not pay damages within ten days after the effective date of such notice.

How does the FDIC Policy Statement promote a U.S. covered bond market?

The Policy Statement is helpful in promoting a U.S. covered bond market because it provides certainty to holders of covered bonds regarding the amount of their damages and the manner in which they can exercise their rights in the event of a default where the FDIC is appointed conservator or receiver.

How does the FDIC Policy Statement affect the structure of U.S. covered bonds?

The FDIC noted that there is nothing in the Policy Statement requiring the use of a SPV to issue covered bonds. See “How are covered bonds structured when a SPV is established to issue the covered bonds?” Rather, the FDIC will use its “well-defined standards to determine whether to treat such entities as separate from” the depository institution. The determination as to whether a SPV is a separate entity will be based on specific facts and circumstances. This guidance most likely will enable new issuers to consider direct issuance structures for covered bonds in order to benefit from a securities law exemption. See “How are covered bonds structured when the depository institution issues the covered bonds directly?”

**The Treasury Department Best Practices
for Residential Covered Bonds**

What is the scope of the Treasury Department Best Practices for Residential Covered Bonds?

The Best Practices for Residential Covered Bonds establish a template for U.S. covered bond issuances and outline additional standards intended to bolster investor confidence in covered bonds. The Best Practices are not enforceable, but are meant to complement the Policy Statement and promote the creation of a high-quality, standardized U.S. covered bond market.

The Treasury Department defines a covered bond as debt instruments secured by a perfected security interest in a specific pool of collateral with a maturity of more than one year and less than thirty years.

What guidance do the Best Practices offer relating to assets in the cover pool?

The cover pool is limited to residential mortgage loans that meet certain quality characteristics. The Best Practices recommend that an issuer maintain an over-collateralization of at least 5% of the outstanding principal amount of the covered bonds at all times and actively manage the assets to maintain the quality required.

In addition, the Best Practices recommend that collateral have a maximum loan-to-value (LTV) ratio of 80% in order to be eligible for the cover pool. No single metro statistical area should make up more than 20% of the cover pool, and negative amortization mortgages should not be included. Mortgages in the cover pool should be first-lien only. For purposes of calculating the 20% restriction, only the 80% portion of the LTV will be credited.

How do the Best Practices suggest further securing timely payments to covered bond holders?

The Best Practices recommend that, at the time of issuance, the covered bond issuer enter into one or more swap agreements to: (1) provide scheduled interest payments in case the issuer becomes insolvent; and (2) mitigate timing mismatches between interest payments and interest income, if applicable. This is consistent with the existing U.S. covered bond structure.

If a covered bond is denominated in a currency other than U.S. dollars, the Best Practices recommend the issuer enter into a currency swap at the time of issuance.

The Best Practices also recommend that an issuer enter into a GIC, or other similar arrangement. The

GIC should pay ongoing scheduled interest and principal payments after a default or repudiation by the FDIC, so long as the GIC provider receives proceeds from the cover pool at least equal to the par value of the covered bonds.

How do the Best Practices promote a U.S. covered bond market?

In addition to providing guidance that complements the Policy Statement, the Best Practices expand on issues affecting the covered bond market in an attempt to standardize industry practices.

The Best Practices set forth cover pool disclosure requirements intended to boost investor confidence in the covered bond market. For example, the Best Practices suggest that the issuer should make available to investors descriptive information about the cover pool at the time of issuance and on a monthly basis thereafter. If more than 10% of the cover pool is substituted within any month, or more than 20% within any quarter, the issuer should provide investors with updated information. Results from asset coverage tests that are required to be performed monthly to ensure compliance with threshold collateral levels also should be made available to investors. In addition, the depository institution and the SPV (if one is used) should disclose any other information that an investor might view as material to an investment decision.

The information that the Best Practices suggest be included in a disclosure document is consistent with the information that would be disclosed for a registered asset-backed securities offering to which the disclosure requirements of Regulation AB

(promulgated pursuant to the Securities Act) would be applicable.

