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

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Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, I am grateful for your invitation to testify today on the crucial role that U.S. covered bonds can play in stabilizing our financial system and contributing to our economic recovery.

I am a partner in the Washington, D.C., office of King & Spalding LLP and a member of the Steering Committee for the U.S. Covered Bond Council (the **Council**). The Council is a collaborative forum comprised of investors, issuers, dealers, and other participants in the covered-bond market, and we strive to develop policies and practices that harmonize the views of these different constituencies and that promote a vibrant market for U.S. covered bonds.[1]

When I last testified before the House Financial Services Committee in December 2009 on the need for U.S. covered bonds, policymakers faced an economic recovery that was slow and uneven. Fifteen months later, the environment is little changed. The percentage of unemployed or underemployed Americans has declined less than half a point from 17.1% to 16.7%. Despite over 1 million distressed home sales in 2010 and an increase in the distressed-sale discount from 30% to 37%, the percentage of negative-equity households has held steady at approximately 23%. The S&P/Case-Shiller National Home Price Index is down 4.1% since the fourth quarter of 2009, which is the lowest annual growth rate since the third quarter of 2009 when prices were falling at an annual rate of 8.6%. The delinquency rate on loans backing commercial mortgage-backed securities has increased to a record 9.39%, even though more loans were modified in 2010 than in the prior two years combined. State tax collections, adjusted for inflation, are down 12% from pre-recession levels, and for fiscal year 2012, 45 States and the District of Columbia are projecting budget shortfalls.

In the Council's view, sustained economic growth begins with a stable financial system. While the Dodd-Frank Act has supplied some important structural elements, there remains a considerable need for long-term and cost-effective funding that is sourced from diverse parts of the private-sector capital markets and that can be translated into meaningful credit for households, small businesses, and the public sector.

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[1] The U.S. Covered Bond Council is sponsored by The Securities Industry and Financial Markets Association (**SIFMA**). SIFMA brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation, and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, please visit www.sifma.org.

We believe that U.S. covered bonds are an untapped but proven resource that could be invaluable in meeting this need. The recent financial crisis has confirmed once again that nonlinearities and information constraints preclude reliable economic forecasts and that systemic risk is best mitigated by enabling markets to flex and market participants to pivot in short order. This, in turn, requires that financial intermediaries have more rather than fewer tools at their disposal to maintain a constant flow of credit through the economy, and essential among these tools are covered bonds.

We also believe that the time for U.S. covered bonds is now. While the balance sheets of financial institutions cannot replace the multi-trillion dollar securitization market, covered bonds can bridge funding gaps in the short term and can supply a much needed source of complementary liquidity in the long term. Similarly, while covered bonds are no panacea for the difficult policy issues that have been raised in the context of GSE reform, a robust covered-bond market would immediately attract private capital without need of a federal subsidy and would ultimately contribute to a more stable system of mortgage finance. With the success of a fragile economic recovery hanging in the balance, we simply cannot afford to wait any longer.

The Benefits of a U.S. Covered-Bond Market

Much has been written about U.S. covered bonds in the last two years, and because not all of the commentary has been entirely accurate, I want to take just a moment to describe this financial tool. At its core, a covered bond is simply a form of high-grade senior debt that is issued by a regulated financial institution and that is secured – or "covered" – by a dynamic cover pool of financial assets which is continually replenished. What distinguishes covered bonds from other secured debt is a legislatively or sometimes contractually prescribed process for managing (rather than immediately liquidating) the cover pool upon the issuer's default or insolvency and continuing scheduled (rather than accelerated) payments on the covered bonds. Over the course of this product's 240-year history, cover pools have included residential mortgage loans, commercial mortgage loans, agricultural loans, ship loans, and public-sector loans, and in the Council's view, loans for small businesses, students, automobile owners and lessors, and consumers using credit or charge cards also are appropriate.

Covered bonds are an effective vehicle for infusing long-term liquidity into the financial system. With maturities that typically range from 2 to 10 years and that can extend out to 15 years or more, they provide a natural complement to the short- and medium-term funding that is available through the Federal Home Loan Banks (the **FHLBs**) and the securitization and repo markets. This kind of stable liquidity allows financial companies to turn around and provide long-term credit to consumers, small businesses, and governments without being vulnerable to sudden changes in interest rates or investor confidence. In addition, by using covered bonds to more closely match the maturities of their assets and liabilities, financial institutions are able to reduce refinancing risks that can have a destabilizing influence on the banking system more broadly.

Covered bonds also represent a cost-efficient form of on-balance-sheet financing for financial institutions that, in turn, can reduce the cost of credit for families, small businesses, and the public sector. The importance of this cost efficiency cannot be overstated. Recent accounting changes and increased regulatory capital requirements, as well as continued challenges in the

securitization market, have made lending far more expensive. Spreads on long-term unsecured debt, moreover, are substantially wider than the short-term rates that have been pushed down to historically low levels by recent government initiatives, and these long-term rates could move even higher as the federal government exits those initiatives and competes for funding to finance its own budget deficits.

Another benefit of covered bonds is their separate and distinct investor base. These investors are providing liquidity that would not otherwise be made available through the unsecured-debt or securitization markets, and as a result, covered bonds enable financial institutions to add another source of funding rather than merely cannibalize their existing sources. Such diversification, not only in the kind but in the supply of liquidity, is crucial to reducing systemic risk and securing the financial system. With a growing shortage of fixed-income securities of the kind that appeal to rates investors, moreover, covered bonds are attracting as much interest as ever.

