Statement of Tim Skeet

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Committee on Financial Services

Subcommittee on Capital Markets and

Government Sponsored Enterprises

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Hearing on

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

European covered bonds performance during and after the crisis

March 11, 2011

[1] See Annex A

Mr Chairman and members of the Committee, I am honoured to have the opportunity to discuss with you the European covered bond landscape and how the product fared during and after the crisis.

This testimony provides an overview of the European covered bond market, and is the result of discussions with various European stakeholders, in particular the International Capital Market Association ('ICMA') and one of the Association's subcommittees, which was created nearly two years ago as the Covered Bond Investor Council ('CBIC'). This Council serves to consider issues related to the evolution of the product in Europe and the type of information available to investors. We have also liaised closely in the preparation of this paper with the European Covered Bond Council ('ECBC')[2], which represents a wide group of market participants.

Our experience in the European Union is that covered bonds did not contribute to fuelling the mortgage or other bubbles and indeed have been consistently regarded as part of the solution to resolving market imbalances, not a cause. This can be explained by the fact that because collateral stays on banks' balance sheets and covered bonds set high collateral quality criteria, the moral and market hazard of the sub-prime mortgage problem was sidestepped. Whereas during the crisis European bank funding relied upon government-insured deposits across the European Union, covered bonds are now perceived as a very stable source of wholesale term liquidity for banks, including for smaller regional institutions, and not exclusively major institutions or too big to fail, 'Strategically Important Financial Institutions' ('SIFIs')[3].

In Europe, it is generally accepted that the covered bond market plays a pivotal role in the exit strategies from government and central bank support. They have provided lenders with a cost-efficient instrument to raise long-term funding and importantly offer private investors non state-guaranteed, top-quality credit exposure to credit institutions. From the consumers' perspective, the success of the covered bond market has ensured a flow of funds to the mortgage sector and helped keep costs down.

[2] The European Covered Bond Council represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was created by the European Mortgage Federation (EMF) in 2004 to represent and promote the interests of covered bond market participants at the international level. As of February 2011, the ECBC has over 100 members from more than 25 active covered bonds jurisdictions. ECBC members represent over 95% of the €2.4 trillion covered bonds outstanding.
[3] Systemically Important Financial Institutions

PURPOSE OF EUROPEAN COVERED BONDS

Covered bonds have become increasingly important for bank funding in Europe, because they provide low execution risk, long maturities, and help issuers and investors diversify their portfolios of liabilities and assets respectively. Currently investors remain reluctant to buy senior unsecured debt in some jurisdictions, and regulatory discussion of such debt being 'bail-inable' further increases concerns. The structure and security of covered bonds have set this asset class apart and they have remained largely acceptable to investors.

From the issuer's perspective covered bonds offer cheap funding in absolute and relative terms and secondly also offer longer term funding. The success of this funding tool is related to the fact that it has always been difficult to measure the creditworthiness of a bank, and the crisis has only served to reinforce this point in the eyes of many investors. Disillusion with regulators and the credit rating agencies have contributed to an atmosphere of distrust. However, covered bonds represent a form of insurance against the failure of a bank as the bond rating and credit quality is partially delinked from the issuing entity [1][4] by dint of the high quality collateral provided.

As the market for sovereign and agency debt has hit turbulence, new investors came to view covered bonds as offering an acceptable and stable investment opportunity for the cash reserves that had accumulated during the period of market crisis. Moreover, the jumbo market[5] has offered some reasonable liquidity and volume to investors.

The financial crisis has, moreover, highlighted the final major advantage: market accessibility. Although covered bonds clearly did suffer, along with every other asset class, especially in Q4 2008 and in early 2009, there has been a tremendous comeback in terms of spreads and issuance volume as well as investor confidence [1]. Banks can raise term liquidity without running the risk of a failed issue. An absence of defaults, continued strong ratings, lack of the need for official guarantees and strong profit opportunities have driven growth in the market. The ECB purchase programme (see below) helped kick start the restoration of market liquidity for weaker jurisdictions but success has been achieved through the intrinsic qualities of the instrument.

