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

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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

Friday, March 11, 2011

U.S. House of Representatives,
Subcommittee on Capital Markets and
Government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 2220, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Campbell, Pearce, Hayworth, Grimm, Stivers; Waters, Maloney, Donnelly, and Carson.

Chairman Garrett. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises will come to order. Today's hearing, of course, is titled, "Legislative Proposals to Create a Covered Bond Market in the United States." Without objection, all members' opening statements will be made a part of the record.

And at this time, I will yield myself 2 minutes for my opening statement.

I would like to welcome everyone here to the smaller committee hearing room, which is not reflective of anything to do with the importance of the topic that we are discussing today.

As our Nation continues to recover from the recent financial crises in certain credit markets—as we know, Congress must examine new and innovative ways to encourage the return of private investment to our capital markets. We must also consider cleaner ways to enable the private sector to provide additional mortgage, consumer, commercial, and other types of credit as well.

I believe establishing a U.S. covered bond market would further these shared policy goals. So, today we are here to examine legislative proposals to establish a covered bond market here in the United States.

This past Tuesday, my good friend, the gentlewoman from New York, Mrs. Maloney, and I introduced H.R. 940, the U.S. Covered Bond Act of 2011. The legislation sets the foundation, if you will, for a U.S. covered bond market. And it does so by creating a regulatory framework and then detailing the exact process that occurs if an issuer fails.

One reason that I am particularly interested in covered bonds is the fact that they can be a purely private means, if you will, of finance in this area without government guarantees or subsidies. Many proposals will help alleviate the current strains on our credit market, and alternatives will focus on government loans or guarantees. But I believe that the current bond legislation offers an alterative, a way for the government to provide additional certainty to private enterprises and generate increased liquidity through innovation of a new marketplace, if you will, without putting the taxpayers on the hook.

There are many potential benefits for a wide variety of interested parties that can be derived from the U.S. covered bond market. There are about four of them I can list. First, consumers will experience lower loan rates because of the additional liquidity in the marketplace and the various asset classes as well. Second, consumers will also be able to more easily have their loans modified, which we see is an issue right now because the loans will still be on the balance sheets of the originating institutions.

Third, investors will have a new and transparent and secure vehicle to invest in. And this will allow for additional diversification within their portfolios. And finally, the broader financial markets will benefit. How? By having an additional low-cost, diverse funding tool for financial institutions.

So covered bonds will ensure a more stable and longer-term liquidity in the credit markets, which reduces financing risk as well as exposure to the sudden changes in interest rates and investor confidence. And finally, they will allow U.S. financial institutions to once and for all to compete more effectively against their global peers.

I look forward to hearing from the witnesses at our table today.

And right now, I yield Ranking Member Waters.

Ms. WATERS. Thank you, Mr. Chairman, for convening this hearing today to examine the potential for creating a covered bond market in the United States. Today, we convene to discuss covered bonds and Representative Garrett's covered bond bill, H.R. 940.

Covered bonds offer a way for financial institutions to raise funds by selling a bond that is backed by their institution's assets, which were pledged as collateral. The assets under cover per pool remain on the balance sheet of the issuer. And the covered bonds provide dual recourse to both the cover pool and to the issuer.

Covered bonds represent a potentially promising alternative to securitization. We know that securitization failed us in many ways leading up to the 2008 financial crisis, particularly as originators used securitization as a means to originate bad loans and then quickly transfer them off their books. This lack of "skin in the game" was a cause of the financial crisis and is something we addressed in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

We also are seeing title problems in foreclosures stemming from banks not following proper legal protocols when structuring securitization deals. These problems are creating significant legal reverberations as banks' ability to foreclose on borrowers is questioned. For these reasons, I am interested in exploring covered bonds more fully. I am also interested in learning more about the potential limits of covered bonds, including whether the issuers will be able to accomplish the same environment of lending with this more capital-intensive system.

I do not believe that covered bonds could constitute a full replacement for the government-sponsored enterprises. For example, each ratings makes in a recent report their buying capacity to covered bonds amounts to about 11 percent of the market securitization gap spending.

I am also interested in learning more about the concerns of regulators, particularly whether covered bonds present risk to the FDIC when they try to resolve failed institutions. Given the main resolution responsibilities provided to the FDIC under the Dodd-Frank Act, we must ensure that their ability to protect the deposit insurance fund is protected.

Again, I want to thank you, Mr. Chairman, for convening this hearing. And I look forward to exploring covered bonds more fully. I yield back.

Chairman GARRETT. I thank you for your statement. I thank you for those questions, as they are on point with what we need to discuss. I appreciate you bringing those up.

The gentleman from California, Mr. Campbell, for 2 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman. There is wide agreement that we will be winding down Fannie Mae and Freddie Mac. But there is not yet agreement, or a decision, and a lot of what we will be doing in this subcommittee and in this committee is discussing what we are going to replace it with.

I happen to be one of those people who believes that we cannot replace it with nothing. And without getting into details on my reasoning, that we cannot leave something with as gigantic an impact on the economy as the entire housing market open to the vicissitudes of the general ups and downs of credit markets without some support and stabilization mechanism.

I have been very vocally supportive of what is called the public utility model. I know the Treasury Secretary hates that term. But he prefers more a reinsurance of government, reinsurance policy where instead of having a government guarantee, as Fannie and Freddie did that was implicit and unlimited, that we have ones instead that are explicit, but very limited.

However, that being said, I am here today because I am open to being convinced otherwise that the covered bond option is a better, stronger or equal option to that. And so, I look forward to the testimony and to the entire discussion today.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And I thank you.

The gentlelady from New York for 2 minutes.

Mrs. MALONEY. Thank you. I will place my opening statement in the record, in the interest of time. And we have a very strong panel. I am looking forward to hearing your statements.

But I particularly thank the chairman, really, for his commitment on looking for ways to increase the flow of credit and provide liquidity to the securities markets. He has worked on this issue with great commitment over several years. And I am pleased to support him in his latest effort on covered bonds, which are successful in Europe. I look forward to gaining more insight into how those should be regulated. In the way it has been drafted now, there would be no government guarantee, but has the promise of really providing liquidity to our markets and helping.

So I will place my statement in the record and look forward to the comments from the panel. Thank you.

Chairman GARRETT. And, as I said before you came in, thank you so much for joining with me in this legislation.

Mrs. MALONEY. Thank you. I look forward to it. I think it is very promising. I think it is exciting. It may be part of the answer.

Chairman GARRETT. Thank you. I appreciate it.

The gentleman from New Mexico, for 2 minutes.

Mr. PEARCE. Thank you, Mr. Chairman, for having the hearing. I will place my comments into the record also, but appreciate the opportunity to come and listen in on the hearing.

Chairman GARRETT. Does the gentleman from New York seek time?

Mr. GRIMM. Just 1 minute, Mr. Chairman. First of all, I thank the panel for coming today. I appreciate the opportunity to have a discussion and certainly look for more solutions as we reflect on what has happened in the housing market and we look for the innovation and the creativity that the United States really should be driving in the marketplace and elsewhere.

So I will place my full statement in the record because I am eager to get to the questions and get the debate started. So thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And I thank you.

If that is all the statements, I now look to the panel and Mr. Stengel to go first for 5 minutes. And your complete statement, obviously, will be made a part of the record. We thank you for joining us today.

STATEMENT OF SCOTT A. STENGEL, PARTNER, KING & SPALDING LLP, ON BEHALF OF THE U.S. COVERED BOND COUNCIL

Mr. STENGEL. Thank you. 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 in contributing to our economic recovery. I am a partner with King & Spalding and a member of the steering committee for the U.S. Covered Bond Council.

The Council is 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.

When I last testified before the full committee in December 2009, the economic recovery was slow and uneven. Fifteen months later, little has changed. Almost 17 percent of Americans remain unemployed or underemployed. Nearly one out of every four homeowners is still underwater on a mortgage.

A record percentage of commercial mortgage loans are delinquent. And for Fiscal Year 2012, 35 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 revamped the regulatory landscape, there is still an unmet need for long-term and cost-effective funding from the private sector capital markets that can be translated into meaningful credit for households, small businesses, and the public sector.

We believe that covered bonds are an untapped but proven resource that could be invaluable in meeting this need. We also believe that the time for U.S. covered bonds is now.

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 by a dynamic cover pool of financial assets. What distinguishes covered bonds from other secured debt is a legal framework for managing and maximizing the value of this cover pool after the issuer's default or insolvency. And if the cover pool is adequate, continuing scheduled payments on the covered bonds.

Over the course of their 240-year history, covered bonds have been backed by a wide array of asset classes that benefit from stable, long-term liquidity and that are significant to national economies. U.S. covered bonds can stabilize our financial system and contribute to the economic recovery in several ways.

First, with maturities that extend out to 10 years or more, covered bonds can infuse longer-term liquidity into the credit markets as a complement to the shorter-term funding that is supplied through the Federal Home Loan Banks and the securitization and repo markets.

Second, by providing more cost-effective liquidity for lenders, covered bonds can produce less expensive and more available credit for consumers, small businesses and the public sector.

Third, covered bonds can add funding from a separate investor base that would not otherwise make this liquidity available through other markets.

Fourth, covered bonds can deliver funding from the private sector even in distressed market conditions without any explicit or implicit government guarantee.

Fifth, because the issuers continue to own the assets in their cover pools and have 100 percent "skin in the game" incentives related to loan underwriting, performance and modifications can be strongly allied.

And sixth, as a straightforward financial instrument, covered bonds can increase transparency and uniformity in the capital markets. To function successfully, however, a U.S. covered bond market must be deep and highly liquid. And that requires the kind of legal certainty that only legislation can provide. Covered bonds developed in Europe under dedicated legislative frameworks in this precedent now found in almost 30 other countries have set expectations.

The twin pillars of such a framework are: one, public supervision by a covered bond regulator that can protect the interests of investors, free of any conflict of interest like the FDIC's duty to the Deposit Insurance Fund; and two, a separate resolution process that is clear and unequivocal and that is designed to avoid a forced acceleration of the covered bonds and a wasteful fire sale of the cover pool.

These two pillars, which afford the legal certainty required for investors to dedicate funds to this market, cannot be replicated by regulatory action alone. Without action by Congress, European and other non-U.S. issuers will be left to fill the void.

In 2010, they targeted over $27 billion in U.S. dollar covered bonds to investors in the United States, and over $55 billion more is expected in 2011. The result is an increasingly uneven playing field for U.S. institutions of all sizes and more expensive and less available credit for families, small businesses, and the public sector.

The Council, therefore, fully supports covered bond legislation of the kind introduced by Chairman Garrett and Representative Maloney as H.R. 940. And I want to thank them for their leadership. I would be pleased to answer any questions that members of the subcommittee may have.

[The prepared statement of Mr. Stengel can be found on page 104 of the appendix.]

Chairman GARRETT. Thank you for your testimony.

Mr. Ely?

STATEMENT OF BERT ELY, ELY & COMPANY, INC.

Mr. ELY. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, I very much appreciate the opportunity to testify today about covered bonds and H.R. 940, which will create the legal framework for a vibrant U.S. covered bond market.

Covered bonds offer important attributes which are often overlooked or misunderstood. They include the following: First, covered bonds will not be explicitly or implicitly backed by the Federal Government. Clearly, H.R. 940 does not provide an explicit Federal guarantee of covered bonds issued under the provisions of this bill. Further, no provision in H.R. 940 even suggests an implicit Federal guarantee of covered bonds.

There is widespread and legitimate belief among investors that when a GSE bond default threatens, the implicit Federal guarantee of that debt, by virtue of the issuer's GSE status, will become explicit, as has been the practical effect of the Fannie Mae and Freddie Mac conservatorships. Covered bond issuers will not have GSE-like Federal charters.

Further, Federal regulation of covered bond issuance is no more a government guarantee of covered bonds than is the regulation of securities insurance by the SEC. The covered bond regulator will merely ensure that covered bonds will at all times be purely private sector credit instruments of the highest possible credit quality.

Second, covered bonds will enhance the ability of lenders to offer 30-year, fixed-rate mortgages because covered bonds can be issued with medium- and long-term maturities at a fixed rate of interest. Therefore, banks will be able to profitably hold 30-year, fixed-rate mortgages in portfolio because the interest rate spread on such loans will be locked in at the time the mortgage is made.

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

Fourth, community banks will be able to issue covered bonds due to the bill's pooling provision. This provision will enable community banks and even larger banks, each too small to sell their covered bonds directly to investors, to join together to sell the covered bonds they issue into a covered-bond pool that in turn will sell covered bonds to investors. In effect, the covered bonds issued by the pool will be secured by the covered bonds sold into the pool by its participants. The covered bonds sold by a participating bank into the pool will in turn be secured by the assets in that bank's cover pool.

Fifth, authorizing non-bank firms to issue covered bonds, as the bill provides, will broaden the range of covered-bond issuers, which in turn will provide greater depth and liquidity to the covered bond secondary market, bringing the efficiencies of covered bond financing to a broader range of borrowers.

Sixth, covered bonds will be a money maker for the FDIC. In just 20 days, the FDIC assessment base will expand from total domestic deposits to total global assets minus tangible equity capital. In effect, FDIC assessments will become a tax on bank liabilities, including covered bonds, whether insured by the FDIC or not.

Assuming a 10-basis-point annual premium rate, the FDIC will collect $1 million dollars annually for every billion dollars of covered bonds outstanding. Yet, the FDIC's additional realized losses due to those outstanding covered bonds will be minimal.

Widespread use of covered bond financing will deliver numerous benefits to the U.S. economy, specifically the safety and efficiency of financing home mortgages and other types of credit. Better lending will be one of the principal benefits of covered bonds because covered bonds will be backed by loans that lenders make and then keep on their balance sheet rather than selling those loans into the securitization marketplace.

Lenders keeping the loans they make will eliminate the moral hazard inherent in the securitization process. When a lender keeps the mortgages it makes by funding them with covered bonds, it will retain 100 percent of the credit risk and 100 percent of its lending mistakes. It will eat its own cooking.

This is far preferable to the 5 percent retention mandated for home mortgages by the Dodd-Frank Act. Covered bonds will enhance bank safety and soundness by providing the means for banks to safely fund high-quality assets, such as conservatively underwritten mortgages. For example, instead of selling the fixed-rate mortgages it originates, thereby weakening its relationship with those borrowers, a bank will be able to keep those mortgages, which will deepen its relationship with its borrower-customers. This stronger relationship will enhance the bank's franchise value.

Other benefits include: stronger borrower protections—for a default situation, loan modifications will be much less complicated; highly-efficient bank funding because covered bonds will have high-credit ratings and low transaction costs; reduced maturity mismatching by lenders; a reduction in interest-rate risk; and a substantial new supply of high-quality debt for investors to purchase, especially international investors.

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

[The prepared statement of Mr. Ely can be found on page 68 of the appendix.]

Chairman GARRETT. Thank you for that. I only came up with three good reasons for covered bonds, so I appreciate that.

Mr. ELY. My written statement has even more.

Chairman GARRETT. Even more—I can only imagine.

From the International Capital Markets Association, Mr. Tim Skeet, for 5 minutes.

STATEMENT OF TIM SKEET, CHAIRMAN, COMMITTEE OF REGIONAL REPRESENTATIVES, INTERNATIONAL CAPITAL MARKET ASSOCIATION

Mr. SKEET. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, I am pleased and honored to be here today to share some thoughts on behalf of the International Capital Markets Association in Europe on the proposal for the creation of a covered bond market in the United States.

There is, as we all know or perhaps as we have all discovered, a lot of complexity in financial markets and the instruments found therein. But covered bonds are not complex by their nature. They are not risky by their nature. This is a simple product, which, as my paper indicates, has done well in Europe. And it serves the banks, the regulators and the European taxpayers well. The paper I brought charts the performance of this asset class and points to its essential ingredients.

It also sets out how this asset class did not need the benefit of government guarantees or subsidies, just solid legislation and prudence. I am here today to say how much we in Europe welcome the work going on, on covered bonds in the United States. That is not to say that the United States needs a carbon copy of what we have in Europe. Indeed, it is right that you design a market for your own needs.

Nevertheless, there are good lessons to be learned from the European experience. We have learned simply to keep it simple, go for quality assets and make investors feel confident. Covered bonds worked in Europe despite the crisis on account of three irrefutable characteristics that meant that the market functioned. And today, it represents the strongest and the most reliable source of term funding for European banks.

Those three characteristics are: high-quality collateral; a robust legal framework; and solid supervision. We also note it has not just been the European investors that have supported the market for covered bonds. As we already heard, U.S. institutional investors have been doing their homework, and they increasingly like what they see—bullet maturities, cash-flow certainty and an enviable track record of no defaults. This is close to what we once referred to as a rates-type product in the market.

We note that there is work to be done on detailed regulations and limits, on getting a regulator up to speed and so on. This is serious work. In Europe, for instance, regulators already recognize that banks cannot simply be funded by pledging collateral. Some considerable thought has gone into encumbrance levels, particularly like a Basel III and the concept of the net stable funding ratio.

In the United Kingdom specifically, limits on covered bond issuance have been set and have been monitored for years. Work continues on this and across Europe, also on the standards of collateral transparency. This work is relevant here also.

Covered bonds in Europe have, moreover, allowed a lot smaller, and in some cases weaker, financial institutions to fund themselves on a term basis, illustrating the simple fact that stable funding contributes to a reduction in the probability of a default, and it makes the overall system a safer and more stable place.

As investors do a lot more of their own due diligence and homework, they look for certainty, and they look for safety. This bill gives them the basis for legal certainty, but it does not completely remove, it just diminishes, the credit risk. In Europe, we view covered bonds as part of the solution, not part of the problem. We believe that it can and should work also here in the United States.

Moreover, we believe that they are straightforward and deliverable, give U.S. investors a chance to buy covered bonds issued by U.S. institutions, allow U.S. private sector money back into the U.S. mortgage market and not just be there for the Europeans and the Canadians, as we have seen. Covered bonds are not the complete answer to the future of mortgage finance in the United States. But it could and it should be one practical element in the solution. This product, covered bonds, can play a part.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Skeet can be found on page 84 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

And now, from the American Securitization Forum, and also representing the 5th Congressional District in the State of New Jersey as well, Mr. Daloisio is recognized for 5 minutes.

STATEMENT OF RALPH DALOISIO, MANAGING DIRECTOR, NATIXIS, ON BEHALF OF THE AMERICAN SECURITIZATION FORUM (ASF)

Mr. DALOISIO. Thank you, Chairman Garrett, Ranking Member Waters, and distinguished members of the subcommittee for the opportunity to testify before you today. Can we restart? All right. Thank you.

I promise I won't move. I will stay in the 5th District.

Thank you, Chairman Garrett, Ranking Member Waters, and distinguished members of the subcommittee for the opportunity to testify before you today on behalf of the 330 institutional members of the American Securitization Forum and in particular, its 60-plus pension funds, mutual funds, and insurance company members, which collectively manage trillions of dollars of Main Street's financial assets.

Assuming a legislative U.S. covered bond market is established, our members will have a leading and lasting role in this new financial instrument, much like they did over 25 years ago with the creation of the first asset-backed security. As we gather today, there is a vibrant market in covered bonds, which has raised over 2.5 trillion euros in secured financing for over 140 credit institutions from 29 countries. These issuers benefit from a deep and liquid market, more stable asset liability management and lower financing costs that are transmitted to their customers, individuals, companies, and small businesses.

Despite the benefits obvious to so many other sovereign banking systems, American banks are noticeably absent from this market. Meanwhile, U.S. institutional investors have become active investors in covered bonds beginning last year when they purchased over $30 billion issued by foreign banks. Half of this issuance came from Canadian banks, which crossed our financial borders to tap investor demand for high-quality, private-sector, fixed-income investments. In the absence of a comparable alternative from our domestic banks, those dollars have left our country to the benefit of other financial systems.

