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COVERED BONDS: PROSPECTS FOR A U.S. MARKET GOING FORWARD

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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COVERED BONDS: PROSPECTS FOR A U.S. MARKET GOING FORWARD

Tuesday, December 15, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Maloney, Watt, Moore of Kansas, Baca, Scott, Green, Cleaver, Bean, Perlmutter, Foster, Carson, Minnick, Adler, Peters; Bachus, Royce, Hensarling, Garrett, Marchant, Jenkins, Lee, and Paulsen.

The CHAIRMAN. This is a hearing on the subject of covered bonds, and I recognize for 2 minutes the gentleman from Illinois, Mr. Foster.

Mr. FOSTER. Thank you, Mr. Chairman. I would just like to say very briefly that I think this is a great initiative, and it is wonderful to see the Republican Party claiming their historical support for European financial and social structures—but all kidding aside—if you look at the history of how different segments of the economies in different countries have performed in the last crisis, one of the high points is the covered bond, the performance of the covered bond market.

I think particularly the—one of the segments that will be brought up in the testimony here is in fact a variation of these that is supported in Denmark has maintained very good liquidity across the whole crisis, as well as historically provided the best deal for consumers. This, I think, is a fundamental issue here. We have to look at what provides over time the best stability and the best deal for consumers, and I think that both of these lead to the covered bond market as the way forward.

I'm also very interested in the possibilities for covered bonds to provide a path forward out of the situation with Fannie Mae and Freddie Mac, which no one likes. And I think that having a strong covered bond market out there will make all the decisions we're going to be faced with much, much easier. So, for all these reasons, I think this is a great initiative. I think this is an example where—another point that is made in some of the testimony that we ought to pay attention to is that the markets that have held up the best have been those—in terms of having small spreads, are ones where there's quite prescriptive legislation, because one of the variables that we have to address if we're going to go ahead and provide legislative support for this is the degree to which we should say here

is exactly the simple form of covered bonds that we're going to legislatively support or whether we just provide—let a thousand flowers bloom and let a very broadly regulated market provide a variety of products.

It's a very interesting lesson that it appears as though the market in times of stress prefers to have a rather tightly prescribed set of conditions. And as we try to bootstrap the covered bond market, I think that we may want to err on the side of being more prescriptive and saying, here is the simple form that we're going to start out with. And when we have a successful covered bond market in the United States, then perhaps loosen the rules to allow more elaborate products.

So those are the things that I will be keeping my eyes on in the testimony. I read it all last night, and I found it very, very encouraging, and I yield back.

Mr. SCOTT. [presiding] The gentleman from New Jersey, Mr. Garrett, is recognized for 5 minutes.

Mr. GARRETT. And I thank the chairman. I thank Chairman Frank for working with me during the last few months on this and helping to schedule today's hearing. I would also like to thank Chairman Kanjorski and Ranking Member Bachus for their continued support and hard work on this important issue. I appreciate the opening comments from Bill over there, as well.

The United States continues to recover from the financial crisis, as you referenced, over the last year, and so it is essential that Congress examines new and innovative ways to basically unthaw or unlock the credit markets and encourage private capital to confidently reengage by turning cash now on the sidelines into active investments in our country's future. And one of those innovative ways that I believe could provide that additional liquidity to our credit markets is by establishing covered bonds in the marketplace here in the United States. Covered bonds are simply debt instruments issued by financial institutions and backed, or covered if you will, by a pool of high-quality loans. Covered bonds are kept on the balance sheet of the issuing institution, which is important, and investors have a dual recourse to both the assets used as collateral as well as the underlying institution.

Covered bonds have been used, as I said, in Europe for hundreds of years to help provide additional funding options for the issuing institutions, and are a major source of liquidity for many European nations' mortgage markets. Covered bonds have performed extremely well during the financial crisis, largely because of the high underwriting standards used for loans in the covered pools. And so I do believe that a robust U.S. covered bond market would offer numerous benefits to investors and consumers in the broader financial sector.

Investors would benefit by having a new, safe, innovative vehicle which will allow for more diversification in their portfolio. Consumers would stand to benefit greatly by the increase in liquidity to their credit markets. There will be more funding available for loans and thus lower rates for home mortgages, auto and student loans, and for small businesses.