[4] Numbers in brackets refer to documents listed as references at the end of this statement.
[5] for issue over €1bn or US$ 1bn in size

OFFICIAL SUPPORT DURING THE CRISIS

Some observers of the European covered bond market have assumed that the market's success was, and continues to be, due to implicit guarantees by European governments. Whilst it was the case that, at the height of the crisis, all markets for Western financial institutions' debt (and more recently certain government debt) were given varying degrees of support, the strength of the covered bond product is derived from its robust legal framework which explicitly defines and protects investors' rights and not government guarantees or support[6]. Recent discussions around the possibility of extending the burden-sharing concept from hybrid subordinated debt to senior unsecured debt while explicitly excluding covered bonds[7] have further enhanced the attractiveness to and appetite of investors for covered bonds. Regulators and politicians view the European covered bond markets favourably and have taken every opportunity to provide investors with comfort on the safety of the product. This support and confidence has fallen well short of guarantees and the product, post-crisis, does not carry guarantees, explicit or implicit. The essential fact remains that, notwithstanding the drama of the crisis, there has not been any default of principal, or deferment of a covered bond coupon, even where there have been cases of banks failing. Moreover, no significant/systemic downgrade of covered bonds was recorded. As a result no taxpayers' money has been employed to cover covered bond losses. The ultra-conservative eligibility criteria of assets in the cover pool provided stability and have served the product well.

ECB Purchase Programme

In July 2009, as part of the European Central Bank's ('ECB') policies to revive markets and underpin European bank liquidity, a Covered Bond Purchase Programme ('CBPP') was established. This had a finite life of one year and a finite amount of €60bn ($84bn) and was aimed at both primary market (new issues) and secondary paper. The CBPP provided important support in terms of giving private investors confidence as the market recovered [2].

But as publicly stated by the ECB and fully described in their report (published in January 2011) on the impact of the purchase programme [2], their programme *'led to a noticeable broadening of the spectrum of euro area credit institutions that turned to the covered bond product as a funding*

[6] Although in the case of Ireland an explicit guarantee was granted and other governments had been ready to provide guarantees as in the case of Germany, this was not needed so none were provided.
[7] See European Commission (2011), *Consultation on technical details of a possible European crisis management framework*, Internal Market and Services DG, Unit H1 – Banking and Financial conglomerates

instrument, which helped increase primary market activity in previously underdeveloped or smaller jurisdictions or segments and revived, at least temporarily, segments that had suffered particularly badly from the financial crisis. These developments contributed significantly to improving the overall funding situation in euro area and also non-euro area financial institutions, and arguably also alleviated some of the pressure on euro-area banks to relay on the Eurosystem's liquidity providing operations' [2, p.24].

The purchase programme as well as other measures to stabilise financial markets – covered bonds or others – should be considered in the context of governmental steps to stabilise financial markets during the crisis. We also note in this context the unprecedented levels of support provided to the market for certain Western European Government debt – which could expose taxpayers to potential losses. In the ECB's report it is stated clearly that there is an expectation that the programme will prove profitable for the public purse, '*there is a high likelihood that the CBPP will generate positive returns to the Eurosystem'* [2, p.6].

Ratings of Covered Bonds

Part of the collapse in bond prices generally across different markets was provoked by a collapse of investors' confidence in rating agencies and concerns over the underlying asset quality and liquidity of financial issuers. The quality of the legal framework for covered bonds as well as the tight eligibility criteria of the assets in the cover pools on the other hand, has assisted this asset class to address most of the investor concerns, setting covered bonds apart.

Rating agencies still nevertheless play a significant role in the credit assessment of covered bonds, even if investors are now doing far more of their own homework. As result of the crisis, rating agencies have changed and tightened their covered bond rating methodologies. Although this has not resulted in many individual issues actually being downgraded, over-collateralisation levels have been adjusted upwards as a result. Each of the agencies continues to apply their own criteria and there remain important differences between the agencies and the level of de-linkage of the covered bond from the parent stand alone rating.

The question of increased over-collateralisation levels is beginning to be looked at as is the issue of structural subordination of other creditors, although thinking on these matters is still at an early stage. Generally, the rating agencies and European regulators appear, at current encumbrance levels, to appear to favour the covered bond market as contributing vitally to a reduction in systemic risk and increasing term funding in ways that are consistent with current thinking on, for instance, the 'Net Stable Funding Ratio'.

As noted above, European investors are, however, doing a lot more of their own credit analysis on covered bonds in-house, looking at country, legal and credit risks and performing their own assessment of the quality of the cover pool. Efforts are being made in Europe to further enhance transparency and quality of covered bonds. Various discussions are taking place between interested parties including the ECB, ECBC, CBIC and others with a view to arriving at higher disclosure levels, thus allowing investors to better assess underlying risks in the cover pools.

LACK OF DEFINITION OF COVERED BONDS

In European jurisdictions, there is specific legislation setting out a framework for the issuance of covered bonds. Some laws are highly prescriptive (such as German's 'Pfandbriefgesetz'), something generally favoured by European investors, while others are closer to what has been proposed in the US in the past (such as the UK Regulated Covered Bond Law of 2008). There is, however, no universally agreed definition of a covered bond. Indeed, several different types of covered bond have been developed in the European market thus far. The closest to a shared definition is the "Essential features of covered bonds" agreed by the ECBC (see Annex B).