Chairman Garrett, your effort last year to legislate into existence a U.S. covered bond market was the right idea at the right time, which has now been validated by the flow of U.S. dollars into exactly these types of investments. As you recognize, without the right kind of legislation, there will be no U.S. covered bond market.

Earlier attempts in 2006 by Washington Mutual and Bank of America remain the only isolated cases of U.S. covered bond issuance. The financial crisis highlighted the weakness in the contractual legal framework under which those covered bonds were issued and discouraged investor participation.

The Treasury Department and the FDIC collaborated in July 2008 to set policy and guidelines to promote the development of U.S. covered bonds. But not one dollar of issuance followed.

It should be clear by now that a U.S. covered bond market can only be seated by a specific enabling act of legislation, which has, at its cornerstone, a dedicated legal framework for the treatment of covered bonds in the event the issuer becomes insolvent. This is the case in every country that supports a vibrant covered bond market. The lack of such a legal framework in the United States is the single best explanation for a nonexistent U.S. covered bond market.

The final policy issued by the FDIC in 2008 to encourage a U.S. covered bond market remains unchanged and insufficient. Current FDIC insolvency authorities afford the FDIC actions adverse to investor interests, including the authority to liquidate the cover pool at a loss to investors. Covered bond holders need legal certainty that the insolvency of the issuer will not result in a market liquidation of the cover pool and an early return of their investments at par value or less.

Accordingly, legislation is required to curb FDIC authorities over covered bonds in order to bring those authorities in line with the legal frameworks in use elsewhere around the world. The systemic benefits of enabling banks and non-banks to issue covered bonds under a legislative framework would appear to vastly outweigh the concerns such as the fear that covered bonds could increase the risk of loss to the FDIC's Deposit Insurance Fund and therefore, to the U.S. taxpayer.

Covered bond investors are not entitled to receive more than the return of their original investment at the contracted rate of interest. In an issuer's insolvency, if there were a deficiency between the cover pool and the covered bonds, covered bond holders would be treated as unsecured creditors of the issuer for the amount of the deficiency.

This unsecured claim would run pari-passu with other unsecured claims, while depositors would have a more senior rank. Moreover, any excess cover pool collateral existing after the scheduled repayment of the covered bonds would revert to the insolvency estate, not to the covered bond holders.

Also, the Dodd-Frank Act strengthened the DIF by granting the FDIC the ability to achieve goals for DIF fund management that it had sought for decades. In our view, the contrary concerns are far more troubling, namely, the concern that we failed to encourage the necessary resurgence in private sector finance to accelerate an orderly exit from the excessive fiscal and monetary support measures that remain, including the continued overreliance on the GSEs and FHA to finance our mortgage system when most other developed nations finance those privately. A new market like covered bonds can enable the process of replacing public sector subsidies with private sector initiatives and prime the process for resolving the GSEs.

Thank you for your time and attention to my testimony. And I look forward to your questions.

[The prepared statement of Mr. Daloisio can be found on page 44 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

Mr. Andrews, for 5 minutes.

STATEMENT OF STEPHEN G. ANDREWS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BANK OF ALAMEDA

Mr. ANDREWS. Mr. Chairman, Ranking Member Waters, my name is Steve Andrews. I am pleased to appear before you today at this important hearing covering the United States Covered Bond Act of 2011.

I am a community banker. I guess I am sitting with a bunch of capital market guys. We jealously guard our community bank franchises, and we jealously guard our relationships with our constituents.

Community banks are conservatively run. I am pleased to present testimony today and raise a couple of concerns that I have as a community banker about the possible development of a covered bond market in the United States. And to cut to the chase, I am going to speak to you today as a community banker, a banker, not a capital market individual who is interested in his investors.

I think, in my opinion, that we have a covered bond market today, and that is called the Federal Home Loan Banking system. That has been around for a long time. It is operated very, very well. I am not sure or certain that we need to import from Europe or from other places a system that differs when we have a tool in place today. And I see that this new system would largely benefit the largest banks.

By contrast, the Federal Home Loan Bank today is alive. It is vibrant. It is doing its job. During this downturn when we saw the financial crisis, they stepped up. As you all are aware, they have the ability for the balance sheet to expand and contract to provide the very liability that we are talking about here today through advances.

They provide the liquidity. They stepped up for the community banks and all the small banks during this crisis and became a lender. The correspondent banks, the banks that you will see these assets go to, they didn't. They stayed away from the community banks.

The Federal Home Loan Bank, during the height of this mortgage crisis, 2007, 2008, provided member institutions $250 billion in advances. When the credit markets were frozen, both large and small banks were able to provide themselves through the Federal Home Loan Bank. In sum, the Federal Home Loan Bank manages mortgage collateral differently.

They take haircuts. They don't take collateral pools. They know their customers. A community bank can go to the Federal Home Loan Bank, customize in advance to fit their needs. It is not a cookie-cutter, take a 10-year bond, take a 7-year bond. They customize that. And for that, they are more flexible than the covered bond market.

I am not here today to bash the big banks. The big banks certainly have their place in the Federal Home Loan system, and they also provide by their usage low-cost, cheap deposits, which we all benefit from.

My understanding of the covered bond market is that it is a recosted obligation. And we have heard that described before as what remains on the balance sheet of the institutions. Covered bonds provide funding to a bond issuer, and the issuer retains a pool of assets related credit risks on its balance sheet. Therefore, in contrast to the mortgage-backed securities where secured assets are off the balance sheet, the issuer pool assets remain on the balance sheet.

Interest on covered bonds are paid the investors from issuers' general cash flows, while the pool of assets serve as collateral on those products. If the assets become nonperforming, typically what transpires is they are told to, or they by contract will bring another replacement asset. The issuer must always be overcollateralized. And so, they have an overcollateralization going on. That is the covered bond market.

Where the majority of these purchases have maturities that are shorter—7, 10, 15 years—we have heard talk that they can match and help our market. We have 30-year mortgages. I see, unfortunately, the lion's share of the benefits of the covered bond market going to the largest banks.

As I sit here today, the debate in Congress has been on "too-big-to-fail." And now we are going to push all these mortgages onto the balance sheets of the biggest banks, which we already have systemic risk issues with. To me, that is interesting.

In Europe, it is touted. I don't see that Europe doesn't have problems. I have heard the acronyms of the PIGs. I have heard issues over there. It is not an elixir or a magic bullet. Those markets froze up just as ours did during that time.

The United States has over 7,000 banks—7,000 banks—while Germany and other European countries have three, four, and maybe a spattering of small banks. These are different models. Our financial systems are slightly different. The latter financial market was fewer, larger banks are more conducive to this.

We have talked about the ability of smaller community banks; they might be at a disadvantage because of pooling. If you throw an intermediary into this process, we can't compete.

Big banks have deal flow. Small banks don't have deal flow. They don't have a ton of loan mortgages hitting their balance sheet every day. But they are the fabric of the communities, which are your constituents. They need a process of which to make these loans.

I think that there will be a competitive disadvantage to the community banks on pricing by the pool, not to mention, when you pool together, there is a little bit of a consolidation that is going on. I think that we have a system that works today with the Federal Home Loan Bank.

In addition, what I didn't hear from anyone here is, what about the borrowers? What about our low- to moderate-income borrowers? They are going to get frozen out. These products typically require large downpayments and short maturities. I think we need to address our borrowers as well.

In the FDIC, it does have concerns. If you read through that process, they are concerned about resolving these large banks when they go.

I see that my time is up on the red dot there. So I am happy to address questions when they come available.

But in closing, I would like to say that, in summary, I don't want to see a 30-year mortgage harmed. I think we have a robust Federal Home Loan Bank handling the intermediary role that it was designed to do by Congress.

I think that small banks need to be at the table. They need to be able to play. They need to be able to get advances from the Federal Home Loan Bank at a reasonable cost.

And I think we need to deal not just with the investors. We need to deal with our borrowers. Our borrowers need to chase the American dream.

In Europe, homeownership is about 50 percent. I want my children, my grandchildren to have ownership. I want them to be able to chase the American dream. A covered bond market has very strict underwriting guidelines. And that is why you see homeownership so small in European countries.

Thank you for your time.

[The prepared statement of Mr. Andrews can be found on page 36 of the appendix.]

Chairman GARRETT. Thank you, Mr. Andrews.

And thank you to the entire panel.

Let us begin with questions. I will probably just go from the left to the right and run down some points I would like to make or ask about.

Maybe I will start off; the ranking member is not here right now, but she raised some good points during her opening statement. One of them, and I go to Mr. Stengel on this, raised the concerns that the FDIC has raised, specifically regarding the impact of covered bonds on the DIF. Do you want to just chime in on that to respond to that concern?

Mr. STENGEL. Sure. Thank you, Mr. Chairman. I grew up as a bankruptcy lawyer, so if there is anyone who is empathetic to the concerns of the FDIC, I would like to think that I am at the top of the list.

Whether resolving any distressed organization, any failed organization is very, very difficult. Our regulatory system is balkanized. Unlike most other countries that have one or two regulators focused on banks during their lives and in the resolution, we have divided that up in the United States. And so, we have an institution, the FDIC, that is focused solely on resolution, similar on the—for banks.

And I think that creates an institutional bias that is built in as a matter of statute for focused on concerns about resolution. So I would divide their concerns into two buckets. One would be a desire to control all aspects of a resolution, to control anything that touches upon the resolution of a bank. Again, the likely economic incentives for the FDIC—it is very understandable that would be something that they would want.

They sought broader powers under Dodd-Frank, which they got. They have sought to seek—to regulate securitization, for example, secured borrowings, which they have sought to do and to take similar actions. And so, I think on the covered bond legislation that has been proposed, their desire to control the resolution of the covered bond program levered them to allow that to happen as part of the private market and under this legislation, again, an understandable concern, one that, in my mind, from the covered bond markets perspective, is misplaced for a couple of reasons.

One, in the United States, we have incredibly debtor-friendly laws, creditor-unfriendly laws compared to other jurisdictions. And that has historically put us at a disadvantage. And so, the FDIC has very broad powers. They are vaguely defined. And the FDIC also has government-funded litigation to back those up.

And so, that puts private investors at a disadvantage. And investors in covered bonds have said, "We are not comfortable with the FDIC and the optionality that the FDIC has."

Mr. ELY. Mr. Chairman, if I could just add to that? I have been a student of FDIC finances for over 25 years. I have looked closely at their numbers, particularly under the new assessment scheme. Covered bonds will actually generate a substantial profit, or, if you will, additional income for the FDIC. For the DIF, that income will far exceed any additional loss that the FDIC might suffer because of covered bonds.

Chairman GARRETT. Okay. As long as you are speaking, let me ask you another question. Mr. Andrews raised a couple of interesting points, I thought. One point he raised was with regard to the Federal Home Loan Bank and what have you. Can you just, not rhetoric, but just sort of address that issue?

Mr. ELY. There will still be a role for the Federal Home Loan Banks. In effect, covered bonds will be another form of bank funding. The whole idea of covered bonds is to put another channel of financing out there for depository institutions of all sizes.

Some have speculated that the Federal Home Loan Banks might be more competitive in the shorter maturities, whereas covered bonds would be more appropriate for longer-term maturity debt. But there is room for both, covered bonds and the Federal Home Loan Bank system, going forward. And again, to emphasize, the pooling provision in the legislation would enable commmunity banks to access the covered bond market in the same way that larger banks can, but through a pooling process.

Chairman GARRETT. Yes, and I can go into this in a lot of detail, and I would like to, but—Mr. Skeet, you are here as well. Talk to us a little bit more. I would appreciate the international flavor that you bring to this as far as what is going on in Europe and what have you. But one of the aspects of it is—I have heard some stories—the absence or lack of absence, if that is a word, of the backing in Europe, vis a vis that we are trying to do here. Can you touch upon that? Some say that in Europe you had a covered bond market that was successful to varying degrees, but because there was implicit guarantee?

Mr. SKEET. Right.

Chairman GARRETT. We are trying to say here—

Mr. SKEET. I hope—

Chairman GARRETT. —in our legislation there is no explicit, there is no implicit, there is no guarantee.

Mr. SKEET. And that is the right road to take. I think I have been clear, and we have made clear in the statement that we have submitted, that there are no guarantees. During the height of the crisis, some of the national regulators did offer guarantees. I think there was one case, in the case of Ireland, and we know what happened in Ireland, where explicit guarantees were given. That was the exception, not the rule.

Guarantees were not given. And the investors and the work they have done do not factor in government support.

Chairman GARRETT. So it is not priced—

Mr. SKEET. So there is no—

Chairman GARRETT. —it is not priced into it?

Mr. SKEET. It is not, no. Look at the way that this market has come back. It has come back phenomenally strongly, post-crisis. And we have not had a default of any covered bond. We have had banks go down, but we have not suffered any of the consequences of that through the covered bond market.

Now, there are no implicit guarantees. What there is, and we mustn't confuse the two things, there is explicit legislation. And there is good supervision provided by arms of the state. But that is not the same as any form of guarantees. Nor do the investors factor that in.

That is the very important point that needs to be made. And people fudge that. The fact that you have given a law to provide a framework doesn't mean you have given State support.

Could I perhaps just take up another point that was being raised here about the—

Chairman GARRETT. Yes.

Mr. SKEET. —size of the issuers? Because in Europe, we do have much smaller financial institutions that have been able to tap into the covered bond market. For instance, in Norway, we have a lot of very small regional savings banks that collectively come together and have successfully issued in various markets. This includes a transaction that came to the United States market late last year.

And that actually proves that you can have, through the covered bond instrument, the ability for the smaller institutions to compete and get the same pricing terms as the larger institutions. I think that is an important point to make as well.

Chairman GARRETT. I am curious as how that works as far as replenishing the pool when you have that pooling. But my time is up.

So, I yield now to the gentlelady from New York.

Mrs. MALONEY. Thank you very much, Mr. Chairman.

And thank you to all the panelists.

I would like to ask anyone on the panel who would like to discuss it, how covered bonds could facilitate housing finance, which is the challenge in the country now.

Mr. ANDREWS. I would like to respond to that first, if I may.

Mrs. MALONEY. Yes.

Mr. ANDREWS. I think that it is a little bit of an issue. Today, as I mentioned in my testimony, the American dream is homeownership. It always has been. My father returned from World War II. That was the dream: to own a home.

When I look to the European markets, I see 50 percent and less of homeownership. I see all the loans with large downpayments, strong credit underwriting to protect the investor. And, as I mentioned earlier, this is also a housing issue.

This is getting people in homes and having them stay in homes. It is not just about an investor never losing a dime. We have a big issue in front of us. And I think when you start to require tremendously large downpayments, you have very strong underwriting criteria, you freeze out a lot of the market. You freeze out a lot of the American dream for your own constituents. So I don't see that as favorable.

Mrs. MALONEY. Yes.

Could the others comment on how it would affect the financing of the housing market and also, the fear covered bonds would produce?

Mr. ELY. If I could address that. First of all, covered bonds, because they are so well secured and generally AAA rated, would bring banks, including community banks, a relatively low cost of funding, certainly comparable to what they would be able to get from the Federal Home Loan Banks for longer maturities.

Second of all, covered bonds can be issued for relatively long maturities, which makes them highly desirable to enable banks to hold on-balance-sheet 30-year, fixed-rate mortgages, keeping in mind that most 30-year mortgages get paid off long before 30 years have expired. So I see covered bonds as a way to bring back onto bank balance sheets mortgages that banks now feel compelled to sell because they can't fund them safely.

That becomes very powerful in terms of lenders keeping all of their risk, and underwriting appropriately. That becomes a very powerful positive of covered-bond funding.

Mrs. MALONEY. So are you saying, Mr. Ely, that covered bonds would not be sold in the secondary market?

Mr. ELY. Covered bonds certainly would be sold by investors. That is one of the reasons to bring on a large covered bond market, so that you develop liquidity so investors could sell. But the key here is that the mortgages would stay on a lender's balance sheet, the individual covered bond issuer, and then once the bonds are in the market, they could be bought and sold the same way any other type of debt instrument can be.

Mrs. MALONEY. Okay.

Mr. STENGEL. If I could just supplement that with one point, and it is probably fairly elemental, so my apologies for sharing it with you in that way. No bank—and Mr. Andrews probably knows this as well as anyone—will extend a loan unless it knows where it is going to get the funding and the liquidity.

And so, for every single loan that is made, a mortgage loan, a credit card loan, a student loan, an auto loan, for every loan, there has to be a place where the bank can turn the other way and get funding. That can come from deposits.

It can come from securitization. It can come from the GSEs. It can come from other sources. But ultimately what we are doing with this legislation and what the Covered Bond Council has supported is another tool in that toolbox for banks to turn around and pull liquidity out of the capital markets and turn around and make cost-effective loans to borrowers.

Mr. SKEET. Could I just add, though? We don't regard this as the same means of financing mortgages in Europe. It is only a part of what we do.

Mrs. MALONEY. Could I also comment on the fact that the bill goes into great detail in how the covered bonds are treated when a bank fails, a large portion of the bill. And since the current pool is held on the bank balance sheet, could you talk about how the regulators would work to ensure that the covered bonds are successful as possible? Could you speak on the regulation of and how you see it? I think that is a big part of the bill.

Mr. STENGEL. I think a key portion of this legislation is that covered bonds are issued by regulated financial institutions, so concerns about safety and soundness in issuance. No institution, under the proposed legislation, would be allowed to issue covered bonds without regulatory approval. So it would be a highly regulated product.

What makes covered bonds different than ordinary secured debt is the limited risk of prepayment because the pool is managed rather than having a fire sale foreclosure of a large pool of loans. If you would go into the market with a billion dollars worth of mortgage loans that the buyers knew had to be sold within 90 days, you would get cents on the dollar. And that is basic economics. And so, what this legislation does is create a framework to manage that pool, continue making scheduled payments on the bonds if the pool will support it and maximize value and decrease losses.

Mr. ANDREWS. If I could retort, to a degree?

Mrs. MALONEY. Yes.

Mr. ANDREWS. What happens there is that those banks will not be holding those nonperforming assets on their balance sheet. What they will actually be doing is when the loan becomes nonperforming, they will pull that out of the pool. They will substitute a good loan that meets the underwriting criteria of the pool contract, and then they will fire sale that nonperforming asset. So I respectfully disagree to that point.

Mrs. MALONEY. My time has expired. Thank you.

Chairman GARRETT. Before I turn to the next questioner, who will be Mr. Schweikert, I would, without objection, enter into the record statements, just the statements with regard to this, from the OCC and the FDIC and statements in support of the legislation from the National Association of Realtors and the National Multi Housing Council. Without objection, it is so ordered.

Mrs. MALONEY. Clarification—are the FDIC and the OCC supporting it or objecting?

Chairman GARRETT. I don't know. That is why I said the first two are the statements.

Mrs. MALONEY. Okay. Just the statements, but not taking a position.

Chairman GARRETT. They are couched in terms that they are in support of it, but they might not appreciate that.

Mrs. MALONEY. Okay.

Chairman GARRETT. The gentleman from Arizona, Mr. Schweikert, for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Stengel, just on the last point that was made, I noticed you sort of bounced up in your chair. Can you share what your thought was?

Mr. STENGEL. Sure. I think Mr. Andrews was confusing what happens during the life of a bank, what happens with any loan on a bank's balance sheet and then what happens to the cover pool if the bank were to go into insolvency. And so, certainly, during the life of a covered bond program, nonperforming loans are pulled out. They are kept on the bank's balance sheet so they can be worked out.

One of the advantages is this is 100 percent "skin in the game" for banks. But the resolution process that I was discussing was talking about what happens if the issuer were to enter into receivership. If that pool then, instead of being liquidated, billions of dollars worth of loans liquidated at a single moment, it instead managed and collections brought in and its value maximized.

Mr. SCHWEIKERT. Okay. Mr. Chairman, Mr. Stengel, actually, walk me through a mechanic like what we have suffered through the last couple of years. My real estate market goes to hell in a handbag. I have institutions in your community that are participants. What happens to the unwind?

