Statement of:

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On behalf of the American Securitization Forum
ASF Covered Bonds Subforum

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Committee on Financial Services
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Hearing on:

Legislative Proposals to Create a Covered Bond Market in the United States

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Chairman Garrett, Ranking Member Waters, and Distinguished Members of the Subcommittee, I thank you for this opportunity to testify before you today.

Preamble

The American Securitization Forum (the "ASF") was formed to enable participants in the US securitization industry to pursue a mission of education, consensus, and advocacy on matters relating to the form and function of the US securitized debt capital markets. The ASF has over 330 institutional members engaged in every significant aspect of this market—issuers, investors, servicers, dealers, ratings agencies, law firms, trustees, and a variety of data and technology vendors. Assuming a legislated US covered bond market is established, our members will have a leading and lasting role in this new financial instrument, much like they did over 25 years ago with the creation of the first asset-backed security.

As the current Chair of the ASF Board of Directors, a former Chair of the ASF Investor Committee, and as a Managing Director of Natixis, I offer testimony today in support of a promising legislative framework for covered bonds in the United States. In particular, I seek to represent the views of institutional investors, who could bring the necessary capital to invest in this product. By way of background, the ASF Investor Committee represents over 60 pension fund, mutual fund and insurance company member institutions, who collectively manage trillions of dollars of Main Street's financial investments. The institution I am employed with, Natixis, is the commercial and investment banking subsidiary of BPCE, the second largest bank in France as measured by retail deposits. Natixis and its affiliates have held a long-standing leadership role in the European covered bond market, acting as an issuer, dealer, and investor and conduct significant investment and banking activities in the United States. My professional experience in securitized debt capital markets and related investment activity covers the past 20 years.

The right kind of legislation, like the legislation you Chairman Garrett and Congresswoman Maloney have introduced on Tuesday, has the power to create a new channel of efficient credit flow through our financial system while facilitating an accelerated and more orderly exit of US government financial support for the private sector. The proposed legislation would create a new and disciplined market structure around which free market forces can organize to better balance the flow of money, capital, and credit in our highly sophisticated financial system. The concentrated US banking system market structure invites the creation of new financing channels, so we can better democratize the flow of credit to Main Street in an effort to improve its post-crisis affordability and accessibility to American consumers and businesses. Credit democratization is something the securitization markets have been particularly effective in doing, but additional forms of financing are necessary to support appropriate levels of credit creation in the US. As such, we fully support your initiative to establish a new credit channel for the ultimate benefit of Main Street.

The Short History of US Covered Bonds

It appears ironic to acknowledge that US covered bonds have already been issued, without legislation. As many of you may know, the first US insured depository institution ("IDI") covered bond was issued by Washington Mutual ("WaMu") nearly 5 years ago, even without a legislative framework for it. Approximately a year later, Bank of America became the second US bank to issue covered bonds. In the absence of any legislative framework in the United States, these issuances were denominated in Euros and sold predominantly into the European covered bond market as "contractual" covered bonds.

In July 2008, the FDIC published a Final Statement of Policy (the "Final Policy") for the exercise of its receivership and conservatorship authority in respect of covered bond contracts entered into by a US IDI and the US Treasury issued its "Best Practices for Residential Covered Bonds Guidelines"[1] (the "Best Practices Guidelines") for the issuance of contractual US covered bonds in coordination with the FDIC's Final Policy. At the time, Treasury believed a framework defined by policy and regulation[2] would be sufficient to initiate a US covered bond market that could restore the financing that was withdrawing from a declining asset securitization market. This belief was disproved quickly as the financial crisis accelerated into the autumn and culminated with historic emergency measures passed by Congress. Just two months after the Treasury and FDIC frameworks were issued, Washington Mutual was closed by the OTS and the FDIC was appointed receiver. During those two months, secondary market prices of WaMu's

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[1] Best Practices for Residential Covered Bonds, Department of the Treasury, July 2008.
[2] A framework not defined by specific legislation (a "legislative framework") is herein referred to interchangeably as a regulatory framework, policy framework, or contractual framework.

