STATEMENT OF THE
FEDERAL DEPOSIT INSURANCE CORPORATION

on

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

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT-SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
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The FDIC appreciates the opportunity to provide its views on the regulatory and legislative issues posed by covered bonds. The FDIC has long worked with the financial industry to establish a sound foundation for a vibrant covered bond market that will provide U.S. banks with an additional source of liquidity. These efforts include working with the first U.S. banks to issue covered bonds in 2006 and the FDIC's adoption in July 2008, of a Statement of Policy on the treatment of covered bonds to clarify key issues related to deposit insurance and bank resolutions. Our efforts facilitated the creation of a market-tested and market-accepted covered bond program for U.S. banks that meets investors' needs without increasing the government's exposure to this investment class.

The FDIC has significant concerns with the proposed legislation, the *United States Covered Bond Act of 2011" (H.R. 290)*. The FDIC believes that this legislation fails to maintain that important balance between investor demands and government exposure, providing investors with lopsided benefits at the direct expense of the Deposit Insurance Fund (DIF).

As discussed in more detail below, the regime set up in H.R. 940 creates an implied subsidy to financial institutions and investors that does not exist for any other privately issued security. The bill provides for a new class of investments that is "risk free" by giving covered bond investors protections in the form of an unfettered claim on significant amounts of collateral that would be unavailable to any other creditors, including the FDIC. This structure will skew the market, limit the demand for long-term, stable unsecured debt, and will thwart the nascent efforts to enhance market discipline in the wake of the financial crisis. At a time when the government is carefully removing its

extraordinary support of the financial system, we should not create a new permanent government subsidy of the financial markets.

The FDIC believes this legislation will create winners and losers. The creation of this new government program will primarily benefit large complex financial institutions which already enjoy funding advantages over smaller financial institutions and non-financial commercial entities of all sizes. To provide these firms with additional government backed funding advantages over smaller banks and nonfinancial firms would be at odds with everything we learned coming out of the crisis and work in contravention to current efforts to end too big to fail. Since covered bonds are likely to be issued by only the largest FDIC insured institutions, their failure would pose a risk of substantial losses to the DIF. Moreover, given the likely limited number of issuers, it would not be practical for such losses to be absorbed solely by the other covered bond issuers. This shifting of risk from investors to the FDIC as deposit insurer is unacceptable in our view.

The FDIC believes that the legislation fails to recognize that U.S. banks already have access to a covered bond market – one that was able to grow without the need for a government guarantee. Covered bonds were successfully issued prior to the 2008 crisis, and in fact, the FDIC was able to sell an intact covered bond program from a receivership of a failed thrift.

The FDIC believes that the existing U.S. covered bond market has significant advantages over the European model from a taxpayer perspective. European programs offer generous collateral protections to investors, and as a result, trade more like sovereign debt than bank or securitization debt. One of the clear lessons of the financial crisis is that such government guarantees or subsidies can distort normal market prices by

essentially providing ‘risk-free’ investments. We have already seen the devastating consequences when risks are mispriced in the market.

Further, the independent financial regulatory agencies are experienced safety and soundness supervisors and standards setters - yet do not have a leading role under H.R. 940 in setting safety and soundness standards for the prudent development and operation of a covered bond market. The types of assets employed to support a covered bond can have an impact on the overall performance of the issuer (an insured depository institution).

This statement will provide background on covered bonds, discuss the FDIC’s principles for a covered bond program outlined above, and address the proposed legislation, H.R. 940.

Covered Bonds in Context

Covered bonds are general obligation bonds of the issuer, normally an insured bank or thrift, with payment secured by a pledge of a pool of loans. During normal operations, like any general obligation corporate bond, investors are paid from the issuing bank’s general cash flows, while the cover pool of loans serves simply as collateral for the bank’s duty to pay the investors. As a result, both functionally and legally, the cover pool is not the source for repayment, as in a securitization, but is simply collateral to secure payment if the issuing bank cannot make payment from its general cash flows.