Mr. STENGEL. I think what you will see in that process, again, if an individual bank were to fail, so if banks aren't failing, banks are working with their borrowers directly. Again, you don't have loans that have been securitized. Banks are working with their borrowers directly to manage those defaults on the individual loans.

If a bank that had issued covered bonds were to fail, the loans on its books in the normal receivership process, the bank would be put into receivership. The FDIC has to do something with that pool of loans on the bank's balance sheet. Normally, those are going to be sold.

They are going to be sold to another institution. They are going to be liquidated in the market. Again, they are pledged as collateral for the benefit of bondholders. What this legislation does differently is instead of having to force a fire sale, a liquidation sale of those loans pledged as collateral, instead they are managed so that there is value realized, not only by the bondholders, but also the residual ownership interest that is retained by receivership for the benefit of other creditors.

Mr. SCHWEIKERT. All right.

Mr. ANDREWS. Can I respond as well and give you the scenarios you are asking for?

Mr. SCHWEIKERT. Sure.

Mr. ANDREWS. Okay. So you have this credit-quality bond covered pool. During that meltdown, collateral values plummet across the Nation. Loans go bad. So what they do by contract in that covered pool is they pull those bad loans out. They put in their good ones.

When the receiver, the FDIC, comes in, they only have the poor assets. The investor doesn't get stung. It is the Deposit Insurance Fund that gets stung and all the players that play into that Deposit Insurance Fund. And so, what you have heard from the capital markets is the investors—

Mr. SCHWEIKERT. Help me with one thing, because didn't you, a moment ago, walk me through that you would be doing that swap and you would be liquidating the nonperforming assets?

Mr. ANDREWS. That is just what I said. So earlier when you have a pool which is pristine and it starts to go bad because the economy has tanked, that pool needs to be overcollateralized and remain pristine. So they swap out the nonperforming asset, and they put in a good one. Where does that nonperforming asset go? It goes on the balance sheet of the bank, and they start getting a pile upon pile of nonperforming assets.

Mr. SCHWEIKERT. That means you are liquidating those assets—

Mr. ANDREWS. Then they have to liquidate them. And they fire sale them. Or if it is so great, like a WaMu situation, the FDIC comes in and asks, "What do we have here?" Well, we have a bunch of junk.

Mr. SCHWEIKERT. Mr. Chairman, and forgive me, but the other alternative is even more devastating. If you are in that market upheaval, at some point then, do you have the taxpayers step in? Do you also, it also brings down the institution.

Mr. ANDREWS. The taxpayers step in. And there are potential for those things. Who comes out a winner here is Wall Street and the investor.

Mr. SCHWEIKERT. And, in many ways, forgive me for cutting in, but you also have the taxpayers being the loser in that scenario. And I know I am running out of time, but one mechanic. Okay, let us say the loans have been bundled and securitized. Walk me through the same scenario where—

Mr. ELY. If I could address that point, you can probably see that the securitization market today is tremendously trying to work out and modify mortgages. This is an issue before you all the time because there are so many different players involved in protecting their interests.

The thing with covered bonds is that the bank that made the loan still has it. If the mortgagee is in trouble, it moves out of the cover pool, but it still is on the bank's balance sheet. That leaves the bank without any competing and conflicting interests, who then has to modify the loan.

I disagree with Mr. Andrews that these problem loans would lead to a fire sale. The bank is going to, like any other problem loan it has on its books, try to work that out to minimize its loss.

And I would suggest that in the current banking environment where the bank still has 100 percent of the loan, it is going to be a much easier and more straightforward process to resolve that loan problem. That is not the case when mortgages are securitized.

Mr. SCHWEIKERT. Thank you.

Mr. Chairman, I know I am out of time. But I would love someone to address what happens when the bank doesn't still retain 100 percent of the loan—and hopefully someone else on the panel will ask that. There you go.

Mrs. MALONEY. They are required to, aren't they?

Chairman GARRETT. I will yield now to Mr. Campbell for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

And if you indulge me, I am going to go to covered bonds kindergarten here. And I am going to use Mr. Andrews because you are here. So prior to 2008, Mr. Andrews makes 30-year, fixed-rate home loans. And he can either retain them in the old model of the 1970s and so forth, or he sells them off and, to a collateral pool, is what happened prior to that.

Okay, so now we have this covered bond alternative. So he sells that loan and covered bond. The cover is the pool of the loans, his and other banks, presumably. And, when I am wrong, I will give you an opportunity to tell me I am wrong. But, all right, then, if that is not the cover, what is the cover?

Mr. ELY. What is in the cover pool are the assets that are securing the bonds. Those assets are loans that are on that bank's balance sheet. There is not a pooling of the loans.

Mr. CAMPBELL. Okay. The bank owns the loans, and it issues covered bonds. Then he does that for his liquidity and so forth out there? But the only thing covering that is the same loans that would have covered it had it been sold into a CMBF in the mortgage-backed securities market of some sort. Right? There is no additional collateral?

Mr. ELY. May I offer a distinction?

Mr. ANDREWS. You could substitute loans if they go bad.

Mr. CAMPBELL. Okay.

Mr. ANDREWS. So we could sit here on our balance sheet and pull out this one and pull up that one. And that is exactly what WaMu is doing.

Mr. CAMPBELL. So why do you do that? Why would you go to a covered bond? And then I will come back to you on that one. Why would you go to a covered bond market if there were a mortgage-backed securities market available?

Mr. ANDREWS. We personally wouldn't. We could hold 30-year mortgages on our books today all day long. If we were worried about interest rate risk, say, we are making loans today at 4 percent—

Mr. CAMPBELL. Let us say you couldn't.

Mr. ANDREWS. —we would get an interest rate swap.

Mr. CAMPBELL. Let us say you couldn't. Let us say you could go on, either, you needed liquidity, so, on these things. So you either went to mortgage-backed security or a covered bond market?

Mr. ANDREWS. Or the Federal Home Loan Bank.

Mr. CAMPBELL. Okay.

Mr. SKEET. Can I just interject? The U.K. banks, Mr. Chairman, they look at both instruments. And they want to have access to both instruments. This is not either/or. This is not an exclusive. All we are talking about is an additional instrument for which you have investors in the United States. It is in addition to what you have already have.

And I think the U.K. banks in particular want access to the old ABS market. They think it is a good market. However, they use covered bonds because it is actually cheaper. This is a better, cost-effective, longer-term source of funding for them. And it is important liquidity. Lack of liquidity had been killing our banks.

Mr. CAMPBELL. Okay.

Mr. SKEET. This is a good way to get term liquidity back.

Mr. CAMPBELL. Mr. Daloisio?

Mr. DALOISIO. Congressman Campbell, thank you. The distinction I would like to offer for the subcommittee, between what Mr. Andrews offers, which is a hypothetical, and what we have experienced, is this. The assertion is that the economy goes bad, and as a result, the loans go bad. That is really not the cause-effect relationship that we just experienced in the prior crisis.

The cause-effect relationship we experienced in the prior crisis was the underwriting went bad, the loans went bad, and the economy went bad. The underwriting went bad because there was an ability to transfer risk without a proper disciplined market mechanism for the supervision of that risk for a number of reasons we don't need to get into.

If banks had the incentive to ensure that the risk that was being retained in the whole loans that they have on their balance sheet was no different than any other risk that they are managing in those mortgage loans, there could not be that cause-effect relationship. So we would have had—if we had a covered bond paradigm, it is my opinion that we may very well have created the situation where the underwriting discipline was reinforced because the banks continued to own that risk and, therefore, the loans did not go delinquent, and therefore, the economy did not go south.

Mr. CAMPBELL. Okay. Let me ask this, then. My concern, going forward, is that, and to Mr. Andrews' point, we will have 69 percent homeownership, probably 65 or 66, whatever we are now. And the banks get excited about certain segments of the loan market for a while, and they will lend to anybody. And then they pull back.

They do that in home loans. They do it in car loans. They do that in commercial loans. They do in all kinds of segments.

And we can't let the entire home market be subject to the fact that you are right about the concentration of banking now. That large banks, it is true we don't like home loans for the next 3 months, so we pull back and tank the whole economy along with it because people can't sell homes and the liquidity, etc.

I am not sure I see where this solves that problem, where this creates any—it provides a new option. But I am not sure it provides a lot of stability when the banking sector decides to pull back from a particular market.

Mr. DALOISIO. If I could just add, I am not sure why a bank would pull back from a market.

Mr. ANDREWS. They do it all the time. Because their delinquencies go up. And they decide this is a bad place to be and then the bank down the street sees that they have pulled out and they do it all the time.

Mr. STENGEL. I guess I would propose that the banks are pulling back—to be said that they are pulling back in home loans today, that is because they don't have liquidity on the back end to fund the new loans that are been made. The Basel III proposals are requiring banks to hold an enormous amount of liquid assets on their balance sheet.

There are many factors at play right now that are going into reduced lending. And I think one of those factors is a lack of liquidity, a lack of funding for banks where they feel comfortable they have long-term funding and they can turn around and make a long-term loan. The last thing we want is banks making bigger loans based on 90-day short-term funding. That is the volatility we ran into in the crisis.

Mr. CAMPBELL. My time has expired. But trust me, they will go completely out of an entire segment, large—

Mr. SKEET. If they don't have the money, they can't—

Mr. CAMPBELL. —completely out of an entire segment of the economy for a while.

Chairman GARRETT. If the gentleman is ready, I will yield to Mr. Carson.

Mr. CARSON. Thank you, Mr. Chairman.

This question is for Mr. Tim Skeet on behalf of the International Capital Market Association. Much has been made of the performance of European covered bond markets during the initial stages of the global financial crisis of 2008 to 2009. How much of that success can be attributed to the fact that in most cases, those administering the European covered bond pools were prohibited from buying U.S. ministered assets, which really act as the original source of financial contagion?

Mr. SKEET. Obviously, we did suffer in Europe from European institutions buying U.S. products. If you take a look at certain parts of the European market, I think it was clear that many European investors bought products that they simply didn't understand, and where they hadn't done due diligence correctly.

We do have an opportunity here with this new product, the covered bonds from the United States, whereby investors who are doing a lot more of their homework would be able once again to buy American assets, but feel happy about it and feel safe about it. So I think we have European investors who want to buy U.S. mortgage-backed products, even though if it is ABS, they probably would be unhappy, they will look at this when it is created. I don't know whether that answers your question, but—

Mr. CARSON. I yield back.

Chairman GARRETT. To the gentleman from New York, Mr. Grimm. Thank you.

Mr. GRIMM. Thank you, Mr. Chairman.

I guess for me, the heart of the debate lies with the disparity somewhat between the facts, as Mr. Andrews states them in the passion—and I appreciate that, and, again, it is four to one. So I am been there myself many times.

All right.

Mr. Andrews, why do you see that the community banks will not have access and be squeezed out? And we are hearing that the pools will be available. I am not so sure. I think on that one part, I probably tend to lean towards your concern that something tells me that—

Mr. ANDREWS. You should.

Mr. GRIMM. —the intentions are going to be great that community banks will have complete access, but when the rubber meets the road, they might not. So if you can expound on that for a second.

Mr. ANDREWS. Okay, certainly. Community banks have access right now to the Federal Home Loan Bank for this very purpose. They are an aggregator of sorts for us to have liquidity, to make these loans and transactions. What I foresee in the covered bond market as it develops, it will all migrate to the big deal flows, the big four banks.

I think what we have today is we have a huge hangover from systemic risk and "too-big-to-fail." And what we are doing is we are pushing this train of Freddie and Fannie and all these players, all the volume they had, those trillions of dollars we are talking about, right onto the balance sheets of the largest banks. They are going to out-price the little guys, and they won't be able to compete. And that, to me, is a bunch of issues.

Mr. GRIMM. But this would not replace the Federal Home Loan Bank. That would still exist. That option would still be there for the community banks, but not—

Mr. ANDREWS. I am not saying it would replace it, as long as Congress continues to charter it. But there will be an issue in a sense that the big banks will back away. They will back away from using the Federal Home Loan Bank because now they have their own conduits. And believe me, they provide revenue sources to the Federal Home Loan Bank. And that will increase the advanced pricing that we enjoy as a community bank.

And we don't have the same ability to access capital markets, being a small player, either for liquidity or for capital.

Mr. GRIMM. If I may, I will let Mr. Ely respond to that, as far as the Federal—Mr. Andrews' legitimate concern with the Federal Home Loan Bank and the bigger players no longer being involved because they are all on the covered bond market.

Mr. ELY. There may be some pull-back but it is interesting that in the White Paper that the Administration presented on GSE reform, they proposed putting limits on the ability of the Federal Home Loan Banks to lend large amounts of money to large institutions.

But even so, first of all, the Federal Home Loan Bank balance sheets have shrunk a lot as advances have been paid down. Federal Home Loan Bank operations and their wholesale business, the way it is going, they will be able to continue to operate very efficiently and serve the smaller community banks very efficiently because their operating expenses are so low as it is. So I don't think that you would see a situation where the cost of Federal Home Loan Bank advances to community banks would rise in a meaningful way.

But again, it is important to stress the pooling provision in the covered bond bill and the experience in Europe. In fact, smaller depository institutions, smaller lenders can, in fact, participate in the covered bond market. Thank you.

Mr. SKEET. Yes, if I could just reinforce that. We do have smaller banks use this market. This market is not simply for very, very large, jumbo-type transactions. Increasingly, the market is flexible. They are much smaller sized transactions being brought to the covered bond market in Europe by much smaller financial institutions.

Mr. GRIMM. Time is running out. If I could, Mr. Stengel, why is the FDIC opposed to creating a covered bond regulatory framework? Because I still don't know why they are opposed to it. If you could explain.

Mr. STENGEL. Sure. I really do think it is an institutional bias. If I were the Chairman of the FDIC sitting before you now, I would be concerned about wanting to control all aspects of a resolution of a bank. So I wouldn't like securitization. I wouldn't like Federal Home Loan Bank lending and their priority status. I wouldn't like any repo funding. And I wouldn't like any secured credit at all.

And I think it is largely driven by an institutional bias with a focus on the risk to the Deposit Insurance Fund. And again, that is natural. It is understandable. But I think, again, it is my—

Mr. GRIMM. Is it legitimate?

Mr. STENGEL. It is myopic. It fails to recognize that what we need is long-term, stable liquidity for banks so they don't end up in the FDIC's lap in the first place.

Mr. ELY. If I could add to that, I think the FDIC is not making a proper evaluation of the risk covered bonds pose to the Deposit Insurance Fund, particularly in light of the Dodd-Frank change in the FDIC assessment base, which is going to bring an enormous amount of revenue into the Deposit Insurance Fund from assets that are funded by covered bonds.

Mr. CAMPBELL. Mr. Chairman, since the FDIC is not here, you might want to read the first two sentences of their conclusion that clarifies where they are.

Chairman GARRETT. I will yield 15 seconds to the gentleman from California to do that. In the completion of that, I will yield, without objection, an additional 15 seconds to the co-sponsor of the legislation to follow-up on the question that the gentleman from New York raised with regard to the pooling issue.

Mr. CAMPBELL. “The FDIC supports a vibrant covered bond market that would increase liquidity of financial institutions and enables sustainable and robust asset organization. However, any legislation should avoid promoting development of a covered bond market that provides bipolar risk to covered bond investors and give rights to investors that are superior to that of any other secured”—I just thought that their position should be put in their words.

Chairman GARRETT. Mr. Grimm, any—

Mr. GRIMM. I yield back.

Chairman GARRETT. Okay.

The gentlelady from New York?

Mrs. MALONEY. Thank you, Mr. Chairman.

I would like to ask Mr. Andrews, certainly, the purpose we have is to provide liquidity for those Americans, community banks and banks. And I would like you to respond to the statement made by many that the pooling aspect of the bill would allow community banks to be—in response to Mr. Ely’s question on Home Loan Banks—on what they could do.

And what are the limits on this, in terms of how large these covered pools can be? Are there any limits upon it? But Mr. Ely’s—pooling aspect—why is that such a—community banks be part of this new—

Mr. ANDREWS. When you talk about capital markets, capital markets are interested in big players with big deal flow. For instance, today a small community bank could go out and access the capital markets to a degree to bring in capital. And it couldn’t go out and access to bring in debt as well. And that is what we are really talking about here, is bringing in more debt financing in lieu of deposits funding the same way that Wall Street did.

And so, I think it is a little bit academic in the sense you are saying, you can all—you good little banks can get together and pool and do this. Maybe that can happen, maybe it won’t. But I think practically what is going to happen is all this business will end up on the books of the large banks. And they will price out the little guys. You see that in every industry.

Community banks do have access to liquidity through the Federal Home Loan Bank. But it is difficult for them to tap capital markets because they are not significant enough in size. And the argument being made here is, we will let all these little guys pool together, and once they pool together, they can price as competitively as we do. And I say, no, that is not going to be the case.

Mr. STENGEL. Could I offer just very quickly? I would just—2 seconds on the Federal Home Loan Banks. The distinction between the Federal Home Loan Bank funding and covered bonds really falls into two categories. One is the breadth of the asset classes. U.S. covered bonds can fund a much broader range of asset classes. They can also fund a maturities with the Federal Home Loan Banks offer—don’t offer.

And if I can remind the members, and this shouldn’t be lost, the Federal Home Loan Banks are GSEs with an implicit Federal subsidy. We have every implicit subsidy that Fannie Mae has and Freddie Mac has. So, of course, they can provide more economical pricing for the community banks. And that is not necessarily bad.

But let us not forget that the Federal Home Loan Banks are not GSEs.

And if I could—

Chairman GARRETT. Let me try to get back to regular order here. We can do another round, I guess.

To the gentleman from New Mexico, Mr. Pearce?

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Andrews, Mr. Ely points out that loans on the books was one of the problems. In other words, the issuing institutions really didn't have much stake in seeing that the loan performed. Is that something that you see as a problem, or is that something you don't object to, keeping a loan somewhat on your books?

Mr. ANDREWS. Community banks do carry mortgage loans on their books. And if they get concerned about interest rate risk, they can always do an interest rate risk swap.

Mr. PEARCE. So it is not a concern?

Mr. ANDREWS. Or they can use Federal Home Loan Bank to—no, it is not a concern, other than having the additional capital.

Mr. PEARCE. Right. Okay.

Mr. ANDREWS. And so, it is easier for banks to sell it and get a fee than provide more capital.

Mr. PEARCE. Yes. Right. I just wanted to clarify that.

And, Mr. Stengel, you mentioned that we really didn't have anything to worry about, that the market would come from—on the covered bonds would come from—or be issued by regulated institutions, highly-regulated institutions. Didn't all the collateralized debt obligations in the MBS—didn't those originate in highly-regulated institutions? Just yes or no.

Mr. STENGEL. No, sir. I would say most of them—

Mr. PEARCE. They did not?

Mr. STENGEL. —originated with institutions that are not necessarily as highly regulated as insured depository institutions.

Mr. PEARCE. Okay. All right. I find that curious.

Mr. Daloisio, that is kind of hard to say with a West Texas accent.

[laughter]

You said that in the process of the transferred risk the underwriting went bad, and then the economy went bad. Now, somewhere in there, the underwriting, the market just assumed the underwriters were not even going to look, that the truth was we had an entire bonds issued with no performing loans anywhere in them. That is the reason that four or five institutions made a bunch of money selling short.

And so, it appears that it is far more complex than just the transfer of risk, the underwriting went bad, and the economy went bad. It looked like an organized, a disorganized structure that simply never checked itself, that bad loans were made with never the potential of paying back. In 2 years, you are going to sell that house, and you don't really have to make any initial payments, no principal, no interest.

And so, to say that simply a transfer of risk was, or the originating thing, I would include as a hunger in the market for these instruments that allowed tremendous profits to be made as long as the game was going up. And then when the game went the other way, we tagged the taxpayer with the downside. And so, you stand by your statement that it was simple process, transfer of risk, underwriting went bad, the economy went bad?