Equally important, covered bonds deliver funding from the private-sector capital markets without any reliance on U.S. taxpayers for support. The recent crisis is a stark reminder of how dependent some parts of the financial system have become on government intervention. That kind of intervention not only exposes the taxpayers to risk but also can create significant market dislocations if investors are not incented at the same time to direct their capital to unsubsidized investments. Covered bonds, which have demonstrated resilience even in distressed market conditions, can serve as an important bridge from an economy that is limping along on government support to one that is able to stand and thrive on its own.

Two other features of covered bonds bear mention. First, in contrast to securitization, a financial company issuing covered bonds continues to own the assets in the cover pool that are pledged as security. This creates 100% "skin in the game," and as a result, incentives relating to underwriting, asset performance, and loan modifications are strongly aligned. Second, the success of covered bonds is attributable in no small measure to their high degree of transparency and uniformity. As one of the most straightforward of financial products, covered bonds are a model of safe and sound banking practices.

With covered bonds supplying long-term and cost-efficient liquidity from a separate private-sector investor base, the Council believes that credit will more effectively flow to households, small businesses, and State and local governments. Because covered bonds are ultimately constrained by the balance sheets of issuers, however, they cannot be called a silver bullet, and action still needs to be taken to resuscitate securitization and other parts of the financial markets. But, like some of the measures in the Dodd-Frank Act, covered bonds represent a critical first step – and one that, in this constrained credit environment, is urgently needed now.

The Need for a Legislative Framework

To function successfully, a U.S. covered-bond market must be deep and highly liquid. Covered bonds are viewed as a conservative and defensive investment, and just as with any other high-grade instrument, investors expect active bids, offers, and trades. Sporadic issuances, one-

off transactions, cumbersome trading, and shallow supply and demand are incompatible with covered bonds.

This need for a deep and liquid covered-bond market was recognized by the Treasury Department (the **Treasury**) and the Federal Deposit Insurance Corporation (the **FDIC**) in 2008 when they collaborated to issue, respectively, Best Practices for Residential Covered Bonds and a Final Covered Bond Policy Statement. Regulators and market participants alike hoped that, in the absence of a legislative framework, these regulatory initiatives might serve as an adequate substitute and foster the growth of U.S. covered bonds.

But, during the last three years, it has become apparent that regulatory guidance alone will not suffice.

Covered bonds were originated and developed in Europe under legislative frameworks that require public supervision designed to protect covered bondholders, and this precedent has set market expectations. Today, almost 30 countries across the continent of Europe have adopted national legislation to govern covered bonds. These include Germany, France, the United Kingdom, the Netherlands, Spain, Italy, Russia, Denmark, Ireland, Portugal, the Czech Republic, the Slovak Republic, Austria, Hungary, Slovenia, Switzerland, Luxembourg, Sweden, Finland, Norway, Poland, Latvia, Lithuania, Ukraine, Romania, Bulgaria, Greece, Armenia, and Turkey. Even in Canada, where financial institutions have been able to actively tap the covered-bond market because of more creditor-friendly insolvency laws and the unique nature of their cover pools, a legislative framework is being developed.

Dedicated covered-bond legislation and public supervision, from the perspective of market participants, creates a degree of legal certainty that regulatory initiatives just cannot replicate. This kind of certainty is critical because the nature of covered bonds as a high-grade defensive investment with limited prepayment risk has no room for ambiguity on the rights and remedies available at law, especially in the event of the issuing institution's insolvency. Investors will not dedicate funds to this market unless the legal regime is unequivocal and the risks can be identified and underwritten.

To provide an example, if a U.S. depository institution were to issue covered bonds and later enter receivership under existing law, the FDIC has expressed the view that three options are available at its discretion: (1) the FDIC could continue to perform on the covered bonds according to their original terms, (2) the FDIC could repudiate the covered bonds or allow a default to occur, make a determination about the fair market value of the cover pool securing them, pay covered bondholders an amount equal to the lesser of that fair market value and the outstanding principal amount of the covered bonds with interest accrued only to the date of its appointment as receiver, and retain the cover pool, or (3) the FDIC could repudiate the covered bonds or allow a default to occur, leave covered bondholders to exercise self-help remedies against the cover pool, and recover from them any proceeds in excess of the outstanding principal amount of the covered bonds with interest accrued only to the date of its appointment as receiver. Any of these three options would be exercised against the backdrop of a temporary automatic stay that would last for 90 days after the FDIC's appointment as receiver or, at best under the Final Covered Bond Policy Statement, 10 business days after an uncured monetary default (though not an uncured nonmonetary default).

In these circumstances, investors face a number of uncertainties: Which of the three options will the FDIC exercise? When will the FDIC make its choice? How will the FDIC calculate the fair market value of the cover pool, and how long will that process take? Will self-help remedies alone suffice, or will the FDIC instead need to be involved in releasing the cover pool? Will the FDIC challenge the method of liquidation used by the trustee for the covered bondholders? What will happen if the FDIC elects to perform for some period of time and then later repudiate, especially if the cover pool has deteriorated in the meantime? Legal uncertainties like these simply do not exist under the legislative frameworks found in Europe.

