



UNITED STATES
**DEPARTMENT OF
THE TREASURY**



Developing a U.S. Residential Covered Bond Market

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Our Housing Market Objectives

- ◆ Avoid preventable foreclosures
- ◆ Ensure the availability of mortgage finance
- ◆ Enable the necessary housing correction to move forward as quickly as possible
- ◆ Minimize the spillover from housing to the real economy



Ensuring the Availability of Mortgage Finance

- ◆ **FHA Secure**
 - 348,000 refinancings since September 2007
- ◆ **HOPE for Homeowners**
 - Signed into law by President Bush on July 30, 2008 - establishes a new \$300 billion FHA refinance program in exchange for a principal write-down
- ◆ **Fannie Mae and Freddie Mac**
 - Treasury's actions to aim ensure Fannie Mae and Freddie Mac continue to fulfill their important role in the housing market (currently ~70% of originations)
- ◆ **Federal Home Loan Banks**
 - Expanding their role to fund balance sheet lending
- ◆ **Improving Transparency of Mortgage-Backed Securities**
 - ASF task force to improve and standardize loan-level reporting
- ◆ **Covered Bonds**
 - Treasury introduced a Best Practices Guide and is mobilizing the private sector to kick-start the market



Originators Currently Have Several Sources of Funding For New Mortgages

Off Balance Sheet

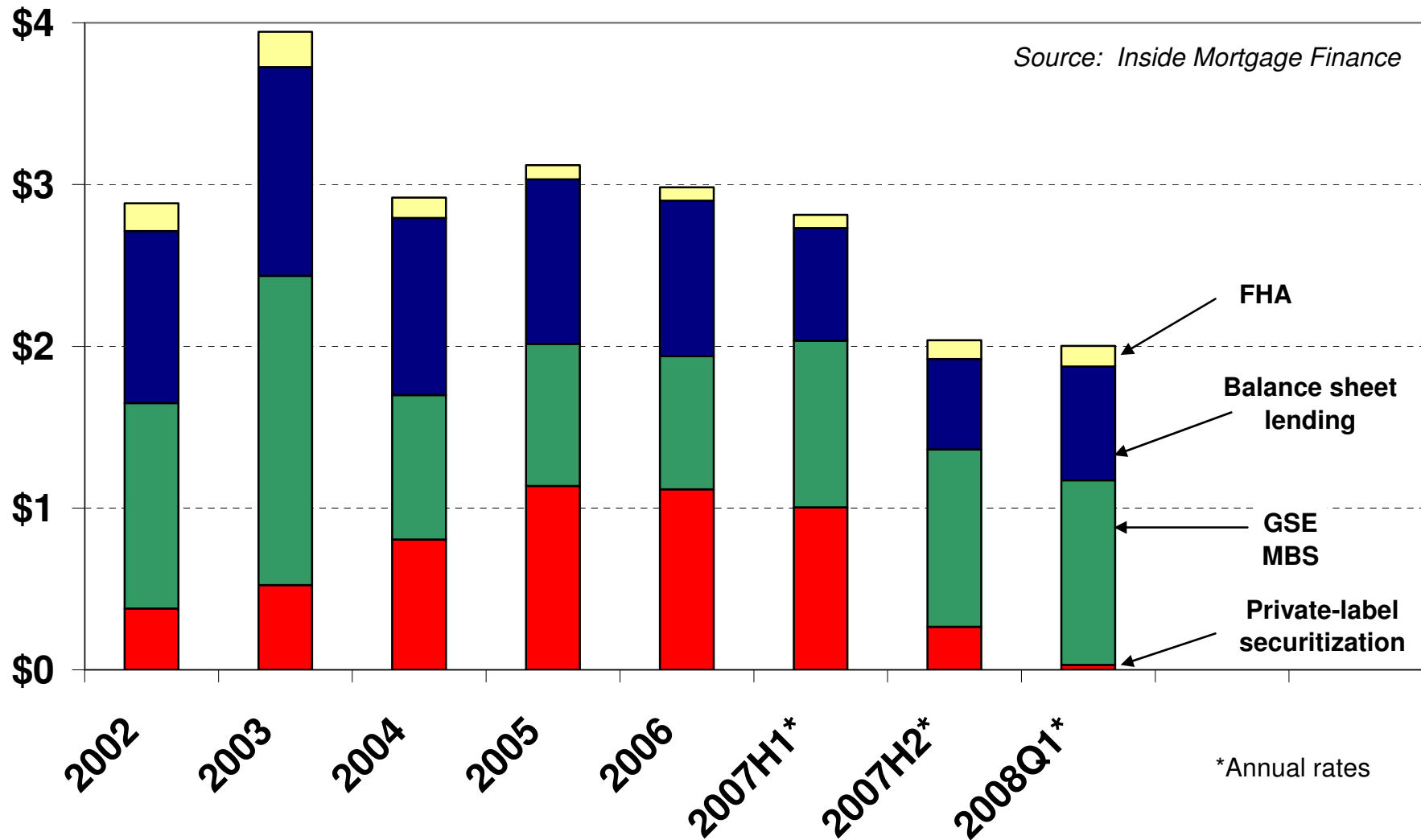
- ◆ Selling whole loans to investors
- ◆ Private label securitization
- ◆ GSE securitization
- ◆ FHA /Ginnie Mae