Mr. DALOISIO. I do believe it is that simple because I do think the incentives to relax the underwriting standards were enabled by the ability to more readily transfer the risk into a capital market system, which started to operate on, more so on the basis of what seemed to be an ever-increasing rise in home prices and an ever-lengthening favorable past historical experience.

Mr. PEARCE. Okay. I will accept that.

Mr. Stengel, you have mentioned that there is no liquidity, that the lack of liquidity, the lack of funding. And I find just the opposite. I find the local community bankers tell me that they have quite a bit of money to lend.

Because, number one, if they make one bad loan, they stand to lose their entire institution. And, number two, now the compliance reviews are more rigorous than the safety and soundness reviews and that things that used to be simple exceptions are now written up as $50,000 fines. And they are saying, why in the world would we do a home loan when one small thing on a flood insurance program, which, one, collected flood insurance—we started 3,000 feet above sea level and we go higher than that.

And so, down on the coast—and yet, one bad statement in there is a $50,000 fine. They are saying, why should we, why should we bear the risk. What do you base your statement on that small banks have no liquidity?

Mr. STENGEL. On your comments about the regulatory exams, that may well be the case. And so, I think your concerns may well be founded and, certainly, worth investigating. On the question about liquidity, the liquidity that exists today are all deposits where people have put into banks because they are afraid of investing their money elsewhere because the economic recovery has been fragile.

And I think what you are going to see is when the economy turns, the deposits are going to get yanked out as people look for better yields. So today, I think there is probably plenty of liquidity. I suspect the banks have deposits they don't want because they can't make any money with them and that when the economy turns, we are going to need these tools, we are going to need securitization. And we are going to need all of those tools to keep our economy growing.

Mr. PEARCE. And do you think the policy of paying interest on these areas is maybe contributing, in other words, just the banks can borrow at, more or less and get 2 percent, is that maybe contributing also, you have more risk guarantees?

Mr. STENGEL. I would be reticent to comment about—

Mr. PEARCE. Okay.

Mr. GRIMM. Can we just thank Mr. Pearce for those in the coastal regions with the Fed problems? We do appreciate that.

[laughter]

Chairman GARRETT. Thank you.

Mr. Stivers for 5 minutes, please.

Mr. STIVERS. Thank you, Mr. Chairman. And I want to kind of go a little backward and back to the beginning of why we are here.

We are here because the GSEs, thankfully, helped fuel the crisis that we are in. And now a lot of folks in Washington are saying, gee, should we have an implicit government guarantee through the GSEs, should we look for a different model? So one of the reasons that we are here is because covered bonds are a different model.

And I know Mr. Skeet talked earlier and said that you don't think covered bonds are the only solution. What kind of capacity could the covered, could a buyer-covered bond market create? Would it create enough of a capacity to replace what the GSEs are doing today? And we can start with Mr. Skeet.

If anybody else wants to comment—

Mr. SKEET. Just very briefly, no, we don't think it will replace the GSEs. It is an additional tool. It is a logical tool. It is a tool that makes sense.

Remember that, again, you asked earlier about limits, whether or not you can issue. The U.K. guidance is about 20 percent of total assets. You can do a quick calculation. That is the upper limit that the regulator in the United Kingdom feels comfortable with the bank issuing. Beyond that, they will stop you or up the amount of capital you need to hold.

You do the calculation. That is a good capacity. You can do a lot of term funding. But remember, the Net Stable Funding Ratio is an important ratio for all financial institutions here on after because regulators care about, not just deposits and the amount of deposits, but do you have 5- and 10- and 15- and 20-year money out there. That is part of keeping banks safe and sound for the future.

Mr. ELY. If I could just add to that, Mr. Stivers. The U.S. residential mortgage market for owner-occupied housing is now $10 trillion outstanding. A covered bond market would develop because investors would get used to it, what you put out there. It is conceivable that the covered bond market might grow to 5 or 10 percent of that.

Then let us say you owe $500 billion or $1 trillion of paper. That is still small, even in the European market. But it would be a very significant market, a highly liquid market and covered bonds become an important, not the sole source, but an important source of funding for home mortgages, particularly as Fannie and Freddie shrink and more specifically, as their balance sheets shrink.

Mr. STIVERS. Thank you. I think you pretty much agree. And I know it is an important tool. But we all need to understand we have a lot more work to do. And maybe Mr. Skeet is right and it is 20 percent. So it is $2 trillion. But it is not going to fix it completely. But it is a good tool, I think.

I do have a question about the overcollateralization. So essentially, the 20 percent rule is basically how they, how the European market manages that. You have 100 percent of loans to cover the 20, whatever, 100 percent of the loans you haven't securitized to cover the 20 percent of loans you allowed to issue covered bonds against. Is that essentially correct?

Mr. SKEET. It is getting quite complicated because of the way this Net Stable Funding Ratio has been introduced. Because if you look at that, the overcollateralization portion of a covered bond has to be 100 percent funded from the senior unsecured market, whereas the mortgages themselves outside the pool have to be funded 65 percent. So there are various calculations that need to be done.

The world will become a lot more complicated in the future. But, of course, I think it will become a safer and more stable place if we are allowed to do that.

By the way, the FSA is a little bit vague about how it monitors the collateralization levels. It is specifically the U.K. that has done the most work on this. What they are monitoring on an ongoing basis is the overall level of the collateral that is in the pools against the covered bonds. If it gets beyond a certain level, they get uncomfortable and they will increase the capital charge for those banks.

So it is not a file and forget. This is constant monitoring. It is proper supervision.

Mr. STIVERS. Great. Mr. Andrews brings up some good points. And Mr. Skeet talked about, I think you talked about in Norway, how some smaller banks have come together. But I believe you said they came together under a larger bank who, it was on the larger bank's balance sheet.

Mr. SKEET. They created a third-party bank, if you like, which specifically took the—

Mr. STIVERS. Okay.

Mr. SKEET. —assets from there.

Mr. STIVERS. As a conduit.

Mr. SKEET. It was a properly constituted bank. But it was set up for the sole purposes of taking in the assets of these lesser institutions.

Mr. STIVERS. —finance.

Mr. SKEET. —of the financing and then issuing. And they issued in the United States market, interestingly enough.

Mr. STIVERS. Great. That was the only other question I had.

Thank you. I yield back the balance of my time, Mr. Chairman.

Chairman GARRETT. And I thank you for your questions, sir.

If the panel is still ready, we are going to—we have just noticed that we are going to have votes called. We have many members who have not had an opportunity to ask questions, so if you are ready, we are going to switch into lightning round here. Each member will be allowed 1 minute of questions and quick answers. And then by that time or during that time, we may actually be called to votes. But I will say thank you to the panel right now.

So just very quickly on a couple of points, I entered into the record earlier today the FDIC's comments and statements with regard to this. They propose significant changes. And I guess the question on that is if they were to be adopted, what would happen with regard to the investor interests of purchasing these?

Mr. STENGEL. There would be no market.

Mr. SKEET. I agree with that. There would be no market.

Chairman GARRETT. Okay. You can say a little more than that. [laughter]

Mr. SKEET. Let me just say that investors need certainty. What the FDIC proposed does not give certainty. In Europe, as in the United States, I believe that many of the investors will be highly concerned about the nature of the instrument and their rights thereunder.

Chairman GARRETT. Okay, 26 seconds. There we go. So in the pooling arrangement in the European model where you have—the last question just came. What is the responsibility there for the member banks to that created bank? Do they have an obligation, as Mr. Andrews properly raised, to go back to those member banks and to say, you have to repool, take out—

Mr. SKEET. Yes, they do. And they have to put capital in and contribute capital as—

Chairman GARRETT. That central bank, I will call it, if that bank fails, can you, do you still have the liability back to those individual banks?

Mr. SKEET. Yes, you will do.

Chairman GARRETT. Okay, thank you very much.

Mr. CARSON. Thank you, Mr. Chairman.

This question is for Mr. Daloisio. Some have suggested that the covered bond market should replace the mortgage-backed securitization model for financing home loans. If this were to happen, sir, would you recommend the GSEs like Fannie and Freddie?

Mr. DALOISIO. In my professional opinion and as a citizen of this country, I think I would prefer to see governmental resources be used to stimulate markets that don't exist as opposed to markets that could be operated properly by the private sector, which have existed for quite some time, particularly alternative energy I would use as an example. I think that would be a far more efficient use of the public resources. I think the public sector system for financing mortgages is fully replaceable by the private sector.

Mr. CARSON. I yield back.

Chairman GARRETT. Mr. Schweikert for 1 minute, please.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Back to where I was trying to tap before, what happens, is there a model, in your mind, of the institution, let us say, our community bank, not retaining all the liability or not retaining mortgage or pumping them up into a securitization market? Tell me your vision on that flow working.

Mr. ELY. That is the model for many community banks. They sell their 30-year, fixed-rate mortgages to Fannie or Freddie or, if they are jumbos, they try to securitize those jumbos. The key thing about covered bonds is that a mortgage doesn't get sold. The lender keeps it. So instead of moving the mortgage to the source of funds, you are bringing the funds to the lender and leaving the loan and the covered bond funding on the lender's balance sheet.

Mr. SCHWEIKERT. Mr. Chairman, I am probably almost out of time. Any method you see within there to provide that enhanced liquidity of having a securitization participation, such a thing? Or is it, do they just need to stay completely separate? These are different ways of funding mortgages. So if there has ever been sort of a model or a discussion of a sort of a bifurcation.

Mr. ELY. I am not aware of it.

Mr. SCHWEIKERT. Okay.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentlelady from New York.

Mrs. MALONEY. Given this covered bond, in Europe, how did they perform during the financial crisis and the credit crunch in 2007, and 2008 when bank balance sheets were under pressure? And I do know that we have had previous hearings on it, but they did not perform well in the United States during the crisis. Any comments of why it didn't perform in the United States and how it performed in—so we can get a sense of—

Mr. SKEET. Very, very briefly, Mr. Chairman, in the paper that I submitted prior to this hearing, we set out how we learned a lot about what happened. And there are some statistics in there. Every single asset class, including, as we now know, sovereign assets, were hit by the crisis, that the most recent problems have been sovereign-related and not any specific instrument.

Covered bonds probably were the least affected. Yes, they were effective. Yes, there was illiquidity. All of that is correct. It came out the fastest from this particular crisis.

That is the important aspect. We have done very well in Europe, but we are not complacent. And that is why, precisely why, we are tightening up the rules, the transparency and the legislation, even though it is several hundred years old.

Chairman GARRETT. Thank you.

Mr. Campbell, for 1 minute.

Mr. CAMPBELL. One of the causes of the financial collapse is a lot of people made a lot of money and transferred the risk onto other places, which ended up being the taxpayer. The FDIC is concerned that we are doing that here again with covered bonds.

And Mr. Andrews' scenario where there is this pool, and as things get bad, they get pulled into the bank, replaced with good loans, and then the bank finally has all the bad loans and goes down, the FDIC has to step in. But the covered bondholders are fine because they have all the good loans, and the bank has all the bad loans. Why is that not a concern?

Mr. STENGEL. I would just make two points. The first is when you talk about the DIF, let us remember who funds it. The taxpayers who fund it are the banks. The top 10 banks from 43 percent; the next 100, 39 percent.

Mr. CAMPBELL. I get that. But the scenario I just described can occur.

Mr. STENGEL. It can. And the banks are paying insurance premiums right now to cover it for post, the after-crisis and before. So the banks are self-insuring against that risk.

Mr. ELY. Mr. Campbell, I have done some financial modeling on this in terms of what the risk is to the FDIC. I would be glad to submit that analysis for the record. But basically, the additional loss that the FDIC would experience as the deposit insurer would really be quite modest, especially related to the premium income on covered bonds as of April 1st.

Chairman GARRETT. Thank you.

Mr. Pearce, for the last word?

Mr. PEARCE. I would like to wrap up with Mr. Ely.

Mr. Skeet, I don't mean to overlook you and ignore you, but I represent New Mexico, which has a lot of Hispanic descendants. And that whole thing with the Spanish Armada still hasn't quite settled out yet.

[laughter]

Mr. SKEET. The Armada—I think we won that battle.

Mr. PEARCE. Okay. We will look for it.

Mr. SKEET. That is done and gone.

Mr. PEARCE. Mr. Ely, Mr. Andrews expressed that all the money is going to migrate to the big deals. And I worry about that, too, that the further away the institutions get from New Mexico, the rates of return on their investments in New Mexico look microscopic. We don't have high-priced properties. And we don't have high-priced anything. So can you give the assurance to Mr. Andrews and myself that won't happen?

Mr. ELY. Yes, I will certainly try.

Mr. PEARCE. Instead of—

Mr. ELY. The key thing is that community banks can participate in the covered-bond marketplace. And they will be able to do so. As Mr. Skeet has indicated, there is history in Europe to that effect. I see no reason why that wouldn't be the case in this country.

In many ways, I think covered bonds will actually strengthen community banking because community banks will be better positioned than they are today to not just make these mortgages, but to keep them and maintain the customer relationship and not just sell the mortgage, but as they also do many times they sell the servicing rights. So there is a complete detachment of the customer, the borrower, if you will, from the bank.

What covered bond funding will do is allow for the preservation of that customer relationship. And I would argue that one of the benefits of covered bonds will be to actually strengthen community banking in this country by enabling banks to hang onto loans rather than feel compelled to sell them because it is not necessarily a piece of cake today to go out and assume interest rate risk on a 30-year, fixed-rate mortgage, which is why most community banks sell off all their 30-years.

Mr. PEARCE. Mr. Andrews, do you want to wrap up? I am out of time. Thanks.

Chairman GARRETT. I thank you.

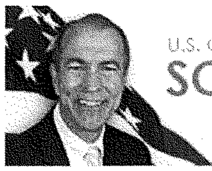
And I thank all the members of the panel. I very much appreciate all of you coming here today and your testimony and your views.

Without objection—and it doesn't look like there will be any objection—the hearing record will remain open for 30 days for members to submit questions to these witnesses and to place their responses into the record. And with that, this hearing is adjourned. Thank you very much.

[Whereupon, at 11:41 a.m., the hearing was adjourned.]

A P P E N D I X

March 11, 2011



U.S. CONGRESSMAN
SCOTT GARRETT
PRESS RELEASE

FOR IMMEDIATE RELEASE
March 11, 2011

Contact: Ben Veghte
Phone: 202-226-0443

Covered Bonds Will Help Private Investment Return to Capital Markets

WASHINGTON, DC – Rep. Scott Garrett (R-NJ), Chairman of the House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises, delivered the following opening statement today at a subcommittee hearing to review legislative proposals to create a covered bond market in the U.S.:

"As our nation continues to recover from the recent financial crisis and certain credit markets remain locked, Congress must examine new and innovative ways to encourage the return of private investment to our capital markets. We must also consider creative ways to enable the private sector to provide additional mortgage, consumer, commercial, and other types of credit. I believe establishing a U.S. covered bond market would further these shared policy goals.

"Today, we are here to examine legislative proposals to establish a covered bond market in the U.S. On Tuesday, my good friend, the gentlewoman from New York, Ms. Maloney, and I introduced H.R. 940, the U.S. Covered Bond Act of 2011. The legislation sets the foundation for a U.S. covered bond market by creating a regulatory framework and detailing the exact process that occurs if an issuer fails.

"One reason I am particularly interested with covered bonds is the fact that they can be a purely private means of finance without government guarantees or subsidies. Many proposals to help alleviate the current strains in our credit markets focus on government loans or guarantees. However, I believe covered bond legislation offers a way for the government to provide additional certainty to private enterprise and generate increased liquidity through the innovation of a new marketplace without putting the taxpayers on the hook.

"There are many potential benefits for a wide variety of interested parties that can be derived from a U.S. covered bond market.

"Consumers will experience lower loan rates because of the additional liquidity in the various asset classes.

"Consumers will also be able to more easily have their loans modified because the loans will still be on the balance sheet of the originating institution.

"Investors will have a new transparent and secure vehicle to invest in. This will allow for additional diversification within their portfolios.

"And finally, the broader financial markets will benefit by having an additional, low cost, diverse funding tool for financial institutions.

"Covered bonds will ensure more stable and longer term liquidity in the credit markets, which reduces refinancing risks as well as exposure to sudden changes in interest rates and investor confidence. And they will allow U.S. financial institutions to compete more effectively against their global peers.

"I look forward to our witnesses' testimony."

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TESTIMONY OF
STEPHEN G. ANDREWS
BANK OF ALAMEDA

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

BEFORE THE HOUSE FINANCIAL SERVICES SUBCOMMITTEE
ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

MARCH 11, 2001

Mr. Chairman and Ranking Member, my name is Steve Andrews. I am pleased to appear before you today at this hearing on covered bonds and the United States Covered Bond Act of 2011. This is a very important issue and I am pleased to see the thoughtfulness being shown by the Congress in studying the covered bond market.

I am a community banker with the Bank of Alameda in Alameda, California, a successful California community bank. We guard jealously our community reputation and take pride in the positive impact that we have in our communities. We are conservatively run, and we know our customers well.

I am pleased to present testimony raising several serious concerns and objections about the possible development of a covered bond market in the United States (U.S.). To cut to the chase, speaking from my perspective as a community banker, I do not think that we as a country need to expend the time, energy and resources to attempt to create a covered bond market in the

U.S. In my opinion, and I believe that I am supported in this view by Treasury Secretary Geithner, we already have a covered bond market: it is the Federal Home Loan Bank System. I am a member of the Federal Home Loan Bank of San Francisco. We do not need to try to import from Europe an experimental housing finance tool that would be deployed under greatly different conditions and circumstances and as far as I can see would largely benefit the biggest banks in the industry.

By contrast, the Federal Home Loan Bank (FHLB) system is alive and well and doing the job congress chartered it to do. Let me remind you that the FHLB system expands and serves as a buffer to its members under its cooperative ownership structure when the economy demands it, and the system contracts when the economy no longer requires that level of liquidity. Indeed, consistent with the Federal Home Loan Bank Act, the Federal Home Loan banks provide funds in good and bad economic times. During the height of the mortgage credit crunch in 2007-2008, Federal Home Loan banks increased their advances to member institutions by over $250 billion. Frozen out of credit markets during the financial crisis, large and small institutions relied on Federal Home Loan banks for funding. If such funding had not been available at reasonable cost, the crisis would have been even worse. In sum, Federal Home Loan banks manage mortgage collateral differently. Federal Home Loan Banks take haircuts on the collateral provided. Most importantly they know their customers and are able to customize funding needs to meet mortgage-financing needs in a way that covered bonds are not intended to achieve. Because true low risk covered bonds require term debt to match up with term assets.

I am not here to "bash" the big banks. They are an important part of the FHLB System. As members and users of that System, both large and small institutions contribute to its strengths and permit it to make reasonably priced advances which members use to make mortgages. Without large member participation, the System would not be as strong as it is and able to provide reasonably priced advances.

My understanding is that a covered bond is a recourse debt obligation of the bond issuer (usually a depository institution), in which the issuer has a continuing interest in the performance of the loan, and is secured by a pool of mortgage assets. Covered bonds provide funding to the bond issuer, and the issuer retains the pool of assets and related credit risk on its balance sheet. Therefore, in contrast to mortgage backed securities, where secured assets are off the balance sheet of the issuer, the pools of assets remain on the covered bond issuer's balance sheet. Interest on the covered bonds are paid to investors from the issuer's general cash flows, while the pool of assets serve as secured collateral on the products.

If the assets within the covered bond's asset pool become non-performing, they should be replaced with cash or be over collateralized. The issuer must maintain a pool of assets in excess of the notional value of a covered bond and therefore be "over-collateralized" at all times. In general, the maturity of a covered bond is greater than one year and no more than thirty years; in Europe assets are matched for the durations of the covered bond. Moreover, while the majority of covered bond issuances have maturities between one and ten years, there has been a recent trend toward longer-term instruments that are greater than ten years in duration.

