Testimony by Bert Ely
to the
Subcommittee on Capital Markets and Government Sponsored Enterprises
of the
House Committee on Financial Services
at a hearing titled
Legislative Proposals to Create a Covered Bond Market in the United States
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Mr. Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, I very much appreciate the opportunity to testify today about covered bonds and legislation to create the legal framework for a vibrant covered-bond market in the United States, specifically H.R. 940. I will first provide a brief description of covered bonds but focus most of my testimony on why Congress needs to enact a covered-bond statute and the many benefits covered bonds will bring to the United States, and specifically to housing finance. I will close by offering some specific comments on H.R. 940.

By way of background, I am a long-time champion of covered-bond financing, on a *pro bono* basis. I have not received any compensation with regard to my work on covered bonds nor for my testimony today. On December 15, 2009, I testified to the Financial Services Committee about covered bonds.

A brief description of covered bonds

The covered bond concept is quite simple. Essentially, covered bonds are debt instruments issued by a bank or any other type of financial firm which are secured by assets owned outright by the issuer. The bonds also are a direct liability of the issuer, which provides a second source of repayment should the assets securing the covered bonds be insufficient to provide for repayment. In this regard, covered bonds differ sharply from asset securitization wherein assets are sold to a bankruptcy-remote trust which then issues debt securities of various types and tranches to pay for the purchase of those assets.

The unique feature of covered bonds is the "cover pool," which consists of specifically identified assets directly owned by the covered-bond issuer. These assets collectively secure a set of covered bonds. That is, there are multiple assets securing multiple bonds. This multiplicity differentiates covered bonds from mortgage bonds, where a single asset, such as a large office building, is the sole security for one or more mortgage bonds.

To provide a high level of security for the covered bonds, so that they can earn a very high credit rating, the size of the cover pool must always exceed by some factor the amount of bonds secured by the cover pool. That is, the bonds are overcollateralized. For example, the total assets in the cover pool must at all times at least equal 104% or some other percentage greater than 100% of the face amount or par value of the bonds the cover-pool assets secure.

Further, every asset in the pool must always be performing in accordance with covered-bond regulations and the terms of the bond indenture governing a particular issue of covered bonds. For example, a home mortgage in a cover pool cannot be more than 60 days past-due in its scheduled payments, the loan-to-value (LTV) ratio must be below 80%, and the borrower's FICO credit score must be above 700.

If an asset in the cover pool ceases to perform in the manner prescribed by regulation or in a more restrictive bond indenture, the bond issuer must immediately replace that asset with another eligible asset performing in the prescribed manner. This "evergreening" feature ensures that the covered bonds will always be extremely well secured by high-quality assets, which is absolutely essential to obtaining and maintaining a very high credit rating, usually AAA, for the bonds.

Figure 1 attached to this testimony illustrates a simplified balance sheet of a covered-bond issuer. In particular, it emphasizes the on-balance-sheet nature of both covered bonds and the assets in the cover pool securing those bonds. Assets of the covered-bond issuer would move in and out of the cover pool merely through a change in the issuer's financial records as to whether a specific asset was designated as a cover-pool asset.

There would be no external legal recordation as to whether a particular asset was designated as a cover-pool asset. However, an independent "cover pool monitor" or "asset monitor" would continuously monitor the composition of the cover pool to ensure that the covered-bond issuer was continuously in compliance with all applicable regulations as well as all terms of the bond indenture. Given today's technology, that should be a relatively low-cost and highly reliable auditing process.

Numerous types of credit instruments can be financed with covered bonds. Home mortgages represent the largest class of credit instruments which are candidates for covered-bond financing. Other types of credit instruments which are candidates for covered-bond financing include (1) home equity loans; (2) commercial mortgages, including multifamily residential mortgages; (3) debt issued by municipalities and public authorities; (4) automobiles, trucks, construction equipment, and other moveable forms of equipment; (5) ships and airplanes; (6) student loans; (7) credit-card and charge-card receivables; (8) small business loans; (9) leased equipment; and (10) any other type of credit instrument for which covered-bond financing makes economic sense.

It would not be unreasonable to initially authorize just a few classes of assets as eligible for covered-bond financing – home mortgages, commercial and multi-family mortgages, and debt issued by municipalities and public authorities. Once covered-bond financing was well-established for those asset classes, then covered-bond financing could be authorized for other classes of assets.

The following table, based on Federal Reserve Flow of Funds data[1], provides some sense of the magnitude of credit instruments which could be funded with covered bonds. While covered bonds will not come close to providing 100% of this funding, even a 10% share would be enormous – over $2 trillion, which begins to approach the size of the well-established European covered-bond market.

[1] Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2010; Federal Reserve statistical release Z.1 (http://www.federalreserve.gov/releases/z1/Current/z1.pdf); Board of Governors of the Federal Reserve System; December 9, 2010, Tables L. 100, L.101, L.217, and L.218.

Types of credit instruments which potentially could be funded with covered bonds

(dollars in billions)

Home mortgages	$ 9,637
Home equity loans	975
Multifamily residential mortgages	847
Commercial non-residential mortgages	2,356
Farm mortgages	133
Total mortgage debt	13,947
Consumer credit of all types	2,409
Non-mortgage borrowings by non-financial businesses	2,779
Local government debt[2]	1,447
Total debt potentially financeable by covered bonds	$20,582

Important attributes of covered bonds

Covered bonds offer important attributes which are often overlooked or misunderstood, including the following.