On Balance Sheet

- ◆ Deposits
- ◆ Unsecured debt
- ◆ Federal Home Loan Banks



Private Label Securitization has Become Severely Strained



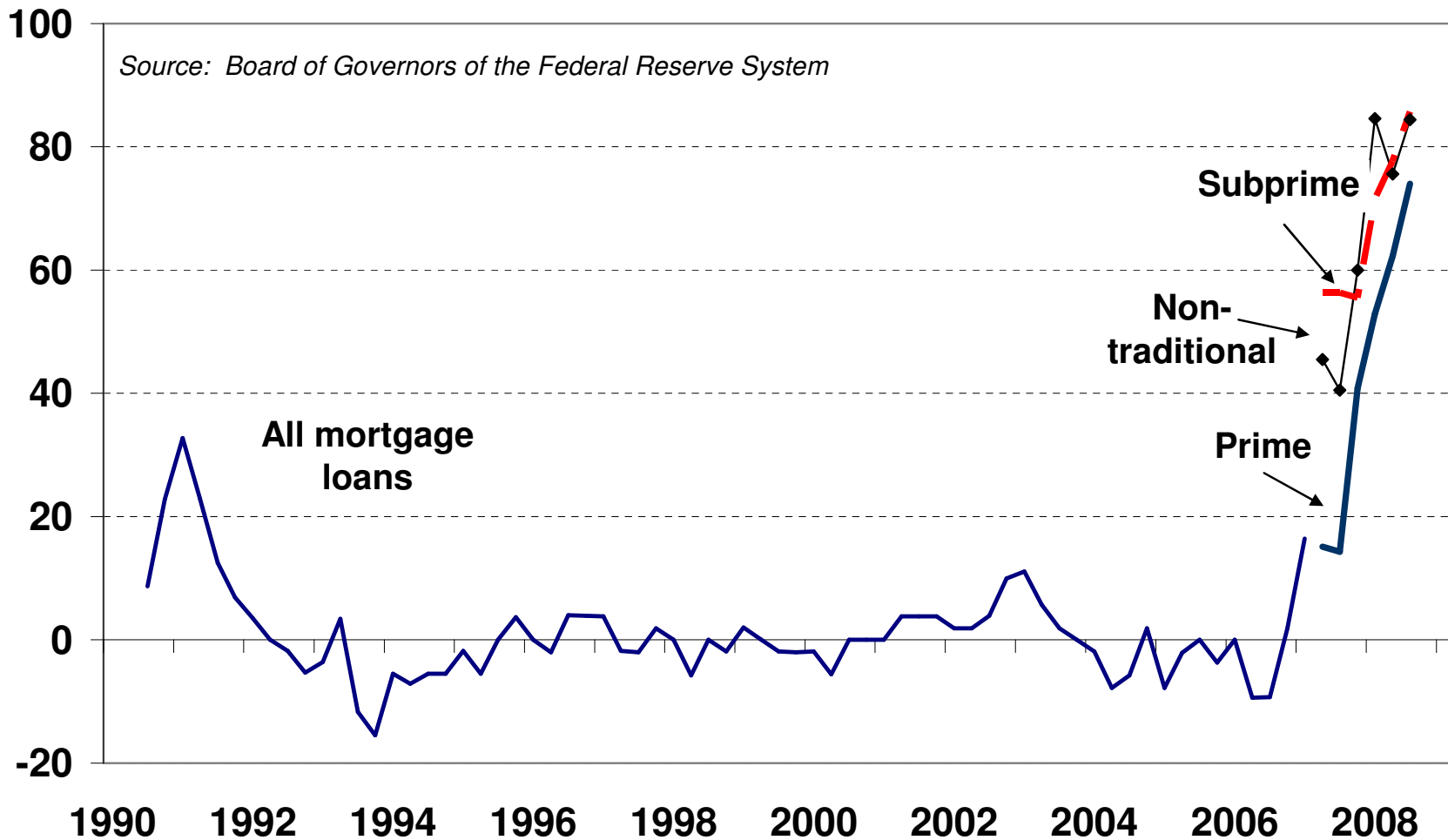
FHLBs Have Expanded Their Role

Federal Home Loan Bank Advances (billions of dollars outstanding, end of period)