Although the statutory regime in each European jurisdiction differs, all of the regimes incorporate certain core principles: first, covered bonds must be secured by high quality assets; second, management of the cover pools must be supervised; and third, covered bond holders are first in priority upon an issuer bankruptcy or insolvency event. Legislation provides certainty regarding the treatment of covered bonds, especially in an insolvency scenario [3]. The segregation of the cover pool is fundamental to the structure of a covered bond program. The assets comprising the cover pool must be available to ensure that covered bond investors receive scheduled interest and principal payments when due, even if the issuing financial institution is insolvent [4]. Once the covered bond investors are paid off, the residual collateral will be passed back to the insolvency estate for the benefit of the other creditors.

THE IMPORTANCE OF SPECIFIC COVERED BOND LEGISLATION

A key feature of covered bonds and one that clearly distinguishes them from securitisations in particular is that investors' rights are defined by law and not a series of commercial contracts. This is a key point for investors, but the presence of a law does not constitute government guarantees or subsidies for the market. European and indeed US investors buying the product do not view covered bonds as being government supported, but they do see them as being legally robust.

We therefore welcome discussion of a legal-based covered bond structure in the US and the certainty that a law would give investors in terms of their rights to the security of the cover pools. As we have already noted, investors post-crisis have responded in a very positive fashion to the explicit robustness of the product in Europe, which arises from product-level legislation and a specific supervisory structure.

We note also the increasing appetite of US investors for European (and Canadian) covered bonds. We would observe that European issuers are likely to increasingly access the US covered bond market as part of their funding strategy. A number of Nordic issues have tapped the market and France's CFF issued three times in 2010 and has already completed a transaction in 2011. The establishment of a US domestic market would have the beneficial effect of enhancing acceptance of the product in the US, expanding the investor base, but also potentially unlocking European demand for US products. US demand has been fuelled by a lack of strongly rated, high quality 'agency style' assets (diminishing supply of GSE issues, disappearance of TLGP and high investor cash balances). Investors acknowledge that all these instruments implicitly carry credit risk, but US investors are well equipped and increasingly motivated to analyse the component elements of risk that underpin covered bonds. Legislative frameworks do nothing to mitigate credit risk but do serve to mitigate legal and structural risks and ensure that only quality assets may constitute cover pools. US investors have taken note.

The US market experimented with structured covered bonds (i.e. covered bonds that were issued without the benefit of specific legislation) in 2006/2007. However, the structures were cumbersome, costly, cannot be easily replicated today, and do not appeal to investors in Europe or the US. European investors in particular, are unlikely to develop a significant appetite for US covered bonds in the absence of a robust legal framework that only a strong covered-bond statute can provide. The crisis has served to further increase investor concerns over structured covered bonds.

THE IMPORTANCE OF THE COVER POOL: ELIGIBLE ASSETS

European covered bonds offer a very limited variety of collateral for the cover pool and very strict quality criteria. The major categories of cover assets are mortgage loans (including in many cases commercial real-estate) and public sector loans. The range of eligible cover assets is defined by a country's covered bond laws. There has been a strong shift from public sector covered bonds to mortgage covered bonds as the dynamics of profitability and riskiness of public sector lending has changed in recent years. Investors are comfortable with these underlying assets as there is sufficient data and information to allow them to assess the value of collateral. European investors in covered bonds are generally highly conservative and do not currently appear to have much appetite for other underlying asset classes (although there is a very small, local and mainly private placement market in Germany and Denmark for shipping backed covered bonds).

As noted previously, Investors are becoming more vociferous over disclosure levels on cover pools. Although they rely upon public supervision and legal protection, there is now a widespread acceptance in Europe that investors will need to perform their own due diligence and monitoring, something that was rare pre-crisis and this is also further recognition of the resolve not to expose taxpayers' money in future crises within the financial services sector.

AN EXPANDING MARKET

Covered bonds were one of the first non state-guaranteed funding instruments to resume issuance activity after the Lehman default.