Euro-denominated covered bonds fell precipitously as holders of those investments began to focus on the risk that the FDIC's repudiation authority could override contractual protections while the value of the residential mortgages in the covered pool would decline. Historical price data indicate that the WaMu covered bonds traded as low as 75 cents on the dollar, before rallying after the acquisition by J.P. Morgan later that same September in 2008.[3] The 2006 and 2007 issuances by WaMu and Bank of America remain the only US covered bond issues to date. Curiously, no US covered bonds were issued after the FDIC published its Final Policy and the US Treasury published its Best Practices Guidelines.

Policy and Regulation Are Insufficient to Support a U.S. Covered Bond Market

The experience of investors in WaMu covered bonds highlighted the weakness in relying on a regulatory, rather than a legislative, framework for US covered bonds. In general, regulatory frameworks are more easily revised than legislative frameworks, which would require an act of sovereign government to change, rather than a regulatory action under the regulator's own control. Consequently, regulatory frameworks are more susceptible to whim or political expediency that can be disruptive of markets and injurious to investors who relied on such frameworks. In particularly good times, investors might be willing to overlook or de-emphasize the risk posed by a regulatory regime, buy the bonds, and accept even an insignificant premium for the incremental risk. This is basically what occurred in the WaMu story. When stress arises, however, at the precise moment that a framework needs to show stability and resilience, markets

[3] "Washington Mutual's Covered Bonds", Harvard Business School, 9-209-0923, Daniel B. Bergstresser, Robin Greenwood, James Quinn, Rev. October 22, 2009.

will focus their attention on the weaknesses and extract a sometimes painful toll for their sheer presence. If we are to start a new and promising financial sector, we can ill-afford to marry it to a weak legal framework. The centerpiece of any legal framework will be that framework's treatment of covered bonds in the event of an issuer's insolvency.

The Need to Curb FDIC Insolvency Resolution Authorities by Passing US Covered Bond Legislation

In a prospective US covered bond market, the FDIC would be the operative regulator for IDIs that choose to issue covered bonds. Our expectation would be for much of the early US covered bonds market to be developed by US banks, given the experience in other countries. As it now stands, the FDIC's authority as receiver or conservator is simply contradictory and counterproductive to the creation of a healthy legal framework for a covered bond market. This is because the FDIC has too much discretion to choose among resolution alternatives that would have varying consequences for covered bondholders, especially including the worst-case outcome that the FDIC could elect to repudiate a covered bond contract, determine the fair market value of the cover pool securing the covered bonds, and pay covered bondholders the lesser of par or cover pool fair market value with interest accrued only through the date of the FDIC's appointment as receiver, and not to the date on which investors are actually repaid.

Even if the FDIC were to promulgate guidance limiting itself to its more investor-friendly bank insolvency resolution alternatives, investors would lack confidence in and be reluctant to rely on such self-governed guidance. This is because the FDIC would have an inherent conflict of interest to take action that minimizes losses to the Depositary Insurance Fund ("DIF"), regardless of whether such result came at the expense of secured creditors. Such conflict of interest was amplified in acts of earlier Congresses requiring the FDIC to use the "least costly" transaction(s) for resolving insolvent IDIs and giving depositors a payment priority over other unsecured creditors of an insolvent bank. This being the case, legislation is required to limit the FDIC's optionality in resolving the covered bond contracts of a bank under the receivership or conservatorship control of the FDIC. Allowing the FDIC to retain its current authority under Section 11(e)(12) of the Federal Deposit Insurance Act ("FDI Act") in respect of an IDI's secured indebtedness for covered bonds would be a grave policy misstep in our view, and would undermine the market before it can be developed. In the opinion of our issuer and investor members, covered bond legislation needs to set a clear and unmistakable set of resolution mechanics that assure investors will receive the economic value of a market-based negotiation of contracts consistent with the principles already in long-standing operation around the globe for this type of indebtedness. Only legislation can create a carve out for covered bonds in order to curb the insolvency authorities the FDIC now has over covered bonds to the extent necessary to establish a US legislative framework that is competitive with the more established programs domiciled elsewhere.