How do the Best Practices affect the structure of U.S. covered bonds?

The Best Practices specifically contemplate covered bond issuance—either through a newly created, bankruptcy-remote SPV, or directly by the depository institution and/or a wholly-owned subsidiary. The SPV approach is in line with the current U.S. structure. The direct issuance approach, where the issuing institution designates a pool of residential mortgages that constitute the cover pool, is the structure currently used in Europe. See “Covered Bond Structure in the United States” and “Covered Bond Structure in Europe.”

By recognizing both structures, the Best Practices provide issuers with flexibility when determining how to structure transactions. This flexibility is important because the Best Practices also specify that covered bonds may be issued either as registered securities or pursuant to an exemption from the registration requirements of the Securities Act. If banks were to use a direct issuance structure, covered bonds might be eligible for the exemption from registration provided by Section 3(a)(2) under the Securities Act for “bank securities.”

Although the Best Practices provide additional guidance that will assist in promoting a U.S. covered bond market, the guidance is limited to covered bonds where the collateral in the cover pool consists of residential mortgages. The structure set forth in the Policy Statement and Best Practices can be used to issue covered bonds using various types of receivables as collateral, such as car loans and credit

card receivables. Broadening the scope of assets that could be used in the cover pool would make this guidance applicable to a greater number of financings.

The Equal Treatment of Covered Bonds Act

What would the Equal Treatment of Covered Bonds Act accomplish?

The Equal Treatment of Covered Bonds Act would codify the treatment of covered bonds, providing a statutory framework for their issuance. The proposed legislation would achieve three goals necessary to foster a vibrant covered bond market in the United States.

First, the proposed legislation would characterize a covered bond as a “qualified financial contract” under the FDIA, which would mean that covered bond holders could exercise their rights almost immediately after the FDIC’s appointment as conservator or receiver for a depository institution.

Second, the legislation would set forth the actual amount of compensatory damages payable by the FDIC when acting as conservator or receiver: outstanding principal and interest on the covered bonds, the cost of a guaranteed investment contract, and other costs (including reasonable attorney’s fees) relating to the exercise of any right, power, or remedy under the covered bonds.

Third, the proposed legislation would increase the types of assets eligible for use in the cover pool by expanding the definition of covered bond. See “What type of assets can make up the cover pool?” The proposed definition of covered bond is “a nondeposit

recourse debt obligation of an insured depository institution, with a term of at least 1 year, which is secured by specifically identified assets which are performing in accordance with the terms of the contracts which created the assets.”

What effects might the Equal Treatment of Covered Bonds Act have on the U.S. covered bond market?

With a statutory framework for covered bonds, U.S. covered bond issuers could abandon the two-tier synthetic structure for a structure similar to those used in Europe. Thereafter, U.S. issuers could benefit from such advantages as preferential risk weighting and greater investor protection in the event of issuer insolvency. In addition, the broad definition of covered bond contained in the proposed legislation will open the door for more diverse cover pool assets, including credit card receivables, commercial mortgage loans, home equity lines of credit, and public sector loans.

Covered Bonds and Securitization

How do covered bonds differ from securitizations?

Covered bonds in the United States use a synthetic structure derived from securitization techniques in order to replicate the bankruptcy protection provided by statute in Europe. Securitization structures have been a popular method of financing mortgage lending in the United States since the establishment of government sponsored entities. By comparing covered bonds to the well-known securitization structure, it is easy for prospective market participants to see the similarities and differences between the two funding alternatives.

Below is a chart comparing certain aspects of covered bonds to securitizations.

