

## US Covered Bonds – Senate Introduces Legislation to Encourage Market Development

On November 9, 2011, Senator Kay Hagan (D-NC) and Senator Bob Corker (R-TN) and co-sponsors Chuck Schumer (D-NY) and Mike Crapo (R-ID) introduced the "The United States Covered Bond Act" to the United States Senate. The bi-partisan Senate bill is intended to promote the development of a covered bond market in order to diversify the sources of financing available in the United States, thereby increasing both retail and commercial lending. This bill is the Senate's response to H.R. 940, which passed the Financial Services Committee of the House of Representatives in June of this year and is currently pending before the House Ways and Means Committee.

Covered bonds are dual-recourse securities issued by a bank or other financial institution and backed by a revolving pool of financial assets (most commonly mortgage loans and public sector debt). Covered bonds have been a primary source of funding for lending to the real estate sector in many European jurisdictions and have been increasing in popularity among investors as a more secure way of lending to the financial sector, when compared to investing in Senior unsecured bonds and MTNs. In the United States, however, the lack of a legislative framework and concern about banks creating liens over substantial amounts of their assets have hindered the development of a covered bond market. The Senate Bill and H.R. 940 seek to address these problems.

### Comparing the House and Senate Proposed Legislation

Although the language of the Senate bill closely tracks that of H.R. 940, there are a few important differences:

- The Senate bill expands the definition of "eligible issuer" to include broker-dealers and insurance companies, as well as certain systematically important non-bank financial institutions.
- The Senate bill adds a provision not found in the House bill which allows the covered bond regulator, as well as a majority of covered bond holders, to replace the independent asset monitor. The asset monitor's role is to verify and report on the compliance of the cover pool with the applicable minimum overcollateralization

### Highlights

- The US Senate follows House of Representatives in introducing legislation to stimulate the market for domestic covered bonds
- The proposed legislation expands the definition of "eligible issuer" from House bill to include insurance companies and broker-dealers
- The current wording of the bill could create disparate treatment for foreign banks as to their ability to issue covered bonds

requirements. The Senate's proposal is an appropriate recognition of the fact that covered bond holders may not have sufficient information to be able to assess whether the asset monitor is performing adequately until a breach is imminent.

- Responding to an FDIC concern, the Senate bill provides that the covered bond regulator for covered bond issuers that are not subject to the jurisdiction of a federal banking agency will be the Federal Reserve Board, rather than the Treasury (as specified in the House bill). This change addresses the FDIC's concern that in all cases the covered bond regulator should be a prudential regulator (which is not a role of the Treasury), although it presents the possibility that a funding program of, for example, a State-regulated insurance company could be regulated by the Federal Reserve Board, which generally oversees banks and banking entities.
- The Senate bill contains no tax provisions, unlike the House bill. This is likely a procedural step in order to avoid the additional process of requiring the Senate bill to go through the Senate Finance Committee in addition to the Senate Banking Committee which it is already subject to, with the likely hope of expediting the process of bringing the bill up for consideration before the full Senate.

## Possible Implications

The draft Senate bill defines an "eligible issuer" as, among other things, any bank holding company, any insured depository institution, and any subsidiary of such entities. Foreign banking organizations that operate branches or agencies in the United States are treated as "bank holding companies" under the U.S. Bank Holding Company Act but technically are not "bank holding companies." Only foreign banking organizations that control a bank subsidiary in the United States are "bank holding companies" within the meaning of that term under relevant banking laws. The language of the draft bill may be interpreted more broadly in implementing regulations, but as drafted it suggests that foreign banks that do not operate bank subsidiaries in the United States may not be "eligible issuers." Accordingly, foreign banks that operate branches but not bank subsidiaries in the United States may not be able to issue covered bonds under the proposed legislation through their U.S. branches.

Additionally, the inclusion of insurance companies and broker-dealers in the category of eligible issuers may indicate that the Senate is contemplating the use of covered bonds for a wider range of assets and circumstances, when compared with the objectives of the House bill.

## Conclusion

While the introduction of the Senate covered bond bill is a positive step towards the development of meaningful U.S. domestic covered bond issuance, there is still a long road before any such law is realized. The next step is one or a series of hearings on the legislation before the Senate Banking Committee, where it is likely that several concerns of the FDIC will be considered.

It is noteworthy that, with a few modifications, the Senate chose largely to mirror the text of H.R. 940, rather than attempting to address some of the perceived flaws in the House bill (such as the impracticality of the proposed framework for allowing smaller

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issuers to combine pools to tap the market). Although this approach may ease the legislative process and increase the chances of a complete piece of legislation actually passing in the relative near term (i.e., 2012 – 2013), it is also a missed opportunity on the part of the Senate to show leadership in this area by improving on the House proposal.

Ultimately, this latest legislative development is a positive sign that a serious conversation on the topic has started and that Congress is clearly focusing on the development of the covered bond market in the United States.

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This client memorandum does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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