

Testimony by Bert Ely
to the
House Committee on Financial Services
at a hearing entitled
Covered Bonds: Prospects for a U.S. Market Going Forward
December 15, 2009

Mr. Chairman Frank, Ranking Member Bachus, and members of the Committee, I very much appreciate the opportunity to testify today about covered bonds and the prospects for a U.S. covered-bond market going forward. I will first provide a brief description of covered bonds but focus most of my testimony on the many benefits covered bonds will bring to the U.S. financial system. I also will address the legislative and regulatory framework which should be created for 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 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 do so. 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 to the covered bonds, so that they can earn a 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 amount of bonds the assets secure.

Further, every asset in the pool must be performing in accordance with covered-bond regulations and the terms of the bond indenture governing the covered bonds. For example, a mortgage or car loan 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 in regulations 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 very 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 the 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” would continuously monitor the composition of the cover pool to ensure that the covered-bond issuer was continuously in compliance with all applicable regulations and 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 would be 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 where covered-bond financing makes economic sense.

The following table, based on Federal Reserve Flow of Funds data¹, 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 European covered-bond market.

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

(dollars in billions)

Home mortgages	\$ 9,799
Home equity loans	1,053
Multifamily residential mortgages	912
Commercial non-residential mortgages	2,523
Farm mortgages	<u>132</u>
Total mortgage debt	14,419
Consumer credit of all types	2,496
Non-mortgage borrowings by non-financial businesses	3,031
Local government debt ²	<u>1,567</u>
Total debt potentially financeable by covered bonds	<u><u>\$21,513</u></u>

¹ Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2009; Federal Reserve statistical release Z.1 (<http://www.federalreserve.gov/releases/z1/Current/z1.pdf>); Board of Governors of the Federal Reserve System; December 10, 2009, Tables L. 100, L.101, L.217, and L.218.

² Estimated by multiplying total state and local government debt at September 30, 2009, per the Federal Reserve Flow of Funds table L.105 (\$2.556 trillion), times local government debt as a percentage of state and local government debt for 2006-07 (61.3%), as published in the 2007 Census of Government Finance published by the U.S. Census Bureau.

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 back 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 all of the credit risk of the loans being securitized to investors in the liabilities issued by securitization trusts.

Pending financial-reform legislation would require lenders selling mortgages into the securitization process to retain a small portion – 5% to 10% – of the credit risk associated with those mortgages. 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. That is far preferable to a 5% or 10% risk retention as the lender is then on the hook for 100% of his lending mistakes.

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 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.

Better borrower protection

As the experience of recent years has taught, asset securitization has led to widespread lending abuses, with borrowers paying the price. Arguably, the housing bubble which triggered the current financial crisis is a costly byproduct 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 resecured 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 than 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.

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 enterprises³ (GSEs) contracts, guaranteed liabilities under the FDIC’s Temporary Liquidity Guarantee Program mature, and as asset securitization shrinks in the face of tougher asset-securitization standards and the growth of covered bonds as a funding source for financial assets. To put this point another way, as 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 rate 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 off of bank balance sheets onto 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.

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

The international appeal of 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 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 about one-seventh of the total credit outstanding to U.S. borrowers – public and private. According to Federal Reserve Flow of Funds data, foreign investors provided \$7.73 trillion, or 14.7% of the credit outstanding in the U.S. economy on September 30 of this year.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.

Creating the appropriate legal structure for covered bonds

It is absolutely crucial to have a sound, efficient legal structure governing the issuance of covered bonds by U.S. banks and other firms. This legal structure consists of three layers – (1) a statutory foundation, (2) a regulatory mechanism based on that statutory foundation to ensure the smooth functioning of the covered-bond marketplace while responding in a timely manner to changing marketplace conditions, and (3) readily enforceable bond indentures tailored to the unique circumstances of a covered-bond issuer and the assets in the cover pool securing those assets.

The statutory foundation for covered bonds

It is vital to the development of a U.S. covered-bond market for Congress to enact a covered-bond law which creates a sound, efficient legal framework for the issuance of covered bonds by banks and other entities. Above all, the statute must create legal certainty for covered-bond investors, specifically the certainty that no matter what happens to the issuer, principal and interest will be paid on the covered bonds at the contracted times and that the covered bonds will not be stripped of their cover pool should the issuer default on the bonds or be placed in a receivership or bankruptcy proceeding. That certainty is absolutely crucial to covered bonds being able to obtain, and retain, the AAA rating that covered bonds almost always earn.

