TESTIMONY OF
STEPHEN G. ANDREWS
BANK OF ALAMEDA

HEARING ON
"LEGISLATIVE PROPOSALS TO CREATE A
COVERED BOND MARKET IN THE UNITED STATES"

BEFORE THE HOUSE FINANCIAL SERVICES SUBCOMMITTEE
ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

MARCH 11, 2001

Mr. Chairman and Ranking Member, my name is Steve Andrews. I am pleased to appear before you today at this hearing on covered bonds and the United States Covered Bond Act of 2011. This is a very important issue and I am pleased to see the thoughtfulness being shown by the Congress in studying the covered bond market.

I am a community banker with the Bank of Alameda in Alameda, California, a successful California community bank. We guard jealously our community reputation and take pride in the positive impact that we have in our communities. We are conservatively run, and we know our customers well.

I am pleased to present testimony raising several serious concerns and objections about the possible development of a covered bond market in the United States (U.S.). To cut to the chase, speaking from my perspective as a community banker, I do not think that we as a country need to expend the time, energy and resources to attempt to create a covered bond market in the

U.S. In my opinion, and I believe that I am supported in this view by Treasury Secretary Geithner, we already have a covered bond market: it is the Federal Home Loan Bank System. I am a member of the Federal Home Loan Bank of San Francisco. We do not need to try to import from Europe an experimental housing finance tool that would be deployed under greatly different conditions and circumstances and as far as I can see would largely benefit the biggest banks in the industry.

By contrast, the Federal Home Loan Bank (FHLB) system is alive and well and doing the job congress chartered it to do. Let me remind you that the FHLB system expands and serves as a buffer to its members under its cooperative ownership structure when the economy demands it, and the system contracts when the economy no longer requires that level of liquidity. Indeed, consistent with the Federal Home Loan Bank Act, the Federal Home Loan banks provide funds in good and bad economic times. During the height of the mortgage credit crunch in 2007-2008, Federal Home Loan banks increased their advances to member institutions by over $250 billion. Frozen out of credit markets during the financial crisis, large and small institutions relied on Federal Home Loan banks for funding. If such funding had not been available at reasonable cost, the crisis would have been even worse. In sum, Federal Home Loan banks manage mortgage collateral differently. Federal Home Loan Banks take haircuts on the collateral provided. Most importantly they know their customers and are able to customize funding needs to meet mortgage-financing needs in a way that covered bonds are not intended to achieve. Because true low risk covered bonds require term debt to match up with term assets.

I am not here to "bash" the big banks. They are an important part of the FHLB System. As members and users of that System, both large and small institutions contribute to its strengths and permit it to make reasonably priced advances which members use to make mortgages. Without large member participation, the System would not be as strong as it is and able to provide reasonably priced advances.

My understanding is that a covered bond is a recourse debt obligation of the bond issuer (usually a depository institution), in which the issuer has a continuing interest in the performance of the loan, and is secured by a pool of mortgage assets. Covered bonds provide funding to the bond issuer, and the issuer retains the pool of assets and related credit risk on its balance sheet. Therefore, in contrast to mortgage backed securities, where secured assets are off the balance sheet of the issuer, the pools of assets remain on the covered bond issuer's balance sheet. Interest on the covered bonds are paid to investors from the issuer's general cash flows, while the pool of assets serve as secured collateral on the products.

If the assets within the covered bond's asset pool become non-performing, they should be replaced with cash or be over collateralized. The issuer must maintain a pool of assets in excess of the notional value of a covered bond and therefore be "over-collateralized" at all times. In general, the maturity of a covered bond is greater than one year and no more than thirty years; in Europe assets are matched for the durations of the covered bond. Moreover, while the majority of covered bond issuances have maturities between one and ten years, there has been a recent trend toward longer-term instruments that are greater than ten years in duration.

Unfortunately, the lion share of the benefits of a covered bond market in the U.S. would be to help the largest banks in the U.S. to the detriment of excellent community banks. Moreover, instead of the covered bond market being an effort to privatize mortgage finance obligations as is sometimes touted as a benefit, it seems pretty clear that in Europe the government is viewed as backing up the covered bonds issued by the large European banks and indeed the various governments in Europe have stepped in to support the covered bond markets when difficulties arose.

The U.S. has over 7000 banks while Germany and other European nations often have 3 or 4 major banks and a small number of additional institutions. The latter financial market structure, with fewer and larger banks, is more conducive to covered bond issuances. Smaller community banks would be at a competitive disadvantage in a covered bond market because they do not have the volume of mortgages necessary to support covered bond financing. To create covered bond assets with enough diversity would require adequate "mortgage deal flow." Smaller banks in this struggling market may simply not have the number of loans to provide competitively priced covered bonds. The government or market might be able to consolidate mortgage loans for smaller banks into covered bonds, but even this solution is likely to be at a higher cost compared to larger national originators with substantial deal flow. In contrast to the U.S., European countries have different banking structures.