The success of the instrument and its role in channelling private funds directly to bank on a term basis has encouraged additional jurisdictions and banks to embrace covered bonds. At least 10 countries are now considering the introduction of covered bonds into their financial systems [1]. Today there are about 25 different European jurisdictions that have active covered bond markets [5]. According to the 2010 ECBC Fact Book [1], there is a strong expectation that the covered bond market will continue to grow, especially as national legislators across Europe have shown a willingness to adapt and update regulations and laws [1], further enhancing the product, at a time of uncertainty over other forms of financial institution funding. Over 30 new issuers joined the market in 2009 alone bringing the total number of issuers to more than 300. Significantly, covered bond jumbo issuance had already reached over 70 bn EUR (US$100bn) by early March 2011, in comparison to €175 bn (US$245bn) for all of 2010 *(See below Table 1).*

EUR bn	**2003-2006 average**	**2007**	**2008**	**2009**	**2010**	**2011 YTD**
Issuance	138	174	93	121	175	70

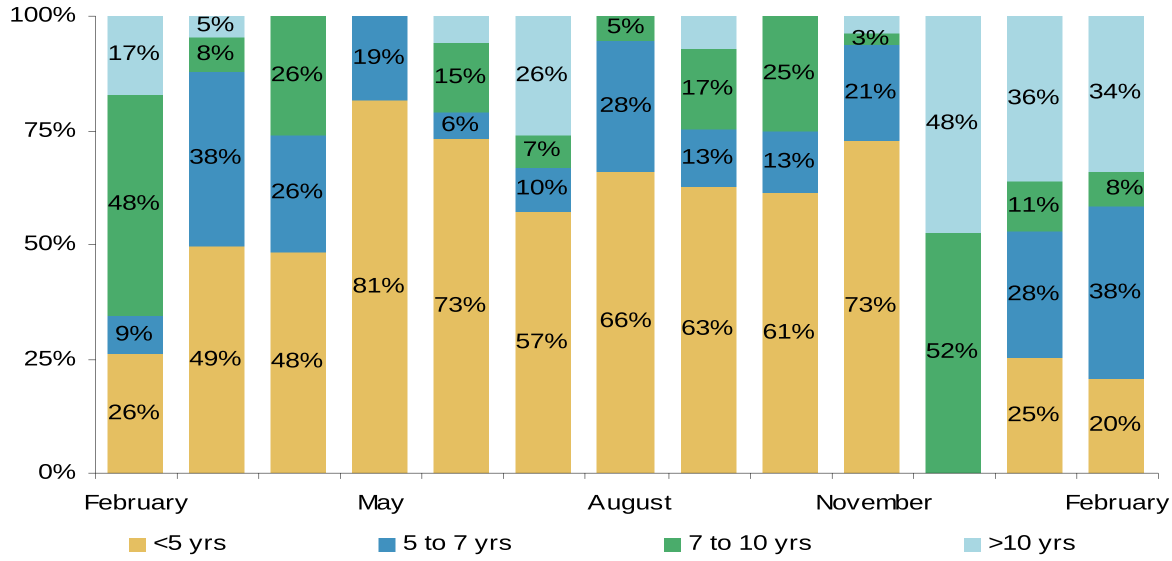
Table 1: Total Jumbo Issuance, *Source: The Euroweek Cover*

If some of the volume in the primary market was sustained by the ECB Purchase Programme (see above), the high level of activity seen since July 2010 has been purely been sustained by investors working on commercial terms. 2011 is expected to witness record levels of covered bond volumes.

Whilst we do not have any statistics relating to covered bond issuers' size, it is clear through the increase in numbers of issuers during the crisis that far more than just the largest banks have established covered bond programmes. A review of the 17 new issuers since 2010 reveals both large and small banks, jumbo and non-jumbo issuers and includes new ('developing') countries. In some countries, for instance, small regional financial institutions have been able to club together, pool their assets, and benefit from market access (Terra in Norway and Aktia in Finland) including the ability to tap the US investor market (Sparebank 1 of Norway). Regulators have been encouraged by the ability of smaller issuers to make use of this market segment.

MARKET PERFORMANCE AND DATA

The covered bond market was able to generate primary market activity throughout most of the crisis. Evidence suggests that even in times of adverse market conditions, issuers have found it possible to issue covered bonds, particularly in shorter-dated maturities (typically with two year tenors) (see Graph 1). Also in terms of two-way flows, liquidity was concentrated at the shorter-end of the curve. As markets have recovered, covered bonds have taken the lead in providing term-funding to banks, with recent statistics showing that a third of the issues so far in 2011 are of maturities over 10-years for instance, and most issuance is in excess of 5 years.