One of the problems that we experienced during our current crisis was the difficulty of modifying mortgage loans because the own-

ership of those loans had been transferred out through the securitization process. Not here. This is not a problem with covered bonds, because they are held in service by the lender. The lending institution thus has a greater ability to modify consumer mortgage loans, which will benefit the consumer.

Finally, the broader financial markets will stand to benefit from a covered bond market. Covered bonds provide an additional low-cost, diverse funding tool for financial institutions. They will ensure more stable and longer-term liquidity in the credit markets, which reduces refinancing risk, as well as exposure to sudden changes in interest rates and investor confidence as well. And they also allow U.S. financial institutions to compete more effectively, I believe, against their global peers.

Now to date, there have only been two issuances of covered bonds here in the United States. That was by Bank of America and Washington Mutual, which is now part of JPMorgan Chase. But over the last several months, there has been a tremendous increase in demand by investors for these bonds. In 1 week in September alone, there were 7 new issuances in a variety of different European countries, and that totaled over $20 billion. And for the year to date, there has been a total of around $120 billion of covered bonds issued in Europe alone. Also, the European covered bond market was one of the first markets to rebound when the financial panic ebbed, and I think that's important.

And so that is why during this committee's consideration of the Financial Stability Improvement Act, I offered an amendment that would create a detailed statutory framework to help facilitate the broader use of these funding instruments in the United States. A detailed statutory framework is common in the European countries where these bonds basically flourish, and is indeed in this country to provide the investors what they're looking for, and that is greater certainty in regards to exact recourse if the issuing institution fails.

This legislation will spell out the variety of different asset classes which will be eligible to be included in the covered bonds. In Europe, the covered bond market is very narrowly tailored to just residential mortgage. However, in ours, we would include a wider array of asset classes, like commercial mortgages, as well as auto loans, small business loans, and public sector loans. And so we will be working there to increase liquidity to a broader consumer base and allow financial institutions to further spread their risk.

So finally, this legislation also designates the Secretary of the Treasury as a covered bond regulator, because the Department of the Treasury, basically they have the unique knowledge and expertise in this area of the U.S. debt market which is needed here. And it also details the procedures that are to be followed in the case that an issuer of a covered bond were to fail or default, also all needed.

So a U.S. covered bond market offers a wide variety of possible benefits to investors, to consumers, and to our capital markets as a whole. And so at a time when our credit markets are still experiencing a great deal of difficulty and our financial institutions are slow to reopen on a broader basis to our American public, we must consider these new and innovative methods, and so I'm pleased

that this committee is taking a closer look into this unique funding, and I'm pleased that the chairman and the ranking member have been working with us to move this matter along.

Thank you, Mr. Chairman, and I yield back.

The CHAIRMAN. The gentleman from Georgia is recognized for 3 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. First, let me thank you and the ranking member for holding this important hearing. Our economy is still struggling, despite the fact, the good news of Wall Street's recovering to a degree that many have said that we're out of the recession. The stock market has rebounded, and they're saying we're out of the recession, but nothing can be further from the truth for many, many of the communities in this country, for they're not only not out of the recession, their economic indicators point very dramatically that many of them are in fact in a depression.

It's a struggle, with jobs, foreclosure rates continue to hit record highs. The employment rate continues to hover around 10 percent, and in many communities, it's hovering at 40 and 50 percent.

As this hearing focuses on the potential role that covered bonds could have in U.S. markets, I am interested in identifying the possible benefits they could have for our market stability and our economy, particularly in some very, very depressed communities. Since the original lenders of covered bonds retain an ongoing interest in the performance of the loans, this type of loan could provide a sense of accountability for both the lender and the borrower. The bank must stand behind the mortgage it issues in this case, which could potentially decrease risky lending practices. This area is clearly in need of investigation and improvement.

My home State of Georgia has the 7th highest foreclosure rate in the country. I have 2 counties that have among the highest of the top 20 counties in the country of foreclosure rates. With covered bonds, the collateral pool, the bonds against which the bonds are written may be swapped out for better assets if it begins to underperform. So we have to question if this practice could promote more careful lending. Covered bonds are used exclusively in Europe now, but they are nearly untested in the United States, and that's what makes this hearing so important this morning, that we can determine what the full potential is of covered bonds here in the United States economy.