Covered bonds will not be explicitly or implicitly backed by the federal government

Contrary to the assertions of some, covered bonds will not be explicitly or implicitly backed by the federal government. Clearly, H.R. 940 does not provide an explicit federal guarantee of covered bonds issued under the provisions of this bill.

Further, no provision in H.R. 940 can reasonably be argued as even suggesting an implicit federal guarantee of covered bonds. There is a widespread, and legitimate, belief among investors that when a GSE bond default threatens, an implicit federal guarantee of that debt, by virtue of the issuer's GSE status, will become explicit, as has been the practical effect of the Fannie Mae and Freddie Mac conservatorships. Covered-bond issuers will not have GSE-like federal charters. Further, federal regulation of covered-bond issuance is no more a government guarantee of covered bonds than is the regulation of securities issuance by the SEC. The thrust of covered-bond regulation is merely to ensure that covered-bonds will be at all times purely private-sector credit instruments of the highest possible credit quality.

The authority the bill grants to the FDIC (Sec.(d)(6)) to assess against all covered-bond issuers any incremental losses the FDIC suffers in protecting insured depositors in a failed covered-bond issuer further undercuts the argument that covered bonds will have any taxpayer backing, which is the effect of any government guarantee. Likewise, any authority the Federal Reserve would be granted to lend against or to purchase covered bonds, as I recommend, can and should be structured statutorily so that such Fed lending or purchasing would not cause any loss to taxpayers; i.e., a reduction in the amount of income the Federal Reserve periodically returns to the Treasury.

[2] Estimated by multiplying total state and local government debt at September 30, 2010, per the Federal Reserve Flow of Funds table L.105 ($2.388 trillion), times local government debt as a percentage of state and local government debt for 2007-08 (60.6%), as reported in the 2008 Census of Government Finance published by the U.S. Census Bureau.

Covered bonds will enhance the ability of lenders to offer 30-year, fixed-rate mortgages

Covered bonds will enable banks to make and hold in portfolio 30-year fixed-rate mortgages because covered bonds can be issued at medium and long-term maturities at a fixed-rate of interest. Therefore, banks will be able to profitably hold 30-year fixed-rate mortgages in portfolio because the interest-rate spread on such loans (the mortgage interest rate minus the covered-bond interest rate) will be established at the time the mortgage is made.

Further, the average life or duration of a 30-year fixed-rate mortgage is much less than 30 years due to periodic principal repayments and mortgage prepayments arising from house sales and mortgage refinances. For example, at a 5% interest rate, the remaining principal balance on a 30-year fixed-rate mortgage will decline by eight percent during the first five years of its life, decline another eleven percent during its second five years, and decline yet another thirteen percent during its third five years. At the end of fifteen years, the principal balance will have been paid down by almost a third; by that time the remaining balance on most 30-year mortgages will have been paid off due to the sale of the home or a mortgage refinance. Hence, 30-year fixed-rate mortgages can safely be financed (i.e., with relatively little maturity mismatching) with covered bonds with maturities of less than 30 years. Maturity mismatches due to the unpredictability of mortgage prepayments can be hedged through interest-rate swaps and other hedging instruments.

Covered-bond financing of home mortgages offers another rarely recognized benefit – the notion of the "conforming" mortgage becomes completely irrelevant. That is the case because there is absolutely no rationale for limiting the size of individual fixed-rate mortgages kept on a lender's balance sheet and funded by covered bonds. This aspect, or really a benefit of covered bonds, makes covered-bond funding of the balance sheets of mortgage lenders especially attractive for areas with high home prices, and therefore large mortgages, such as New Jersey, New York, Massachusetts, and California as well as many large metropolitan areas. In this regard, covered bonds will address one of the major concerns which has been raised about phasing out Fannie and Freddie – funding high-cost mortgages larger than the conforming loan limit.

Covered bonds are not GSE reform, but another horse in the housing-finance horse race

While covered bonds will become an important element of American housing finance, once a strong covered-bond statute is enacted, covered bonds do not represent GSE reform, for the issuance of covered bonds will have no direct bearing on the eventual resolution of Fannie and Freddie. Instead, covered bonds should be viewed as another horse in the housing-finance horse race and a way to bring sound, low-cost financing to American residential finance as well as to other classes of financial assets suitable for covered-bond financing.

Covered bonds will be an ideal way to fund multi-family rental housing

Covered bonds will provide an excellent source of funding for lender financing of multi-family rental housing for the same reason covered bonds will provide highly efficient funding for owner-occupied homes – covered bonds provide long-term, fixed-rate funding. Sec. 2(8)(C) of H.R. 940 specifies that commercial mortgages shall be an "eligible asset class" for inclusion in a covered-bond cover pool. Sec.2(7)(C) further provides that the commercial mortgage asset class includes "any multifamily mortgage loan." Because borrowers under commercial mortgages usually must

pay a prepayment penalty should they refinance the mortgage, prepayments of commercial mortgages are more predictable, which reduces possible maturity mismatches between commercial mortgages of all types and the covered bonds funding those mortgages.