Unfortunately, the lion share of the benefits of a covered bond market in the U.S. would be to help the largest banks in the U.S. to the detriment of excellent community banks. Moreover, instead of the covered bond market being an effort to privatize mortgage finance obligations as is sometimes touted as a benefit, it seems pretty clear that in Europe the government is viewed as backing up the covered bonds issued by the large European banks and indeed the various governments in Europe have stepped in to support the covered bond markets when difficulties arose.

The U.S. has over 7000 banks while Germany and other European nations often have 3 or 4 major banks and a small number of additional institutions. The latter financial market structure, with fewer and larger banks, is more conducive to covered bond issuances. Smaller community banks would be at a competitive disadvantage in a covered bond market because they do not have the volume of mortgages necessary to support covered bond financing. To create covered bond assets with enough diversity would require adequate "mortgage deal flow." Smaller banks in this struggling market may simply not have the number of loans to provide competitively priced covered bonds. The government or market might be able to consolidate mortgage loans for smaller banks into covered bonds, but even this solution is likely to be at a higher cost compared to larger national originators with substantial deal flow. In contrast to the U.S., European countries have different banking structures.

In addition, I believe many lower and middle-income consumers would be affected by higher priced mortgages from small banks unable to compete with large bank issuers of covered bonds. Moreover, some contend that covered bonds will include mortgages with down payments of 20% or more and because of duration matching, may encourage mortgages of less than 30 years. Such a result would obviously not be in the best interests of consumers or small banks that serve them.

Moreover, the Federal Deposit Insurance Corporation (FDIC) has raised serious concerns about the functioning of a covered bond market and the ability of the FDIC to resolve financial institutions that fail which hold such instruments. The FDIC's 2008 Final Statement of Policy on Covered Bonds (FDIC Policy Statement) is the pertinent position of the FDIC on the use of covered bonds. One of the main concerns detailed in the FDIC Policy Statement was the potential for covered bonds to increase the costs to the FDIC's deposit insurance fund in a receivership. More specifically, the FDIC was concerned that unrestricted growth in the covered bond market could excessively increase the proportion of secured liabilities to unsecured liabilities, which could lead to a smaller value of assets that are available to satisfy depositors and creditors in a receivership and therefore lead to a greater potential loss for the FDIC's deposit insurance fund. The FDIC is also concerned about the agency's potential inability to obtain proceeds from covered bonds in the insolvency process in circumstances when the covered bond issuer has failed. The FDIC also stated its concern about being powerless to repudiate covered bond contracts in the insolvency process which could transfer risk from covered bond investors to the general public.

Some argue that the bill would allow covered bonds to be removed from the FDIC Insurance coverage. If this were the case, it would lower the amount of insurance that large institutions pay into the FDIC fund and potentially increase the cost of FDIC insurance on small community banks.

As to the proposed bill, as drafted, it contains provisions that some argue could have far reaching implications. Namely, expanding covered bonds to include other forms of collateral beyond mortgages, using assets as substitute collateral instead of cash and potential providing a federal guarantee to covered bond-issuing entities – namely large banks.

As to the proposed bill, as drafted, it contains provisions that could have far reaching implications namely expanding covered bonds to include other forms of collateral beyond mortgages, using assets as substitute collateral rather than cash, and potentially providing a federal guarantee to covered bond-issuing entities – namely large banks.

(1) The Act would allow for covered bond usage on non-mortgage assets that have short duration such as credit cards, auto loans, and student loans. This is the opposite of the established European model.

(2) The legislation also refers to dynamic collateral, which can mean that a large bank does not have to buy the non-performing asset out with cash, which could be problematic. Dynamic capital was the equivalent of what WAMU

did when it issued covered bonds, and substituted loans internally rather than providing cash, and we all know what happened to WAMU.

(3) The legislation also request that a study be performed on how the government could provide a backstop to the covered bond market. If a backstop is put in place, large lenders could have a government guarantee in a way that could be riskier and more expansive than Fannie Mae or Freddie Mac.

Now, as a country, we should have a robust debate about the level of home ownership in the U.S. And, I will be the first to admit that banks and others made mistakes during the housing bubble and ensuing recession by too aggressively pushing marginal borrowers into home ownership. But, let's be clear. Owning a home is a vital part of the American dream. In Germany and other European nations that rely on the restrictive processes of the covered bond market, the national home ownership rate is below 50%. That's not part of the American fabric or part of our culture. Americans want to be able to work hard, save a reasonable amount of money for a down payment and own their "castle," and have the freedom to move elsewhere in this great country if employment, family or other obligations requires a change in residence. That's not the way it works with covered bonds. Borrowers are locked in by the onerous down payment, underwriting criteria and inability to sell and relocate to another residence for whatever reason of personal freedom or economic necessity. Having the personal freedom to move where you want and to play by the rules to grab your piece of the American dream, well that's the America that I grew up in. That's the country that I am proud of, and that's what is fair to keep in place for my children, your children, my grandchildren, your grandchildren and the other generations in the years ahead.

Let me close with this thought. Housing should be viewed as a long term investment and as a place of belonging. It should not be transformed through legislation or other marketplace maneuvering into a financial speculative asset. That happened during the financial crisis and the housing bubble that contributed mightily to that crisis. I suggest that you consider some principles to guide any covered bond legislation such as; (1) do no harm to the 30 year mortgage as the industry standard; (2) insure a robust Federal Home Loan Bank System that provides a significant advance product to large, medium and small banks at a reasonable cost; (3) not increase FDIC insurance fees on smaller banks as a consequence of establishing a covered bond market; and (4) ensure consumers are held harmless in their continual search for low interest and nationally available mortgages.

I thank you for the opportunity to appear before you today, and I welcome the opportunity to respond to your questions.

American SECURITIZATION FORUM®

Statement of:

Ralph Daloisio
Managing Director
Natixis

On behalf of the American Securitization Forum
ASF Covered Bonds Subforum

Testimony before the:

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on:

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

March 11, 2011

One World Financial Center, 30th Floor ▪ New York, NY 10281 ▪ 212.412.7100 ▪ www.americansecuritization.com

Chairman Garrett, Ranking Member Waters, and Distinguished Members of the Subcommittee, I thank you for this opportunity to testify before you today.

Preamble

The American Securitization Forum (the "ASF") was formed to enable participants in the US securitization industry to pursue a mission of education, consensus, and advocacy on matters relating to the form and function of the US securitized debt capital markets. The ASF has over 330 institutional members engaged in every significant aspect of this market—issuers, investors, servicers, dealers, ratings agencies, law firms, trustees, and a variety of data and technology vendors. Assuming a legislated US covered bond market is established, our members will have a leading and lasting role in this new financial instrument, much like they did over 25 years ago with the creation of the first asset-backed security.

As the current Chair of the ASF Board of Directors, a former Chair of the ASF Investor Committee, and as a Managing Director of Natixis, I offer testimony today in support of a promising legislative framework for covered bonds in the United States. In particular, I seek to represent the views of institutional investors, who could bring the necessary capital to invest in this product. By way of background, the ASF Investor Committee represents over 60 pension fund, mutual fund and insurance company member institutions, who collectively manage trillions of dollars of Main Street's financial investments. The institution I am employed with, Natixis, is the commercial and investment banking subsidiary of BPCE, the second largest bank in France as measured by retail deposits. Natixis and its affiliates have held a long-standing leadership role in the European covered bond market, acting as an issuer, dealer, and investor and conduct significant investment and banking activities in the United States. My professional experience in securitized debt capital markets and related investment activity covers the past 20 years.

The right kind of legislation, like the legislation you Chairman Garrett and Congresswoman Maloney have introduced on Tuesday, has the power to create a new channel of efficient credit flow through our financial system while facilitating an accelerated and more orderly exit of US government financial support for the private sector. The proposed legislation would create a new and disciplined market structure around which free market forces can organize to better balance the flow of money, capital, and credit in our highly sophisticated financial system. The concentrated US banking system market structure invites the creation of new financing channels, so we can better democratize the flow of credit to Main Street in an effort to improve its post-crisis affordability and accessibility to American consumers and businesses. Credit democratization is something the securitization markets have been particularly effective in doing, but additional forms of financing are necessary to support appropriate levels of credit creation in the US. As such, we fully support your initiative to establish a new credit channel for the ultimate benefit of Main Street.

The Short History of US Covered Bonds

It appears ironic to acknowledge that US covered bonds have already been issued, without legislation. As many of you may know, the first US insured depository institution ("IDI") covered bond was issued by Washington Mutual ("WaMu") nearly 5 years ago, even without a legislative framework for it. Approximately a year later, Bank of America became the second US bank to issue covered bonds. In the absence of any legislative framework in the United States, these issuances were denominated in Euros and sold predominantly into the European covered bond market as "contractual" covered bonds.

In July 2008, the FDIC published a Final Statement of Policy (the "Final Policy") for the exercise of its receivership and conservatorship authority in respect of covered bond contracts entered into by a US IDI and the US Treasury issued its "Best Practices for Residential Covered Bonds Guidelines"[1] (the "Best Practices Guidelines") for the issuance of contractual US covered bonds in coordination with the FDIC's Final Policy. At the time, Treasury believed a framework defined by policy and regulation[2] would be sufficient to initiate a US covered bond market that could restore the financing that was withdrawing from a declining asset securitization market. This belief was disproved quickly as the financial crisis accelerated into the autumn and culminated with historic emergency measures passed by Congress. Just two months after the Treasury and FDIC frameworks were issued, Washington Mutual was closed by the OTS and the FDIC was appointed receiver. During those two months, secondary market prices of WaMu's

[1] Best Practices for Residential Covered Bonds, Department of the Treasury, July 2008.
[2] A framework not defined by specific legislation (a "legislative framework") is herein referred to interchangeably as a regulatory framework, policy framework, or contractual framework.

Euro-denominated covered bonds fell precipitously as holders of those investments began to focus on the risk that the FDIC's repudiation authority could override contractual protections while the value of the residential mortgages in the covered pool would decline. Historical price data indicate that the WaMu covered bonds traded as low as 75 cents on the dollar, before rallying after the acquisition by J.P. Morgan later that same September in 2008.[3] The 2006 and 2007 issuances by WaMu and Bank of America remain the only US covered bond issues to date. Curiously, no US covered bonds were issued after the FDIC published its Final Policy and the US Treasury published its Best Practices Guidelines.

Policy and Regulation Are Insufficient to Support a U.S. Covered Bond Market

The experience of investors in WaMu covered bonds highlighted the weakness in relying on a regulatory, rather than a legislative, framework for US covered bonds. In general, regulatory frameworks are more easily revised than legislative frameworks, which would require an act of sovereign government to change, rather than a regulatory action under the regulator's own control. Consequently, regulatory frameworks are more susceptible to whim or political expediency that can be disruptive of markets and injurious to investors who relied on such frameworks. In particularly good times, investors might be willing to overlook or de-emphasize the risk posed by a regulatory regime, buy the bonds, and accept even an insignificant premium for the incremental risk. This is basically what occurred in the WaMu story. When stress arises, however, at the precise moment that a framework needs to show stability and resilience, markets

[3] "Washington Mutual's Covered Bonds", Harvard Business School, 9-209-0923, Daniel B. Bergstresser, Robin Greenwood, James Quinn, Rev. October 22, 2009.

will focus their attention on the weaknesses and extract a sometimes painful toll for their sheer presence. If we are to start a new and promising financial sector, we can ill-afford to marry it to a weak legal framework. The centerpiece of any legal framework will be that framework's treatment of covered bonds in the event of an issuer's insolvency.

The Need to Curb FDIC Insolvency Resolution Authorities by Passing US Covered Bond Legislation

In a prospective US covered bond market, the FDIC would be the operative regulator for IDIs that choose to issue covered bonds. Our expectation would be for much of the early US covered bonds market to be developed by US banks, given the experience in other countries. As it now stands, the FDIC's authority as receiver or conservator is simply contradictory and counterproductive to the creation of a healthy legal framework for a covered bond market. This is because the FDIC has too much discretion to choose among resolution alternatives that would have varying consequences for covered bondholders, especially including the worst-case outcome that the FDIC could elect to repudiate a covered bond contract, determine the fair market value of the cover pool securing the covered bonds, and pay covered bondholders the lesser of par or cover pool fair market value with interest accrued only through the date of the FDIC's appointment as receiver, and not to the date on which investors are actually repaid.

Even if the FDIC were to promulgate guidance limiting itself to its more investor-friendly bank insolvency resolution alternatives, investors would lack confidence in and be reluctant to rely on such self-governed guidance. This is because the FDIC would have an inherent conflict of interest to take action that minimizes losses to the Depositary Insurance Fund ("DIF"), regardless of whether such result came at the expense of secured creditors. Such conflict of interest was amplified in acts of earlier Congresses requiring the FDIC to use the "least costly" transaction(s) for resolving insolvent IDIs and giving depositors a payment priority over other unsecured creditors of an insolvent bank. This being the case, legislation is required to limit the FDIC's optionality in resolving the covered bond contracts of a bank under the receivership or conservatorship control of the FDIC. Allowing the FDIC to retain its current authority under Section 11(e)(12) of the Federal Deposit Insurance Act ("FDI Act") in respect of an IDI's secured indebtedness for covered bonds would be a grave policy misstep in our view, and would undermine the market before it can be developed. In the opinion of our issuer and investor members, covered bond legislation needs to set a clear and unmistakable set of resolution mechanics that assure investors will receive the economic value of a market-based negotiation of contracts consistent with the principles already in long-standing operation around the globe for this type of indebtedness. Only legislation can create a carve out for covered bonds in order to curb the insolvency authorities the FDIC now has over covered bonds to the extent necessary to establish a US legislative framework that is competitive with the more established programs domiciled elsewhere.

Concerns that Covered Bond Legislation Would Increase the Risk of Loss to the Depositary Insurance Fund and to the U.S. Taxpayer Are Misplaced

Some fear that an investor-friendly US covered bond legislation would pose greater risks to the FDIC DIF and ultimately to the US taxpayer. We believe any such fears are misplaced, especially since, by the FDIC's own account, Dodd-Frank has "granted the FDIC the ability to achieve goals for [DIF] fund management that it has sought for decades but lacked the tools to accomplish"[4]. Among other things, Dodd-Frank raised the minimum designated reserve ratio ("DRR"), removed its upper limit, eliminated the requirement that the FDIC dividend amounts when the DRR is between 1.35% and 1.5%, granted the FDIC sole authority to determine dividend policy above a DRR of 1.5%, and set the calculation of insurance premiums against total assets, not total deposits.[5] Accordingly, it would seem more logical for the FDIC to adjust deposit insurance premiums to the asset-liability practices of IDIs, including any covered bond issuance practices, rather than seek to maintain their traditional insolvency authorities which could impede or even prevent a US covered bond market from becoming a feature of our credit system. Perhaps even the FDIC has come to recognize this in a post Dodd-Frank world, as the September 15, 2010 testimony of the FDIC before the Senate Banking Committee includes a sentence whereby the FDIC witness Michael Krimminger, currently the FDIC's General Counsel, states, "[t]he FDIC would support covered bond legislation that clarifies the amount of repudiation damages to be the par value of outstanding bonds plus interest accrued through the

[4] Federal Register Vo. 76, No. 38, Friday February 25, 2011, Part II, Federal Deposit Insurance Corporation, 12 CFR, Part 327, Assessments, Large Bank Pricing; Final Rule, page 10673.
[5] Ibid

date of payment."[6] Such a policy stance would be a significant improvement from the FDIC's Final Policy wherein the FDIC takes the position that repudiation would mean a payment equal to the lesser of par or the fair market value of the cover pool, plus bond interest accrued to the date on which the FDIC was appointed receiver. This Final Policy subjects investors to market-value loss on the cover pool and could additionally cause a period of lost interest payments for investors. While such movement in policy stance is encouraging, it does not go far enough as the FDIC would still retain an option that is exercisable against investors: *if the cover pool were* *unhealthy*, the FDIC would turn the cover pool over to an estate for the benefit of covered bondholders who would likely encounter a loss and a resulting unsecured deficiency claim against the issuer; *if the cover pool were* *healthy*, the FDIC would liquidate it, capture the excess collateral value for the insolvent estate, and pay par to investors, exposing them to what could be potentially material re-investment risk. Still, the movement in the FDIC's policy stance is encouraging in that it signals further movement could occur in favor of a globally competitive US covered bond framework.

[6] Statement of Michael H. Krimminger, Deputy to the Chairman, Federal Deposit Insurance Corporation on Covered Bonds: Potential Uses and Regulatory Issues, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 15, 2010.

The Global Nature of a Substantial Covered Bond Market

Like so many financial markets today, the covered bond market is a global market, though it remains concentrated in its European geography of origin. Covered bonds date back to 18th century Prussia, when the Pfandbriefe was introduced by the decree of King Frederick the Great to enable the property of nobles to be pledged as collateral to investors in exchange for agricultural credit. The German Mortgage Bank Act of 1900 modernized the original concept by creating a formal legal framework that assured the cover pool would be ring-fenced on an issuer's balance sheet and that investors in covered bonds had recourse to both the cover pool and the issuer in the event of a default[7]. The first issue of French legal covered bonds (Obligations Foncières) was created by decree in 1852 by Crédit Foncier de France under the *société de credit Foncier* statute. The main business of Crédit Foncier de France, founded in 1852, is to grant mortgage-backed real estate loans and local authority loans and to issue bonds to finance these loans.[8]

Today, some 29 countries are counted as having covered bond frameworks rooted in regulation, contract law, or legislation. 22 countries now have legislated covered bond market structures, with Australia, Canada, and New Zealand in the process of passing legislation for covered bonds[9]. Germany, Spain, Denmark, France, and the UK represent nearly 80% of the

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[7] *The Conundrum of Covered Bonds*, Steven L. Schwarcz, forthcoming in The Business Lawyer, May 2011.
[8] *Natixis Credit Research*, Cristina Costa and Jennifer Levy, March 2011.
[9] European Covered Bond Fact Book, European Covered Bond Council, September 2009.

outstandings of covered bonds.[10] The Euro is the predominant currency in which covered bonds are issued, and there are between 140 and 150 issuers of Euro-benchmarked covered bonds. [11]

There is a clear preference for legislative (or statutory) covered bond frameworks. Of the estimated €2.5 trillion in outstanding covered bonds, an estimated 92% were issued under legislative frameworks. A central feature of statutory frameworks concerns the legal framework for insolvency of the covered bond issuer. Effective legislative frameworks include a specific legal framework superseding the general insolvency law. The typical legal framework under legislated market structures affords investors dual recourse: recourse to the cover pool as a secured creditor and recourse to the issuer as an unsecured creditor for amounts not repaid by the cover pool. Of additional importance, the insolvency of the issuer does not automatically trigger the acceleration of the covered bond indebtedness and an accompanying liquidation of the cover pool. This last feature mitigates reinvestment risk, or the risk that an issuer's insolvency would trigger a prepayment to covered bond investors that at a given moment could not be reinvested for comparable investment return to that of the prepaid covered bonds.

The economic benefits of a country's covered bond program can be significant. Market research shows that banks issuing covered bonds can save between 20 and 60 basis points per year on interest rates when compared to the rates paid on their senior unsecured issues of comparable maturity[12]. Such savings can be transmitted through society in the form of lower rates on the consumer and commercial credit that finances our economy, stimulates growth, and creates jobs.

[10] Ibid
[11] *Natixis Credit Research*, Cristina Costa and Jennifer Levy, March 2011.
[12] Ibid

During periods of economic stress, the relative differential between secured and unsecured borrowing costs increases. Over the past year, such differential expanded to over 4% per annum for weaker banks operating in stressed economies.[13] The ability to issue relatively lower-cost financing, which becomes increasingly relative lower-cost financing during periods of worsening economic and financial stress, is a distinguishing benefit of covered bonds.