Another distinction between covered bonds and most securitizations further demonstrates that the cover pools function as collateral and not as sources of payment when covered bonds are not in default. In a covered bond, any loans and other assets in

the cover pool that become delinquent must be replaced with performing assets. As a result, the collateral for the covered bond is constantly refreshed—and the issuing bank has an ongoing obligation to produce new loans or other qualifying collateral to replace delinquencies. Finally, the issuer must always maintain more collateral in the cover pool than the outstanding notional or "face" balance of the outstanding bonds. If the issuing bank fails to pay on the covered bond, then the investors have recourse to the cover pool as secured creditors. This is precisely how normal collateral arrangements work in other secured transactions.

Under the long-standing U.S. law applied to all types of secured transactions, secured creditors have a claim to the collateral—here the loans or other assets pledged to secure payment on the covered bond—only to the full amount of their claim for payment at the time of any default. They do not have a claim to any part of the value of the collateral that exceeds their current claim for payment. Any collateral or proceeds in excess of that claim for payment are returned to the debtor or, if it has been placed into bankruptcy or receivership, are used to pay the claims of unsecured creditors. If, on the other hand, the secured creditor's claims are greater than the value of the collateral, the creditor will have a secured claim up to the value of the collateral and an unsecured, general claim for the remaining balance along with other unsecured creditors.

The same rules apply in FDIC receiverships. Secured creditors are fully protected under Section 11(e)(12) of the Federal Deposit Insurance Act ("FDI Act") for the amount of their claim up to the value of the collateral. As a result, covered bonds provide two avenues for recovery—from the issuing bank and from the cover pool of collateral. What

they do not have, and should not have, under U.S. law, is a right to keep collateral in excess of their right to payment.

Legislation to Address Covered Bonds

As mentioned at the outset, the FDIC supports balanced covered bond legislation. However, any such legislation should avoid transferring investment risks to the public sector or to the DIF and should remain consistent with long-standing U.S. law and policy for secured creditors. Unfortunately, H.R. 940 would muddy the relationship between investors and regulators, transfer some of the investment risks to the public sector and the DIF, and provide covered bond investors with rights that no other creditors have in a bank receivership. As a result, this legislation could lead to increased losses in failed banks that have issued covered bonds.

The United States Covered Bond Act of 2011

H.R. 940, the *United States Covered Bond Act of 2011*, establishes new standards for the development of a covered bond market in the U.S. It requires the Secretary of the Treasury ("Treasury") to establish an oversight program that would prescribe minimum overcollateralization requirements, identify eligible asset classes for cover pools, and create a registry to enhance the transparency of covered bond programs. The banking agencies would carry out the Treasury-prescribed oversight program. A critical portion of the bill deals with an issuer's default on its covered bond obligations, and the procedure for dealing with the covered bond program of an issuer in receivership. The bill calls for the transfer of the assets of the pools securing the covered bonds out of the

receivership estate and into a separate estate solely for the benefit of the covered bond investors. Upon a joint determination by the Secretary and the FDIC that the DIF suffered losses because of the resolution of the covered bonds through the separate estates, the FDIC may recover such losses by assessments on other covered bond issuers.

Legislation Should Not Create a New Subsidy for Covered Bond Investors

As stated earlier, no new government program should create an implied subsidy or guarantee for financial institutions or investors. A new class of investments that appears "risk free" by providing covered bond investors with protections unavailable for any other creditors will skew the market and lead to moral hazard.

If, as proposed in the bill, the investors are secured by the entire cover pool for the duration of the covered bonds irrespective of the degree of over-collateralization, it will provide a strong incentive for investors to maximize the over-collateralization. Naturally, this will increase pressure on the issuing bank during periods of stress. The creation of separate estates consisting of the entire cover pool will also further reduce the loan assets available for sale by the FDIC in any receivership. If creditors of covered bonds are shielded from all risks, there is a strong possibility that covered bonds could lead to a mispricing of risk and distortions in the market, imperiling banks in the future. On the other hand, if the long-standing treatment of secured creditors is maintained – which would allow the FDIC to pay the outstanding principal and interest on the bonds and recover the over-collateralization—there will be very limited incentive for the creditors to demand increasing levels of collateral as a bank becomes troubled.