Community banks will be able to issue covered bonds through the bill's pooling provision

Sec. 2(9) of H.R. 940, which defines the term "eligible issuer," provides in paragraph (D) that an eligible issuer can be a covered-bond issuer "that is sponsored by 1 or more eligible issuers [such as community banks] for the sole purpose of issuing covered bonds on a pooled basis." [emphasis supplied] This provision will enable community banks, and even larger banks, each too small to efficiently sell their covered bonds directly to investors, to join together to sell the covered bonds they have issued into a covered-bond pool that in turn will sell covered bonds to investors. In effect, the covered bonds issued by the pool will be secured by the covered bonds sold into the pool by its participants. The covered bonds sold by a participating bank into the pool would be secured by the assets in that bank's cover pool. Conceivably the creditworthiness of the covered bonds issued by a covered-bond pool could be further enhanced with a third-party credit guarantee.

Covered bonds are a "rates" product – a very desirable characteristic

Because of their very high creditworthiness – usually AAA – covered bonds are known as a "rates" product. That is, when making investment decisions, investors buying "rates" products are much more concerned about the investment's yield than about the investment's creditworthiness – high credit quality is a must. Because of their structure and statutory protections, covered bonds appeal to those investors who invest only in very high credit-quality securities. Consequently, the interest-rate spread between covered bonds is very close, or "tight," to the yield on government debt. It is reasonable to expect that once a sufficiently large covered-bond market has developed in the United States, which should occur once H.R. 940 is enacted, covered bonds should consistently offer yields roughly comparable to yields on GSE debt. Hence, covered bonds will enable lenders to offer long-term, fixed-rate mortgages at rates comparable to the rates available today on home mortgages eligible for purchase by Fannie and Freddie.

Covered bonds can be issued by non-bank financial firms

Sec. 2(9) of H.R. 940, which defines who can be an "eligible issuer" of covered bonds, provides in paragraph (C) that "any nonbank financial company," as defined in the Dodd-Frank Act, can be a covered-bond issuer. A nonbank financial company in turn is a company with annual gross revenues and consolidated assets equal, respectively, to at least 85% of the company's total gross revenues and assets. Essentially, financial intermediaries who are not banks or bank holding companies can be covered-bond issuers. Nonbank financial companies include insurance companies, the finance subsidiaries of industrial companies, as well as free-standing financial firms, provided they meet the two 85% tests. Authorizing non-bank firms to issue covered bonds will broaden the range of covered-bond issuers, which in turn will provide greater depth and liquidity to the covered-bond secondary market, bringing the efficiencies of covered-bond financing to a broader range of borrowers.

Benefits covered bonds will deliver to the U.S. economy

Widespread use of covered-bond financing will deliver numerous benefits to the U.S. economy, specifically in the safety and efficiency of financing home mortgages and other types of credit that financial intermediaries provide to individuals, families, businesses, and governments. The following is a discussion of the principal benefits.

Better credit-risk management due to lenders retaining 100% of the credit risk

Better lending will be one of the principal benefits of covered bonds because covered bonds will be backed by loans that lenders make and then keep on their balance sheet rather than selling those loans into the securitization marketplace. Lenders keeping the loans they make will eliminate the moral hazard inherent in the securitization process in which lenders shift the credit risk of the loans being securitized to investors in the liabilities issued by securitization trusts. However, when a lender keeps the mortgages and other loans its makes by funding them with covered bonds, it retains 100% of the credit risk, and 100% of its lending mistakes. That is far preferable to the 5% risk retention mandated for home mortgages by the Dodd-Frank Act.

One supposed benefit of securitization is diversification of credit risk that can arise if a lender is highly concentrated in its geographic credit exposures or borrower types. This can especially be the case with smaller lenders. The problem of insufficient credit-risk diversification by a covered-bond issuer can be dealt with in one or a combination of ways.

First, the lender can enter into credit-default swaps (CDS) to shift an excess of credit-risk concentration to other parties. While CDS have been abused in recent years, notably by AIG, CDS can be a very useful technique for diversifying credit risk away from a lender. CDS would be much less likely to be abused in a covered-bond context than occurred in a securitization context because the party buying the CDS protection actually made the loan and still owns it. This type of CDS transaction also will be much more transparent to investors and to the credit-rating agencies.

Second, investors can demand higher overcollateralization for their covered bonds if they view the lender as having an excess concentration of credit risk. The higher overcollateralization would force the lender to operate with a higher equity-capital ratio so that it would have sufficient equity capital backing its assets not funded by covered bonds.

Third, statutorily authorizing numerous covered-bond asset classes would permit greater asset diversification by lenders. That is, instead of a lender being highly concentrated in just one or two classes of assets funded by covered bonds, the lender could have multiple classes of such assets. That diversity would reduce the need for the lender to purchase CDS protection or to overcollateralize its covered bonds as much as it might have to were it a more narrowly focused lender. This greater diversification will in turn lead to sounder banks and a stronger banking system.

Enhanced bank safety-and-soundness

Covered bonds will enhance bank safety-and-soundness by providing the means for banks to safely fund high-quality assets, such as conservatively underwritten home mortgages. For example, instead of selling the fixed-rated mortgages it originates, thereby weakening its relationship with

those borrowers, a bank will be able to keep those mortgages, which will deepen its relationship with its borrower-customers. That stronger relationship will enhance the bank's franchise value.