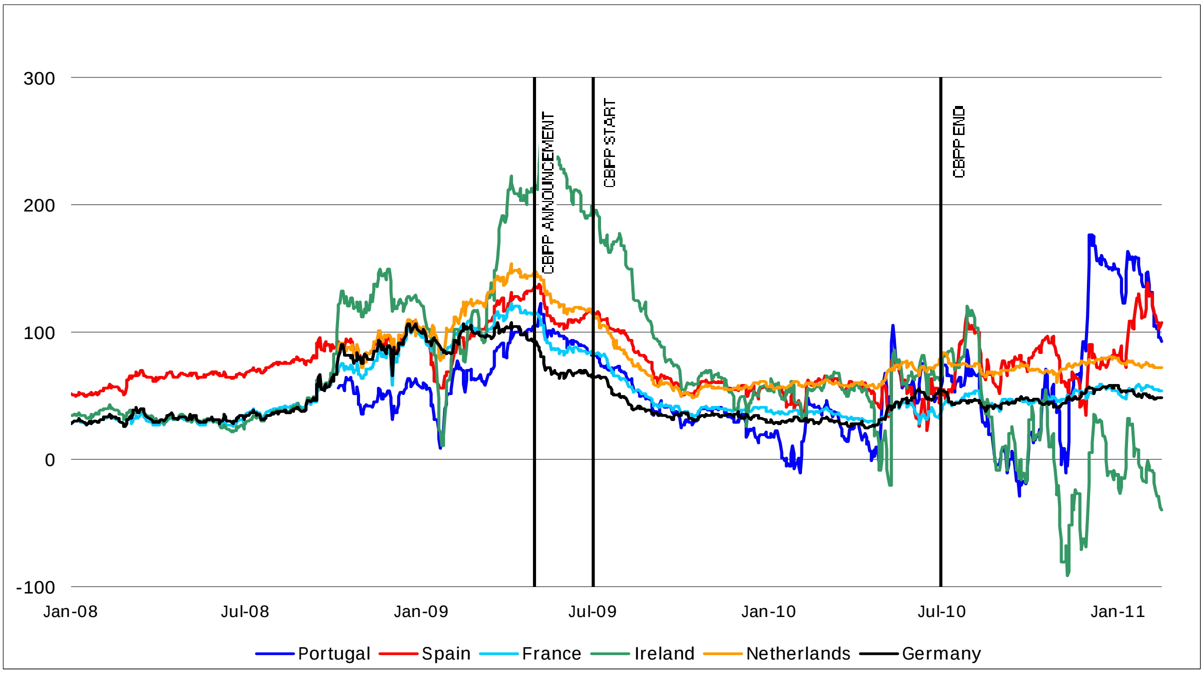


Graph 1: Maturity pattern of newly issued covered bonds, February 2010 to February 2011
Note: December 2010 data is not representative as it refers to taps only.
Source: Morgan Stanley

It should be noted also that during the crisis, covered bonds, on account of their acceptability as good collateral with central banks, were used by many financial institutions as a prime source of liquidity through their creation and retention and repoing by issuers [2]. This accounted for a lot of volume issuance (although not counted as 'jumbos'[8]). The market has however rapidly moved on from the repo funding model with increasing numbers of banks able to go directly to private investors with longer term covered bonds, as noted above. The recent success of Spanish banks in this regard is another sign of post-crisis recovery with covered bonds leading the way.

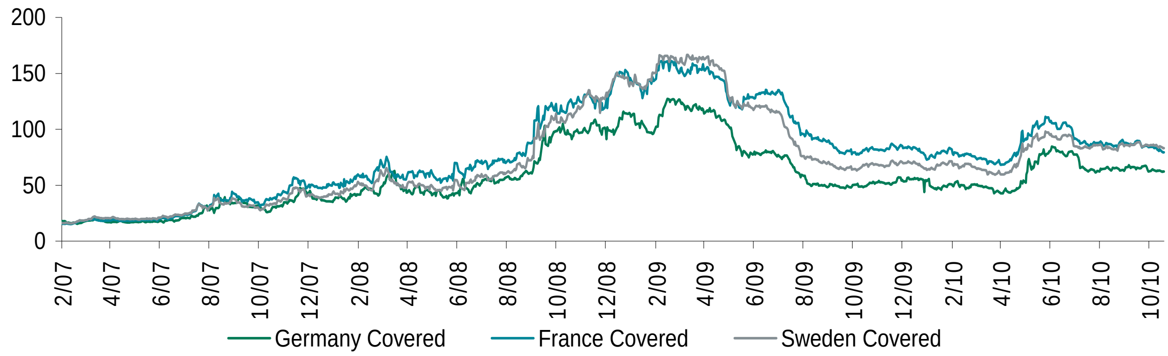
Overall, the secondary market for covered bonds performed better than most other asset classes, although the system of forced market making that used to be at the centre of the 'jumbo' market was suspended early in the crisis and is unlikely to return. The ECB intervention (CBPP, see above) certainly provide a floor for prices and liquidity during the period of its operation, but other markets were similarly sustained by central bank intervention.

[8] Covered bond transactions totaling €1 billion or more



Graph 2: Covered Bond spreads vis-a-vis sovereign yields, *Source: ECB*
Note: All spreads refer to the IBoxx indices for 5-year maturity.