Concerns that Covered Bond Legislation Would Increase the Risk of Loss to the Depositary Insurance Fund and to the U.S. Taxpayer Are Misplaced

Some fear that an investor-friendly US covered bond legislation would pose greater risks to the FDIC DIF and ultimately to the US taxpayer. We believe any such fears are misplaced, especially since, by the FDIC's own account, Dodd-Frank has "granted the FDIC the ability to achieve goals for [DIF] fund management that it has sought for decades but lacked the tools to accomplish"[4]. Among other things, Dodd-Frank raised the minimum designated reserve ratio ("DRR"), removed its upper limit, eliminated the requirement that the FDIC dividend amounts when the DRR is between 1.35% and 1.5%, granted the FDIC sole authority to determine dividend policy above a DRR of 1.5%, and set the calculation of insurance premiums against total assets, not total deposits.[5] Accordingly, it would seem more logical for the FDIC to adjust deposit insurance premiums to the asset-liability practices of IDIs, including any covered bond issuance practices, rather than seek to maintain their traditional insolvency authorities which could impede or even prevent a US covered bond market from becoming a feature of our credit system. Perhaps even the FDIC has come to recognize this in a post Dodd-Frank world, as the September 15, 2010 testimony of the FDIC before the Senate Banking Committee includes a sentence whereby the FDIC witness Michael Krimminger, currently the FDIC's General Counsel, states, "[t]he FDIC would support covered bond legislation that clarifies the amount of repudiation damages to be the par value of outstanding bonds plus interest accrued through the

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[4] Federal Register Vo. 76, No. 38, Friday February 25, 2011, Part II, Federal Deposit Insurance Corporation, 12 CFR, Part 327, Assessments, Large Bank Pricing; Final Rule, page 10673.
[5] Ibid

date of payment."[6] Such a policy stance would be a significant improvement from the FDIC's Final Policy wherein the FDIC takes the position that repudiation would mean a payment equal to the lesser of par or the fair market value of the cover pool, plus bond interest accrued to the date on which the FDIC was appointed receiver. This Final Policy subjects investors to market-value loss on the cover pool and could additionally cause a period of lost interest payments for investors. While such movement in policy stance is encouraging, it does not go far enough as the FDIC would still retain an option that is exercisable against investors: *if the cover pool were unhealthy*, the FDIC would turn the cover pool over to an estate for the benefit of covered bondholders who would likely encounter a loss and a resulting unsecured deficiency claim against the issuer; *if the cover pool were healthy*, the FDIC would liquidate it, capture the excess collateral value for the insolvent estate, and pay par to investors, exposing them to what could be potentially material re-investment risk. Still, the movement in the FDIC's policy stance is encouraging in that it signals further movement could occur in favor of a globally competitive US covered bond framework.

[6] Statement of Michael H. Krimminger, Deputy to the Chairman, Federal Deposit Insurance Corporation on Covered Bonds: Potential Uses and Regulatory Issues, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 15, 2010.

The Global Nature of a Substantial Covered Bond Market

Like so many financial markets today, the covered bond market is a global market, though it remains concentrated in its European geography of origin. Covered bonds date back to 18th century Prussia, when the Pfandbriefe was introduced by the decree of King Frederick the Great to enable the property of nobles to be pledged as collateral to investors in exchange for agricultural credit. The German Mortgage Bank Act of 1900 modernized the original concept by creating a formal legal framework that assured the cover pool would be ring-fenced on an issuer's balance sheet and that investors in covered bonds had recourse to both the cover pool and the issuer in the event of a default[7]. The first issue of French legal covered bonds (Obligations Foncières) was created by decree in 1852 by Crédit Foncier de France under the *société de credit Foncier* statute. The main business of Crédit Foncier de France, founded in 1852, is to grant mortgage-backed real estate loans and local authority loans and to issue bonds to finance these loans.[8]

Today, some 29 countries are counted as having covered bond frameworks rooted in regulation, contract law, or legislation. 22 countries now have legislated covered bond market structures, with Australia, Canada, and New Zealand in the process of passing legislation for covered bonds[9]. Germany, Spain, Denmark, France, and the UK represent nearly 80% of the

[7] *The Conundrum of Covered Bonds*, Steven L. Schwarcz, forthcoming in The Business Lawyer, May 2011.
[8] *Natixis Credit Research*, Cristina Costa and Jennifer Levy, March 2011.
[9] European Covered Bond Fact Book, European Covered Bond Council, September 2009.

outstandings of covered bonds.[10] The Euro is the predominant currency in which covered bonds are issued, and there are between 140 and 150 issuers of Euro-benchmarked covered bonds. [11]