Additionally, the bank will be able to grow its balance sheet, and its revenues, with high-quality mortgages that will strengthen its overall financial condition and profitability. One of the many unfortunate consequences of securitization has been that banks have sold their higher-quality assets while retaining or increasing their focus on riskier lending, such as for land development and construction loans. Covered bonds will permit banks to bring safer, less risky assets back onto their balance sheets, which will greatly enhance the safety and soundness of the U.S. banking system..

Stronger borrower protection

As the experience of recent years has taught, asset securitization has led to widespread lending abuses, with borrowers paying the price. The housing bubble which triggered the recent financial crisis and the subsequent foreclosure paperwork crisis, are costly byproducts of those lending abuses.

If a lender can sell a loan soon after it is originated, the lender is much less likely to be concerned about the loan's quality or its impact on the borrower – the lender does not have to eat its cooking. By retaining ownership of a loan, and being fully responsible for any credit losses (to the extent not shifted elsewhere through CDS), lenders will not only be much more careful about the loans they make, but they can be more easily held accountable for their lending abuses because they will still be around, as the owner of the abusive loans. One characteristic of the current crisis is that many lenders who made abusive loans later went out of business because they lacked the capital to repurchase the loans they had sold into the securitization sausage mill.

If needed, loan modifications are much less complicated

If a lender retains 100% of the credit risk of the loans it makes – the case with loans funded with covered bonds – the lender can more easily modify a loan should the borrower experience financial difficulty. As recent experience has taught repeatedly, loan modification becomes extremely complicated when the lender no longer owns the loan yet the lender or a loan servicer must contend with the legal complexities of modifying a loan owned by a securitization trust which has scores or hundreds of investors, usually in different tranches, and often where some of the interests in that trust having been resecuritized one or several times. In the case of covered-bond financing, by the time a loan reaches the point where it needs to be modified, it has long ceased to be eligible for inclusion in the bonds' cover pool, so the fate of that loan is not of any concern to the owners of covered bonds issued by that lender. The modification impacts only the lender's bottom line.

Foreclosure also would be much simpler because there would be no ambiguity as to who owns the mortgage and who will bear any loss associated with the foreclosure – it will be the lender who bears 100% of the loss. With securitized mortgages, legal questions have arisen as to who owns a mortgage and therefore is entitled to foreclose. That would not be an issue where the lender never sells the mortgage. If the lender purchased CDS protection, the lender might then have to seek some loss recovery from its CDS counterparty, but that would be an event independent of the foreclosure.

Highly efficient funding because of high credit ratings, low transaction costs

Covered-bond financing will be highly efficient for two key reasons. First, properly structured covered bonds usually are rated AAA and therefore carry correspondingly low yields relative to lower-rated debt of a comparable maturity. Growth in covered bonds outstanding will increase liquidity in the secondary market for covered bonds, further lowering covered-bond yields.

Second, covered-bond structures are simple and straight-forward relative to asset securitization. Consequently, covered bond issuance is much cheaper that constructing and selling a complicated, multi-tranche asset securitization. Also, paying interest and principal to covered bond investors is much more straight-forward than the management of cash flows during the life of an asset securitization.

Efficient funding will translate into lower borrowing costs. That is, the spread between the interest rate paid by borrowers and the interest rate paid to covered-bond investors will be low or "tight" because the transaction and overhead costs of intermediating funds between the source of funds (covered bonds) and the user of those funds (the borrower) will be lower. Key to that efficient funding, though, is providing legal certainty to covered-bond investors, for that legal certainty will be crucial to covered bonds earning, and keeping, AAA credit ratings.

Reduced maturity mismatching by lenders and an attendant reduction in interest-rate risk

Covered bonds generally have "bullet" maturities; i.e., they mature on a pre-established date, with the longest-dated covered bonds having maturities of 15 years, 20 years, or more. Consequently, the maturities of covered bonds can be set to match the scheduled principal amortization and projected prepayments of the mortgages or other types of loans financed by the covered bonds. To the extent needed, the maturity gap between bond maturities and the projected life of the loans can be hedged through the use of derivatives and call options embedded in the bonds.

The wide range of maturities for covered bonds will permit banks and other leveraged lenders to better match the maturities of their assets and liabilities, thereby minimizing maturity mismatching and its associated interest-rate risk, a risk which led to the liquidity crises that have plagued the U.S. financial system in recent years and the S&L crisis of the early 1980s. Covered bonds will be especially well-suited in helping banks to meet the new Basel III liquidity requirements.

A substantial new supply of high-quality debt for investors to purchase

AAA-rated covered bonds will provide investors with a new class of high-quality debt of medium and long-term duration to purchase. Investors will be seeking new classes of high-quality debt as debt issuance by the government-sponsored enterprises[3] (GSEs) contracts, guaranteed liabilities under the FDIC's Temporary Liquidity Guarantee Program mature, and as asset securitization contends with tougher asset-securitization standards. To put this point another way, as

[3] There are five GES: Fannie Mae, Freddie Mac, the Federal Home Loan Banks, the Farm Credit System, and Farmer Mac.

covered-bonds grow as a highly rated class of debt, funds will flow to covered bonds as the supply of other types of heretofore highly rated debt shrinks.

This shift towards covered-bond financing will lead to the growth of assets held on bank balance sheets and a corresponding reduction in the size of "shadow banking," which consists principally of asset securitization. As **Figure 2** shows, shadow banking has grown in recent decades largely at the expense of banks and other depository institutions. That is, the securitization process shifted loans from bank balance sheets to the balance sheets of securitization trusts. Covered-bond financing will reverse that trend, which should improve the overall stability of the U.S. financial system.