The super-priority given covered bond investors by the proposed bill also runs against the policy direction established by Congress in recent legislation. In 2005, Congress enacted Section 11(e)(13)(C) of the FDI Act, which prohibits secured creditors from exercising any rights against any property of a failed insured depository institution without the receiver's consent for the first 90 days of a bank receivership. This provision prevents secured creditors from taking and selling bank assets at fire sale prices to the detriment of the receiver and the DIF. More recently, section 215 of the Dodd-Frank Wall Street Reform and Consumer Protection Act mandates a study to evaluate whether a potential haircut on secured creditors could improve market discipline and reduce cost to the taxpayers. This study was prompted by the recognized roles that the run on secured credit and the insatiable demand for more collateral had in the financial crisis of 2008. In contrast, the unprecedented protection in the bill for one form of secured creditors—covered bond investors—runs counter to the policies underlying these provisions.

A further concern created by the proposed legislation is that it could encourage covered bond transactions that include "triggers" for early termination or default before a bank is closed by the regulators. Under the proposed bill, a separate estate, which removes the entire cover pool from the bank's control, is created upon any event of default. Once created, the separate estate and all collateral in the cover pool would be outside the control of the FDIC, as receiver for the bank. The residual value of the pool, and all of the loans, would be outside the receivership and be lost for all other creditors of the failed bank. This additional special protection creates a strong incentive for covered bond transactions to include a trigger that acts before the bank is placed into receivership. Since such a trigger would deprive the bank of the cash flows from the cover pool and

signal to the market its imminent demise, the bank would almost inevitably suffer a liquidity failure. As a result, these early triggers represent another source of increased loss to the DIF.

The shift in H.R. 940 of federal regulation towards protection of the investment interest of specific investors raises significant questions about the proper role of federal regulation for individual investment programs. Issues involving investor protection are best resolved by private contracts based on transparent disclosures about the operations of covered bond programs.

In addition, the proposed bill would also make the Federal prudential regulators the appointing and supervising authority of trustees that would operate the separate estates of the covered bonds. This level of government entanglement in what are private contractual matters could also lead to an implied guarantee of covered bonds. An implied guarantee of covered bonds would put covered bonds on a near par with the government sponsored enterprises—a status that should not be granted without strong policy reasons because of the risk that status represents for taxpayers. It would also make the FDIC a virtual guarantor to covered bond investors.

An FDIC Guarantee is Not Necessary For a Successful Covered Bond Market

Any covered bond legislation must preserve the flexibility that current law provides to the FDIC in resolving failed banks—including the options of continuing to perform under the covered bond program pending a sale of the program to another bank, turn-over of the collateral to the investors, and repudiation—a statutory termination of the contracts—of the covered bond obligation. Repudiation is the authority, granted to the

FDIC by Congress, to terminate (or breach) a contract and then pay statutorily-defined damages to the other parties. In the case of covered bonds, repudiation allows the FDIC, as receiver for the failed issuer, to cut-off future claims and end the obligation to replenish the cover pool with new assets. Under the FDI Act, the FDIC will then pay damages to compensate the covered bond investors.

Covered bond investors, as noted above, are secured creditors of the bank. The amount of their claim is defined by the balance or par value of outstanding bonds plus interest. The 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 date of payment. This provides a remedy that fully reimburses the covered bond investors. In return, as in any other repudiation, the FDIC as receiver would be entitled to reclaim the collateral in the cover pool after payment of those damages. The receiver could then sell this collateral and use the proceeds to satisfy the claim of the DIF (which has the largest receivership claim as a result of having satisfied its insurance obligation for insured deposits), uninsured depositors, and other creditors of the failed bank.