While the covered-bond statute should provide the fundamental legal certainty, it should not overreach or get too precise about specific protections and processes. That is the case because not only should the underlying statutory law change infrequently, but Congress generally moves slowly

⁴ Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2009; Federal Reserve statistical release Z.1 (<http://www.federalreserve.gov/releases/z1/Current/z1.pdf>); Board of Governors of the Federal Reserve System; December 10, 2009, Table L.1, line 32.

and cautiously in changing such a law, as should be the case. That is, the covered-bond statute should not “love covered bonds to death” by being overly prescriptive. Instead, the more detailed prescriptions and processes governing covered bonds should be left to regulation, to a covered-bond regulator, and to the indentures governing specific covered-bond issuances.

Specific statutory provisions should include the following:

- A definition of the specific asset classes for which covered bonds can be issued with a bar on comingling between those classes.
- A definition as to who can be an eligible covered-bond issuer. Essentially, any type of financial intermediary should be an eligible issuer, provided that it complies with the applicable covered-bond law and regulations.
- Designation of the Treasury Department as the covered-bond regulator and the specification of its regulatory duties and powers. Specifically, the covered-bond regulator should be the registrar of covered bonds so as to ensure that it knows of and can regulate all covered-bond issuances.
- Specification of the rules which shall apply should a covered-bond issuer default on its covered-bond obligations or be placed in a receivership or bankruptcy proceeding. Importantly, the assets in the issuer’s cover pool and the covered bonds secured by those assets should either be transferred promptly to another covered-bond issue, under the original terms of the covered-bond issuance, or be placed in a separate estate or trust so as to maintain the integrity of the covered bonds’ security interest. The Treasury Department should be empowered to appoint a trustee for any such a trust or estate; that trustee could be the trustee under the indenture for the covered bonds.
- The Federal Reserve Bank of New York should be empowered to lend, on a collateralized basis, to the covered-bond trust or estate such funds as may be needed to enable the trustee to make timely payments of principal and interest on the covered bonds.
- In order that smaller lenders, such as community banks, can obtain covered-bond financing, pooling of covered bonds issued by smaller lenders should be permitted so that covered bonds issued by that pool can be sold to covered-bond investors. Such pooling will be much more efficient than if individual smaller lenders sell covered bonds directly to investors.
- The blanket lien that the Federal Home Loan Banks (FHLB) have on all the assets of an FHLB borrower must have a carve-out for assets in cover pools.

Moody’s, one of the three major credit-rating agencies, has written quite positively about these protections, stating in a recent newsletter that “The latest proposal for covered bond legislation is robust and . . . would provide very strong protection to future covered bond investors following an issuer default.” Moody’s goes on to say that “the development of a covered bond market in the U.S. would be a positive development for the funding profile of U.S. banks by providing an additional funding source for residential mortgage loans.⁵”

Regulatory oversight of the covered-bond marketplace

The Treasury Department, as the covered-bond regulator, would develop regulations to implement the statute and then enforce those regulations. Such an authorization would be a classic

⁵ Moody’s Week Credit Outlook, 14 December 2009, pp.17-18.

delegation of legislative authority to an administrative agency. Treasury would develop and adopt its rules in accordance with the well-established procedures of the Administrative Practices Act. This regulatory activity could be self-financed by a very small covered-bond issuance fee the Treasury would collect comparable to the fees the Securities and Exchange Commission collects.

Specific regulations would govern each covered-bond asset class, such as maximum LTV and minimum credit scores for borrowers and other criteria for loans eligible for a cover pool. The rules also would provide for an independent “cover pool monitor” to ensure that each cover pool was monitored on a continuous basis to ensure that only eligible assets were in that pool at all times and that assets which lost their eligibility were withdrawn from the pool and replaced by other eligible assets so as to at all times maintain the minimum overcollateralization required for that pool.

Because financial intermediation is constantly changing, the regulation of covered bonds will have to change, too, as the covered-bond marketplace adapts to an ever-changing financial world. By virtue of being the covered-bond regulator, the Treasury Department will be quite aware of changes in the covered-bond world that necessitate revisions in covered-bond regulations. Treasury will be able to do this by changing regulations on its own motion, after having received public and industry comment on proposed regulatory changes as well as input from other financial regulators. This process will keep covered-bond regulations up-to-date and functioning smoothly and effectively.

Covered-bond indentures

Although seldom discussed in the legislative arena, each covered-bond issuance would be governed in its most specific details by a bond indenture, which essentially is a contract between the bond issuer and bond investors. The administration of the indenture would be carried out by an independent bond trustee, who would perform the duties normally conducted by bond trustees, in accord with the covered-bond statute and regulations and enforceable in the appropriate court of law.