The international investor appeal of U.S. covered bonds

Because there is a well-developed covered-bond market in Europe, European investors will be prepared to invest in dollar-denominated covered bonds issued by U.S. banks and other institutions – it is an investment class they understand. However, these investors will seek the same assurances and legal protections – safety of principal and timeliness of interest payments in accord with contractual terms – which they have come to expect from the covered bonds in which they now invest. Presumably investors elsewhere, and especially Asian investors, will come to view U.S.-issued covered bonds as a safe alternative to U.S. Treasuries and GSE debt.

It is especially important that U.S.-issued covered bonds gain international investor acceptance and appeal as international investors supply a steadily increasing amount of the credit demand in the U.S. economy. As **Figure 2** illustrates, the Rest of the World, i.e., non-U.S. investors, now supply almost one-sixth of the total credit outstanding to U.S. borrowers – public and private. According to Federal Reserve Flow of Funds data, foreign investors provided $8.32 trillion, or 15.9% of the credit outstanding in the U.S. economy on September 30, 2010.[4] Given the trade deficits the United States continues to run, that dollar amount and percentage will continue rising for the foreseeable future. Therefore, U.S. borrowers need to increase the supply of highly-rate debt paper they sell to the rest of the world. Covered bonds represent an excellent, efficient way to do so.

Specific comments with regard to H.R. 940

H.R. 940 is a very good bill. However, I offer the following recommendations to make it an even better bill, thereby creating the statutory framework for a vibrant, efficient U.S. covered-bond market. I have keyed these recommendations to the section and paragraph numbering of H..R. 940, as introduced on March 8, 2011.

Sec. 2(6) – Covered bond regulator

I recommend that there be just one regulator for covered bonds and that that regulator be located in the Treasury Department as a subordinate of the Secretary of the Treasury, for the following reasons. Presently, the bill gives the Secretary of the Treasury the authority to establish

[4] Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2010; Federal Reserve statistical release Z.1 (http://www.federalreserve.gov/releases/z1/Current/z1.pdf); Board of Governors of the Federal Reserve System; December 9, 2010, Table L.1, line 32.

rules implementing the covered-bond statute, after consulting with the appropriate financial institution regulators, but then delegates the administration of the covered-bond rules to those regulators. Multiple administrators of a common rule will lead to differing interpretations of the rules and potentially to regulatory arbitrage. A single regulator will ensure a much more consistent application of the rules governing covered-bond issuance and administration. However, it would be quite appropriate for the Treasury Secretary to consult with the appropriate safety-and-soundness regulators when formulating the covered-bond rules.

Multiple regulators could be especially detrimental to the pooling of covered bonds by community banks. Because community banks can have one of three regulators – the Fed, the OCC, or the FDIC – it would be difficult for community banks with different primary regulators to join together in one pooling arrangement to issue covered bonds in the name of the pool. That difficulty would lead to an unnecessary fragmentation of the covered-bond market and would be especially harmful to community banks in competing against larger banks which will not have to pool their covered-bond issuances.

Finally, once the covered-bond statute and its rules have been implemented, the regulator is not likely to need a large staff since much of the work of monitoring covered-bonds will be conducted by trustees operating under the terms of covered-bond indentures. Concentrating all regulation of covered bonds in one agency will result in a high-quality staff focused on just one mission – ensuring the smooth and safe operation of the U.S. covered-bond market.

The bank safety-and-soundness regulators would not be left out in the cold. Besides providing input into covered-bond rulemaking, they still could, as safety-and-soundness regulators, supervise the covered-bond issuance of the institutions they regulate, just as they can act to curb any type of risky practice they detect. For example, those regulators could act to enjoin any material maturity mismatching by covered-bond issuers, in accord with the forthcoming Basel III liquidity requirements.

Sec. 2(7) – Eligible asset

This section of H.R. 940 authorizes numerous types of assets eligible to be financed by covered bonds. Sec. 2(8) then defines the term "eligible asset class," with one class for each type of eligible asset. The argument has been made that some of the types of assets that H.R. 940 makes eligible for covered-bond financing are inappropriate for covered-bond financing, at least initially. Those asset types thought to be inappropriate for covered bond financing include home-equity loans, auto loans, student loans, credit or charge-card receivables, and SBA loans.

A U.S. covered-bond market could launch quite successfully if at least initially eligible assets included only first mortgages on homes, commercial mortgages (including multifamily mortgages), and public-sector loans. It is important to keep in mind that Sec. 2(7)(I) empowers the Secretary of the Treasury to designate other types of assets as eligible for covered-bond financing, which opens the door, once a U.S. covered-bond market has been established, to expand covered-bond financing to home-equity loans, auto loans, student loans, credit or charge-card receivables, and SBA loans.

Sec. 3(b)(3) – Monthly reporting

In today's Internet world, it makes no sense to require each covered bond issuer to send a monthly report to each owner of the issuer's covered-bonds as to whether the bonds, over the previous month, at all times met the applicable overcollateralization requirements, for two reasons. First, the issuer should merely have to post the required information on a password-protected website that any investor can access at any time. Second, and much more important, the applicable indenture trustee will have a fiduciary obligation to the owners of covered bonds issued under the indenture to monitor the issuer's compliance with all the terms of the indenture agreement, including ensuring that the minimum overcollateralization requirement was met at all times. Therefore, subparagraph (D) in that paragraph can be dropped.