Equally troubling to investors and other market participants is the fact that this optionality resides with the FDIC, which has a rather clear conflict of interest because of its fiduciary duty to depositors and the deposit-insurance fund. The conflict was recently highlighted by the FDIC's repeated calls for legislation that would force secured creditors like covered bondholders to take a haircut even if their claims are fully collateralized – a development which, to our knowledge, would be unprecedented in the history of credit.[2] Although this proposal was not adopted as part of the Dodd-Frank Act, the FDIC's advocacy was sufficiently vigorous to prompt a wide-ranging study on the subject.[3]

Layered on top of these concerns is the obvious incompatibility of a forced acceleration by the FDIC with the core nature of a covered bond. A *sine qua non* of covered bonds is the use of collections and other proceeds from the cover pool to continue making scheduled payments after the issuer's default or insolvency. If forced acceleration were possible, the instrument would no longer be a covered bond but instead would be just plain-vanilla secured debt. In addition, if the FDIC were to take the position that secured claims of investors are limited to the fair market value of the cover pool at a moment in time rather than to its cash flow value over time, forced acceleration would expose them to losses arising from short-term market volatility and liquidity risks that are not part of the economic bargain in the covered-bond market.

For these reasons, the Council has concluded that a well-functioning market for U.S. covered bonds cannot develop without a legislative framework that stays true to the distinctive features of traditional covered bonds. Anything less would preclude issuing institutions – and ultimately consumers, small businesses, and the public sector – from realizing the cost efficiencies that make covered bonds worthwhile.

We are confident, moreover, that such a framework could be constructed in a way to fully protect the interests of an issuer's other creditors (including, in the case of a bank, the deposit-insurance fund) as well as any conservator, receiver, or bankruptcy trustee. Taking a bank receivership as an example once again, we would support a period of up to 180 days for the

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[2] *See, e.g.*, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Establishing a Framework for Systemic Risk Regulation before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 23, 2009); Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Regulatory Perspectives on Financial Regulatory Reform Proposals before the U.S. House Committee on Financial Services (July 24, 2009); Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Remarks to the International Institute of Finance (October 4, 2009); Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Systemic Regulation, Prudential Measures, Resolution Authority, and Securitization before the U.S. House Committee on Financial Services (October 29, 2009).

[3] *See* Section 215 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. § 5395).

FDIC to transfer an affected covered-bond program to another eligible issuer so long as all monetary and nonmonetary obligations were performed during that time.[4] If such a transfer turned out to be impossible or inadvisable and the covered-bond program were moved to a separate estate for administration, we believe that the receivership's equity in that estate should take the form of a residual interest that the FDIC could sell or otherwise monetize immediately for the benefit of other creditors and the deposit-insurance fund. We also could support the holder of that equity interest being afforded consent rights over the selection of any servicer or administrator for the estate.

The absence of a legislative framework for U.S. covered bonds is already coming at a cost. European and other non-U.S. issuers have been taking advantage of favorable laws in their home countries and filling the vacuum. In 2010 alone, over $27 billion in U.S. Dollar covered bonds were targeted to investors in the United States, and over $55 billion more is expected in 2011. With governments in Europe providing the requisite legal certainty for covered bonds issued by their domestic institutions, we fear that the playing field could grow increasingly uneven in the fierce competition among banks for less expensive and more stable sources of funding.

The cost of such an outcome, of course, will be born in the end by families, small businesses, and governments throughout the United States, especially those that are dependent on banks for their liquidity needs. When possible, the higher funding costs will be passed along to them; when not, credit will be denied altogether. Neither result can be described as at all desirable.

<u>Some Myths Dispelled</u>

Myth – U.S. covered bonds would have an implicit federal guarantee.

Fact – U.S. covered bonds would not be backed, either explicitly or implicitly, by the federal government.

The implicit federal guarantee enjoyed by Fannie Mae, Freddie Mac, and the FHLBs has arisen from an extraordinarily unique set of components:

- Each GSE has been federally chartered with a targeted public-policy purpose.[5]
- The U.S. Treasury has been authorized to extend credit to each GSE.[6]
- Each GSE has been exempted from most State and local income taxes.[7]

[4] This would be consistent with the FDIC's existing policy on the treatment of secured obligations. *See* Federal Deposit Insurance Corporation, Statement of Policy Regarding Treatment of Security Interests After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver (March 23, 1993).

[5] 12 U.S.C. §§ 1716-1717 (Fannie Mae), 1452-1454 (Freddie Mac), and 1423-1430c (FHLBs).

[6] 12 U.S.C. §§ 1719(c) (Fannie Mae), 1455(c) (Freddie Mac), and 1431(i) (FHLBs).

[7] U.S.C. §§ 1723a(c)(2) (Fannie Mae), 1452(e) (Freddie Mac), and 1433 (FHLBs).

- Each GSE's debt securities and mortgage-backed securities have been made eligible for open-market purchases by the Federal Reserve Banks,[8] for deposits of public funds,[9] and for investments by fiduciaries.[10]

- Each GSE's debt securities and mortgage-backed securities have been exempted from investment limits that are otherwise imposed on banks, savings associations, and credit unions.[11]

- Each GSE has been entitled to use any Federal Reserve Bank as its depository, custodian, and fiscal agent.[12]

Under the legislative framework that the Council has proposed, no issuer of U.S. covered bonds could lay claim to any status or preference that even remotely resembles those afforded to the GSEs. For example, to the extent that any misguided inference could be drawn from a covered-bond estate inheriting an insolvent issuer's access to liquidity from the Federal Reserve Banks, we have proposed that legislation expressly provide that (1) no advance can be made by a Federal Reserve Bank for the purpose, or with the expectation, of absorbing credit losses on the estate's cover pool, (2) any advance must have a maturity that is consistent with an advance for liquidity only, (3) repayment of any advance must constitute a superpriority claim against the estate that is secured by a superpriority lien on the cover pool, and (4) any Federal Reserve Bank making an advance must promptly report to Congress on the circumstances giving rise to the advance, the terms of the advance, the nature of the cover pool securing the advance, and the basis for concluding that credit losses on the cover pool will not be absorbed by the Federal Reserve Bank.