The Barren but Rapidly Changing Landscape for US Covered Bonds and the Investment Market's Need for Highly-Rated Fixed Income Private Sector Investment

Since the US Treasury, in coordination with the FDIC, issued guidelines in support of establishing a US covered bond market, there has been no issuance of a covered bond by a US issuer. Part of this absence may be explained by the limited investor appetite for exposure to U.S. residential mortgage loans not guaranteed by one of the GSEs (residential mortgage loans are, by far, the primary type of collateral in cover pools worldwide). Part of this absence may also be explained by the continuing role of the GSEs and FHA, which have been responsible for 95% of all new residential mortgage loans having been made in the US in these recent years. Part of the absence may also be explained by the repaired balance sheets of US banks, which have shown a limited need for securitization or secured financing in the face of a rising deposit base.

[13] Ibid

But the landscape is changing rapidly. Although there was only one US$ issuance of a covered bond in 2009—which took place outside the United States—2010 saw a huge increase in US$ issuance of covered bonds. 21 covered bond issues were denominated in US$ in 2010, from issuers based in France, Germany, the United Kingdom, Sweden, Norway and the Netherlands. 2010 US$ covered bond issuance aggregated $30 billion, beginning a trend that has been continuing into 2011[14]. Our neighbors to the North, in Canada, issued 9 of these 21 US$ deals in 2010, aggregating half the total 2010 US$ issuance volume. They issued at rates of interest that were materially lower than other US$ issuers, which is attributable to the extremely low risk of the collateral in their cover pools, which consists of Canadian residential mortgage loans that are guaranteed by Canada Mortgage and Housing Corp., the "AAA" rated full faith and credit Canadian Government agency. In short, our US$-based investors have been investing noticeably in US$ covered bonds for over a year now, but they have been buying them from non-US issuers.

When the approach taken by Treasury to implement a policy framework for contractual covered bond issuance by US issuers failed to gain traction, ASF membership was very supportive of your efforts Chairman Garrett for a legislative response. In March 2010, the United States Covered Bond Act of 2010 was introduced, which was the right idea at the right time, as the market has already validated the movement towards US dollar-denominated covered bonds even before US legislation has passed. We can now interpret this movement as an invitation to pass legislation, which could have a positive transformative effect on the US banking and financial

[14] *Natixis Credit Research*, Spreads and Credit, Covered Bond, November 2010, Christina Costa, Jennifer Levy, in collaboration with François Le Roy.

system. Asset securitization was the primary manufacturer of "AAA" rated private-sector investments, but the post-crisis issuance of "AAA" rated securities has dropped to a fraction of its pre-crisis volume. It is clear that non-US issuers are tapping into the US investor demand for high-quality investments like those offered under existing covered bond frameworks. The ASF voices its full support for such an enacting piece of legislation.

ASF Recommendations in Support of Effective US Covered Bond Legislation

In contemplating the United States Covered Bond Act of 2011 and in considering the type of legislation that would be most constructive to the emergence of a deep and liquid US covered bond market, the members of the ASF would like to articulate some principles that we believe should be present in the legislation.

In particular, effective legislation in favor of covered bonds should be as investor-friendly as possible. Many institutional investors in the US and abroad are living with the painful memory of recent government-sponsored intervention that has compromised the operation of contracts. Moreover, the attempt by some regulators to exercise expansive authority over the efficacy of certain debt capital markets products also threatens the confidence investors have in government-led market initiatives. A striking recent example of this expansive view is the securitization safe harbor rules which have been promulgated by the FDIC. The FDIC has publicly stated that such rules are intended to protect the investors in future asset-backed securities sponsored by IDIs, but in fact it will be the investors who lose the protection of an insolvency-remote true sale if the affected IDI failed to meet or comply with the requirements of the securitization safe harbor over which investors have no control.

ASF submits the following essential principles that we believe should be present in the legislation, among others:

1. **The legislation should allow for bank and non-bank entrants without discriminating on the basis of size or credit quality.** Investors should be afforded a menu of alternative covered bonds, which includes multiple issuers of varied standing. This would allow a more balanced flow of capital into the credit sector and avoid imbalances and over-investment in a small number of issuers and too few covered bond programs. It also would avoid the pitfall of having legislation pick the "winners" and "losers."

2. **The legislation should allow a wide variety of collateral types to be included in the cover pool.** Such optionality would allow for investor choice and market-based preferences to balance the flow of capital into an emergent US covered bond sector. Collateral types could include residential mortgage loans, loans outstanding under home equity lines of credit, multi-family housing loans, commercial mortgage loans, auto loans, auto leases, student loans, consumer credit card loans, public sector loans, other types of loans deemed appropriate by the supervising authority, and securities backed by any of the foregoing collateral types provided the security is not backed by more than one, homogenous collateral type.

3. **<u>The legislation should not allow different types of collateral to be co-mingled in the same cover pool, but instead require asset type homogeneity within a cover pool.</u>** This will facilitate elegant simplicity and create standardization and enhanced transparency from the investment perspective. As the U.S. emerges from a rather opaque, complex, and non-standard system of mortgage securitization, aspects of a new secured finance system would find greater uptake in biasing themselves to enhanced simplicity, standardization, and the resulting improvement in transparency.

4. **<u>The legislation must allow investors full dual recourse: first, to the cover pool as a primary source of payment for principal and interest on the covered bonds, and second, as unsecured creditors to the issuer in the event the cover pool proceeds are insufficient to repay principal and interest in full on the covered bonds.</u>** A covered bond investor's unsecured claim should rank *pari passu* with the other senior, unsecured claims on the issuer. Dual recourse is, in fact, 100% "skin-in-the-game". The bank is fully liable to repay the covered bonds and the cover pool assets remain on the balance sheet of the issuing bank, leaving no question around the alignment of interest between issuer and investor. For banks and non-banks with high senior unsecured credit ratings, a covered bond issuance should allow them to issue at appreciably lower rates of interest than where they would issue unsecured debt and be competitive to where they would issue securitization debt rated as high as their own rating. In Europe, we see a significant difference between the rates paid by top-tier banks on their unsecured debt versus their

covered bond issuances, with covered bond debt yields being appreciably lower than unsecured debt of comparable maturity.

5. **The legislation should stipulate a specific legal framework that supersedes general insolvency law for the absolute protection of covered bond investors, consistent with the principle articulated in number 4 above.** In our view, investor reception of a US covered bond market will be directly determined by the issuer insolvency framework that accompanies it. If investors fear that an issuer's regulator, the FDIC in the case of US IDIs, can interfere with or have a claim upon the assets in a cover pool, then US covered bonds will be relatively unattractive compared to those issued in other jurisdictions where the priority of claim of bondholders on cover pool assets is a cornerstone of covered bond legislation. Investors would treat them as quasi-secured but price them more like unsecured, which in turn would eliminate the motivation for issuers to issue. If investors fear that an issuer's regulator can force the early liquidation of a covered pool, and leave them under-secured or at risk of reinvesting par proceeds in lower-yielding investments, investors will most likely require a risk premium that would again increase the cost of issuance relative to an issuer's alternatives. Worse still, from a systemic perspective, such a covered bond paradigm would miss a great opportunity to introduce a great stabilizer in the world of bank asset-liability management. The ability to pledge assets under a robust and investor-friendly secured financing framework, like covered bonds, offers banks and non-banks alike a potentially valuable source of financing and simultaneously offers investors a safer investment during periods of credit and liquidity

stress in our financial system. This benefit should not be understated and can become of paramount importance and utility during periods of heightened counterparty credit concerns, like the extreme counterparty credit concerns we experienced in the Credit Crisis of 2008. Indeed, it was precisely this potential that motivated the former US Treasury Secretary Henry Paulson to advance a covered bond framework, but the initiative came too late into the crisis and relied on a weaker regulatory approach rather than a stronger legislative approach to have counteracted the overwhelming forces we confronted in an enormous crisis that was accelerating at the time.

6. **<u>The assets in a cover pool should be segregated from the issuer's other assets, or clearly identified as such to avoid any likelihood that cover pool assets would become co-mingled with other assets of the issuer or with an issuer's insolvency estate.</u>** Covered bond investors should bear no doubt over the proper identification and segregation of assets comprising the cover pool which secures them. One way to assure such treatment would be to require a periodic audit of an issuer's books and records to determine that the asset segregation standard has been satisfied, to report any deficiencies to a responsible party, and to assure an actionable remedy is imposed on a capable party to cure any non-compliance in a timely fashion.

7. **<u>The issuer should maintain a continuing obligation to "cover" the bonds issued under their covered bond program with a sufficient level of collateral and overcollateralization consisting of performing (non-defaulted), self-liquidating financial assets.</u>** This requirement is universally incorporated into covered bond programs around the world and provides assurance to investors that the cover pool would at all times generate sufficient, self-liquidating proceeds from performing financial assets to repay the full amount of principal and interest without their having to rely on the issuer's unsecured credit quality to do so.

8. **<u>The maturity limit applicable to covered bonds (and cover pool assets) should extend to 30 years.</u>** Such a limit is consistent with the FDIC's Final Policy, which was increased from 10 years after consideration of comments received on their Interim Policy Statement and the FDIC's own view that "longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility."[15] A 30-year term limit would allow issuers to tap into the long-end of the yield curve and better maturity-match to longer dated assets, such as 30-year, fixed-rate mortgages. With regard to such a feature, like a maturity limit on cover pool assets, the more flexibility the final legislation affords issuers, the more likely issuance will emerge.

[15] Federal Register / Vol. 73, No. 146 / Monday July 28, 2008, page 43756.

9. **<u>Covered bonds should be allowed to include provisions for additional credit enhancements, liquidity support, interest rate and currency swaps or options.</u>** These types of instruments may prove useful, and even necessary, by the market to create a more stable investment profile for investors and an even better asset-liability match for issuers than they might otherwise be able to achieve if the use of hedge instruments like the ones mentioned here were disallowed or unnecessarily restricted.

<u>Other Considerations for the Legislative Process</u>

In promoting the principles set forth above, it may also be worth noting that our members do not necessarily feel that the legislation needs to be overly prescriptive. Certain elements may be best left for the market to discover, or by Treasury as the principal covered bond regulator. One such element may be the level of overcollateralization. Considering that Dodd-Frank is mandating risk retention for asset securitization on the order of 5% generally, it should be a strikingly clear distinction that covered bonds, by definition, have a 100% risk retention associated with them. This being the case, overcollateralization would exist solely for the benefit of global, market-based investors of adequate sophistication to evaluate the appropriateness of overcollateralization requirements vis à vis the collateral comprising a cover pool. As our recommendation is to allow a wide range of collateral to be eligible for inclusion in covered bond programs, it would be natural to let the investor market set corresponding overcollateralization requirements, especially since we know from experience that different types of assets require different levels of overcollateralization to achieve comparable credit profiles for the liabilities issued against the assets. This would make sense from the regulator's perspective as well, as in theory, regulators would prefer lower overcollateralization requirements so more assets are immediately available to depositors and unsecured creditors than would otherwise be the case if overcollateralization levels were mandated at levels above what was needed in the market.

Other features of an emergent covered bond system may be best decided by legislation if it is likely regulation will only serve to restrain the formation of a deep and liquid market. For example, the FDIC Final Policy restricts covered bond issuance to 4% of an IDI's liabilities. While their reasoning is understandable,[16] a 4% limit would impose a theoretical initial maximum market size for covered bond issuance of $474 billion, assuming the highly improbable outcome that every bank issued to their maximum limit.[17] When banks are already subject to leverage ratios, we question the necessity of requiring an initial market size cap that could merely serve to dissuade issuance by signaling to IDI's that covered bonds will not be allowed to become a sufficiently meaningful asset-liability tool needed to justify the upfront commitment of time, effort, money, and resources to commence an issuance program.

Still, other features are worthy of inclusion in any final legislation, and some may even be necessary for a US covered bond market. For example, it is typical of many European covered bond frameworks to provide for special supervision of an issuer's obligations in respect of the cover pool, which is supervision specifically for the benefit of covered bondholders, as compared

[16] "The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds." Federal Register / Vol. 73, No. 145 / Monday July 28, 2008, page 43756.

[17] Fitch Ratings, U.S. Housing Reform Proposal FAQs: Filling the Void, February 24, 2011

to more general credit institution or markets supervision. Frequently, this kind of supervision is conducted by designated public authorities, which frequently require a covered bond issuer to obtain a license to issue covered bonds. In a number of countries, the public authority is also the banking supervisory authority. In others, the covered bond supervisory authority is the markets regulator. Such public authorities either appoint or approve a cover pool monitor to assure covenant compliance with the terms and conditions of the covered pool legal contracts, and some of these authorities may conduct their own periodic audits of the cover pool programs they supervise. Article 22 (4) of the Directive in Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive"), which is included in other EC directives, affords favorable treatment, such as risk weightings, to covered bonds subject to special public supervision. Calibrating the legislation to afford special treatment for covered bond investments could enlarge the potential for this new market and may also be necessary if US covered bonds are to find as broad and deep an investor base as the covered bonds issued from frameworks in other countries.

Conclusion

Given the extensive history, longevity, and size of the European covered bond market and the remaining need to encourage private sector credit flows in the United States, the ASF is strongly supportive of a legislative framework for US covered bonds. Our support comes despite the potential for covered bond issuance to draw market share from securitization issuance. This is because we believe securitization will re-emerge as a healthy and viable financing, capital-management, and risk-management technology whether or not a covered bond market is established in the United States. Moreover, covered bonds and securitization can co-exist in a complementary fashion with one another, as they have for some time in Europe. We also believe it is our obligation as professionals to advocate for disciplined, market-based developments that will promote the availability and affordability of consumer credit to all Americans, just as securitization has been doing for many years. We believe that industry, legislators, regulators, and other policymakers can work in an open, democratic fashion to innovate financial solutions for this greater good. We applaud Chairman Garrett, his co-sponsor Congresswoman Maloney, and this Subcommittee for its forward-thinking initiative and persistence to see the dawn of a new financial technology that will establish a more balanced continuum of asset-liability management alternatives for our credit institutions. By offering credit institutions the ability to issue longer-term, secured liabilities, covered bonds will fill a void that exists among existing alternatives, like short-term unsecured debt (eg, demand deposits), short-term secured debt (eg, repos), longer-term unsecured debt (eg, term CDs and MTNs), and securitization. The filling of such a void can lower the cost of financing a credit institution, which in turn can lower the cost of consumer credit while simultaneously expanding its availability. At a time when we need to transfer public sector support for private sector financing back to the private sector to reduce our fiscal deficits and remove our potentially inflationary monetary policies; at a time when we need to find avenues to create and expand credit to drive consumer spending and real GDP growth; at a time when we need to create jobs, this covered bond legislation could not come at a better time for the financial industry or our economy.

Again, I thank you very much for the opportunity to testify here today and look forward to answering any questions that you may have.

Testimony by Bert Ely
to the
Subcommittee on Capital Markets and Government Sponsored Enterprises
of the
House Committee on Financial Services
at a hearing titled

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

March 11, 2011

Mr. Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, I very much appreciate the opportunity to testify today about covered bonds and legislation to create the legal framework for a vibrant covered-bond market in the United States, specifically H.R. 940. I will first provide a brief description of covered bonds but focus most of my testimony on why Congress needs to enact a covered-bond statute and the many benefits covered bonds will bring to the United States, and specifically to housing finance. I will close by offering some specific comments on H.R. 940.

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

A brief description of covered bonds

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

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

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

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

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

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

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

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

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

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

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

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

(dollars in billions)

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

Important attributes of covered bonds

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

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

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

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

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

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

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

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

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

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

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

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

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

Covered bonds will provide an excellent source of funding for lender financing of multi-family rental housing for the same reason covered bonds will provide highly efficient funding for owner-occupied homes – covered bonds provide long-term, fixed-rate funding. Sec. 2(8)(C) of H.R. 940 specifies that commercial mortgages shall be an "eligible asset class" for inclusion in a covered-bond cover pool. Sec.2(7)(C) further provides that the commercial mortgage asset class includes "any multifamily mortgage loan." Because borrowers under commercial mortgages usually must pay a prepayment penalty should they refinance the mortgage, prepayments of commercial mortgages are more predictable, which reduces possible maturity mismatches between commercial mortgages of all types and the covered bonds funding those mortgages.

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

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

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

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

Covered bonds can be issued by non-bank financial firms

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

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

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

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

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

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

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

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

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

Enhanced bank safety-and-soundness

Covered bonds will enhance bank safety-and-soundness by providing the means for banks to safely fund high-quality assets, such as conservatively underwritten home mortgages. For example, instead of selling the fixed-rated mortgages it originates, thereby weakening its relationship with those borrowers, a bank will be able to keep those mortgages, which will deepen its relationship with its borrower-customers. That stronger relationship will enhance the bank's franchise value.

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

Stronger borrower protection

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

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

If needed, loan modifications are much less complicated

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The international investor appeal of U.S. covered bonds

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

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

Specific comments with regard to H.R. 940

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

Sec. 2(6) – Covered bond regulator

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

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

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

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

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

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

Sec. 2(7) – Eligible asset

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

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

Sec. 3(b)(3) – Monthly reporting

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Although it is highly unlikely that the Fed would ever suffer a loss in lending to a covered-bond estate, the taxpayer can be further protected by authorizing the covered-bond regulator to levy an assessment on all covered-bond issuers, in proportion to the amount of covered-bonds they have outstanding, sufficient to cover the Federal Reserve's loss. Such a lending and assessment authority should replace the study called for by this subparagraph. This assessment authority parallels an assessment authority granted to the FDIC, as will be discussed in the next paragraph. The European experience with covered bonds during the recent financial crisis suggests that it is highly unlikely that the Fed would ever suffer any loss. Instead, it would likely make a substantial profit for taxpayers by providing market support to the covered-bond marketplace during times of great stress and distress.