Sec. 3(b)(4)(A) – Independent asset monitor - appointment

This subparagraph provides that an issuer of covered bonds shall appoint the indenture trustee for the covered bonds "or another unaffiliated entity" as an independent asset monitor for the applicable cover pool. In my opinion, the indenture trustee should make that appointment since the asset monitor essentially serves as an agent for the trustee in ensuring that the interests of the bond investors are being protected vis-à-vis the covered-bond issuer. Accordingly, the indenture trustee should have the right to replace the asset monitor, or perform that task itself, if it sees fit, without having to obtain the consent of the bond issuer.

Sec. 4(d)(1)(A) – Trustee, servicer, and administrator – in general

This subparagraph provide that the covered-bond regulator shall appoint itself or another party as the trustee of any separate covered-bond estate created should a covered-bond issuer be placed in a conservatorship, receivership, liquidation, or bankruptcy proceeding. The grant of this appointment power to the covered-bond regulator is neither necessary nor desirable, for the following reasons.

It is not necessary because there is absolutely no reason why the indenture trustee should not continue, once an estate has been created, as the agent for the bond investors in looking out for their interests. Likewise, the trustee should be the party to appoint a servicer or administrator for the cover pool held by the estate and the party to give notice to the covered-bond regulator that an estate has been created.

The covered-bond investors will be better served by keeping the indenture trustee in place since the trustee is obligated to act in a fiduciary capacity and therefore will have a liability to the bond investors for failing to act properly that the regulator will not have by virtue of the statute's grant of sovereign immunity in Sec. 4(d)(1)(L). At the same time the trustee will be obligated to not act in a manner which unnecessary harms the beneficiaries of the estate's residual interest(s). Should any creditor of the estate feel the trustee is not performing its duties satisfactorily, that creditor can ask the appropriate court to direct the trustee to act appropriately or the court can replace the trustee.

It is not desirable for the covered-bond regulator to assume any special role with regard to a covered-bond estate as such involvement reinforces the mistaken belief that covered bonds somehow have government support or taxpayer backing. Deleting the authority for the covered-bond regulator to "act as or appoint the trustee for the estate" would go a long way towards undermining that mistaken belief.

Sec. 4(d)(1)(F) – Supervision of trustee, servicer, and administrator

For the reasons just cited, the covered-bond regulator should not be obligated to "supervise the trustee and any servicer or administrator for the estate," as this subparagraph provides.

Sec. 4(d)(2)(D) – Study on borrowings and credit

Key to a successful, efficient covered-bond market, and to obtaining high credit ratings for covered bonds, is maintaining the timely flow of principal and interest payments to covered-bond investors, even during stressful economic times. That is, it is not enough that covered-bond investors eventually receive all the principal and interest due them, but that they receive those monies on the day they are due, with no ands, ifs, or buts.

Almost all the time, the cash flows generated by the associated cover-pool assets should be sufficient to pay interest and principal on the covered bonds on time. Further, the issuer can tap other resources to maintain timely payment should the cash flows from the cover-pool assets be insufficient. However, upon the creation of a covered-bond estate, the issuer's resources cannot be tapped to meet principal and interest payment obligations should the cash flow generated by the cover-pool assets be insufficient. The draft legislation wisely authorizes the estate, in Sec. 4(d)(2), to borrow funds "from any person . . solely for the purpose of providing liquidity in the case of timing mismatches among the assets and liabilities of the estate." When financial markets are stable, the estate should be able to borrow sufficient funds from private-sector sources at reasonable rates of interest. However, the need to borrow is unlikely to arise when financial markets are stable and the economy is performing reasonably well. The crunch comes during times of financial instability.

As the recent financial crisis demonstrated, during times of economic stress and distress, asset values decline, cash flows shrivel, and markets freeze. These are the times when central banks must act as lenders of last resort, but without imposing losses on taxpayers. Therefore, the Federal Reserve should be empowered to lend to covered-bond estates, on a conservative senior secured basis, during times of economic stress and distress. Because covered bonds cannot be put back for early prepayment, covered-bond estates will not face massive redemption requests nor will regulators have permitted material maturity mismatching by covered-bond investors, at least between the covered bonds and cover-pool assets. Consequently, liquidity shortfalls in meeting a covered-bond estate's cash-flow obligations should be minor relative to the amount of assets in the applicable cover pool. Therefore, the estate will have ample assets to pledge to the Federal Reserve to collateralize any borrowings, should the need to borrow ever rise.

Although it is highly unlikely that the Fed would ever suffer a loss in lending to a covered-bond estate, the taxpayer can be further protected by authorizing the covered-bond regulator to levy an assessment on all covered-bond issuers, in proportion to the amount of covered-bonds they have outstanding, sufficient to cover the Federal Reserve's loss. Such a lending and assessment authority

should replace the study called for by this subparagraph. This assessment authority parallels an assessment authority granted to the FDIC, as will be discussed in the next paragraph. The European experience with covered bonds during the recent financial crisis suggests that it is highly unlikely that the Fed would ever suffer any loss. Instead, it would likely make a substantial profit for taxpayers by providing market support to the covered-bond marketplace during times of great stress and distress.