Some have suggested that the mere existence of a single covered-bond regulator could imply that covered bonds are backed to some degree by the U.S. government. This, in our view, is a questionable proposition. After all, a single regulator – the Comptroller of the Currency (the **OCC**) – supervises all national banks, but no one could seriously argue that the OCC is an implied-in-fact guarantor of their obligations. Similarly, the Securities and Exchange Commission regulates all non-exempt offers and sales of securities but certainly could not be perceived as insuring investors against any loss.

Our reservation about multiple covered-bond regulators, as some have proposed, is rooted in a conviction that market fragmentation would likely doom U.S. covered bonds from the outset. We cannot envision a deep and liquid market developing if national banks, State member banks, State nonmember banks, bank holding companies, and other covered-bond issuers are operating under different regulatory frameworks. At a minimum, therefore, we recommend that

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[8] 12 U.S.C. § 355(2) and 12 C.F.R. § 201.108(b) (Fannie Mae, Freddie Mac, and FHLBs).

[9] 12 U.S.C. §§ 1723c (Fannie Mae), 1452(g) (Freddie Mac), and 1435 (FHLBs).

[10] 12 U.S.C. §§ 1723c (Fannie Mae), 1452(g) (Freddie Mac), and 1435 (FHLBs); see also 15 U.S.C. § 77r-1(a) (preempting any contrary State law in connection with the securities of Fannie Mae and Freddie Mac).

[11] 12 U.S.C. §§ 24(Seventh), 335, 1464(c)(1), and 1757(7) (Fannie Mae, Freddie Mac, and FHLBs).

[12] 12 U.S.C. §§ 1723a(g) (Fannie Mae), 1452(d) (Freddie Mac), and 1435 (FHLBs).

the Secretary of the Treasury be directed to promulgate a single set of regulations for all covered-bond issuers and that each of the individual prudential regulators be tasked with implementing them for the issuers under their primary supervision. This, in our view, would not be ideal but at least would allow for the kind of uniform legal regime that will be critical to developing a vibrant market for U.S. covered bonds.

We also are aware of the FDIC's assertion that the legislative framework proposed by the Council would give covered bondholders "a super-priority in receivership" and would result in their claims being "essentially back-stopped by the FDIC."[13] These statements, however, were not substantiated and, in our view, reflect a fundamental misunderstanding of the proposal and existing law.

A superpriority claim or a superpriority lien, in the context of an insolvency proceeding, is one that has been elevated to a level of priority higher than that otherwise afforded by applicable law to other claims or liens (including administrative claims or liens).[14]

Nothing in our proposed legislative framework, including the treatment of any claim or lien of a covered bondholder, would change the priority scheme in a conservatorship or receivership of the issuing institution. Both before and after the insolvency proceeding, investors would benefit from a first-priority lien on the issuer's cover pool to secure their claims under the covered bonds – just like any other secured creditor – and at no time would they be entitled to a lien (superpriority or otherwise) on any of the issuer's other assets. In addition, to the extent that the cover pool proves insufficient to satisfy their claims in full, covered bondholders would fall in line alongside all other general unsecured creditors without any enhanced priority or preference of any kind. This treatment stands in stark contrast, for example, to the superpriority claims and liens that can arise in connection with post-insolvency financing arrangements[15] and to the springing priority of an FHLB's "super lien" on all of a member institution's property.[16]

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[13] *See, e.g.*, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, *Keynote Address to the "Mortgages and the Future of Housing Finance Symposium"* (Oct. 25, 2010).

[14] *See, e.g.*, 11 U.S.C. § 364(c) and (d) (in a bankruptcy case, authorizing postpetition loans "with priority over any or all administrative expenses" and "secured by a senior or equal lien on property of the estate that is subject to a lien"); 12 U.S.C. § 4617(i)(11) (for a limited-life regulated entity created by the Federal Housing Finance Agency with respect to Fannie Mae, Freddie Mac, or an FHLB, authorizing loans "with priority over any or all of the obligations of the limited-life regulated entity" and "secured by a senior or equal lien on property of the limited-life regulated entity that is subject to a lien (other than mortgages that collateralize the mortgage-backed securities issued or guaranteed by an enterprise)"); 12 U.S.C. § 5390(b)(2) ("In the event that the [FDIC], as receiver for a covered financial company, is unable to obtain unsecured credit for the covered financial company from commercial sources, the Corporation as receiver may obtain credit or incur debt on the part of the covered financial company, which shall have priority over any or all administrative expenses of the receiver under paragraph (1)(A)."); 12 U.S.C. § 5390(h)(16) (for a bridge financial company created by the FDIC with respect to a covered financial company, authorizing loans "with priority over any or all of the obligations of the bridge financial company" and "secured by a senior or equal lien on property of the bridge financial company that is subject to a lien").