	Covered Bonds	Securitization
Accounting	On-balance sheet	On/Off-balance sheet
Recourse	Direct or indirect recourse to the originator	Limited recourse
	Upon default of originator, collateral used to repay bonds	Bankruptcy remote SPV
	Issuer is not limited by business or financial covenants	Cash flows from assets repay the bonds
	Exposure to management risks of parent company	Servicer risk
Liquidity	High degree of homogeneity, liquid trading market	Heterogeneous structures, more illiquid secondary market
	Limited spread volatility	Limited spread volatility
	Bankruptcy segregated from issuer, preferential claim	Bankruptcy remote from issuer
Ratings	Greater linking of bond ratings to parent company (may be viewed by investors as a “hybrid”)	No linking of bond ratings to parent company
Assets	Open-ended vehicle whose collateral pool can evolve over time with strict collateral qualifying criteria	Open or closed-ended pools with strict collateral qualifying criteria
Investors	Large number of eligible investors	Large investor base that typically invests in asset-backed securities
	Taps non-securitization investors (liquidity investors)	
	Limited overlay with senior unsecured investor base	

From an issuer's perspective, what are the advantages of covered bonds over securitization?

The greatest advantage to issuers of covered bonds is that the Federal Reserve will accept high-quality, highly rated covered bonds as collateral at its discount window. Private lenders also are likely to find such bonds attractive as collateral for credit extensions.

Covered bonds provide issuers with long-term financing, rather than the short-term financing most often achieved through securitization.

Covered bonds are not limited to mortgage funding. Similar to securitization, covered bonds are a way to fund originations of receivables, such as auto loans and credit card receivables. For now, while the securitization market is closed, it may be the only way to fund the origination of such receivables. Ultimately, as markets re-open, it is a way to diversify funding sources and to compete with European depository institutions that regularly access the covered bond market.

From a cost perspective, it is less expensive to structure a covered bond program than a securitization. Also, the issuer is able to offer a lower rate of return to investors because all assets in the cover pool are high quality assets and the investors have dual recourse to both the cover pool and the issuer, which reduces investment risk for investors. In the United States, the issuer does not hold the cover pool assets directly. Instead, the issuer uses proceeds from the covered bond offering to purchase mortgage bonds from the affiliate depository institution. The mortgage bonds are direct

obligations of the depository institution rather than assets held by the issuer.

Another advantage for issuers, in the current economic market, is the ability to attract investors who are wary of securitization. By offering a product that is collateralized by high quality assets, providing transparency to investors, and demonstrating an alignment of the interests of the issuer and investors by keeping the mortgage loans on the balance sheet of the mortgage bond issuer, investors will be more confident about investing in covered bonds than they will in a securitization.

The characterization of covered bonds as hybrid instruments because their ratings are linked to the issuer's parent company also expands the investor base.

From an investor's perspective, what are the advantages of covered bonds over securitization?

Covered bonds provide investors with many benefits. The assets in the cover pool are high quality assets, rather than a mix of assets of varying qualities. Since all covered bonds in an issuance are backed by the same high quality assets, there is a larger trading market for covered bonds, which provides greater liquidity for investors.

The assets being used as collateral for the payment of covered bonds remain on the depository institution's balance sheet, so there is an incentive for the issuer to ensure that it originates performing mortgage loans. If any assets in the cover pool are underperforming, the open-ended pool allows the issuer to substitute performing assets, cash, or cash equivalents. Substitutions also can be made to the cover pool to avoid pre-pay risk. In contrast,

securitization vehicles are structured to move mortgage loans off the issuer's balance sheet and transfer risk to investors. Collateral pools in securitizations often are closed-ended pools.

Covered bond holders also have dual recourse in the event of default. Investors have a first priority perfected interest in the cover pool. The value of the assets in the cover pool is monitored monthly and results are reported to investors. If assets are underperforming, higher quality assets or cash, or cash equivalents, must be substituted into the cover pool. If, for any reason, the collateral in the cover pool is not sufficient to satisfy investors' claims, investors have recourse against the issuer as an unsecured creditor *pari passu* with other unsecured creditors.