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

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling, is recognized for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman, and I'm certainly glad I could arrive early enough to get a good seat. I suppose that battle fatigue over the last 3 weeks may have taken its toll, but I'm glad the members who are here are here, and I think that the subject matter is one that certainly deserves our attention. I want to thank you, Mr. Chairman, for calling this hearing, and I certainly want to thank the ranking member of the Capital Markets Subcommittee for his leadership on this issue for a matter of months in attempting to ensure that we look at all possible avenues to bring private investment back into our mortgage markets. And certainly, I think that most of us have an open mind and a

hopeful mind that covered bonds may pose a very promising option in that regard.

As we have come off the recent debate of the last several weeks, I and many others still remain concerned about the role that the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, are playing in our mortgage markets, particularly given that we now have a trillion dollars of taxpayer funds that have been exposed to their operations. This is unwise, and this is unsustainable. And so I would hope that we would look at all different types of avenues to start leveling the playing field and transition Fannie and Freddie back to a competitive marketplace.

I am concerned that too much action taken by the Administration and Congress has let too much private investment remain on the sidelines. I am hopeful again that if there is a statutory infrastructure, if you will, or foundation that can be placed under covered bonds, that again it is a hopeful and promising regime to get private investment and liquidity into our mortgage marketplace.

Knowing that we have an important hearing soon, I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from Illinois is recognized for 3 minutes.

Ms. BEAN. Thank you, Mr. Chairman, for yielding and for holding today's hearing. I want to thank our panel for joining us today and sharing their expertise on this important topic. As the securitization market for residential and commercial mortgages has dried up over the last 2 years, this is a timely hearing as the committee looks for new mechanisms that will increase liquidity in a prudent manner.

Toward that end, a well-structured U.S. covered bond market could be helpful in adding much-needed liquidity to our secondary mortgage market. This is an issue that I—along with others—have been looking at over the last year, recognizing that counterparts in Europe have been operating a covered bond market since 1770 and have relied on covered bonds as a stable and relatively safe source of funding for residential mortgages and other assets.

As noted earlier, the FDIC and Treasury issued guidance last year to encourage financial institutions to issue covered bonds. To my knowledge, however, no financial institution has issued a covered bond in the United States under that guidance. So I look forward to hearing from our witnesses today about whether legislation is needed to establish a statutory structure for a U.S. covered bond market, and I'm interested in knowing if they feel that European nations who have successful covered bond markets have done so because they have established a statutory structure.

I'm also interested in how covered bonds compare to traditional mortgage-backed securities in terms of curing troubled mortgages within the pool. One of the most frustrating aspects of the current foreclosure crisis is that some investors in mortgage-backed securities, depending on the tranche they hold, can veto loan modifications that would benefit both the borrower and the collective pool. My understanding is that is not an issue with covered bonds because the mortgages stay on the bank's books and the bank is required to remove troubled mortgages from the pool and replace them with performing mortgages.

Establishing a U.S. covered bonds market could be very helpful to the residential and commercial mortgage market, and other asset markets like public sector loans and other consumer loans as well. I look forward to today's hearing and potential action by this committee to establish such a market.

Thank you. I yield back.

The CHAIRMAN. The gentleman from Alabama is recognized for 2 minutes. No, I take it back. I'm now told there's a change here, that he gets 3 minutes.

Mr. BACHUS. All right. Thank you, Mr. Chairman. Thank you for holding this hearing, and I thank the ranking member of the subcommittee for introducing this legislation on covered bonds.

The collapse of Fannie Mae and Freddie Mac and their subsequent trillion dollar Federal bailout have renewed calls to explore innovative private market alternatives to the government-sponsored model of mortgage financing. America is about innovation, competition, and the private market, and I think covered bonds could be part of our solution. As one of our witnesses at today's hearing, Mr. Scott Stengel of the U.S. Covered Bond Council, states in his testimony, "covered bonds also represent a cost effective 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." And obviously, that is something we should all strive for.