The market has emerged post-crisis as the one reliable market for financial institution debt and is enjoying an expansion of its investor base. The market consensus in Europe is that though liquidity has not returned to the pre-crisis levels, the primary market for covered bonds is robust, albeit at wider spread levels compared to before.



Graph 3: Covered Bond Spreads, 2007-10, in basis points, *Source: iBoxx, Credit Agricole CIB*

Investors remain concerned about sovereign risk and this has recently helped parts of the covered bond market.

According to a Fitch report [6] published in February 2011, when asked to rank the main challenges that they see ahead for the market, 37.2% of the investors surveyed put sovereign risk at the top of the list, while 20.5% had concerns regarding the performance of the assets in cover pools. The health of the banking sector and the liquidity of the secondary market are the main concerns for 15.4% of investors. 7.7% of investors fear regulatory chances related to the implementation of Basel III and Solvency II. However, overall, the majority of investors who responded (82.9%) are planning either to maintain their current covered-bond holdings or to increase them.

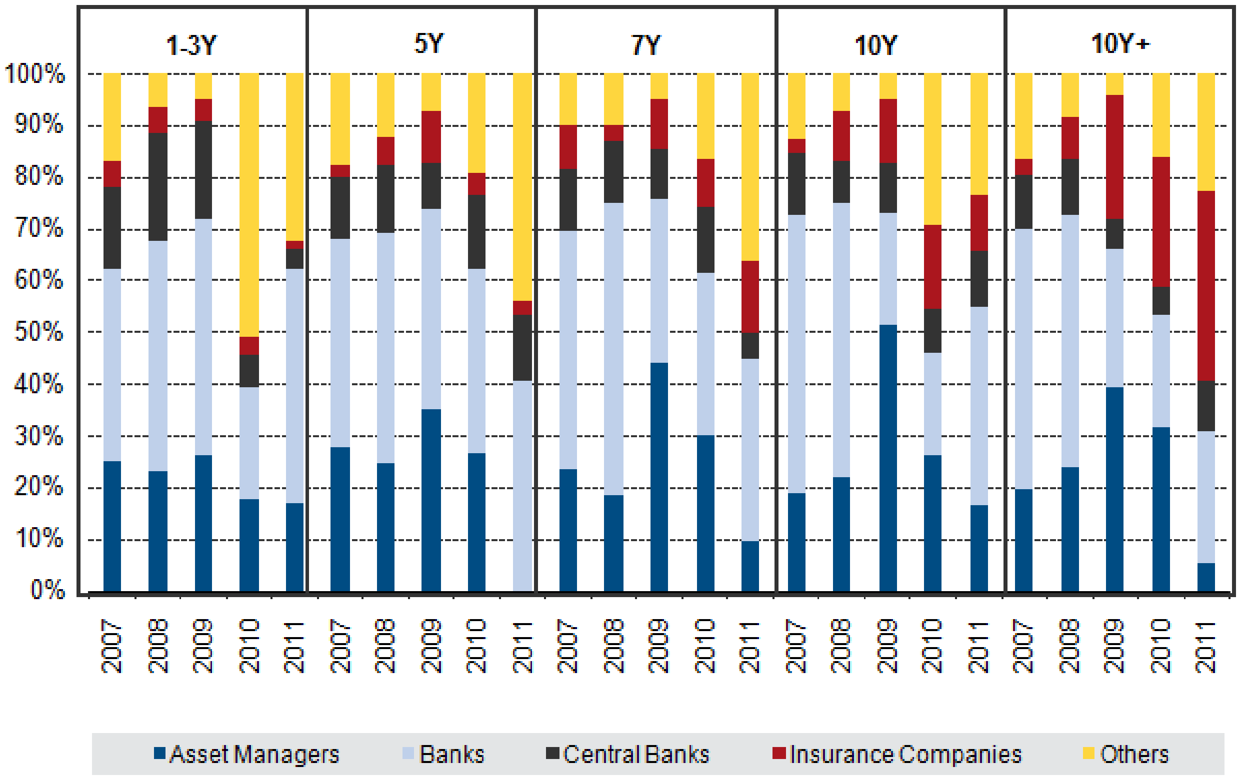
Stable investor base

Covered bonds have long had a very stable investor base that values the qualities of the product. Even during the crisis, the distribution statistics of jumbo covered bond transactions did not materially change, with all the major classes of investor all continuing to purchase covered bonds throughout the crisis and this in a context of issuance volumes being maintained or increasing. This was one of the factors that helped to ensure that spreads in the covered bond market were much more stable than in other parts of the capital market.