[15] *See* the authorities cited in note 14.

[16] 12 U.S.C. § 1430(e) ("Notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member of any Federal Home Loan Bank or any affiliate of any such member shall be entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights of a lien creditor) other than claims and rights that – (1) would be entitled to priority under otherwise applicable law; and (2) are held by actual bona fide purchasers for value or by actual secured parties that are secured by actual perfected security interests."); *see also* 12 U.S.C. §§ 1821(d)(5)(D) (precluding the FDIC from disallowing any claim asserted by an FHLB) and 1821(e)(14) (exempting FHLB advances from the FDIC's authority to disallow or repudiate contracts).

What our legislative proposal would affect is the FDIC's power to compel an acceleration of the covered bonds and to pay only "actual direct compensatory damages . . . determined as of the date of the appointment of the conservator or receiver."[17] Because a *sine qua non* of covered bonds is their limited risk of prepayment, they instead would remain outstanding according to their original terms so long as collections and other proceeds from the cover pool could continue to fund all scheduled payments.

This, however, hardly creates a backstop by the FDIC. To the contrary, our proposal is a more modest iteration of the framework that currently exists for qualified financial contracts (**QFCs**) under the Federal Deposit Insurance Act (the **FDIA**). One notable similarity between them is full restitution, at least to the extent of the posted collateral (including any overcollateralization), for damages that result from reinvestment risk. In the context of QFCs, this is picked up by the counterparty's right under the FDIA to "normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims."[18] Another similarity is found in carefully drawn limits on the FDIC's ability to repudiate or assign contracts or collateral.[19] But, unlike covered bondholders in our proposed framework, a QFC counterparty is entitled to even more, including (1) a unilateral right to terminate, liquidate, or accelerate the QFC and to exercise remedies and rights of setoff under the QFC and against any related collateral,[20] (2) an ability, after the business day following the date of the FDIC's appointment as receiver, to enforce ordinarily nonbinding contractual provisions that are triggered solely by the institution's insolvency or receivership (*ipso facto* clauses),[21] and (3) immunity from all avoidance actions except for those grounded in an actual intent to defraud.[22]

We may be able to support a legislative framework for U.S. covered bonds that is modeled on these QFC provisions, if the use of existing precedent would assuage even misplaced concerns.

Myth – U.S. covered bonds would benefit only the largest banks.

Fact – The U.S. covered-bond market would be available to regional and community banks under the proposed legislative framework.

Covered bonds are a conservative and defensive investment that appeals to investors only if the secondary market is sufficiently deep and liquid to generate active bids, offers, and trades. As a result, each series of covered bonds is typically sized at no less than $500 million.

[17] 12 U.S.C. § 1821(e)(1) and (3).

[18] 12 U.S.C. § 1821(e)(3)(C).

[19] 12 U.S.C. § 1821(e)(9) and (11).

[20] 12 U.S.C. § 1821(e)(8)(A) and (E).

[21] 12 U.S.C. § 1821(e)(10)(B).

[22] 12 U.S.C. § 1821(e)(8)(C).

To ensure that regional and community banks are able to access such a market on competitive terms, we have proposed that pooled issuances be permitted. Under this arrangement, several institutions would issue more modestly sized series of covered bonds to a statutory trust or other separate entity that they have collectively sponsored. This entity then would populate a cover pool with the multiple series that have been acquired and issue into the market a single series of covered bonds backed by all of them together.

In this way, for example, each of ten community banks could establish its own separate covered-bond program comprised of the commercial-mortgage loans on its balance sheet and issue $50 million of related covered bonds to a jointly sponsored trust. All ten of these separate $50 million series of covered bonds then would fill a cover pool established by the trust, and a single $500 million series of covered bonds backed by the entire cover pool would be issued by the trust to investors.

We believe that this approach, which has been used successfully in Europe, would open the U.S. covered-bond market to regional and community banks in a meaningful way. We also believe that the cost-effective, long-term funding that covered bonds can supply would be especially valuable to small-and middle-market institutions that historically have been limited to fewer and less diverse sources of liquidity.

Myth – U.S. covered bonds would merely replace FHLB advances and therefore result in a reallocation of, and not an increase in, funding for financial institutions.

Fact – U.S. covered bonds would constitute an additive source of liquidity for financial institutions and, as a result, would facilitate increased lending.

Each individual decision to lend is a function of return on capital, business strategy, and risk management.

Covered bonds enable financial institutions (1) to lower the cost of funding, which increases the return on capital, (2) to augment rather than cannibalize their funding sources, which provides the fuel for business lines to innovate and boost lending, and (3) to better match assets and liabilities, which reduces the risk of providing longer-term closed-end loans (like residential mortgage loans) and revolving lines of credit (like credit-card loans).

As a result, we must respectfully disagree with any suggestion that covered bonds will not contribute to increased lending. That, in our view, is not supported by the microeconomic incentives that drive the business of banking or by any empirical data.

We also must take issue with any suggestion that covered bonds are similar or equivalent to advances from the FHLBs. First, covered bonds will fund a much broader range of asset classes than the FHLBs typically accept in the normal course of business. Second, covered bonds will supply fixed-rate liquidity with maturities that the FHLBs generally do not offer to their member institutions. For these reasons, we envision covered bonds as a private-sector complement, rather than as a substitute, for federally subsidized FHLB advances.