Covered bonds are also a private market solution to the need for market participants to have skin in the game. The issuers of covered bonds are responsible to their bondholders for the risk posed by the underlying loan pool. For example, if the underlying loans default, bondholders have a secured claim to the assets in the loan pool as well as recourse to other assets of the insolvent firm. Additionally, issuers of covered bonds are required to account for the risk posed by their bonds on their balance sheet. In June, Mr. Garrett introduced legislation providing a statutory framework for a U.S. covered bond market that promotes greater legal certainty for investors in these instruments.

Chairman Frank should be commended for convening this hearing on Mr. Garrett's legislation, and other ideas for encouraging the development of a covered bond market in this country. Mr. Chairman, a functioning securitization market is necessary for successful housing market recovery. Covered bonds are one of several solutions this committee should explore as we move forward with proposals to revive stalled private mortgage credit markets.

I look forward to hearing expert testimony from the witnesses and working with you. And I'm pleased that this seems to be a bipartisan effort and that members on both sides of the aisle realize that this could be a potential source of funding for our mortgage market and a safe source as well.

I yield back the balance of my time.

The CHAIRMAN. The time has expired, and we will now go to the witnesses. I begin with Mr. Alan Boyce, who is chief executive officer of Absalon. Let me say at this point that with unanimous consent, any member who wishes to enter matter into the record will be recognized, and the witnesses at the conclusion of their oral

statements will be free to submit any other material, including the rest of their statements, into the record.

Mr. Boyce?

STATEMENT OF ALAN BOYCE, CHIEF EXECUTIVE OFFICER, ABSALON

Mr. BOYCE. Mr. Chairman, Ranking Member Bachus, Representative Garrett, and members of the committee, I very much appreciate the chance to testify today. In my testimony, I would first like to discuss the general benefits of covered bonds and then to discuss the importance of specialized and rigorous legislation to provide a framework for this market. I will conclude by briefly examining an additional proposal that can make the covered bond approach even more effective in helping homeowners and investors alike.

Covered bonds offer several potential advantages. In the recent past, issuers of loans sold into asset-backed securities were less concerned than they should have been about the quality of these loans, since they were often completely off the hook within weeks of making the loan. By requiring the institution to retain the loan on its balance sheet, covered bonds substantially mitigate this problem.

Covered bonds are simple and transparent, unlike the complex, idiosyncratic, and opaque asset-backed securitization structures of the recent past. Covered bonds can help banks more cleanly manage interest rate risk by matching long-term assets with long-term liabilities. Finally, covered bonds can offer a much needed, low-cost method of private financing, particularly in the context of an appropriate regulatory and legal framework. Substantial risks do of course remain.

The overall 200-year success of the European covered bond market is due to its consistently conservative approach. The U.S. covered bond market should copy this and be started with high-quality assets and strict standards. This should start with a specialized rather than a general law-based approach. It is my view that in starting a covered bond program, covered assets should be limited to well-underwritten, conservative loan-to-value ratio, first-lien mortgages. This is the asset class where the benefits of this approach are the greatest. The legislation should also include strict lending standards, including specific loan-to-value ratio limits, and requiring full recourse.

Strict asset liability management practices should be mandated through an appropriate balance of legislation and regulation. The European covered bond market came to a halt last year after the Lehman bankruptcy filing. While the credit quality of the underlying covered pool assets had deteriorated somewhat, the significant factor was the inability of issuers to raise new liabilities to pay off mismatched maturing covered bonds.

Given the recent experience and future threats to covered bonds from asset liability management risks, the bond ratings agencies have proposed significant changes to their covered bond rating methodologies. I believe that this committee should work in concert with these efforts.

Successful covered bond programs also have clear and definitive rules to deal with problems. The simplest problem arises when

there is a bad loan in the covered pool. The best policy approach is to insist that cash be the only substitute for a bad loan. The rules for estate separation should be clearly defined with a strong covered bond regulator empowered to make quick decisions.

The benefits of covered bonds are maximized when the term of the bond exactly matches the term of the underlying assets. When each loan is exactly balanced by a portion of an identical, transparent, and tradable bond, this is called the principle of balance. Instituting the principle of balance can allow for better-aligned interests between borrowers, intermediaries, and investors.