Sec. 4(d)(6) – No loss to taxpayers

As presently drafted, this paragraph would empower the FDIC to recover any losses it might suffer from the failure of a bank which had issued covered bonds. While legitimate in principal, this provision needs substantial modification in two regards. First, the statutory language needs to be more precise as to how the additional loss is calculated that the FDIC suffered by virtue of the failed bank having been a covered-bond issuer. That is, how much higher was the insolvency loss to the bank's unsecured creditors, including the FDIC, due to the presence of covered bonds and the related cover-pool assets on the failed bank's balance sheet?

Second, any such *ex post* assessment must first be offset by the *ex ante* assessments the FDIC will begin collecting on April 1 on bank assets funded by secured borrowings of any type, including covered bonds. That is, in just twenty days, the FDIC will begin collecting deposit-insurance premiums on what effectively are non-deposit bank liabilities. The forthcoming shift in the FDIC's assessment base, from total domestic deposits, to total assets minus tangible common equity capital, will generate substantial revenues for the FDIC that most likely will far exceed any losses caused by the presence of secured liabilities on bank balance sheets.

Mr. Chairman, I thank you for this opportunity to testify to the Subcommittee today. I welcome the opportunity to answer questions posed by members of the Subcommittee.

Figure 1

Balance sheet of a covered-bond issuer

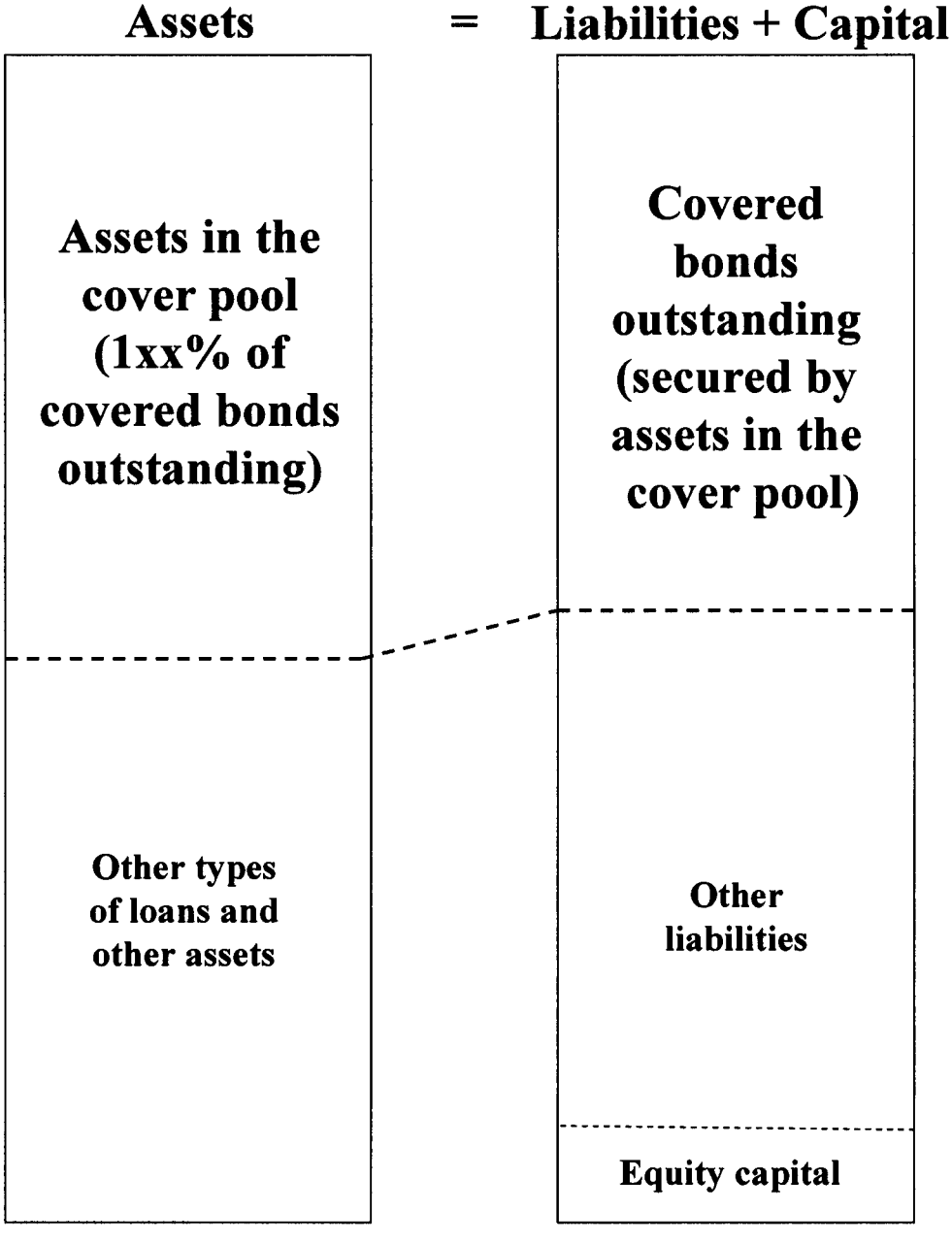
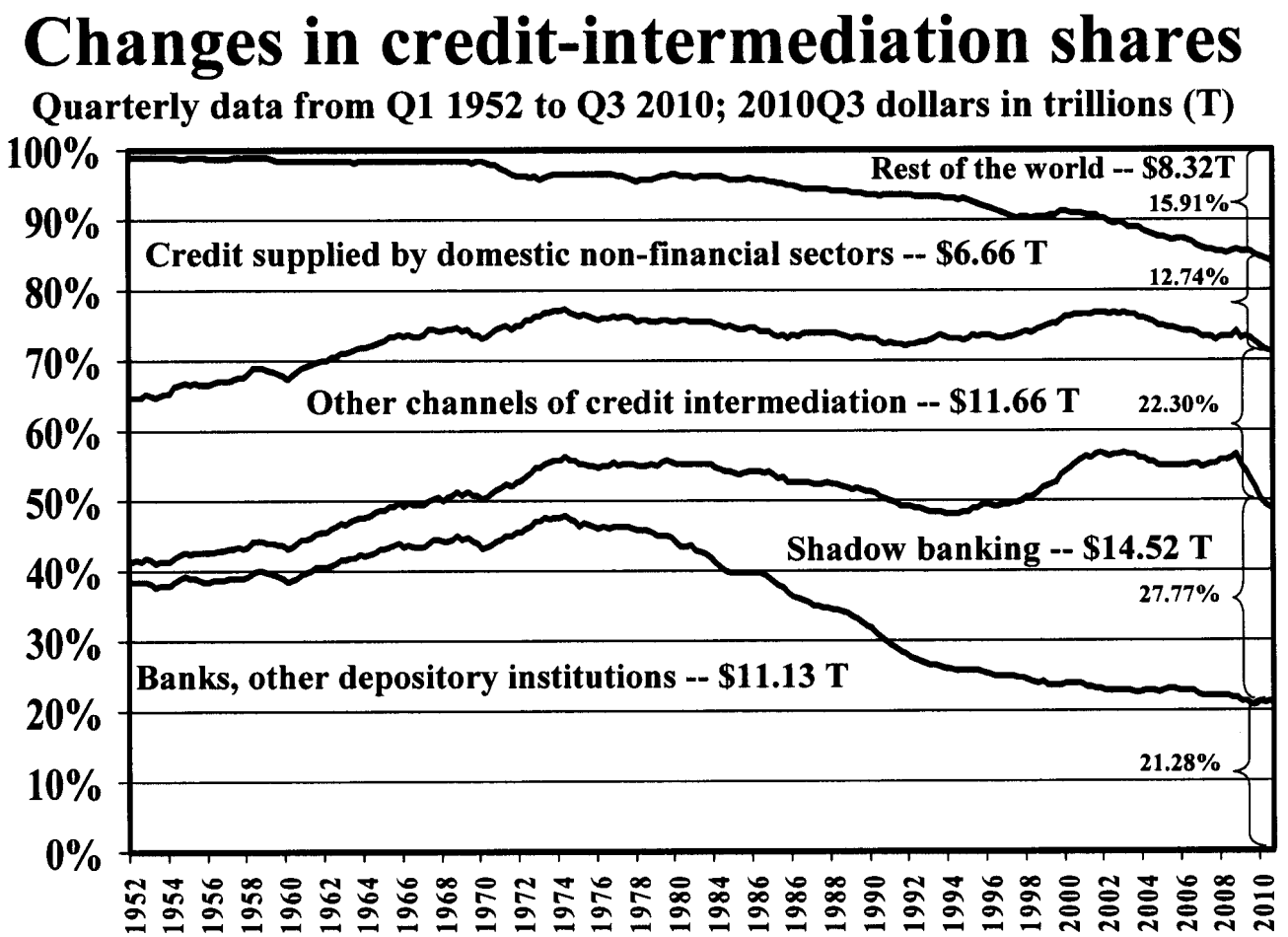