All of this being said, we can foresee financial institutions reallocating a modest portion of their short-and medium-term funding away from existing sources and toward a U.S. covered-bond market that is deep and liquid. But this, in our view, is the very macroeconomic objective that policymakers are seeking to achieve. The liquidity crisis that began in late 2008 was exacerbated in no small part by an overreliance on volatile short-term borrowings to fund long-term assets. Covered bonds will provide financial institutions with a cost-effective source of fixed-rate funding much farther out on the maturity curve than is currently feasible, which will lessen systemic risk in the broader financial markets and will bolster risk-management frameworks inside individual institutions.

Proposal for a Legislative Framework

The Council fully supports the kind of comprehensive covered-bond legislation that Chairman Garrett and Representative Maloney have proposed in the United States Covered Bond Act of 2011 (H.R. 940).

In particular, the Council endorses the following elements of a legislative framework for U.S. covered bonds:

- *Public Supervision by a Covered Bond Regulator* – The public supervision of covered-bond programs by a federal regulator, whose mission is the protection of covered bondholders, is central to any legislative framework. In the European Union, this feature is enshrined in Article 52(4) of the Directive on Undertakings for Collective Investment in Transferable Securities (the **UCITS Directive**).[23] Compliance with Article 52(4) is what has given covered bonds their unique status in Europe, including privileged risk weighting under the EU's Capital Requirements Directive and preferential treatment by the European Central Bank in Eurosystem credit operations.

  We therefore support a framework that includes the following: The Secretary of the Treasury, the Comptroller of the Currency, or another U.S. government agency – excluding the FDIC because of its conflict of interest – would be appointed as the Covered Bond Regulator, which would have as its mission the protection of covered bondholders. The Covered Bond Regulator, in consultation with other applicable primary federal regulators, would ensure compliance with legislative requirements and would establish additional regulatory requirements that are tailored to the different kinds of covered-bond programs. Covered bonds would fall under the legislative framework only if issued under a covered-bond program that has been approved by the Covered Bond Regulator in consultation

[23] Article 52(4) will replace its predecessor, Article 22(4), in July 2011 as part of the recast of EU Directive 85/611 by EU Directive 2009/65 (July 13, 2009).

with the issuer's primary federal regulator. The Covered Bond Regulator would maintain a public registry of approved covered-bond programs.[24]

- *Eligible Issuers* – Issuances by regulated financial institutions is another fundamental element of covered bonds that is also recognized in the UCITS Directive. In order to afford competitive market access to regional and community banks, however, pooled issuances by entities that have been sponsored by one or more regulated institutions should be permitted as well.

We therefore support a framework that includes the following: Eligible issuers of covered bonds would be comprised of (1) depository institutions, domestic branches or agencies of foreign banks, and their subsidiaries, (2) bank holding companies, savings and loan holding companies, and their subsidiaries, (3) nonbank financial companies and their subsidiaries if approved by the Covered Bond Regulator and other applicable primary federal regulators, and (4) issuing entities that are sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis.

- *Covered Bonds* – To ensure that covered bonds retain their essential attributes as the market evolves, we support a framework that includes the following: A covered bond would be defined as a recourse debt obligation of an eligible issuer that (1) has an original term to maturity of not less than one year, (2) is secured by a perfected security interest in a cover pool that is owned directly or indirectly by the issuer, (3) is issued under a covered-bond program that has been approved by the Covered Bond Regulator, (4) is identified in a register of covered bonds that is maintained by the Covered Bond Regulator, and (5) is not a deposit.

- *Cover Pool* – One other indispensable feature of covered bonds is a cover pool that contains performing assets and that is replenished and kept sufficient at all times to fully secure the claims of covered bondholders. This too receives specific mention in the UCITS Directive.

We therefore support a framework that includes the following: The cover pool would be defined as a dynamic pool of assets that is comprised of (1) one or more eligible assets from a single eligible asset class, (2) substitute assets (such as cash and cash equivalents) without limitation, and (3) ancillary assets (such as swaps, credit enhancement, and liquidity arrangements) without limitation. No cover pool would include eligible assets from more than one eligible asset class. A loan would not qualify as an eligible asset while delinquent for more than 60 consecutive days, and a security would not qualify as an eligible asset while not of the requisite credit quality.

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[24] As noted earlier, we also could support a framework where the Secretary of the Treasury is directed to promulgate a single set of regulations for all covered-bond issuers and where each of the individual prudential regulators is tasked with implementing them for the issuers under its primary supervision.

- *Eligible Asset Classes* – The real benefit of covered bonds is long-term and cost-effective funding from the private sector that can be converted into meaningful credit for families, small businesses, and State and local governments throughout the United States.

We therefore support a framework that includes the following eligible asset classes: (1) residential mortgage asset class, (2) home equity asset class, (3) commercial mortgage (including multi-family) asset class, (4) public sector asset class, (5) auto asset class, (6) student loan asset class, (7) credit or charge card asset class, (8) small business asset class, and (9) other asset classes designated by the Covered Bond Regulator in consultation with other applicable primary federal regulators.

- *Overcollateralization, Asset-Coverage Test, and Independent Asset Monitor* – Full transparency, independent monitoring, and regular reporting must be among the hallmarks of U.S. covered bonds.