Indeed, this system has worked extraordinarily well in Denmark since 1797, while the United States Congress was still meeting in Congress Hall in Philadelphia. Further, when combined with optional redemption mortgages, this system can significantly limit the threat of foreclosure during housing busts.

Optional redemption mortgages like covered bonds are a fairly simple idea, but one that is unfamiliar to many in this country. Just as homeowners are allowed to refinance when interest rates drop, optional redemption mortgages offer the homeowner the option of refinancing when the value of his or her mortgage drops due to rises in interest rates. Optional redemption mortgages thus put households in the same situation as corporate treasurers who have the ability to purchase their own debt back at a lower value in the open market when the value of that debt falls. This feature would profoundly improve the overall situation facing the housing market during most housing price declines by directly and substantially reducing the number of homeowners who are underwater.

Transitioning to a new and simpler and more stable system could be done efficiently and effectively by refinancing performing mortgage loans into new standardized principle of balance loans. Many other transition paths can also be considered.

In conclusion, the U.S. Government has become the single payor supporting the mortgage market. As such, it has a profound ability to influence the design of the system moving forward. There should be added urgency to mortgage reform, given the threat from the embedded extension risk that exists in the current mortgage market. Covered bonds can be an important part of the solution. Introducing a legislated covered bond market is a big step in rebuilding the mortgage market in a sound and sustainable fashion. A few additional changes can make this an even more effective step, and I urge the committee to carefully examine the potential of the market in which standardized mortgages with optional redemption are funded through simple and transparent securities.

[The prepared statement of Mr. Boyce can be found on page 28 of the appendix.]

The CHAIRMAN. Your time has expired, Mr. Boyce. Again, members of the panel should feel free to submit anything further that they wish.

Next, Mr. Scott Stengel.

STATEMENT OF SCOTT A. STENGEL, PARTNER, ORRICK, HERRINGTON & SUTCLIFFE LLP, ON BEHALF OF THE U.S. COVERED BOND COUNCIL

Mr. STENGEL. Chairman Frank, Ranking Member Bachus, and members of the committee, 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 funding the needs of consumers, small businesses, and State and local governments.

I am a partner with Orrick, Herrington & Sutcliffe 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 an efficient market for U.S. covered bonds.

Recent reports have confirmed what we are seeing on the ground. Our Nation's economic recovery remains slow and uneven, and the foundations of our financial system are not yet fully repaired. In this volatile environment, credit remains tight for both families and small businesses, public sector resources are increasingly strained, and consumers are understandably cautious.

In the Council's view, sustained economic growth begins with a stable financial system. This in turn requires an ample supply of 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 State and local governments. 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 debt that is issued by a bank or other regulated institution and that is secured by a cover pool of financial assets which is continually replenished. Over the course of their 240-year history, covered bonds have been backed by 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 consumers using credit or charge cards also are appropriate.

U.S. covered bonds can bring a stabilizing influence to our financial system in several ways. First with maturities that range from 2 to 10 years or more, covered bonds can infuse longer-term liquidity into the credit markets. Second, by providing more cost-effective funding 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 liquidity available through the unsecured debt or securitization markets. Fourth, covered bonds can deliver funding from the private sector even in distressed market conditions without relying on U.S. taxpayers for support. Fifth, because covered bond issuers continue to own the assets in their cover pools and have 100 percent skin in the game, incentives relating to loan underwriting, performance and modifications can be strongly allied. And sixth, as a straightforward finan-

cial instrument, covered bonds can increase transparency and uniformity in our capital markets.

Covered bonds, however, are no silver bullet, and action is still needed to resuscitate securitization and the rest of the capital markets. But in our view, covered bonds represent a critical step toward restoring financial stability, and in this constrained credit environment, one that is urgently needed now.

To function effectively, 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, and this precedent, now found in almost 30 countries, has set expectations. Covered bonds programs must be subject to strong public supervision that is designed to protect investors. And a separate resolution process must exist that provides a clear road map in the event of the issuer's default or insolvency, and avoids the waste inherent in a forced liquidation of collateral.