Furthermore, pursuant to the FDIC's Covered Bond Policy Statement, holders of covered bonds that meet certain criteria (qualifying covered bonds) will receive additional protections. In the event of an issuer default, investors will receive actual compensatory damages from the FDIC if the FDIC is appointed as conservator or receiver of the issuer. In addition, if the asset coverage test is breached, the issuer has one month to correct the breach. If not corrected, the trustee may terminate the covered bond program and principal and accrued interest will be returned to investors.

Covered bond holders also are protected from acceleration of covered bond payments upon an issuer default. In the event of an issuer default, proceeds from the mortgage bonds held by the issuer are invested in guaranteed investment contracts; proceeds from those contracts are paid to a swap

provider in exchange for interest and principal due in accordance with the covered bond terms.

Documentation Generally

What operative documents are needed for a covered bond transaction?

In the United States, under the two-tier structure, two sets of documents are needed. See "How are covered bonds structured when a SPV is established to issue the covered bonds?" for an explanation of the two-tier structure. There is a set of documents relating to the covered bond issuance and a set of documents relating to the mortgage bond issuance. The operative agreements in a covered bond transaction are the mortgage bond indenture, the covered bond indenture, the asset monitor agreement, and the swap agreements.

The Indentures

What is the purpose of the mortgage bond and covered bond indentures?

The mortgage bond indenture creates the mortgage bond held by the issuer SPV. Each program has a base indenture with a supplement for each series. The parties to the mortgage bond indenture are the mortgage bond issuer and the mortgage bond trustee. The mortgage bond indenture trustee's role is to protect the issuer SPV and enforce its rights in the event of a mortgage bond issuer default.

Similarly, the covered bond indenture creates the covered bond held by the covered bond holders. Each program has a base indenture with a

supplement for each series. The parties to the covered bond indenture are the covered bond issuer and the covered bond trustee. The covered bond indenture trustee's role is to protect the covered bond holders and enforce their rights in the event of a covered bond issuer default.

The Asset Monitor Agreement

What is the purpose of the asset monitor agreement?

The asset monitor agreement is entered into by the mortgage bond issuer, the mortgage bond indenture trustee, the covered bond indenture trustee, and the asset monitor. The mortgage bond issuer performs an asset coverage test of the collateral in the cover pool on a monthly basis to ensure that threshold requirements set by the rating agencies are maintained. The asset monitor performs such a test for accuracy at the time of issuance and annually by confirming calculations performed by the mortgage bond issuer. If there is a downgrade of the mortgage bond issuer or the mortgage bond issuer makes a significant error in its calculations, the asset monitor will perform the asset coverage test monthly and notify all parties to the agreement, including the rating agencies, of the test results.

How is the asset coverage test calculated?

The monthly asset coverage test protects covered bond holders by ensuring that the cover pool assets are performing and that their investment is secured by collateral at least equal to the principal and interest owed. Calculations are performed to ensure that the adjusted aggregate loan amount is equal to or greater

than the amount owed on the outstanding mortgage bonds.

The adjusted aggregate loan amount is equal to the value of the mortgage loans, adjusted for current valuation, second lien loan adjustments, delinquencies, and material breaches of bank covenants plus principal collected on the mortgage loans following a mortgage bond issuer ratings downgrade plus any substitution assets (not to exceed 10% of the cover pool).

Failure to meet the asset coverage test is a mortgage bond default and no new series of mortgage bonds may be issued. In addition, no mortgage loans may be removed from the cover pool until the asset coverage test is met.

The Swap Agreements

What is the purpose of the swap agreements?

There are two types of swap agreements that the issuer may enter into with the swap provider: interest rate swap agreements and currency swap agreements.

Mortgage bonds have floating interest rates and covered bonds have fixed interest rates. The issuer will enter into an interest rate swap to ensure that there is adequate cash flow to make interest payments to covered bond holders. An interest rate swap also can be used to mitigate timing mismatches between interest payments and interest income, if applicable.

The other swap agreement that the issuer may enter into with the swap provider is a currency swap. The mortgage bonds are issued in U.S. dollars; covered bonds, even in the United States, often are denominated in euros. If the mortgage bonds and the

covered bonds are issued in two different currencies, the issuer enters into a currency swap to ensure that there is adequate cash flow to make interest and principal payments to covered bond holders.