We therefore support a framework that includes the following: The Covered Bond Regulator would establish minimum overcollateralization requirements for covered bonds backed by each of the eligible asset classes based on credit, collection, and interest-rate risks but not liquidity risks. Each cover pool would be required at all times to satisfy an asset-coverage test, which would measure whether the eligible assets and the substitute assets in the cover pool satisfy the minimum overcollateralization requirements. Each issuer would be required to perform the asset-coverage test monthly on each of its cover pools and to report the results to covered bondholders and applicable regulators. Each issuer also would be obligated to appoint the indenture trustee for its covered bonds or another unaffiliated entity as an independent asset monitor, which would periodically verify the results of the asset-coverage test and provide reports to covered bondholders and applicable regulators.

- *Separate Resolution Process for Covered-Bond Programs* – Hand in hand with public supervision is legal certainty on the resolution of a cover pool if the issuer were to default or become insolvent. A dedicated process must exist that provides a clear roadmap for investors, that avoids the waste inherent in a forced liquidation of collateral, and that allows the cover pool to be managed and its value maximized.

Central to this resolution process is the creation of a separate estate – like the ones created under the Bankruptcy Code – for any covered-bond program whose issuer has defaulted or become insolvent. To ensure that timing mismatches among the assets and liabilities of the estate do not unnecessarily erode the cover pool's value or cause a premature default, both private-sector counterparties and the Federal Reserve Banks should be authorized to make advances to the estate on a superpriority basis for liquidity purposes only. Importantly, however, advances by a Federal Reserve Bank should be prohibited if U.S. taxpayers could be exposed to any credit risk whatsoever.

Special rules also are appropriate should the FDIC be appointed as conservator or receiver for an issuer before any default occurs on its covered bonds. All interested parties would benefit if the FDIC were able to transfer the entire covered-bond program to another eligible issuer, much like Washington Mutual's program was conveyed to JPMorgan Chase. As a result, the FDIC should be afforded a reasonable period of time (not to exceed 180 days) to effect such a transfer before a separate estate is created.

In addition, neither an issuer that has defaulted nor its creditors in the case of insolvency should forfeit the value of surplus collateral in the cover pool. To enable this value to be realized promptly by the issuer and its creditors (including the FDIC and the deposit-insurance fund) without disrupting the separate resolution process, a residual interest should be created in the form of an exempted security that can be sold or otherwise monetized immediately. Such an approach should satisfy all constituencies – covered bondholders will be able to rely on the separate, orderly resolution process for their cover pool, and the issuer and its creditors (including the FDIC and the deposit-insurance fund) will not have to wait for that process to conclude before turning any surplus into cash.

We therefore support a framework that includes the following: If covered bonds default before the issuer enters conservatorship, receivership, liquidation, or bankruptcy, a separate estate would be created that is comprised of the applicable cover pool and that assumes liability for the covered bonds and related obligations. Deficiency claims against the issuer would be preserved, and the issuer would receive a residual interest that represents the right to any surplus from the cover pool. The issuer would be obligated to release applicable books, records, and files and, at the election of the Covered Bond Regulator, to continue servicing the cover pool for 120 days.

If the FDIC were appointed as conservator or receiver for an issuer before a default on its covered bonds results in the creation of an estate, the FDIC would have an exclusive right for up to 180 days to transfer the covered-bond program to another eligible issuer. The FDIC as conservator or receiver would be required during this time to perform all monetary and nonmonetary obligations of the issuer under the covered-bond program.

If another conservator, receiver, liquidator, or bankruptcy trustee were appointed for an issuer before a default on its covered bonds results in the creation of an estate or if the FDIC as conservator or receiver did not transfer a covered-bond program to another eligible issuer within the allowed time, a separate estate would be created that is comprised of the applicable cover pool and that assumes liability for the covered bonds and related obligations. The conservator, receiver, liquidating agent, or bankruptcy court would be required to estimate and allow any contingent deficiency claim against the issuer. The conservator, receiver, liquidating agent, or bankruptcy trustee would receive a residual interest that represents the right to any surplus from the cover pool. The conservator, receiver, liquidating agent, or bankruptcy trustee would be obligated to release applicable

books, records, and files and, at the election of the Covered Bond Regulator, to continue servicing the cover pool for 120 days.

The Covered Bond Regulator would act as or appoint the trustee of the estate and would be required to appoint and supervise a servicer or administrator for the cover pool. The servicer or administrator would be obligated to collect, realize on, and otherwise manage the cover pool and to invest and use the proceeds and funds received to make required payments on the covered bonds and satisfy other liabilities of the estate. The estate would be authorized to borrow or otherwise procure funds, including from the Federal Reserve Banks. Other than to compel the release of funds that are available and required to be distributed, no court would be able to restrain or affect the resolution of the estate except at the request of the Covered Bond Regulator.

- *Securities Law Provisions* – With covered-bond programs subject to rigorous public supervision, investors will be well protected. As a result, an expansion of existing securities-law exemptions may be appropriate. Regardless, because legal certainty for covered bonds is paramount, we support a framework that includes at least the following: Existing exemptions for securities issued or guaranteed by a bank would apply equally to covered bonds issued or guaranteed by a bank. Each estate would be exempt from all securities laws but would succeed to any requirement of the issuer to file applicable periodic reports. Each residual interest would be exempt from all securities laws.