While a covered bond regulator can supply more detailed criteria for cover pools and other aspects of covered bond programs, the features that give covered bonds their unique character can be supplied only by legislation. Without action by Congress, European banks will be left to capture the investor demand for covered bonds that is growing in the United States. The result will be an increasingly uneven playing field for U.S. banks of all sizes, and more expensive and less available credit for families, small businesses, and the public sector.

The Council therefore fully supports the kind of comprehensive covered bond legislation that Congressman Garrett has offered, and I want to thank him for his leadership and Chairman Frank for holding this hearing, and I would be pleased to answer any questions that the committee may have.

[The prepared statement of Mr. Stengel can be found on page 67 of the appendix.]

The CHAIRMAN. Mr. Ely?

STATEMENT OF BERT ELY, ELY & COMPANY INC.

Mr. ELY. Chairman Frank, Ranking Member Bachus, and members of the committee, I very much appreciate the opportunity to testify today about covered bonds and the prospects for a U.S. covered bond market going forward.

In my written testimony, I provided a brief description of covered bonds, discussed the many benefits they will bring to the U.S. financial system, and described a legislative and regulatory framework for fostering growth of covered bonds in the United States.

I am speaking today only for myself as a champion of covered bonds. While others have discussed covered bonds, I want to first stress the principal benefits of covered bonds, as follows:

One, better credit risk management due to lenders retaining 100 percent of the credit risk.

Two, better borrower protection, because lenders will keep the loans they make. They will have to eat their own cooking.

Three, if needed, loan modifications would be much less complicated, because the lender will own the loan outright.

Four, highly efficient funding of loans financed with covered bonds, because their high credit ratings and low transaction costs will bring lower interest rates to borrowers.

Five, reduced maturity mismatching by lenders, and an attendant reduction in interest rate risk due to the medium- and long-term maturities of covered bonds.

Six, a substantial new supply of high-quality debt for investors to purchase. Given that $21 trillion of loans currently outstanding in the United States are potential candidates for covered bond financing, a highly liquid covered bond market of several trillion dollars could readily develop, approaching the size of the Europe covered bond market.

Seven, covered bonds would appeal to investors internationally, which is important, given that non-U.S. investors currently provide $7.7 trillion of debt financing to U.S. borrowers.

It is absolutely crucial to have a sound, efficient legal structure governing the issuance of covered bonds, which consists of three layers: One, a statutory foundation; two, a regulatory mechanism based on that statutory foundation to oversee the day-to-day functioning of the covered bond market; and three, bond indentures tailored to the unique circumstances of a covered bond issuer and the assets in a cover pool securing those assets.

Essential to the development of a U.S. covered bond market is for Congress to enact a covered bond law which creates a sound, efficient legal framework for the issuance of covered bonds by banks and other entities.

The statute must create legal certainty for covered bond investors, specifically the certainty that no matter what happens to the issuer, principal and interest will be paid on the covered bonds at the contracted time and that the covered bonds will not be stripped of their cover pool should the issuer default on the bond or be placed in a receivership or bankruptcy proceeding.

That certainty is absolutely crucial to covered bonds being able to obtain and retain the triple-A rating that covered bonds almost always earn.

However, the covered bond statute should not overreach or get too precise about the specific protections and processes. That is, the statute should not love covered bonds to death by being overly prescriptive.

Instead, the more detailed prescriptions and processes governing covered bonds should be left to regulation, to a covered bond regulator, and to the indentures governing specific covered bond issuances.

Moody's has written quite positively about these statutory provisions, stating recently that the latest proposal for covered bond legislation is robust and would provide very strong protection to future covered bond investors following initial default.

Moody's goes on to say that the development of a covered bond market in the United States would be a positive development for the funding profile of U.S. banks, by providing an additional funding source for residential mortgage loans.

The Treasury Department as the covered bond regulator would develop regulations to implement the statute and then enforce those regulations. Specific regulations could cover each covered

bond class, such as maximum loan-to-value ratio and minimum credit scores for borrowers, and other criteria for loans eligible for a cover pool.

The rules would also provide for an independent cover pool monitor to ensure that each cover pool was monitored on a continuous basis. This rule-making process also would enable Treasury to keep covered bond regulations up to date.