Pursuant to the terms of the swap agreement, the swap provider must pay interest payments even if the covered bond issuer cannot make its scheduled interest payment (these become deferred payments to swap provider). These amounts are repaid to the swap provider by the covered bond issuer as soon as possible, provided that following a covered bond acceleration, they are paid only after the covered bonds are repaid in full.

After a covered bond event of default, the covered bond issuer will transfer all amounts (guaranteed investment contract amounts and mortgage bond proceeds) to the swap provider in exchange for the swap provider making all payments in relevant currency for interest and principal to the covered bond holders.

What happens if there is a rating downgrade of the swap provider?

Transaction documents typically provide that, in the event of a swap provider downgrade, the swap provider must obtain a third party guarantee, find a replacement swap provider, post collateral, or take action to maintain/restore ratings of covered bonds.

What ancillary documents are needed in a covered bond transaction?

The ancillary documents needed for a covered bond transaction are the securities account control agreement, the reimbursement agreement, and the guaranteed investment contract (GIC) or similar type of deposit agreement.

The securities account control agreement governs the control of securities in the event that qualified securities are substituted for under-performing mortgage loans in the cover pool. The agreement is entered into between the mortgage bond issuer, the mortgage bond indenture trustee, and the securities intermediary (which often is the same party as the mortgage bond indenture trustee).

Under a reimbursement agreement, the mortgage bond issuer's corporate parent agrees to reimburse certain costs and fees related to the issuance of the covered bond program. The reimbursement agreement is entered into between the mortgage bond issuer, its parent company, and the covered bond issuer.

What is the purpose of the guaranteed investment contract?

The GIC or similar guaranteed contract, like a deposit agreement, is entered into between the covered bond indenture trustee and the GIC provider. The reason for entering into a GIC, pursuant to which the proceeds of the cover pool are invested with (or by) one or more financially sound counterparties, is to ensure ongoing scheduled interest and principal payments after a mortgage bond default or

repudiation of the mortgage bond by the FDIC. Upon a mortgage bond issuer event of default, cash flows from the mortgage loans are transferred directly to the GIC provider and invested for the benefit of the covered bond holders, so long as the GIC provider receives proceeds from the cover pool at least equal to the par value of the covered bonds. Provided the proceeds compliance test (set forth below) is not breached, the GIC is used to keep the covered bonds from being accelerated. Investments are made with maturities immediately prior to payment dates (interest and maturity).

What is a proceeds compliance test?

Upon a mortgage bond event of default, the covered bond indenture trustee performs a proceeds compliance test to ensure that there are adequate proceeds to avoid a covered bond acceleration event. Thereafter, the valuation tests are performed monthly.

The proceeds compliance test is performed by adding the amounts deposited into the GIC account and the aggregate unpaid principal of each series of mortgage bonds. The sum must be greater than the aggregate principal amount of all series of mortgage bonds on the acceleration date (taking into consideration repayments of principal). Failure to meet this test is an event of default under the covered bonds.

What issuance documents are needed for a covered bond transaction?

The issuance documents needed for a covered bond transaction are the mortgage bond purchase agreement, the Rule 144A program agreement, the

Regulation S program agreement, and the subscription agreement.

The mortgage bond purchase agreement governs the sale of the mortgage bonds to the covered bond issuer. The agreement is entered into between the mortgage bond issuer and the covered bond issuer.

The Rule 144A program agreement governs the sale of the covered bonds to investors that meet the requirements to purchase unregistered securities under Rule 144A. The Regulation S program agreement governs the sale of covered bonds for transactions that meet the requirements under Regulation S of the Securities Act.

The subscription agreement also governs the sale of the covered bonds and incorporates by reference the program agreements. The subscription agreement is entered into between the covered bond issuer, securities dealers, and the mortgage bond issuer.