Spreads And Costs For Borrowers Have Increased

Mortgage Rate Spreads to 10-Year Treasury (percent)



Covered Bonds Are A Potential Additional Source of On Balance Sheet Funding

Off Balance Sheet

- ◆ Selling whole loans to investors
- ◆ Private label securitization
- ◆ GSE securitization
- ◆ FHA / Ginnie Mae

On Balance Sheet

- ◆ Deposits
- ◆ Unsecured debt
- ◆ Federal Home Loan Banks
- ◆ Covered bonds

There is no silver bullet. The \$11 trillion residential mortgage market needs all sources of finance.



What Is A Covered Bond?

- ◆ Depository institution originates mortgages and holds them on its balance sheet
- ◆ Retains credit risk in mortgage loans
- ◆ Issues new debt collateralized by mortgage loans
- ◆ If loans become delinquent, issuer replaces them
- ◆ Cash flow from issuer services the debt (not cash flow from mortgages)
- ◆ Loans serve as collateral only
 - Investors retain an unsecured claim on issuer
- ◆ A funding source – not a capital source



History of Covered Bond Market

- ◆ \$3 trillion global market at year-end 2007
- ◆ Dates back more than 230 years to first Prussian issuance
- ◆ Initially used to finance agriculture, later became focused on residential and commercial real estate
- ◆ First German jumbo covered bond in 1995
- ◆ European Model: many European jurisdictions have a “legislative framework”
- ◆ U.S. Model: “structured framework”
- ◆ Two U.S. institutions have issued covered bonds to date
 - GSEs and FHLBs are unique to U.S. market



Comparison Between Covered Bonds And Other Funding Sources

	Covered Bonds	MBS	Unsecured Debt
Collateralized	♦ Yes (dynamic)	♦ Yes (static)	♦ No
Location of Collateral	♦ Held on Issuer's Balance Sheet	♦ Sold to a SPV	♦ N/A
Capital source	♦ No	♦ Yes	♦ No
Recourse	♦ Dual (issuer on an unsecured basis after collateral exhausted)	♦ Collateral only	♦ Issuer on an unsecured basis only
Source of Cashflows	♦ Issuer	♦ Collateral	♦ Issuer
Acceleration / Prepayment	♦ Avoids acceleration via GIC if sufficient collateral value	♦ Prepayment risk depends on underlying mortgages	♦ Acceleration risk if issuer becomes insolvent



Treasury's Approach to Kick-Starting the U.S. Covered Bond Market

- ◆ **Market Outreach:** Extensive dialogue with 50+ market participants
 - Investors, issuers, broker / dealers, law firms, rating agencies, trade groups, and trading platform providers
- ◆ **Regulatory Coordination:** Coordinated effort among the regulatory community
 - Domestic: Treasury, FDIC, Federal Reserve, OCC, OTS, SEC
 - International: Foreign governments and central banks
- ◆ **Formulating Framework:** Balance between structural certainty and market innovation
- ◆ **Market Role:** Encourage market leaders to move forward together



Priorities of Market Participants

◆ **Investors:**

- Liquid market with electronic pricing
- Initial focus on high quality collateral and “blue chip” issuers
- Homogeneity
- Regulatory clarity in the event of an insolvency
 - Options available to FDIC
 - Definition of “Actual Direct Compensatory Damages”

◆ **Issuers:**

- Cost effective funding
- Investor appetite
- Broker / dealer support
- Program flexibility

◆ **Broker / Dealers:**

- Sufficient issuance volume
- Tri-party repo and Federal Reserve Discount Window eligible



Treasury's Objectives In Publishing A Covered Bond Best Practices Guide

- ◆ Provide clarity and homogeneity to the U.S. market
 - “Legislative framework” vs. “structured framework”
 - Complement FDIC Final Policy Statement
- ◆ Start with residential mortgage collateral
 - Support the housing market
 - Provide simplicity for market participants
- ◆ Encourage market participants to move at the same time
 - Issuers, investors, dealers