Although seldom discussed in the legislative arena, each covered bond issuance would be governed in its most specific detail by a bond indenture. The administration of the indenture would be carried out by an independent bond trustee, who would perform its duties in accord with the covered bond statute and regulations and enforceable in the appropriate court of law.

Finally, in the covered bond marketplace, issuers and investors will be the ultimate covered bond regulator; for covered bond issuance will not take off and function in the United States if covered bonds do not meet the needs of both issuers and investors.

However, this marketplace will not develop until such time as Congress enacts a sound covered bond statute which provides for the efficient regulation and operation of the U.S. covered bond marketplace.

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

Thank you.

[The prepared statement of Mr. Ely can be found on page 39 of the appendix.]

The CHAIRMAN. Mr. Phoa?

STATEMENT OF WESLEY PHOA, SENIOR VICE PRESIDENT, THE CAPITAL GROUP COMPANIES

Mr. PHOA. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee.

Thank you for the invitation to testify today on the U.S. covered bond market. It is very encouraging to see the remarkable progress being made on financial regulatory reform.

Covered bonds could, I think, help in this process by playing an important role in making the financial system more robust and less dependent on government support. They also have a useful role to play in investors' portfolios.

I manage portfolios of the Capital Group Companies. You may know us because we manage the American Funds family of mutual funds. I would like to explain briefly how, in my opinion, covered bonds help us serve the needs of our clients.

Investors have different needs. Workers saving for retirement have to build their savings, and for them, we try to purchase shares in good companies from around the world. Retirees need a reliable income to support them, and so we look for stocks and bonds that will generate the income they require.

And almost everyone needs to protect a portion of their savings through difficult markets. So we must also find good sound investments whose value holds up in rough times. This means investing for safety, not just growth or income.

In the past, when investing for safety, we and other investors have turned to government bonds and government-sponsored securities. This has worked well, but it means sacrificing income and diversity and making our portfolios more sensitive to government policy decisions.

We seek private sector alternatives. In Europe, the covered bond market has played this role for more than 2 centuries. The safety comes from good collateral rather than government support. We ourselves have invested in European covered bonds on behalf of European clients for 2 decades. They have earned the confidence of investors by holding their value through turbulent markets.

Thus, firms which can tap this market have access to a broad and deep base of investors to help them continue lending, even in bad recessions.

Covered bond financing also aligns the interest of issuers and investors, since firms continue to hold the collateral on balance sheet and remain exposed to any losses.

I was therefore very encouraged when a U.S. covered bond market started to emerge in the years immediately before the crisis. Hence, my involvement in the U.S. Covered Bond Council.

While only two U.S. financial institutions raised covered bond financing, a number of European banks also tapped the U.S. dollar markets. And it looked as if a diverse market was starting to evolve.

Unfortunately, the global financial crisis intervened. As you know, this severely affected all parts of the private sector bond market, shutting firms off from debt finance. The European covered bond market actually weathered the crisis reasonably well, and European banks were able to resume issuing covered bonds well before they could issue any other kind of debt that was not government guaranteed.

This includes many of the smaller banks, not just the larger firms.

The nascent U.S. covered bond market did not fare as well for a number of reasons. It was very immature. The investor base was not yet fully developed. Liquidity deteriorated much more sharply than in Europe. And crucially, the uncertainty about decisions being taken by policymakers and regulators weighed heavily on investors' minds.

The legal framework in the United States offered less clarity than the more specific principles enshrined in European covered bond legislation. We could not be completely sure precisely what would happen if an issuer failed.

The FDIC and the Treasury Department did take some actions in 2008 to mitigate this uncertainty. But administrative and regulatory actions can't substitute for clear legislation.

I think it is possible for this market to make a fresh start on a sound legislative basis. Today's environment, where there are plenty of savings looking for a conservative home, is quite conducive to the development of a robust and reliable market.

To sum up, it's good for the economy and good for investors if we have a private sector financial system that can stand on its own 2 feet during the most severe recessions and continue lending freely on prudent terms to households and small businesses.

A healthy, well-regulated, and supervised U.S. covered bond market, established on a firm legal basis, should make an important contribution towards this goal, as well as creating a useful asset class for us to invest in.