If the FDIC does not repudiate a covered bond, it should have the authority to continue to perform under the covered bond until it can sell the program to another bank, as it did with WAMU's covered bonds. This strategy would not expose the investors to any loss, by definition, since the FDIC would meet all requirements of the covered bond program, including replenishment of the cover pool and meeting the over-collateralization requirement. As long as the FDIC is performing under a covered bond

agreement, covered bond legislation should not limit the time in which the FDIC has to decide how best to proceed.

Any legislation that fails to preserve these important receivership authorities would make the FDIC the *de facto* guarantor of covered bonds and the *de facto* insurer of covered bond investors.

We saw the beginnings of a covered bond market develop in the U.S. without such a government guarantee. Before the crisis, the FDIC worked closely with Washington Mutual Bank and Bank of America when they launched the first U.S. covered bond programs in 2006. As a result of our efforts, the banks were able to issue covered bonds at a competitive price. The 2008 Statement of Policy adopted by the FDIC's Board of Directors addressed questions from the marketplace about how covered bonds would be treated in the receivership of an issuing bank. The market's reaction to this Statement was very positive, and most commentators stated that it provided a solid foundation for the covered bond market. Shortly after the adoption of the Statement of Policy, the Department of the Treasury ("Treasury") issued a companion document entitled "Best Practices for Residential Covered Bonds" to establish greater clarity and homogeneity for the market so that investors would have confidence in future issuances. The FDIC worked with the Treasury in developing the Best Practices to create a coordinated framework for the responsible and measured roll-out and further development of covered bonds in the U.S. With the FDIC and Treasury guidance, we have seen the successful launch of a covered bond market in the Unites States that does not require implicit government guarantees. This is in contrast to developments in Europe where there do appear to be implicit government guarantees, as we noted above.

Given the FDIC's existing Statement of Policy, the Treasury's companion Best Practices, and the prior successful covered bond programs developed in cooperation with the FDIC, it is unclear that legislation is necessary to re-launch the market. At a minimum, the FDIC suggests that its Statement of Policy should be considered as a framework for any legislation in order to provide a sound, balanced foundation for the market.

Treasury Should Not Set Safety and Soundness Requirements

Another concern with the proposed legislation is that it assigns Treasury the responsibility to set standards for the covered bond oversight program. Any legislation establishing a regulatory framework for covered bonds should instead require the appropriate federal banking regulators to establish joint standards for covered bond issuances by regulated institutions. The oversight program contemplated in H.R. 940 is essentially designed to set safety and soundness standards, and as such, is more appropriately the province of the prudential regulators. Moreover, such an allocation of responsibility would violate the longstanding principle of federal bank regulators having independence from the Treasury in establishing prudential banking policies for insured depository institutions ("IDIs"). This is especially important for the FDIC, as insurer and receiver, since never in our nearly eight decades of FDIC independence has the Treasury interfered with our resolution and assessment mechanism.

The resulting standards, like the FDIC's Statement of Policy, should address the key elements in covered bond transactions and the safety and soundness issues that can be implicated by a bank's use of covered bonds. The banking regulators, working in

concert, should address the types of collateral, underwriting standards, required over-collateralization, frequency and content of reports on collateral and satisfaction of required over-collateralization, disclosure standards for performance of underlying loans or assets, and the rights of the investors in the event of default. A particularly important element in the clarification of investors' rights is the treatment of the covered bonds if the issuer defaults on its payments under the bonds. This is both critical to the investor and to maintaining the balance of risks retained by the investor or transferred to other parties.

The standards setters for covered bonds should have discretion in expanding the use of covered bonds and categories of cover pool assets as sustainable markets develop and the liquidity of the instruments increases. The gradual expansion of cover pool categories is essential to ensure the quality of covered bonds and of the assets in the cover pools.

Legislation Should Not Increase the Potential Loss to the DIF

Any covered bond legislation should not limit the FDIC's ability to recover the losses the DIF incurs in resolving a failed bank. The proposed legislation would create separate estates for covered bonds if the issuer is placed in an FDIC receivership, thus removing the cover pool assets from the receivership and potentially increasing losses to the DIF. Depleting a receivership estate in this way could pose a genuine threat to the DIF.