Sec. 4(d)(6) – No loss to taxpayers

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

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

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

Figure 1

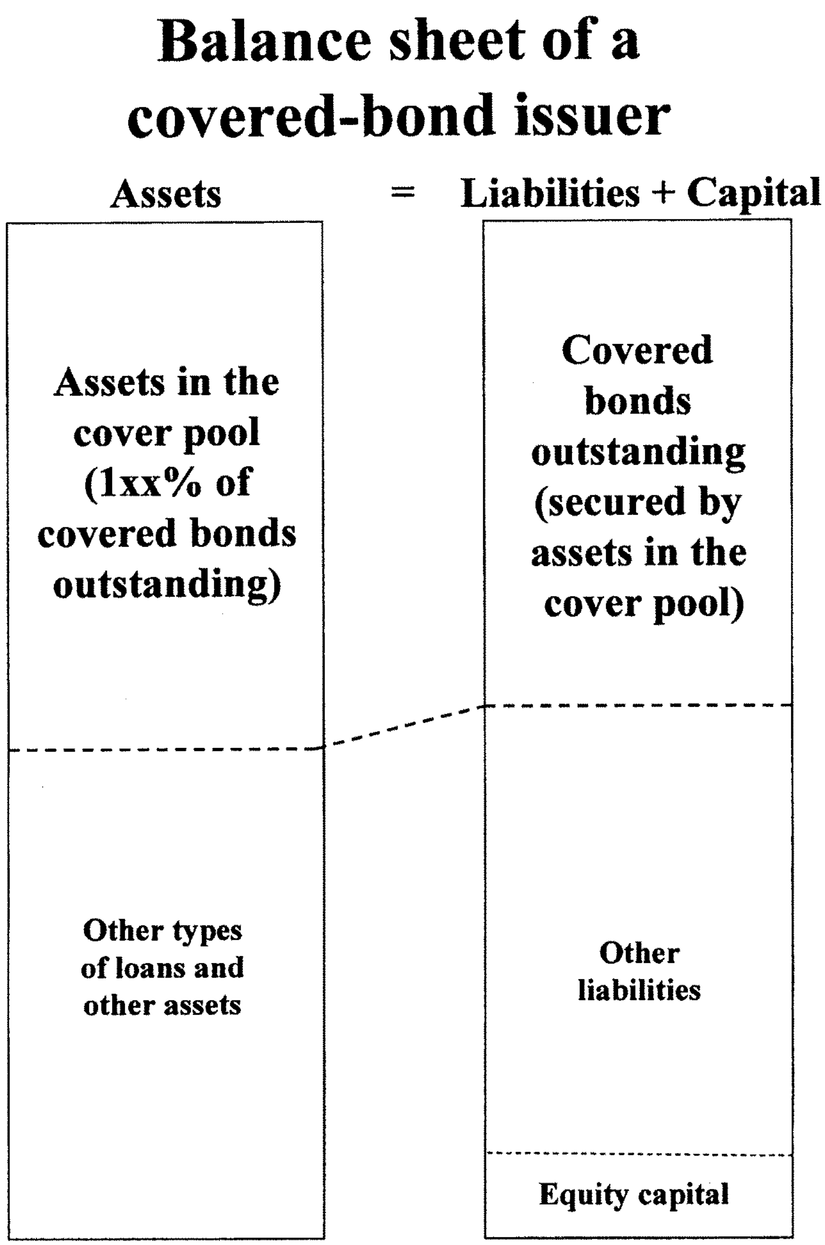
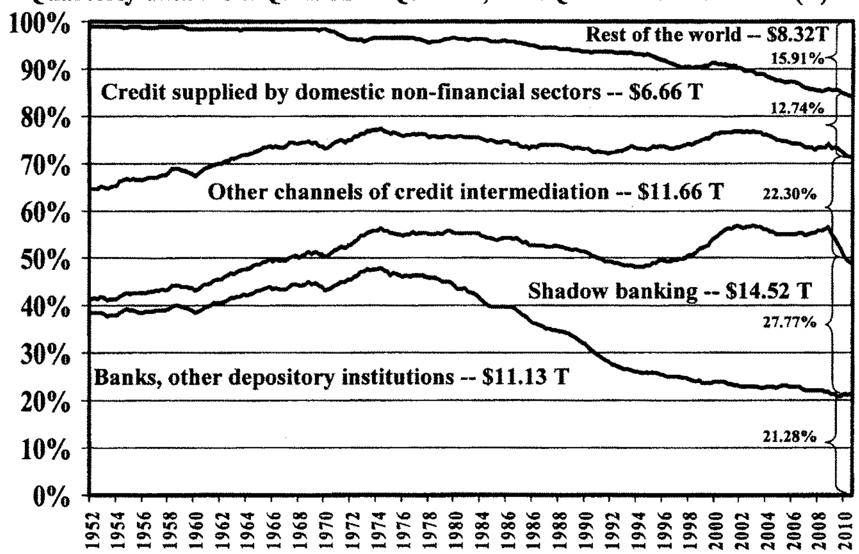

Balance sheet of a covered-bond issuer
Assets
=
Liabilities + Capital
Assets in the cover pool (1xx% of covered bonds outstanding)
Covered bonds outstanding (secured by assets in the cover pool)
Other types of loans and other assets
Other liabilities
Equity capital

Figure 2

Changes in credit-intermediation shares

Quarterly data from Q1 1952 to Q3 2010; 2010Q3 dollars in trillions (T)



Biographical sketch for Bert Ely

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

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

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

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

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ICMA
International Capital Market Association

Statement of Tim Skeet

Board member of the International Capital Market Association[1]

Before the

Committee on Financial Services

Subcommittee on Capital Markets and

Government Sponsored Enterprises

United States House of Representatives

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.

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[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

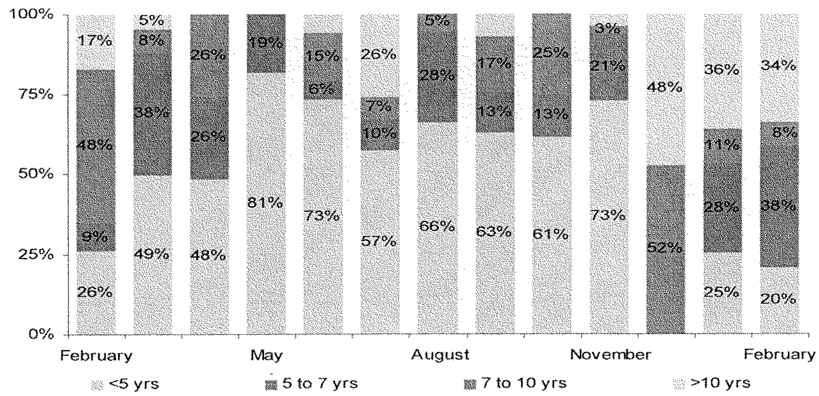
Table 1: Total Jumbo Issuance, *Source: The Euroweek Cover*

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.

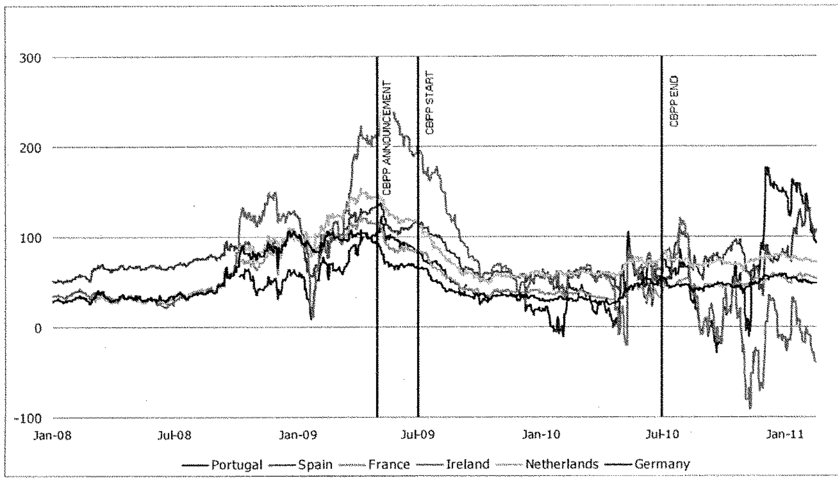


Graph 1: Maturity pattern of newly issued covered bonds, February 2010 to February 2011
Note: December 2010 data is not representative as it refers to taps only.
Source: Morgan Stanley

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.

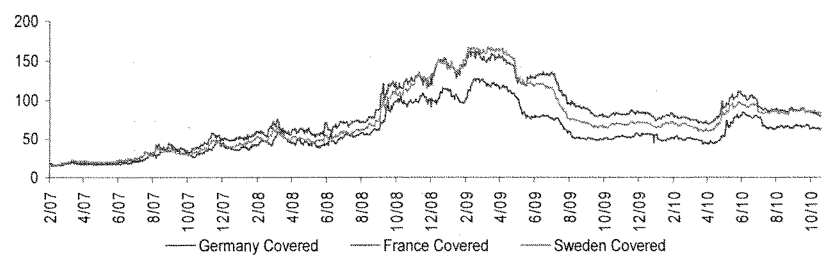
Overall, the secondary market for covered bonds performed better than most other asset classes, although the system of forced market making that used to be at the centre of the 'jumbo' market was suspended early in the crisis and is unlikely to return. The ECB intervention (CBPP, see above) certainly 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.

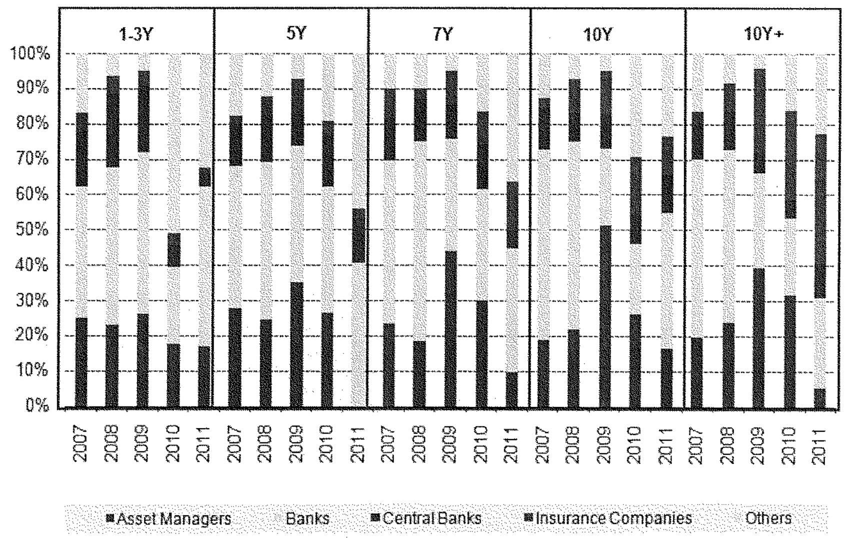
Stable investor base

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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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.

TESTIMONY OF SCOTT A. STENGEL
BEFORE THE
U.S. HOUSE SUBCOMMITTEE ON
CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

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

March 11, 2011

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.

TESTIMONY OF SCOTT A. STENGEL

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).

TESTIMONY OF SCOTT A. STENGEL

- 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]

[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).

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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.

[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.

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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.

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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.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 10, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I appreciate this opportunity to provide the views of the Office of the Comptroller of the Currency (OCC) on creation of a statutory framework for covered bonds in the United States. The OCC recognizes the potential benefits covered bonds may offer to financial institutions, both as alternatives to securitizations and as additional sources of funding for institutions and the communities they serve. In particular, covered bonds offer lenders another tool for managing mortgage-related risk and supporting housing markets. The OCC has supported efforts in recent years to foster the development of a viable covered bond market in the U.S.

Legislation would establish a statutory framework that sets uniform standards for all covered bond programs and puts in place standards to safeguard the safety and soundness of institutions participating in covered bond programs. In designing this framework, we urge consideration of several key issues.

First, a successful U.S. legal framework should establish clear authority and rules on how covered bond issuers and programs will be regulated. We favor an approach that would require the implementation of a single, uniform set of standards that are applicable to all covered bond issuers, makes the issuer's primary regulator responsible for applying those standards, and preserves the authority of that primary regulator to take into account relevant supervisory factors and safety and soundness considerations in granting approvals for specific covered bond programs.

For example, the uniform rules could address issuer eligibility, i.e., whether the issuer is a regulated financial institution, and specify the appropriate covered bond regulator. The uniform rules also could place a limit on an issuer's total covered bond obligations as a percentage of the issuer's total liabilities. Under the rules, however, the institution's primary federal regulator should retain the authority to address institution-specific risk management, such as an issuer's overall liquidity risk management framework, where an issuing institution begins to use covered bonds extensively as a funding vehicle.

Second, to build a strong U.S. covered bond market, the legal framework should establish eligibility standards for the assets that will collateralize covered bonds. With regard to eligible assets, we favor an approach that would start with a limited list of assets that typically have more homogeneous product terms and credit risk profiles (e.g., residential mortgages) but that could be expanded to add other types of assets as more experience is gained with covered bond programs. We also would favor eligible assets having stated quality controls recognizing their high quality nature.

A third critical component in designing a U.S. statutory covered bond framework is determining the consequences of a default of a covered bond issuance and the failure of a covered bond issuer. Without a U.S. legal framework addressing the operation and management of the cover pool and the rights of the covered bondholders in these situations, a U.S. covered bond market is unlikely to flourish because covered bonds will lack predictability and clarity on these crucial issues. In particular, if the issuer is an insured depository institution, the covered bond statutory framework must give appropriate consideration to the interests of the FDIC as conservator or receiver of that institution. But, those interests should be accommodated in a manner that does not defeat the goal of creating a covered bond statutory framework that will be successful.

Particular challenges in creating a statutory resolution framework include important details such as addressing the preservation of deficiency claims against an issuer, the creation of a residual interest that represents the right to any surplus from the cover pool, and the obligation of the issuer to transfer applicable books, records, files and other documents to the covered bond regulator or another designee. Consideration also will need to be given to statutory provisions providing that the covered bond regulator may elect for an issuer to continue servicing the cover pool for some reasonable and operationally practical period of time, and whether the framework should provide for the Federal Reserve Banks or others to make advances to the covered bond estate. A further specific challenge is determining the appropriate treatment of any excess amounts from the cover pool once the covered bondholders and any other liabilities have been fully satisfied. We welcome the opportunity to provide further input on these important details.

Again, thank you for the opportunity to share the views of the OCC on the creation of a statutory framework for covered bonds in the United States. I commend you for your continued leadership on this issue, and we appreciate the opportunity to contribute to the development of this important initiative.

Sincerely,

John Walsh

John Walsh
Acting Comptroller of the Currency

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April 12, 2011

The Honorable Scott Garrett, Chairman
Subcommittee on Capital Markets and
Government-Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

Re: The impact of covered bonds on the Federal Deposit Insurance Corporation

Dear Mr. Chairman:

I am writing to expand upon a statement I made during my March 11, 2011, testimony to the Subcommittee to the effect that covered bonds would have a positive impact on the FDIC, not the negative impact that the FDIC and others assert would be the case. I would be most appreciative if this letter and its two attachments were included in the formal record of the hearing.

Briefly, in this letter, I will explain why, due to a forthcoming change in how deposit-insurance assessments are levied, the FDIC actually will benefit financially as a bank's reliance on covered-bond funding increases. Also, I will explain why any overcollateralization of the covered bonds issued by a bank will not harm the FDIC. Further, there is no rationale for limiting the extent to which covered bonds are overcollateralized or for limiting the amount of covered bonds a bank can issue as a percentage of the bank's total assets. Finally, in trying to impede bank issuance of covered bonds, the FDIC is ignoring the benefits covered bonds will bring to banks and bank borrowers – an increased ability of banks to safely hold long-term, fixed-rate mortgages in portfolio while lowering interest rates for borrowers.

The FDIC will benefit financially as a bank's reliance on covered-bond funding increases

As of April 1 of this year, covered bonds began benefiting the FDIC financially as the proportion of a bank's liabilities funded by covered bonds increases. April 1 is the date on which the FDIC's deposit-insurance assessment base, as dictated by Sec. 331(b) of the Dodd-Frank Act, expanded from total domestic deposits to "the average consolidated total assets of the insured depository institution during the assessment period" minus "the average tangible equity of the insured depository institution during the assessment period."

Viewed from another perspective, on April 1, a bank's FDIC assessment base became its total liabilities plus its intangible assets. Consequently, the FDIC has begun collecting deposit insurance premiums on a bank's secured liabilities, including covered bonds, even though those liabilities are not protected from loss by the FDIC's Deposit Insurance Fund, or DIF. In effect, on April Fool's Day, the

FDIC began collecting deposit-insurance premiums on non-domestic-deposit liabilities, including all secured borrowings, for which it has no insurance obligation.

As I will explain below, that increase in assessment base means that the FDIC will (1) increase its assessment income relative to its insurance risk, to the extent that covered bonds lead to an increase in total bank assets, or (2) decrease its insurance risk relative to its assessment income to the extent that covered bonds replace deposits as a source of balance-sheet funding.

While it is true that the insolvency loss percentage suffered by unsecured creditors will rise as the proportion of secured liabilities on a bank balance sheet rises, the amount of a bank's insolvency loss, in dollars, relative to the FDIC's new, expanded assessment base, will not change. This statement assumes that the presence or absence of any form of secured borrowing will not alter the amount of insolvency loss in a failed bank. Because of asset-quality standards for assets securing covered bonds (the cover-pool assets), the presence of covered bonds in a bank balance sheet should improve the bank's overall asset quality, decreasing the likelihood that the bank will fail and, should the bank fail, lowering the insolvency loss, measured as a percentage of the bank's total assets. If higher asset quality is the result, covered bonds will be an even bigger plus for the DIF.

The FDIC also will benefit in another, little-understood way – depositor preference.[1] In 1993, strictly as a budget gimmick,[2] Congress gave domestic bank deposits (and in effect the FDIC as the insurer of domestic deposits, up to the deposit-insurance limit) a liquidation preference over all other unsecured liabilities of a failed bank, including deposits in the bank's foreign offices. In effect, unsecured, non-domestic-deposit liabilities of a bank are subordinated to domestic deposits and therefore get completely wiped out in the liquidation of a failed bank before the first dollar of insolvency loss reaches domestic deposits, and therefore the DIF. In effect, unsecured, non-domestic-deposits are a second loss-absorbing cushion for the FDIC, after the bank's equity capital. The diagram appended to this letter illustrates the liquidation preference of a bank with FDIC-insured liabilities.

In perhaps an unintended irony, not only did the Dodd-Frank Act extend the DIF assessment base to secured liabilities, but also to liabilities that are junior to domestic deposits. Unsecured non-domestic-deposit creditors troubled by a high proportion of a bank's balance sheet funded by more senior liabilities (secured borrowings and domestic deposits), can be compensated for that additional risk of loss with a higher interest rate on unsecured borrowings or by other protections, including collateralization of the liability; i.e., converting unsecured liabilities into secured debt.

The financial model accompanying this letter demonstrates the beneficial effect covered bonds now have on the DIF, taking into consideration the depositor-preference provision mentioned in a preceding paragraph. As shown on lines 24 to 26 (representing different insolvency loss rates for bank assets), the presence of covered bonds or other secured borrowings in a bank balance sheet does not materially alter the bank's insolvency loss percentage, should the bank fail, relative to the size of the bank's assessment base, and therefore the assessment income the DIF collects from the bank. This is the case because for a given-size bank, the dollar amount of the insolvency loss does not change even as the mix of secured liabilities and domestic deposits changes.

[1] 12 U.S.C. Sec. 1821(d)(11)(A).
[2] Public Law 103-66, Sec. 3001(a).

To put this another way, even though a bank's insolvency loss, as a percentage of total domestic deposits (lines 21 to 23), will increase as the proportion of secured borrowings rises, that higher percentage is fully offset by a corresponding increase in the DIF assessment base relative to total domestic deposits – see line 14 of the appended spreadsheet. Therefore, post April 1, 2011, the FDIC should be indifferent as to the mix of secured borrowings and total domestic deposits on a bank's balance sheet, leaving aside the positive impact covered bonds almost certainly will have on bank-asset quality and maturity matching.

Overcollateralization of covered bonds will not harm the FDIC

This same indifference holds true with regard to the degree of overcollateralization of the covered bonds; i.e., the assets designated as being in the cover pool securing a specified set of covered bonds. The rationale for overcollateralizing any secured borrowing is to reduce the lender's risk of loss, ideally to a zero risk of loss. The major push for higher down-payments for home mortgages is based on the time-and-again-proven premise that the higher the down-payment (and therefore the higher the initial overcollateralization) the less likely the mortgage will default and, should default occur, the lower the lender's loss upon default. To paraphrase an old saying, what is good for home mortgages is good for covered bonds.

The degree of the overcollateralization of covered bonds must be viewed from a marginal-analysis perspective. That is, each additional one percent of overcollateralization (1) reduces the likelihood of a bond default, should the bank fail, and (2) at the same time the additional overcollateralization is less likely to suffer a loss. Provided the overcollateralization can be invested in income-producing assets (and not cash, as some have proposed), additional overcollateralization does not hurt the bank (except arguably limiting its ability to issue additional secured debt), but overcollateralization does bring a lower funding cost to the bank because the secured debt is more secure and therefore will earn a higher bond rating, producing a lower interest rate.

Your covered-bond bill (H.R. 940) clearly provides that any excess collateral securing covered bonds will flow into the receivership estate of a failed covered-bond issuer, as provided in Sec. 4(c)(5)(B)(ii) The covered-bond overcollateralization, however large it might be, will not disappear into the ether, as the FDIC seems to imply. Further, and most importantly, the assets in a covered-bond cover pool will generate income between the time the bank fails and when the covered program is transferred to another bank or the bonds are paid off, thereby releasing the collateral to the receivership estate. That income will accrue to the benefit of the failed bank's receivership estate and therefore to the DIF. To ignore that income effect, as the FDIC seems to do, is to ignore financial reality.

One way to look at the issue as to an acceptable amount of overcollateralization is to ask this question: What are the costs and benefits of raising the overcollateralization of an issue of covered bonds by "X" percent? For example, how much lower might the interest rate on covered bonds be if the overcollateralization rate was increased from 105% to 110% or from 110% to 115%? Offsetting that lower rate, how much greater would the cost of that additional overcollateralization be to the bank, and therefore to the DIF, and/or to uninsured domestic depositors, junior unsecured creditors, and stockholders? More importantly, how would the estimate of that offsetting cost be calculated? It is not at all clear when the cost of excess overcollateralization, however that excess overcollateralization is determined, would exceed the benefits of additional overcollateralization.