Figure 2


Changes in credit-intermediation shares
Quarterly data from Q1 1952 to Q3 2010; 2010Q3 dollars in trillions (T)
Rest of the world -- $8.32T
15.91%
Credit supplied by domestic non-financial sectors -- $6.66 T
12.74%
Other channels of credit intermediation -- $11.66 T
22.30%
Shadow banking -- $14.52 T
27.77%
Banks, other depository institutions -- $11.13 T
21.28%
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
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Biographical sketch for Bert Ely

Bert Ely has consulted on deposit insurance and banking issues since 1981. In 1986, he became an early predictor of the S&L crisis and a taxpayer bailout of the FSLIC. In 1991, he was the first person to correctly predict the non-crisis in commercial banking.

Bert continuously monitors conditions in the banking industry as well as monetary policy. In recent years, he has focused increased attention on banking problems, the crisis in housing and housing finance and the entire U.S. financial system, and the resolution of the Fannie Mae and Freddie Mac conservatorships. More recently, he has been advising clients on the implementation and consequences of the Dodd-Frank Act.

Bert has testified on numerous occasions before congressional committees on banking issues and he often speaks on these matters to bankers and others. He is interviewed by the media on a regular basis about banking and other financial issues.

Bert first established his consulting practice in 1972. Before that, he was the chief financial officer of a public company, a consultant with Touche, Ross & Company, and an auditor with Ernst & Ernst. He received his MBA from the Harvard Business School in 1968 and his Bachelor's degree in economics in 1964 from Case Western Reserve University.

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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:
TIM SKEET	INTERNATIONAL CAPITAL MARKETS ASSOCIATION (ICMA)
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:	

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