The lack of access to the collateral over the life of the covered bonds could result in higher DIF losses and a lower DIF net worth than otherwise in many circumstances. The net worth of the DIF, as subrogee of the insured depositors and thus with the largest

claim on the receivership estate, could be lowered if the receiver has to hold the residual interest in the collateral on its balance sheet at less than expected recovery value because of the residual's lack of liquidity. Additionally, the DIF net worth would be lower if the FDIC receives a lower bid for the failed covered bond issuer because of its inability to free up collateral and package the failed institution's assets in a way that would result in a resolution least costly to the DIF. This increases the chances in a period of banking turmoil that the FDIC would be forced to borrow from the entire banking industry or from the Treasury, simply because of the extraordinary protection accorded to covered bond investors under the proposed legislation.

Unfortunately, the proposed *United States Covered Bond Act of 2011* would expose the DIF to additional losses by restricting the FDIC's ability to maximize recoveries on failed bank operations and assets. This result is contrary to a long-standing Congressional goal of preserving the DIF to help maintain confidence in the U.S. banking system. Over the past several decades, Congress has revised the laws governing the resolution of failed banks on several occasions. Two of those revisions are crucial to the present discussion. First, Congress required the FDIC to use the "least costly" transaction for resolving insured depository institutions. Second, Congress created depositor preference, which gives depositors a priority superior to general unsecured creditors. Both reforms were designed to reduce losses to the DIF.

The proposed bill would restrict the FDIC's current receivership authorities used to maximize the value of the failed bank's covered bonds. The bill leaves the FDIC with only two options: continue to perform until the covered bond program is transferred to another institution within a certain timeframe, or hand over the collateral to a separate

trustee for the covered bond estate, in return for a residual certificate of questionable value.

The restrictions discussed above would impair the FDIC's ability to accomplish the "least costly" resolution and could increase losses to the DIF by providing covered bond investors with a super-priority that exceeds that provided to other secured creditors. The proposed bill attempts to alleviate this problem by permitting the FDIC, upon a joint determination of loss with Treasury, to assess IDIs with covered bond programs for losses associated with the use of separate estates for covered bonds. The FDIC alone is in the best position to determine losses to the DIF as it has done for nearly 8 decades. Never in the history of the FDIC has the political branch been involved in our assessment mechanism. The FDI Act specifically protects the FDIC from such interference. In addition, the approach of H.R. 940 is unsound for two other reasons. First, it is likely that any covered bond issuances will be concentrated in very few, large institutions—certainly for an extended period. This concentration would, in turn, mean that any assessment to allow the DIF to recoup its losses would fall heavily on only a very few large IDIs. Indeed, the attempt to make up for such losses through assessments could threaten the stability of the remaining participating IDIs. Second, in case of a large losses that cannot be absorbed by IDIs issuing covered bonds, DIF losses would be borne by all of the more than 7,600 FDIC-insured institutions, whether or not they issued covered bonds.

The protections to the insurance fund, depositors and the flexibility afforded the FDIC as receiver of a failed depository institution has become a standard that other countries want to emulate. The flexibility that Congress afforded the FDIC permits it to respond to market conditions at the time of insolvency and to achieve bank resolutions

that protect insured depositors at the least cost to the DIF. This is an important public policy that we believe has served the nation well and should be maintained.

Conclusion

The FDIC supports a vibrant covered bond market that would increase liquidity to financial institutions and enable sustainable and robust asset origination. However, any legislation should avoid promoting development of a covered bond market that provides for zero risk to covered bond investors and gives rights to investors that are superior to any other secured creditor – thus reducing market discipline and protection for the DIF. Further – and just as important – the banking regulators, and not the Treasury, should be the lead in promulgating safety and soundness regulations for insured depository institutions involved in the covered bond market. We believe the principles described above will ensure that covered bonds serve as a viable investment for bondholders and the financial system. We will continue to work with the Congress, other regulators and market participants on ways to create a sustainable covered bond market in the U.S.