Payment Flows

What is the payment flow for covered bonds?

Interest on the mortgage bonds is paid monthly, with principal paid on the maturity or redemption date. The covered bond indenture trustee uses the monthly mortgage bond proceeds to make payments to the swap provider. On an interest payment date, the swap provider deposits interest payment date payments with the covered bond indenture trustee and if owed, the covered bond indenture trustee makes a termination payment to the swap provider, but only after payment of all outstanding covered bonds is made in full. On each interest payment date,

the covered bond indenture trustee pays interest to the covered bond holders.

On the maturity date, the swap provider deposits maturity date payments with the covered bond indenture trustee. On the maturity date, the covered bond indenture trustee pays principal to the covered bond holders.

What happens to payment flows if the mortgage bond issuer experiences a rating downgrade?

If the long-term rating of the mortgage bond issuer is reduced to Baa1 or below, or the short-term rating of the mortgage bond issuer is reduced to A-2 / F2 or below, then the mortgage bond issuer must make daily deposits of principal and interest on the existing mortgage loans into a mortgage bond account at the trustee bank within 28 days from such ratings downgrade. The excess interest is returned to the mortgage bond issuer if interest is paid in full to the covered bond issuer on each interest payment date. The excess principal is returned to the mortgage bond issuer if the monthly asset coverage test is satisfied. See “How is the asset coverage test calculated?”

If the long-term rating of the mortgage bond issuer is reduced to BBB- / Baa3 / BBB- or below, then the mortgage bond issuer must make daily deposits of principal and interest on the existing mortgage loans into a mortgage bond account at the trustee bank within 60 days from such ratings downgrade. The excess interest is returned to the mortgage bond issuer if interest is paid in full to the covered bond issuer on each interest payment date. The excess principal is returned to the mortgage bond issuer if the monthly asset coverage test is satisfied.

Also within the 60-day time period, the mortgage bond issuer must transfer all mortgage loan files as directed by the mortgage loan trustee, with notice to the rating agencies. Within five days of the addition or substitution of a mortgage loan into the cover pool, loan files for all such loans must be delivered to the mortgage loan trustee.

What happens to payment flows if there is a mortgage bond acceleration?

On the maturity date, the swap provider deposits maturity date payments with the covered bond indenture trustee. On the maturity date, the covered bond indenture trustee pays principal to the covered bond holders.

If there is a mortgage bond acceleration but no covered bond acceleration, the covered bond indenture trustee, upon receipt of notice of a mortgage bond acceleration, or, if earlier, receipt of money in respect of such mortgage bond (the ‘mortgage bond proceeds’) deposits the mortgage bond proceeds into a GIC. Each month, the covered bond indenture trustee pays trustee and administrative fees. Interest payments from the GIC are paid to the swap provider to fund payments on the covered bond.

On an interest payment date, the swap provider deposits interest payment date payments with the covered bond indenture trustee and if owed, the covered bond indenture trustee makes a termination payment to the swap provider, but only after payment of all outstanding covered bonds is made in full. On each interest payment date, the covered bond indenture trustee pays interest to the covered bond holders.

What happens to payment flows if there is a covered bond acceleration?

Upon receipt of payments, the covered bond indenture trustee deposits into the applicable receipts account at the trustee (1) all payments of interest and principal on the mortgage bonds and (2) mortgage bond proceeds. On the next interest payment date, the covered bond indenture trustee will pay fees and expenses owed to the indenture trustee, the administrative trustee, and the paying agents. Then, pari passu, the covered bond indenture trustee will pay to each swap provider all applicable termination payments (other than excluded payments), the balance of remaining funds for exchange under the swap agreement (for payments of interest and principal), and any excluded termination payments and deferred amounts. Next, the covered bond indenture trustee will pay any unpaid trustee fees, and repay the beneficial owner of the SPV trust its contribution. Lastly, from the amounts received from the exchange with the swap provider above, the covered bond indenture trustee will pay interest and principal due to the covered bond holders.

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