There is a clear preference for legislative (or statutory) covered bond frameworks. Of the estimated €2.5 trillion in outstanding covered bonds, an estimated 92% were issued under legislative frameworks. A central feature of statutory frameworks concerns the legal framework for insolvency of the covered bond issuer. Effective legislative frameworks include a specific legal framework superseding the general insolvency law. The typical legal framework under legislated market structures affords investors dual recourse: recourse to the cover pool as a secured creditor and recourse to the issuer as an unsecured creditor for amounts not repaid by the cover pool. Of additional importance, the insolvency of the issuer does not automatically trigger the acceleration of the covered bond indebtedness and an accompanying liquidation of the cover pool. This last feature mitigates reinvestment risk, or the risk that an issuer's insolvency would trigger a prepayment to covered bond investors that at a given moment could not be reinvested for comparable investment return to that of the prepaid covered bonds.

The economic benefits of a country's covered bond program can be significant. Market research shows that banks issuing covered bonds can save between 20 and 60 basis points per year on interest rates when compared to the rates paid on their senior unsecured issues of comparable maturity[12]. Such savings can be transmitted through society in the form of lower rates on the consumer and commercial credit that finances our economy, stimulates growth, and creates jobs.

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[10] Ibid
[11] *Natixis Credit Research*, Cristina Costa and Jennifer Levy, March 2011.
[12] Ibid

During periods of economic stress, the relative differential between secured and unsecured borrowing costs increases. Over the past year, such differential expanded to over 4% per annum for weaker banks operating in stressed economies.[13] The ability to issue relatively lower-cost financing, which becomes increasingly relative lower-cost financing during periods of worsening economic and financial stress, is a distinguishing benefit of covered bonds.

The Barren but Rapidly Changing Landscape for US Covered Bonds and the Investment Market's Need for Highly-Rated Fixed Income Private Sector Investment

Since the US Treasury, in coordination with the FDIC, issued guidelines in support of establishing a US covered bond market, there has been no issuance of a covered bond by a US issuer. Part of this absence may be explained by the limited investor appetite for exposure to U.S. residential mortgage loans not guaranteed by one of the GSEs (residential mortgage loans are, by far, the primary type of collateral in cover pools worldwide). Part of this absence may also be explained by the continuing role of the GSEs and FHA, which have been responsible for 95% of all new residential mortgage loans having been made in the US in these recent years. Part of the absence may also be explained by the repaired balance sheets of US banks, which have shown a limited need for securitization or secured financing in the face of a rising deposit base.

[13] Ibid

But the landscape is changing rapidly. Although there was only one US$ issuance of a covered bond in 2009—which took place outside the United States—2010 saw a huge increase in US$ issuance of covered bonds. 21 covered bond issues were denominated in US$ in 2010, from issuers based in France, Germany, the United Kingdom, Sweden, Norway and the Netherlands. 2010 US$ covered bond issuance aggregated $30 billion, beginning a trend that has been continuing into 2011[14]. Our neighbors to the North, in Canada, issued 9 of these 21 US$ deals in 2010, aggregating half the total 2010 US$ issuance volume. They issued at rates of interest that were materially lower than other US$ issuers, which is attributable to the extremely low risk of the collateral in their cover pools, which consists of Canadian residential mortgage loans that are guaranteed by Canada Mortgage and Housing Corp., the "AAA" rated full faith and credit Canadian Government agency. In short, our US$-based investors have been investing noticeably in US$ covered bonds for over a year now, but they have been buying them from non-US issuers.

When the approach taken by Treasury to implement a policy framework for contractual covered bond issuance by US issuers failed to gain traction, ASF membership was very supportive of your efforts Chairman Garrett for a legislative response. In March 2010, the United States Covered Bond Act of 2010 was introduced, which was the right idea at the right time, as the market has already validated the movement towards US dollar-denominated covered bonds even before US legislation has passed. We can now interpret this movement as an invitation to pass legislation, which could have a positive transformative effect on the US banking and financial

[14] *Natixis Credit Research*, Spreads and Credit, Covered Bond, November 2010, Christina Costa, Jennifer Levy, in collaboration with François Le Roy.

system. Asset securitization was the primary manufacturer of "AAA" rated private-sector investments, but the post-crisis issuance of "AAA" rated securities has dropped to a fraction of its pre-crisis volume. It is clear that non-US issuers are tapping into the US investor demand for high-quality investments like those offered under existing covered bond frameworks. The ASF voices its full support for such an enacting piece of legislation.