- *Miscellaneous Provisions* – We also support a framework that includes the following conforming changes to other applicable law: The Secondary Mortgage Market Enhancement Act of 1984 would be expanded to encompass covered bonds. Covered bonds that are backed by the residential mortgage asset class, the home equity asset class, or the commercial mortgage asset class would be qualified mortgages for Real Estate Mortgage Investment Conduits (**REMIC**s) and, subject to regulations that may be promulgated by the Secretary of the Treasury, would be treated as real estate assets in the same manner as REMIC regular interests. The estate would not be treated as a taxable entity, and no transfer of assets or liabilities to an estate would be treated as a taxable event. The acquisition of a covered bond would be treated as the acquisition of a security, and not as a lending transaction, for tax purposes. The Secretary of the Treasury would be authorized to promulgate regulations for covered bonds similar to the provisions of Section 346 of the Bankruptcy Code.

In addition to these elements of a legislative framework, the Council also believes that U.S. covered bonds should be afforded favorable regulatory capital treatment like that found in Europe, including in the context of both risk weighting and liquidity buffers.

Concluding Remarks

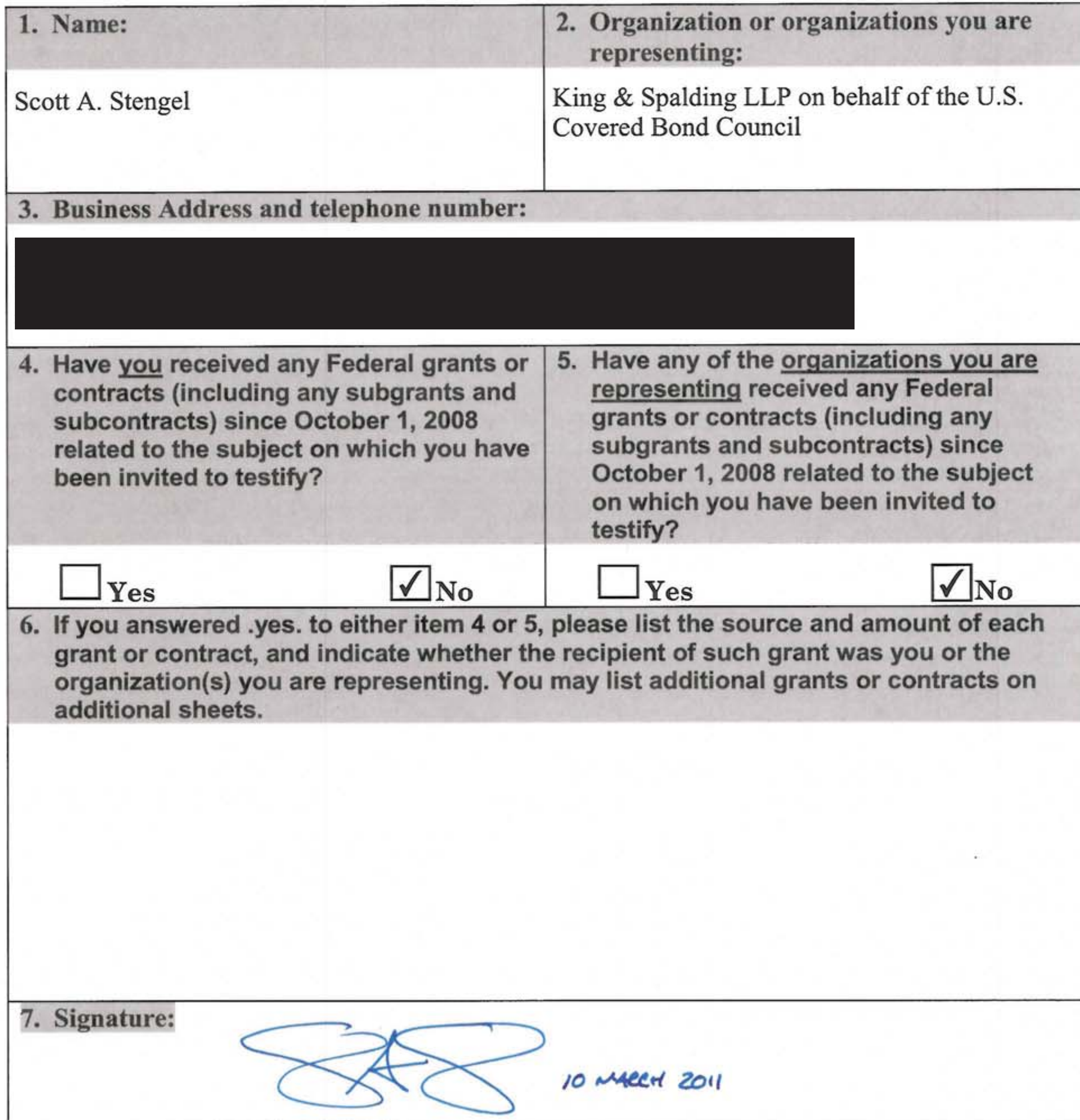
On behalf of the Council, I want to thank Chairman Garrett for holding this hearing and for his leadership on U.S. covered bonds. I also want to thank Representative Maloney for co-sponsoring, together with Chairman Garrett, the United States Covered Bond Act of 2011 (H.R. 940).

I would be pleased to answer any questions that Members of the Subcommittee may have.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.



1. Name:	2. Organization or organizations you are representing:
Scott A. Stengel	King & Spalding LLP on behalf of the U.S. Covered Bond Council
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: [signature] 10 MARCH 2011	

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