Arguably the FDIC could have a concern as to how well the assets in a cover pool are managed during the time that the separate covered-bond estate is in existence. However, it is clear from the provisions of Sec. 4(d) of H.R. 940 that the trustee, servicer, and administer of a covered-bond estate are obligated, under subclause (1)(E)(i)(I) of subsection (d), to "collect, realize on (by liquidation or other means), and otherwise manage the cover pool . . . in a manner consistent with maximizing the value and the proceeds of the cover pool" and in subclause (II) to "deposit or invest all proceeds and funds received . . . in a manner consistent with maximizing the net return to the estate, taking into account the safety of the deposit or investment."

Essentially, the party managing the cover-pool assets during the life of the separate covered-bond estate of a failed bank has a fiduciary obligation to maximize the value of the estate, which effectively includes maximizing the value of the residual interest held by the FDIC. Further, as Sec. 4(d)(1)(C) provides, the covered-bond regulator "may require the trustee or any servicer or administrator for an estate to post in favor of the United States, for the benefit of the estate, a bond that is conditioned on the faithful performance of the duties of the trustee or the servicer or administrator." These statutory protections should be more than sufficient to protect the FDIC's residual interest in the covered-bond estate.

There is no rationale for limiting the overcollateralization percentage for covered bonds

It has been suggested that the maximum overcollateralization percentage for covered bonds should in some manner be linked to the issuing bank's capital ratio. For example, the overcollateralization ratio could not exceed the bank's capital ratio. However, there is no rational rationale for such a linkage. Because the residual interest in the cover pool securing an issue of covered bonds is an asset of the estate of the failed bank, the amount of overcollateralization of any secured borrowing by a failed bank will flow into that bank's receivership estate, to the benefit of the bank's unsecured creditors, specifically the FDIC, and to creditors junior to the FDIC. Imposing overcollateralization limits on covered bonds, particularly in the early years of the covered-bond statute, will impede the development of U.S. covered-bond issuance. Instead, market forces should be relied upon to establish acceptable overcollateralization limits.

There is no rationale for limiting the amount of covered bonds a bank can issue as a percentage of the bank's total assets

It also has been suggested, and some countries in fact have limited, the amount of covered bonds a bank can issue as a percentage of the bank's total assets. These percentage limits usually are quite low – 4%, 6%, 8%, etc. However, at least in a U.S. context, with the FDIC's just-broadened assessment base, there is no rational basis for Congress or regulators to limit covered-bond issuance as a percentage of total bank assets. Market forces and the physics of bank balance sheets, and more specifically the financial benefit of obtaining AAA ratings for covered bonds, will serve as a practical matter to limit covered bond issuance by individual banks.

Bank assets are assets regardless of how they are funded. Whether a specific asset secures a particular bank liability does not alter the character of the asset – all bank assets have one thing in common – they are funded in some manner from the right side of the balance sheet, for debits always equal credits. Likewise, bank liabilities are liabilities regardless of the types of assets they fund.

What is critical, from the perspective of bank safety-and-soundness and minimizing the likelihood of insolvency, is the quality of the assets and the degree of maturity mismatch between bank assets and liabilities. Securing bank liabilities with specific assets merely ensures that a specific liability will be paid in accordance with its original terms should the bank become insolvent or otherwise default on that liability. The "evergreening" feature of covered bonds – at all times the bonds must be secured by performing assets eligible for inclusion in the cover pool – merely acts to strengthen the quality of the assets securing the bonds, with the likely side benefit of improving the overall asset quality of the bank.

As noted above, with an assessment base equal to total liabilities plus intangible assets, the FDIC will collect the same amount of premium income regardless of the composition of the bank's liabilities. Likewise, the maturity structure of a bank's liabilities is independent of whether those liabilities are secured or not and if secured, how they are secured. Therefore, bank safety-and-soundness and the risk of insolvency are <u>not</u> a function of the degree to which a bank's liabilities are secured by bank assets or the mechanics of that security.

Market-imposed overcollateralization <u>minimums</u> will provide practical limits on covered-bond issuance since many of a bank's assets will not be eligible for inclusion in a cover pool, either because they are not an eligible type of asset or they do not meet the cover pool's quality requirement. The more a bank has of <u>ineligible</u> assets, the less it can fund its balance sheet with covered bonds. Therefore, it is a bank's asset mix and the quality of its assets as well as the overcollateralization demands of covered-bond investors which should be relied upon to limit a bank's covered-bond issuance.

Unfortunately, and inexplicably, covered bonds are perceived by some as almost a radioactive form of bank funding., that somehow the presence of covered bonds on a bank balance sheet increases the likelihood that the bank will blow itself up, the European experience notwithstanding. Congress and regulators should rely on marketplace and balance-sheet realities to limit covered-bond issuance by individual banks, not fear of the unknown and a profound misunderstanding of FDIC finances. Should fear triumph, as I fear it will, H.R. 940 should permit a regulatory easing of issuance limits imposed on individual banks rather than hard-wiring percentage limits into the covered-bond statute.

The FDIC completely ignores the funding-cost benefits covered bonds will deliver to borrowers

In its struggle to assert as much control as possible over the cover-pool assets of a failed bank, the FDIC has ignored the impact on covered-bond interest rates should it succeed in its highly parochial power grab. The equation is quite simple: Increased control for the FDIC = greater uncertainty for covered-bond investors = higher interest rates on covered bonds = higher interest rates on loans funded by covered bonds. In order for covered-bonds to deliver the lowest possible interest rates to banks, which competitive forces will push through to borrowers, covered bonds must be rated AAA. Iron-clad <u>statutory</u> collateral protection for covered bonds is absolutely essential, <u>for covered-bond investors must have absolutely certainty at all times as to the treatment of their bonds and of the collateral securing those bonds</u>. The benefits of that AAA rating clearly trump FDIC concerns that have no basis in fact or logic. Providing an absolute certainty of treatment will not impose any costs on the DIF or the American taxpayer.

The FDIC is ignoring the positive safety-and-soundness benefit covered bonds will bring to banks holding long-term, fixed-rate mortgages in portfolio

One of the key bank safety-and-soundness benefits of covered bonds is that they are a source of low-cost, long-term funding for long-term, fixed-rate home mortgages. Accordingly, covered bonds will give banks the potential to become major portfolio lenders of 30-year, fixed-rate mortgages without incurring the maturity-mismatch risk that led to the S&L crisis of the early 1980s. The forthcoming Basel III rules dealing with liquidity risk will help further to minimize maturity mismatching between covered bonds and the assets they fund. Additionally, because banks issuing covered bonds will hold the mortgages they make in portfolio, those banks will retain 100% of the credit risk associated with mortgages funded by covered bonds, thereby giving these lenders a far greater incentive to lend wisely than is the case with mortgage securitization, even under the forthcoming Qualified Residential Mortgage rules. Hence, covered-bond funding will promote higher bank asset quality, to the benefit of the DIF, the banking industry (which pays the DIF's bills), and the U.S. economy.

In closing, there is no logical or factual basis for the FDIC's assertions that it will be harmed by covered bonds issued by FDIC-insured banks. In fact, as a consequence of the expansion of the FDIC deposit-insurance assessment base that has just occurred, the DIF will benefit financially from increased issuance of covered bonds by banks. The FDIC's assertions should therefore be rejected in their entirety.

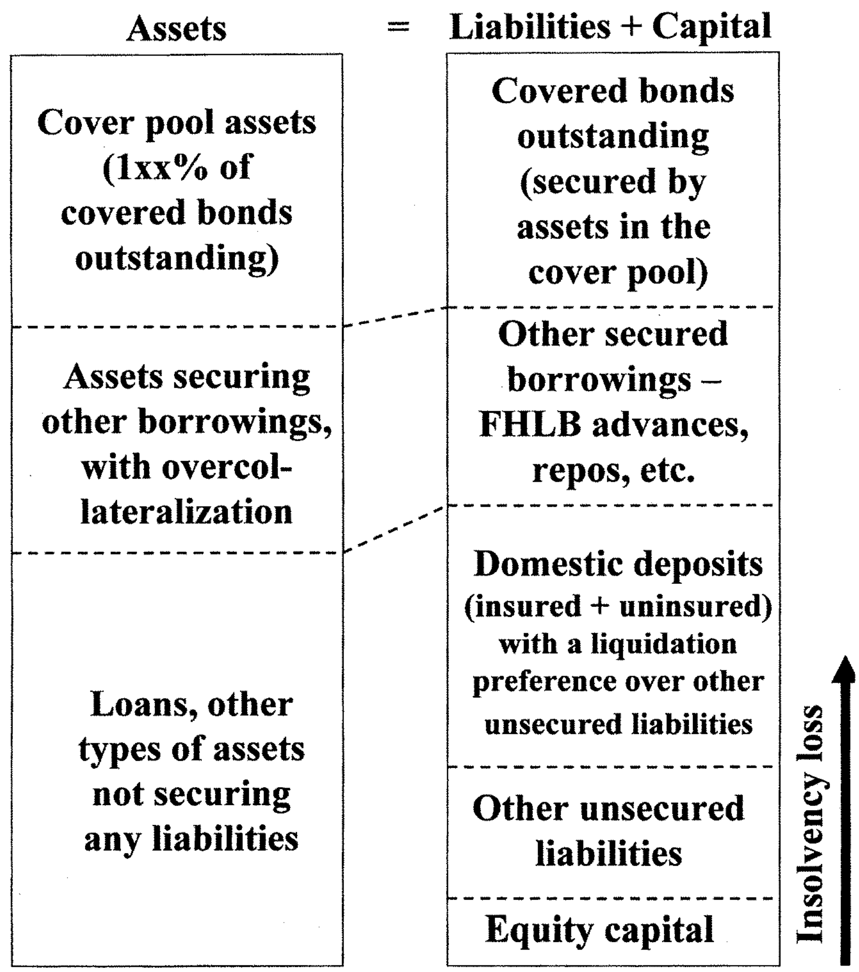
I would welcome the opportunity to testify further to the Subcommittee, or to the full Committee, about covered bonds and to discuss the contents of this letter with you and your staff.

Very truly yours,

Bert Ely

Bert Ely

Balance sheet of a covered-bond issuer with FDIC-insured deposits



Analysis of the impact of (1) the Dodd-Frank Act (DFA) on the FDIC's deposit-insurance assessment base,
(2) the impact of covered bonds on the FDIC's deposit-insurance assessment base in a post-DFA era, and
(3) the impact of covered bonds on the FDIC's loss experience

Variables are in the yellow cells

Prototype bank balance sheet

Line No.		Pre-DFA Case A	Post-DFA Case B1	Case B2	Case C	Case D
	Assets					
1	Cover-pool assets	0	0	263	263	473
2	All other tangible assets	990	990	728	978	1,018
3	Intangible assets	10	10	10	10	10
4	Total assets	$1,000	$1,000	$1,000	$1,250	$1,500
	Liabilities and capital					
	Liabilities secured by bank assets:					
5	Covered bonds	0	0	250	250	450
6	Other secured borrowings (FHLB, repos, etc.)	250	250	100	250	250
	Unsecured "depositor-preference" liabilities:					
7	FDIC-insured domestic deposits	450	450	400	450	450
8	Uninsured domestic deposits	200	200	150	180	200
9	All other unsecured liabilities -- subordinate to domestic deposits	20	20	20	20	30
10	Total liabilities	920	920	920	1,150	1,380
11	Equity capital	80	80	80	100	120
12	Total liabilities and capital	$1,000	$1,000	$1,000	$1,250	$1,500
13	**Equity capital/total assets**	8.00%	8.00%	8.00%	8.00%	8.00%
14	**FDIC's deposit-insurance assessment base =**	$650	$930	$930	$1,160	$1,390
15	**Percentage increase in assessment base above Case A**		43.08%	43.08%	78.46%	113.85%
16	**Collateralized borrowings as a percent of total assets**	25.0%	25.0%	35.0%	40.0%	46.7%
17	**Overcollateralization of covered bonds -- cover-pool assets**	5.0%	5.0%	5.0%	5.0%	5.0%

Deposit insurance loss analysis

Line			Case A	Case B1	Case B2	Case C	Case D
	Insolvency loss attributable to total domestic deposits (insured + uninsured), at various loss percentages:						
18	Insolvency loss as a percentage of the bank's assets =	10%	$0	$0	$0	$5	$0
19	Insolvency loss as a percentage of the bank's assets =	20%	$100	$100	$100	$130	$150
20	Insolvency loss as a percentage of the bank's assets =	30%	$200	$200	$200	$255	$300
	Insolvency loss attributable to domestic deposits as a percentage of domestic deposits:						
21	Insolvency loss as a percentage of the bank's assets =	10%	0.00%	0.00%	0.00%	0.79%	0.00%
22	Insolvency loss as a percentage of the bank's assets =	20%	15.38%	15.38%	18.18%	20.63%	23.08%
23	Insolvency loss as a percentage of the bank's assets =	30%	30.77%	30.77%	36.36%	40.48%	46.15%
	Insolvency loss attributable to domestic deposits as a percentage of the assessment base:						
24	Insolvency loss as a percentage of the bank's assets =	10%	0.00%	0.00%	0.00%	0.43%	0.00%
25	Insolvency loss as a percentage of the bank's assets =	20%	15.38%	10.75%	10.75%	11.21%	10.79%
26	Insolvency loss as a percentage of the bank's assets =	30%	30.77%	21.51%	21.51%	21.98%	21.58%

Notes:

Case A -- Pre-DFA -- Assessment base equals total domestic deposits (line7 + line 8)

Case B1 -- Post-DFA-- Assessment base = average consolidated total assets - average tangible equity capital (line 4 - (line 11 - line 3)).

Case B2 -- Same total assets and assessment base as Case B1, but with $250 in covered bonds offset by a $150 reduction in other secured borrowings, a $50 reduction in insured deposits, and a $50 reduction in uninsured deposits.

Case C -- Post-DFA, with covered bonds outstanding (line 5) equal to 20% of the bank's total assets, with overcollateralization as shown on line 17.

Case D -- Post-DFA, with covered bonds outstanding (line 5) equal to 30% of the bank's total assets, with overcollateralization as shown on line 17.

STATEMENT OF THE
FEDERAL DEPOSIT INSURANCE CORPORATION

on

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

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT-SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 11, 2011

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

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

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

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

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

The FDIC believes that the existing U.S. covered bond market has significant advantages over the European model from a taxpayer perspective. European programs offer generous collateral protections to investors, and as a result, trade more like sovereign debt than bank or securitization debt. One of the clear lessons of the financial crisis is that such government guarantees or subsidies can distort normal market prices by essentially providing 'risk-free' investments. We have already seen the devastating consequences when risks are mispriced in the market.

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

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

Covered Bonds in Context

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

Another distinction between covered bonds and most securitizations further demonstrates that the cover pools function as collateral and not as sources of payment when covered bonds are not in default. In a covered bond, any loans and other assets in the cover pool that become delinquent must be replaced with performing assets. As a result, the collateral for the covered bond is constantly refreshed—and the issuing bank has an ongoing obligation to produce new loans or other qualifying collateral to replace delinquencies. Finally, the issuer must always maintain more collateral in the cover pool than the outstanding notional or "face" balance of the outstanding bonds. If the issuing bank fails to pay on the covered bond, then the investors have recourse to the cover pool as secured creditors. This is precisely how normal collateral arrangements work in other secured transactions.

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

The same rules apply in FDIC receiverships. Secured creditors are fully protected under Section 11(e)(12) of the Federal Deposit Insurance Act ("FDI Act") for the amount of their claim up to the value of the collateral. As a result, covered bonds provide two avenues for recovery—from the issuing bank and from the cover pool of collateral. What they do not have, and should not have, under U.S. law, is a right to keep collateral in excess of their right to payment.

Legislation to Address Covered Bonds

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

The United States Covered Bond Act of 2011

H.R. 940, the *United States Covered Bond Act of 2011*, establishes new standards for the development of a covered bond market in the U.S. It requires the Secretary of the Treasury ("Treasury") to establish an oversight program that would prescribe minimum overcollateralization requirements, identify eligible asset classes for cover pools, and create a registry to enhance the transparency of covered bond programs. The banking agencies would carry out the Treasury-prescribed oversight program. A critical portion of the bill deals with an issuer's default on its covered bond obligations, and the procedure for dealing with the covered bond program of an issuer in receivership. The bill calls for the transfer of the assets of the pools securing the covered bonds out of the receivership estate and into a separate estate solely for the benefit of the covered bond investors. Upon a joint determination by the Secretary and the FDIC that the DIF suffered losses because of the resolution of the covered bonds through the separate estates, the FDIC may recover such losses by assessments on other covered bond issuers.

Legislation Should Not Create a New Subsidy for Covered Bond Investors

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Treasury Should Not Set Safety and Soundness Requirements

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

The resulting standards, like the FDIC's Statement of Policy, should address the key elements in covered bond transactions and the safety and soundness issues that can be implicated by a bank's use of covered bonds. The banking regulators, working in concert, should address the types of collateral, underwriting standards, required over-collateralization, frequency and content of reports on collateral and satisfaction of required over-collateralization, disclosure standards for performance of underlying loans or assets, and the rights of the investors in the event of default. A particularly important element in the clarification of investors' rights is the treatment of the covered bonds if the issuer defaults on its payments under the bonds. This is both critical to the investor and to maintaining the balance of risks retained by the investor or transferred to other parties.

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

Legislation Should Not Increase the Potential Loss to the DIF

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

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

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

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

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

The protections to the insurance fund, depositors and the flexibility afforded the FDIC as receiver of a failed depository institution has become a standard that other countries want to emulate. The flexibility that Congress afforded the FDIC permits it to respond to market conditions at the time of insolvency and to achieve bank resolutions that protect insured depositors at the least cost to the DIF. This is an important public policy that we believe has served the nation well and should be maintained.

Conclusion

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

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March 10, 2011

United States House of Representatives
Washington, DC 20515

Dear Representative:

On behalf of the 1.1 million members of the National Association of REALTORS® (NAR) and our affiliates, the Institute of Real Estate Management (IREM) and CCIM Institute, I respectfully request that you support H.R. 940, the "United States Covered Bond Act of 2011", introduced by Representatives Scott Garrett (R-NJ) and Carolyn Maloney (D-NY).

Real estate is a pillar of our economy. NAR research suggests that one million additional home sales in 2011 over 2010 will create 500, 000 private sector jobs. These jobs are within numerous businesses that are tied to the housing industry (e.g. home renovation, furnishing, etc.) and that will help provide needed revenue to both our state and local governments. Commercial real estate supports more than 9 million jobs and generates billions of dollars in federal, state and local tax revenue. Therefore, as we endeavor to reform and rebuild our real estate finance system, REALTORS® believe that it is imperative that all real estate finance instruments in our arsenal be utilized.

The "covered bond" is one tool which REALTORS® want to see integrated into our real estate finance system. Our members recognize that this tool will not take the place of mortgage-backed securities (MBS) or commercial mortgage-backed securities (CMBS) as the primary generator of liquidity for the U.S. real estate market. However, we do believe that this tool, in tandem with MBS and CMBS, can offer increased liquidity and safety in our secondary market for commercial and all components of residential real estate lending, including jumbo mortgages.

REALTORS® thank you for your diligent work to bring confidence and strength back to our finance system. As you continue this endeavor, we strongly encourage you to support Representatives Garrett's and Maloney's legislation, H.R. 940, ensuring that no real estate finance tool is left unused as we step toward the future.

As always, NAR stands ready to collaborate with you and our industry partners to enact comprehensive and effective mortgage reform legislation.

Sincerely,

Ron Phipps, ABR, CRS, GRI, GREEN, e-PRO, SFR
2011 President, National Association of REALTORS®

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