ASF Recommendations in Support of Effective US Covered Bond Legislation

In contemplating the United States Covered Bond Act of 2011 and in considering the type of legislation that would be most constructive to the emergence of a deep and liquid US covered bond market, the members of the ASF would like to articulate some principles that we believe should be present in the legislation.

In particular, effective legislation in favor of covered bonds should be as investor-friendly as possible. Many institutional investors in the US and abroad are living with the painful memory of recent government-sponsored intervention that has compromised the operation of contracts. Moreover, the attempt by some regulators to exercise expansive authority over the efficacy of certain debt capital markets products also threatens the confidence investors have in government-led market initiatives. A striking recent example of this expansive view is the securitization safe harbor rules which have been promulgated by the FDIC. The FDIC has publicly stated that such rules are intended to protect the investors in future asset-backed securities sponsored by IDIs, but in fact it will be the investors who lose the protection of an insolvency-remote true sale if the affected IDI failed to meet or comply with the requirements of the securitization safe harbor over which investors have no control.

ASF submits the following essential principles that we believe should be present in the legislation, among others:

1. **The legislation should allow for bank and non-bank entrants without discriminating on the basis of size or credit quality.** Investors should be afforded a menu of alternative covered bonds, which includes multiple issuers of varied standing. This would allow a more balanced flow of capital into the credit sector and avoid imbalances and over-investment in a small number of issuers and too few covered bond programs. It also would avoid the pitfall of having legislation pick the "winners" and "losers."

2. **The legislation should allow a wide variety of collateral types to be included in the cover pool.** Such optionality would allow for investor choice and market-based preferences to balance the flow of capital into an emergent US covered bond sector. Collateral types could include residential mortgage loans, loans outstanding under home equity lines of credit, multi-family housing loans, commercial mortgage loans, auto loans, auto leases, student loans, consumer credit card loans, public sector loans, other types of loans deemed appropriate by the supervising authority, and securities backed by any of the foregoing collateral types provided the security is not backed by more than one, homogenous collateral type.

3. **The legislation should not allow different types of collateral to be co-mingled in the same cover pool, but instead require asset type homogeneity within a cover pool.** This will facilitate elegant simplicity and create standardization and enhanced transparency from the investment perspective. As the U.S. emerges from a rather opaque, complex, and non-standard system of mortgage securitization, aspects of a new secured finance system would find greater uptake in biasing themselves to enhanced simplicity, standardization, and the resulting improvement in transparency.

4. **The legislation must allow investors full dual recourse: first, to the cover pool as a primary source of payment for principal and interest on the covered bonds, and second, as unsecured creditors to the issuer in the event the cover pool proceeds are insufficient to repay principal and interest in full on the covered bonds.** A covered bond investor's unsecured claim should rank *pari passu* with the other senior, unsecured claims on the issuer. Dual recourse is, in fact, 100% "skin-in-the-game". The bank is fully liable to repay the covered bonds and the cover pool assets remain on the balance sheet of the issuing bank, leaving no question around the alignment of interest between issuer and investor. For banks and non-banks with high senior unsecured credit ratings, a covered bond issuance should allow them to issue at appreciably lower rates of interest than where they would issue unsecured debt and be competitive to where they would issue securitization debt rated as high as their own rating. In Europe, we see a significant difference between the rates paid by top-tier banks on their unsecured debt versus their

covered bond issuances, with covered bond debt yields being appreciably lower than unsecured debt of comparable maturity.