Among other provisions, the indenture would name the bond trustee, specify its duties, name the cover-pool monitor, and provide for the ongoing administration of the cover pool and the covered bonds, including timely payment of principal and interest, and deal with such other issues as are dealt with in bond indentures. In this regard, a covered-bond indenture would be comparable to corporate and government bond indentures which have existed for decades.

The covered-bond marketplace as the ultimate covered-bond regulator

The covered-bond marketplace – issues and investors – will be the ultimate covered-bond regulator, for covered-bond issuance will not take off and function efficiently in the United States if covered bonds do not meet the needs of both issuers and investors. However, this marketplace will not develop until such time as Congress enacts a sound covered-bond statute which provides for the efficient regulation and operation of the U.S. covered-bond marketplace.

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

Figure 1

Balance sheet of a covered-bond issuer

Assets = Liabilities + Capital

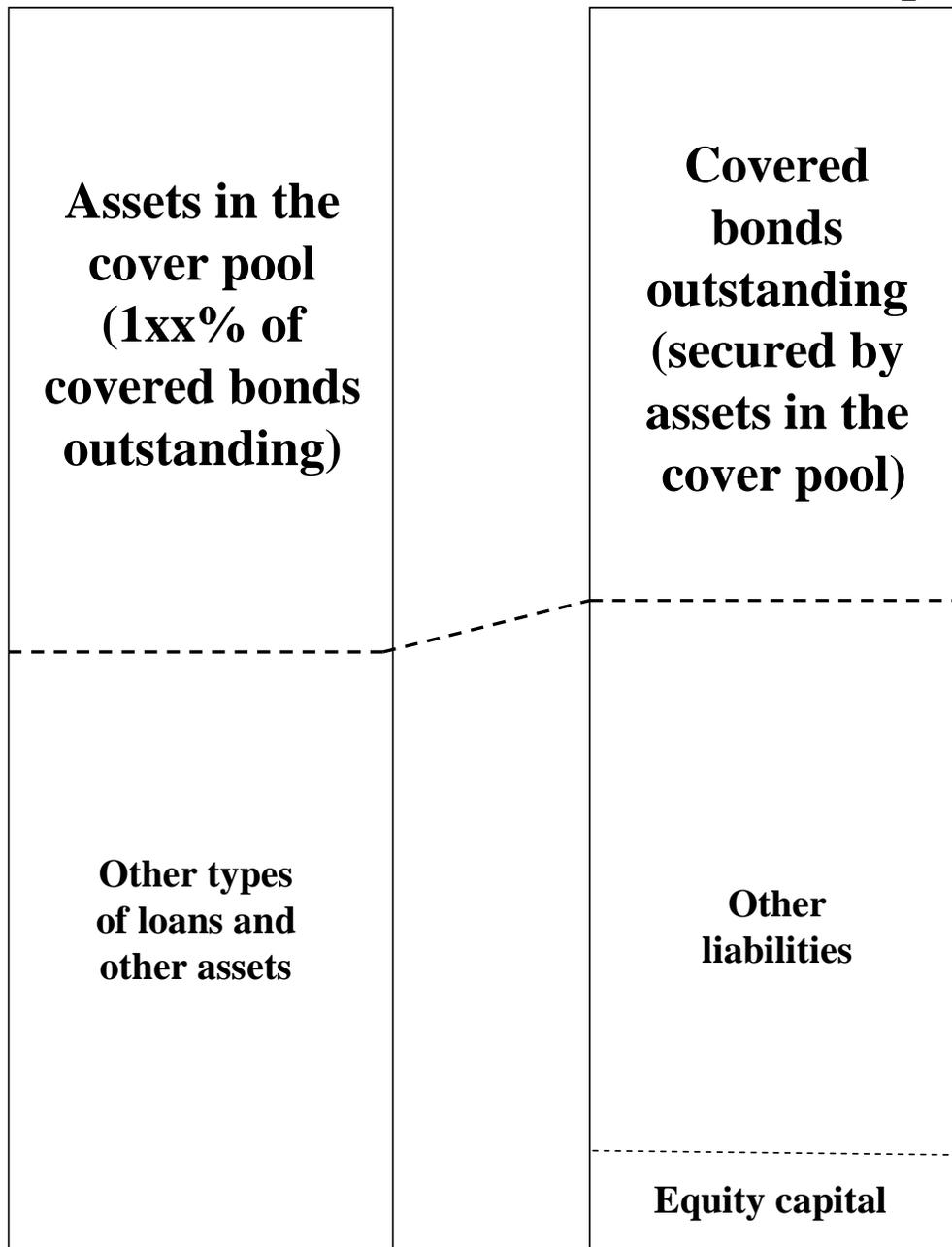
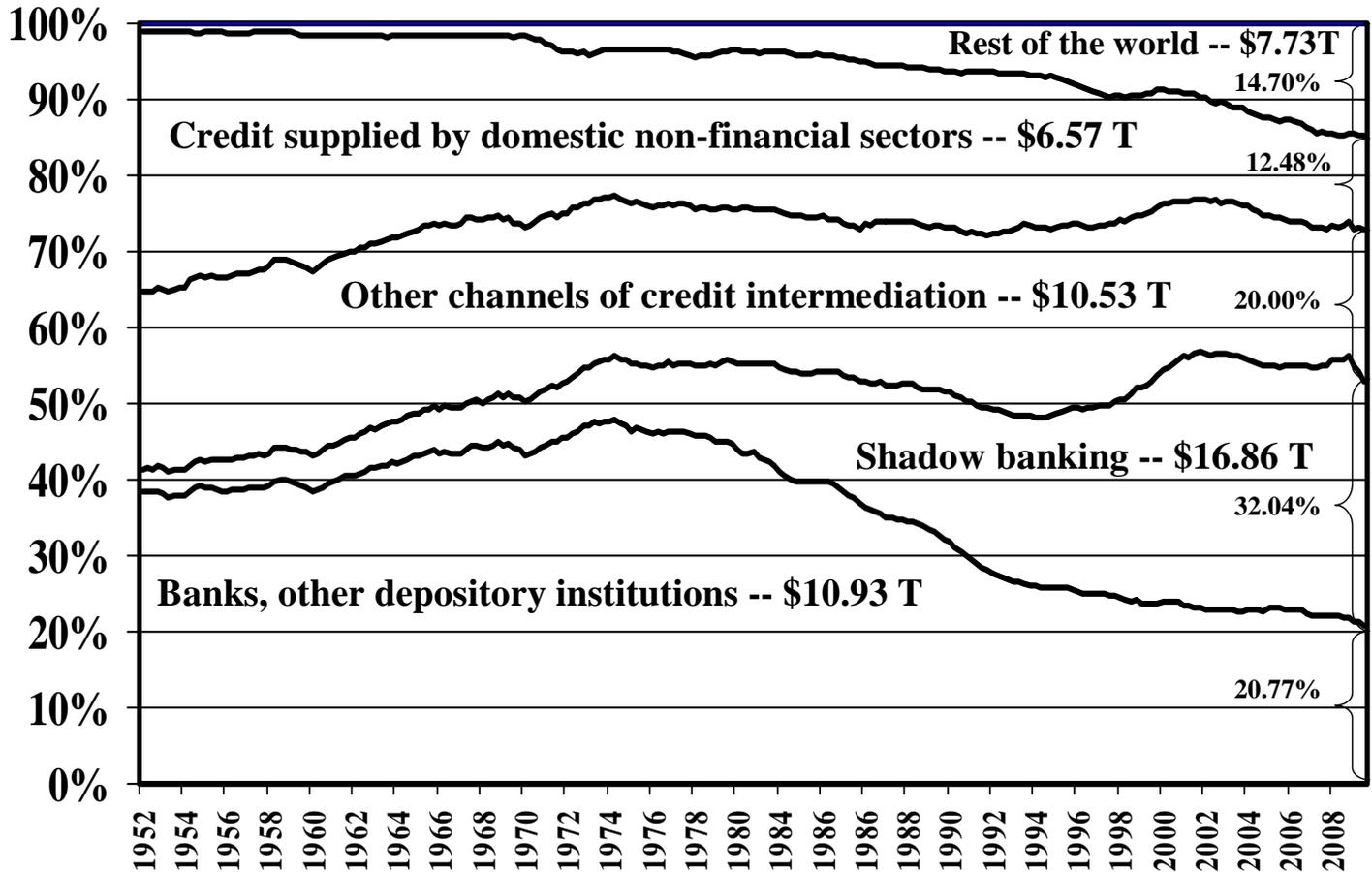


Figure 2

Changes in credit-intermediation shares

Quarterly data from Q1 1952 to Q3 2009; 2009Q3 dollars in trillions (T)



Biographical sketch for Bert Ely

Bert Ely has consulted on deposit insurance and banking structure 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 the GSEs, notably Fannie Mae, Freddie Mac, and the Farm Credit System. He has co-authored a monograph on how to privatize the three housing-finance GSEs. Currently, Bert is focusing his attention on banking problems, the crisis in housing and housing finance and the entire U.S. financial system, and the resolution of the Fannie and Freddie conservatorships.

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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