In addition, I believe many lower and middle-income consumers would be affected by higher priced mortgages from small banks unable to compete with large bank issuers of covered bonds. Moreover, some contend that covered bonds will include mortgages with down payments of 20% or more and because of duration matching, may encourage mortgages of less than 30 years. Such a result would obviously not be in the best interests of consumers or small banks that serve them.

Moreover, the Federal Deposit Insurance Corporation (FDIC) has raised serious concerns about the functioning of a covered bond market and the ability of the FDIC to resolve financial institutions that fail which hold such instruments. The FDIC's 2008 Final Statement of Policy on Covered Bonds (FDIC Policy Statement) is the pertinent position of the FDIC on the use of covered bonds. One of the main concerns detailed in the FDIC Policy Statement was the potential for covered bonds to increase the costs to the FDIC's deposit insurance fund in a receivership. More specifically, the FDIC was concerned that unrestricted growth in the covered bond market could excessively increase the proportion of secured liabilities to unsecured liabilities, which could lead to a smaller value of assets that are available to satisfy depositors and creditors in a receivership and therefore lead to a greater potential loss for the FDIC's deposit insurance fund. The FDIC is also concerned about the agency's potential inability to obtain proceeds from covered bonds in the insolvency process in circumstances when the covered bond issuer has failed. The FDIC also stated its concern about being powerless to repudiate covered bond contracts in the insolvency process which could transfer risk from covered bond investors to the general public.

Some argue that the bill would allow covered bonds to be removed from the FDIC Insurance coverage. If this were the case, it would lower the amount of insurance that large institutions pay into the FDIC fund and potentially increase the cost of FDIC insurance on small community banks.

As to the proposed bill, as drafted, it contains provisions that some argue could have far reaching implications. Namely, expanding covered bonds to include other forms of collateral beyond mortgages, using assets as substitute collateral instead of cash and potential providing a federal guarantee to covered bond-issuing entities – namely large banks.

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(1) The Act would allow for covered bond usage on non-mortgage assets that have short duration such as credit cards, auto loans, and student loans. This is the opposite of the established European model.

(2) The legislation also refers to dynamic collateral, which can mean that a large bank does not have to buy the non-performing asset out with cash, which could be problematic. Dynamic capital was the equivalent of what WAMU

did when it issued covered bonds, and substituted loans internally rather than providing cash, and we all know what happened to WAMU.

(3) The legislation also request that a study be performed on how the government could provide a backstop to the covered bond market. If a backstop is put in place, large lenders could have a government guarantee in a way that could be riskier and more expansive than Fannie Mae or Freddie Mac.

Now, as a country, we should have a robust debate about the level of home ownership in the U.S. And, I will be the first to admit that banks and others made mistakes during the housing bubble and ensuing recession by too aggressively pushing marginal borrowers into home ownership. But, let's be clear. Owning a home is a vital part of the American dream. In Germany and other European nations that rely on the restrictive processes of the covered bond market, the national home ownership rate is below 50%. That's not part of the American fabric or part of our culture. Americans want to be able to work hard, save a reasonable amount of money for a down payment and own their "castle," and have the freedom to move elsewhere in this great country if employment, family or other obligations requires a change in residence. That's not the way it works with covered bonds. Borrowers are locked in by the onerous down payment, underwriting criteria and inability to sell and relocate to another residence for whatever reason of personal freedom or economic necessity. Having the personal freedom to move where you want and to play by the rules to grab your piece of the American dream, well that's the America that I grew up in. That's the country that I am proud of, and that's what is fair to keep in place for my children, your children, my grandchildren, your grandchildren and the other generations in the years ahead.

Let me close with this thought. Housing should be viewed as a long term investment and as a place of belonging. It should not be transformed through legislation or other marketplace maneuvering into a financial speculative asset. That happened during the financial crisis and the housing bubble that contributed mightily to that crisis. I suggest that you consider some principles to guide any covered bond legislation such as; (1) do no harm to the 30 year mortgage as the industry standard; (2) insure a robust Federal Home Loan Bank System that provides a significant advance product to large, medium and small banks at a reasonable cost; (3) not increase FDIC insurance fees on smaller banks as a consequence of establishing a covered bond market; and (4) ensure consumers are held harmless in their continual search for low interest and nationally available mortgages.

I thank you for the opportunity to appear before you today, and I welcome the opportunity to respond to your questions.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Stephen G. Andrews	**2. Organization or organizations you are representing:** Bank of Alameda
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☑ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** ☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Stephen G Andrews	

Please attach a copy of this form to your written testimony.