5. **The legislation should stipulate a specific legal framework that supersedes general insolvency law for the absolute protection of covered bond investors, consistent with the principle articulated in number 4 above.** In our view, investor reception of a US covered bond market will be directly determined by the issuer insolvency framework that accompanies it. If investors fear that an issuer's regulator, the FDIC in the case of US IDIs, can interfere with or have a claim upon the assets in a cover pool, then US covered bonds will be relatively unattractive compared to those issued in other jurisdictions where the priority of claim of bondholders on cover pool assets is a cornerstone of covered bond legislation. Investors would treat them as quasi-secured but price them more like unsecured, which in turn would eliminate the motivation for issuers to issue. If investors fear that an issuer's regulator can force the early liquidation of a covered pool, and leave them under-secured or at risk of reinvesting par proceeds in lower-yielding investments, investors will most likely require a risk premium that would again increase the cost of issuance relative to an issuer's alternatives. Worse still, from a systemic perspective, such a covered bond paradigm would miss a great opportunity to introduce a great stabilizer in the world of bank asset-liability management. The ability to pledge assets under a robust and investor-friendly secured financing framework, like covered bonds, offers banks and non-banks alike a potentially valuable source of financing and simultaneously offers investors a safer investment during periods of credit and liquidity

stress in our financial system. This benefit should not be understated and can become of paramount importance and utility during periods of heightened counterparty credit concerns, like the extreme counterparty credit concerns we experienced in the Credit Crisis of 2008. Indeed, it was precisely this potential that motivated the former US Treasury Secretary Henry Paulson to advance a covered bond framework, but the initiative came too late into the crisis and relied on a weaker regulatory approach rather than a stronger legislative approach to have counteracted the overwhelming forces we confronted in an enormous crisis that was accelerating at the time.

6. **The assets in a cover pool should be segregated from the issuer's other assets, or clearly identified as such to avoid any likelihood that cover pool assets would become co-mingled with other assets of the issuer or with an issuer's insolvency estate.** Covered bond investors should bear no doubt over the proper identification and segregation of assets comprising the cover pool which secures them. One way to assure such treatment would be to require a periodic audit of an issuer's books and records to determine that the asset segregation standard has been satisfied, to report any deficiencies to a responsible party, and to assure an actionable remedy is imposed on a capable party to cure any non-compliance in a timely fashion.

7. **The issuer should maintain a continuing obligation to "cover" the bonds issued under their covered bond program with a sufficient level of collateral and overcollateralization consisting of performing (non-defaulted), self-liquidating financial assets.** This requirement is universally incorporated into covered bond programs around the world and provides assurance to investors that the cover pool would at all times generate sufficient, self-liquidating proceeds from performing financial assets to repay the full amount of principal and interest without their having to rely on the issuer's unsecured credit quality to do so.

8. **The maturity limit applicable to covered bonds (and cover pool assets) should extend to 30 years.** Such a limit is consistent with the FDIC's Final Policy, which was increased from 10 years after consideration of comments received on their Interim Policy Statement and the FDIC's own view that "longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility."[15] A 30-year term limit would allow issuers to tap into the long-end of the yield curve and better maturity-match to longer dated assets, such as 30-year, fixed-rate mortgages. With regard to such a feature, like a maturity limit on cover pool assets, the more flexibility the final legislation affords issuers, the more likely issuance will emerge.

[15] Federal Register / Vol. 73, No. 146 / Monday July 28, 2008, page 43756.

9. **Covered bonds should be allowed to include provisions for additional credit enhancements, liquidity support, interest rate and currency swaps or options.** These types of instruments may prove useful, and even necessary, by the market to create a more stable investment profile for investors and an even better asset-liability match for issuers than they might otherwise be able to achieve if the use of hedge instruments like the ones mentioned here were disallowed or unnecessarily restricted.

Other Considerations for the Legislative Process

In promoting the principles set forth above, it may also be worth noting that our members do not necessarily feel that the legislation needs to be overly prescriptive. Certain elements may be best left for the market to discover, or by Treasury as the principal covered bond regulator. One such element may be the level of overcollateralization. Considering that Dodd-Frank is mandating risk retention for asset securitization on the order of 5% generally, it should be a strikingly clear distinction that covered bonds, by definition, have a 100% risk retention associated with them. This being the case, overcollateralization would exist solely for the benefit of global, market-based investors of adequate sophistication to evaluate the appropriateness of overcollateralization requirements vis à vis the collateral comprising a cover pool. As our recommendation is to allow a wide range of collateral to be eligible for inclusion in covered bond programs, it would be natural to let the investor market set corresponding overcollateralization requirements, especially since we know from experience that different types of assets require different levels of overcollateralization to achieve comparable credit profiles for the liabilities issued against the assets. This would make sense from the regulator's perspective as well, as in theory, regulators would prefer lower overcollateralization requirements so more assets are immediately available to depositors and unsecured creditors than would otherwise be the case if overcollateralization levels were mandated at levels above what was needed in the market.