Even at the height of the crisis the overall investor base for covered bonds remained largely intact (although the appetite for certain jurisdictions did matter). Indeed there has been strong demand for small, non-'jumbo' transactions, something which has greatly aided issuer funding flexibility and asset/liability matching. Graph 3 (below) shows the make-up of the investor market from 2007 to date.

EUR bn	**2003-2006 average**	**2007**	**2008**	**2009**
Issuance	435	464	651	529

Table 2: Total Covered Bond Issuance (including jumbos), *Source: ECBC*



Graph 4: Distribution of Jumbo issues by investor type per maturity bank (%), *Source: LBBW*

IN CONCLUSION

European covered bonds are not new, nor do they constitute "financial engineering". In various formats, covered bonds have been used in Europe for centuries without bonds holders suffering defaults or credit losses. The success of the European covered bond market during and post-crisis can be attributed to many factors: firstly, the legal frameworks under which covered bonds are created, secondly the quality of the assets in the cover pool and the narrow list of eligible assets; and finally the hard-wiring of the product in the European legislation and the positive regulatory treatment that covered bonds has been received. This has been achieved without taxpayers' money being exposed to loss.

Covered bonds enjoyed support during the crisis in line with support to all areas of the financial markets. The nature of the instrument itself has given significant comfort to investors. The very rapid recovery of the covered bond market post-crisis is confirmation that this asset class did not expose taxpayers to losses and continues to play an important part in the mobilising of private sector funding for mortgages and public sector lending. With the end of the ECB CBPP, covered bonds remain a growing market in which investors have confidence and where governments do not need to provide support. Covered bonds in Europe have been a solid part of the solution to the crisis, not a contributor to, or part of the cause.

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[4] Clifford Chance, "*US Covered Bonds – Proposed Legislation Introduced to Encourage Market Development*", Client Memorandum April 2010.

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[8] European Covered Bond Council, "*Introducing covered bonds*", available at http://ecbc.hypo.org/Content/Default.asp?PageID=504

[9] European Covered Bond Council, "*ECBC Position Paper on CRD IV: arguments and supporting evidence*", available at http://intranet.hypo.org/docs/1/CMCACNACFIHFACAOMFLKJMKNPDWY9DBDBKTE4Q/EMF/Docs/DLS/2011-00004.pdf

[10] European Central Bank, "*Recent Developments in Securitisation*", Eurosystem Publications, February 2011.

ANNEX A. The International Capital Market Association

The International Capital Market Association (ICMA) is the trade association representing constituents and practitioners in the international capital market worldwide. ICMA performs a crucial central role in the market by providing a framework of industry-driven rules and recommendations which regulate issuance, trading and settlement in international fixed income and related instruments. ICMA liaises closely with regulatory and governmental authorities, both at the national and supranational level, to ensure that financial regulation promotes the efficiency and cost effectiveness of the capital market.

Annex B. ECBC Essential Features of Covered Bonds [8]

The ECBC sets out what it considers to be the essential features of covered bonds, together with explanatory notes. These common essential features should be understood as the ECBC's minimum standards for covered bonds and have to be read independently from any other definition or interpretation of covered bonds, such as those set out in the Undertakings for Collective Investment in Transferable Securities (UCITS) directive and in the Capital Requirements Directive (CRD)[9]. [8]

The essential features which has been isolated and which are achieved under special-law-based framework or general-law-based framework are the following: [8]

1 The bond is issued by – or bondholders otherwise have full recourse to – a credit institution which is subject to public supervision and regulation.

2 Bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution.

3 The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.

4 The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.

The ECBC database (www.ecbc.eu) offers a unique way to easily access and compare technical details between different covered bond frameworks. The database can also be seen as a contribution towards transparency as well as helping to picture what constitutes a covered bond

[9] See 2006/49/EC and 2006/49/EC.

ANNEX C. Covered bonds definition under CRD and UCITS

Two sets of European directives – UCITS and CRD – regulate the prudential treatment of covered bonds. Although these two directives are primarily aimed at providing harmonisation for the purposes of prudential regulation of banks and UCITS, these two EU directives are essential to understanding the main features and risk profiles of covered bonds. In addition, national legislation gives the basic framework to national covered bonds, particularly the general requirements for issuer banks, the competences of authorities and other entities responsible for controls, and provisions aimed at ensuring ring-fencing of assets and investors' rights in the event of bankruptcy. At the national level, the secondary legislation enacted by government and/or supervisory bodies, lays down more detailed rules on matters such as eligibility requirements, minimum collateralization levels, asset and liability management, and the checks to be carried out.