Legislative vs. Structured Framework

Legislative

- ◆ Defines covered bonds by statute
- ◆ Typically defines acceptable collateral
- ◆ Typically exists in jurisdictions with a long history of covered bonds
- ◆ Typically identifies a dedicated regulator
 - May have perception of “government guarantee”
- ◆ Standardizes covered bonds to provide homogeneity and simplicity

Structured

- ◆ Relies on existing collateral and securities laws
 - Regulations may prescribe implementation
- ◆ Typically exists in jurisdictions with a short history of covered bonds
- ◆ Typically does not have dedicated regulator
 - No perception of “government guarantee”
- ◆ Allows market to innovate
- ◆ Potential for multiple structures through competition

- ◆ While in Europe specific legislation often defines the debt instrument, the U.S. regulatory environment is different and does not require legislation.



FDIC Has Taken Bold Steps to Support the Development of a U.S. Covered Bond Market

- ◆ Clarified three options available to the FDIC in the event of an issuer's insolvency
 - 1) Continue to honor the terms of the covered bond, including payment of interest and principal
 - 2) Pay-off the covered bond in cash
 - 3) Allow liquidation of the pledged collateral to pay-off the covered bond
- ◆ Defined “Actual Direct Compensatory Damages” as par + accrued interest through the date of insolvency
- ◆ Reduced the stay period from 90 days to 10 days



Treasury's Best Practices For Residential Covered Bonds

◆ Issuer

- *SPV or Direct Issuance Structure*

◆ Collateral

- *Performing first-lien mortgages on 1-4 family residences*
- *Underwritten at fully indexed rate with documented income*
- *Compliant with regulatory underwriting guidance*
- *Cash, Treasury, and GSE securities permissible as substitution collateral*
- Maximum LTV of 80% at time of inclusion in cover pool
- 20% limit for a single MSA
- No negative amortization mortgages

◆ Overcollateralization

- Minimum of 5%
- LTVs updated monthly with only 80% portion counting toward overcollateralization

◆ Specified Investment Contract

- Deposit agreement to prevent acceleration
- So long as the Trustee receives proceeds at least equal to par, pays interest and principal to maturity

Note: Italics indicates provisions included in the FDIC Policy Statement

Source: <http://www.treas.gov/offices/domestic-finance/covered-bonds/>










Dealers Have Come Together To Support Covered Bonds

- ◆ SIFMA created a U.S. Covered Bonds Traders Committee to encourage the market's growth in the U.S.
- ◆ Member organizations are making specific commitments to the Covered Bond market:
 - Appoint a dedicated U.S. covered bond trader
 - Provide indicative price information to electronic trading platforms
 - Provide liquidity on a "best intentions" basis
 - Devote research and other resources to Covered Bonds
 - Jointly work to create a SIFMA U.S. Covered Bond Council as a forum for representation and discussion among all market participants and to promote the ongoing development and efficient functioning of the U.S. covered bond market
- ◆ Member firms include:

Banc of America Securities	Barclays Capital	BNP Paribas
Citi	Deutsche Bank Securities	Goldman, Sachs & Co.
HSBC Securities (USA)	JPMorgan	Merrill Lynch & Co.
Morgan Stanley	RBS Greenwich Capital	UBS Investment Bank



Keys To Kick-Starting the U.S. Market

	Source	Status
Regulatory clarity	FDIC Policy Statement	
Simple, homogenous structure with high quality, standardized collateral	Treasury Best Practices	
Tri-party repo eligible	BONY, JPM	
Discount window eligibility	Federal Reserve	
Broker/dealer commitment	SIFMA	
Electronic pricing	Bloomberg and Tradeweb	
Strong support from institutional investors	Blackrock, Cap Re, PIMCO, TIAA	
“Blue chip” bank issuance	BofA, Citi, JPM, Wells	In Process



Market Development - Next Steps:

- ◆ Rarely have we experienced a tougher environment in which to launch a new financial product
 - But rarely has the market needed covered bonds as much as it does now
- ◆ The covered bond market is not immune to stresses in the broader capital markets
 - As with virtually all financing markets, the European covered bond market is stressed → there is no silver bullet
- ◆ Issuers are preparing their programs for issuance
 - Setting up programs
 - Working with regulators for necessary approvals
 - Likely issuance in months
- ◆ Dealers and investors are doing their work to be ready