Other features of an emergent covered bond system may be best decided by legislation if it is likely regulation will only serve to restrain the formation of a deep and liquid market. For example, the FDIC Final Policy restricts covered bond issuance to 4% of an IDI's liabilities. While their reasoning is understandable,[16] a 4% limit would impose a theoretical initial maximum market size for covered bond issuance of $474 billion, assuming the highly improbable outcome that every bank issued to their maximum limit.[17] When banks are already subject to leverage ratios, we question the necessity of requiring an initial market size cap that could merely serve to dissuade issuance by signaling to IDI's that covered bonds will not be allowed to become a sufficiently meaningful asset-liability tool needed to justify the upfront commitment of time, effort, money, and resources to commence an issuance program.

Still, other features are worthy of inclusion in any final legislation, and some may even be necessary for a US covered bond market. For example, it is typical of many European covered bond frameworks to provide for special supervision of an issuer's obligations in respect of the cover pool, which is supervision specifically for the benefit of covered bondholders, as compared

[16] "The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds." Federal Register / Vol. 73, No. 145 / Monday July 28, 2008, page 43756.

[17] Fitch Ratings, U.S. Housing Reform Proposal FAQs: Filling the Void, February 24, 2011

to more general credit institution or markets supervision. Frequently, this kind of supervision is conducted by designated public authorities, which frequently require a covered bond issuer to obtain a license to issue covered bonds. In a number of countries, the public authority is also the banking supervisory authority. In others, the covered bond supervisory authority is the markets regulator. Such public authorities either appoint or approve a cover pool monitor to assure covenant compliance with the terms and conditions of the covered pool legal contracts, and some of these authorities may conduct their own periodic audits of the cover pool programs they supervise. Article 22 (4) of the Directive in Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive"), which is included in other EC directives, affords favorable treatment, such as risk weightings, to covered bonds subject to special public supervision. Calibrating the legislation to afford special treatment for covered bond investments could enlarge the potential for this new market and may also be necessary if US covered bonds are to find as broad and deep an investor base as the covered bonds issued from frameworks in other countries.

Conclusion

Given the extensive history, longevity, and size of the European covered bond market and the remaining need to encourage private sector credit flows in the United States, the ASF is strongly supportive of a legislative framework for US covered bonds. Our support comes despite the potential for covered bond issuance to draw market share from securitization issuance. This is because we believe securitization will re-emerge as a healthy and viable financing, capital-management, and risk-management technology whether or not a covered bond market is established in the United States. Moreover, covered bonds and securitization can co-exist in a complementary fashion with one another, as they have for some time in Europe. We also believe it is our obligation as professionals to advocate for disciplined, market-based developments that will promote the availability and affordability of consumer credit to all Americans, just as securitization has been doing for many years. We believe that industry, legislators, regulators, and other policymakers can work in an open, democratic fashion to innovate financial solutions for this greater good. We applaud Chairman Garrett, his co-sponsor Congresswoman Maloney, and this Subcommittee for its forward-thinking initiative and persistence to see the dawn of a new financial technology that will establish a more balanced continuum of asset-liability management alternatives for our credit institutions. By offering credit institutions the ability to issue longer-term, secured liabilities, covered bonds will fill a void that exists among existing alternatives, like short-term unsecured debt (eg, demand deposits), short-term secured debt (eg, repos), longer-term unsecured debt (eg, term CDs and MTNs), and securitization. The filling of such a void can lower the cost of financing a credit institution, which in turn can lower the cost of consumer credit while simultaneously expanding its availability. At a time when we need to transfer public sector support for private sector financing back to the private sector to reduce our fiscal deficits and remove our potentially inflationary monetary policies; at a time when we need to find avenues to create and expand credit to drive consumer spending and real GDP growth; at a time when we need to create jobs, this covered bond legislation could not come at a better time for the financial industry or our economy.

Again, I thank you very much for the opportunity to testify here today and look forward to answering any questions that you may have.

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:	2. Organization or organizations you are representing:
Ralph Daloisio	The American Securitization Forum

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?	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	☐ 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: RC Daloisio

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