First, the special character of covered bonds has been enshrined in the Article 52 (4) of the UCITS Directive 2009/65/EC. Article 52 (4) does not mention the name "Covered Bond", but defines the minimum requirements that provide the basis for privileged treatment of bonds which are secured by assets. The European Central bank also classifies securities for repo purposes. Banks, which comprise a significant portion of the covered bond investor base, tend to hold covered bonds as collateral for their repo activities. For this purposes, the ECB follows the covered bond definition used in the UCITS directive. In order to have an EU recognised "covered bond" regime, a country must implement the requirements of Article 22(4) of the UCITS Directive, which essentially include covered bonds issued under statutes imposing special bankruptcy protection for covered bond holders [3].

Covered bonds that comply with Article 52 (4) UCITS directive are considered as a particular safe investment, which can explain the easing of prudential investment limits. Therefore, investment funds (UCITS) can invest up to 25% (instead of a maximum of. 5%) of their assets in covered bonds of a single issuer that meet the criteria of Article 52 (4). Similar, the EU Directives on Life and Non-Life Insurance (Directives 92/96/EEC and 92/49/EEC) allow insurance companies to invest up to 40% (instead of a maximum of 5%) in UCITS-compliant covered bonds of the same issuer [1].

A second cornerstone of covered bond regulation at EU level is the Capital Requirement Directive (CRD). The CRD is based on a proposal from the Basel Committee on Banking Supervision to revise the supervisory regulations governing the capital adequacy of internationally active banks. The CRD rules apply to all credit institutions and investment service providers in the EU [1]. The special treatment of covered bonds is an important feature of the CRD as it goes beyond the Basel II framework. With regard to covered bonds, CRD refers to the criteria of the UCITS Directive of 1985. Beyond this legal definition, a series of eligibility criteria for cover assets were stipulated. [8]

Asset Encumbrance

In most EU jurisdictions there are no specific limits placed on asset encumbrance or concerns around depositors and/or unsecured subordination. There has been some work done by the FSA in the UK which resulted in guidance on the amount of covered bonds a bank could issue (4% notification level and 20% asset soft cap). Any discussion of this subject should be looked at in the context of the overall Basel III/CRD capital requirements ratio and regulatory triggers currently being drawn up and put in place to prevent the collapse of a financial institution in the future. It was widely recognised in the EU that covered bonds have been part of the solution and not the problem in the market. And that uncertainty of the senior unsecured debt is further underpinning the demand of investors for covered bonds. We recognise that in some jurisdictions, including the United States, thought is being given to regulatory limits on issuance but they should not be drawn up in such a way that they preclude the development of a covered-bond market.

ANNEX D. Regulatory treatments of covered bonds

Ongoing regulatory reform, notably the Basel III agreement, amendments to the Capital Requirement Directive (CRD) and Solvency II, are likely to affect covered bonds [6]. The main component of Basel III's liquidity regime is the Liquidity Coverage Ratio (LCR). The LCR requires banks to maintain a stock of "high-quality liquid assets" that is sufficient to cover net cash outflows for a 30-day period under a stress scenario. In its initial consultative document[10], the Basel Committee defined "high-quality liquid assets" *extremely* conservatively. Banks' liquidity pools have to be at least 60% Level 1 assets (cash, central bank reserves, and sovereigns) and no more than 40% Level 2 assets (GSE obligations, and non-financial corporate or covered bonds rated AA- or above). The Basel III framework presents that a minimum 15% haircut should be applied to the current market value of each Level 2 assets, such as covered bonds – without any consideration of the underlying maturity. According to the Net Stable Funding ratio (NSFR), as specified in the Basel III framework, covered bonds as assets held in the cover pool are encumbered are given a Required Stable Funding (RSF) factor of 100%. A 65% RSF factor is applied to unencumbered mortgages.

EU banks must also comply with the new proposals contained in CRD 2 and CRD 3 in order to benefit from lower capital charges[11]. Future liquidity ratio regulation may also shift some demand towards covered bond markets, as the latter receive a more favourable treatment for liquidity purpose than the former [9].

Insurance companies and pension funds, in so far they invest on general account and not on behalf of third parties, will also have to comply with Solvency II capital charges. Market commentators argue that the higher capital charges on ABSs in Solvency II may make it less attractive for insurers and pension funds to invest in them than in covered bonds, bank floating rate notes or senior unsecured bonds [9].

[10] BIS (2009), Consultative Document: International Framework for liquidity risk measurement, standards and monitoring, Basel Committee on Banking Supervision, December 2009.

[11] CRD 2: Directive 2009/111/EU and Directive 2009/83/EU amending the CRD. CRD 3: Proposed directive amending CRD (in relation to trading book activities). CRD comprises the Banking Consolidation Directive (Recast) 2006/48/EC and the Capital adequacy Directive (Recast) 2006/48/EC.

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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.