Again, I appreciate the opportunity to testify before the committee, and I hope my remarks have been of some assistance.

[The prepared statement of Mr. Phoa can be found on page 62 of the appendix.]

The CHAIRMAN. Mr. Hoeffel?

STATEMENT OF J. CHRISTOPHER HOEFFEL, MANAGING DIRECTOR, INVESTCORP INTERNATIONAL, INC., ON BEHALF OF THE COMMERCIAL MORTGAGE SECURITIES ASSOCIATION (CMSA)

Mr. HOEFFEL. Thank you, Mr. Chairman. My name is Christopher Hoeffel, and I am the managing director at Investcorp, a provider and manager of altered investment products for both private and institutional clients.

I am testifying today on behalf of the Commercial Mortgage Securities Association, or CMSA, where I serve on the Executive Committee and am immediate past president.

CMSA represents the collective voice of all market participants in the commercial real estate capital markets, including lenders and issuers, investors, rating agencies, and servicers, among others.

I currently am an investor in the commercial mortgage-backed securities (CMBS) market, but I have more than 2 decades of experience as a commercial lender and a CMBS issuer and originator.

CMSA would like to thank the committee for the opportunity to share our perspective on the creation of a U.S. covered bond market.

Today, the commercial real estate finance markets remain severely constrained, despite extraordinary borrower demand. In fact, there is more than $1 trillion of commercial real estate loans maturing in the next several years. At the same time, the CMBS market, which accounted for $240 billion, or approximately half of all commercial lending in 2007, has provided only $1 billion of new lending this year.

As such, we applaud the committee's timely efforts to consider a covered bond framework. We also applaud Capital Markets Subcommittee Ranking Member Garrett and Subcommittee Chairman Kanjorski for introducing legislation to facilitate this market and for including commercial mortgages in CMBS as collateral.

Overall, our members believe that covered bonds would be a helpful financing tool for the commercial property market. Certainly covered bonds would not replace CMBS as the capital source for commercial real estate; however, it would be an additive tool that provides liquidity, helps institutions raise capital to fund loans, and eases the credit crisis facing commercial real estate.

In the current environment, covered bonds could be a helpful means of raising capital relative to CMBS, as today the cost of capital related to a covered bond deal may be less volatile than CMBS. Moreover, such conditions could assist financial institutions in ag-

gregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being faced by the CMBS market.

Additionally, a broader-covered bond market would be a valuable financing tool for smaller banks. Securitization is often not an option for some smaller banks that lack a critical mass of collateral in one asset category.

But the ability to use diverse asset cover pools, made possible under a broad covered bond regime, could give smaller banks a useful new source of capital, enhancing their viability.

Today, commercial mortgages in CMBS are already permitted in covered bond pools in most European jurisdictions. These jurisdictions accord the necessary and appropriate regulatory treatment, including capital requirements, with respect to covered bonds, to facilitate the market and to better serve consumers and businesses seeking access to credit.

It follows that in order to be globally competitive, any U.S. covered bond regime should be closely aligned with the approach used by our European counterparts. Such a framework will give U.S. consumers and businesses access to the same sources of credit availability and support our overall economic recovery.

Also, a covered bond market would attract new investors to the commercial real estate market. This would increase the potential sources of the capital available for consumers and businesses, enhance liquidity, and help to create stability and asset values.

As the previous and current Administrations have rightfully pointed out, no recovery plan will be successful unless it helps restart the securitization markets. Covered bonds should be viewed in the same light, as an important component of any economic recovery plan.

All available tools should be employed to strengthen the credit markets and to provide the certainty and confidence that private investors, who fuel lending, seek.

However, all of these issues and efforts cannot be viewed or considered in a vacuum.

Today, recovery efforts in the commercial real estate market, including TALF and PPIP, have been helpful, but they remain in a delicate stage. They have led to increased liquidity for certain commercial real estate securities, but there still remain serious impediments to new lending for several reasons, including aggregation issues and enormous uncertainty in the securitized credit markets.

In this regard, our markets face unprecedented and retroactive accounting changes, including FAS 166 and 167, that will undoubtedly impact capital and liquidity.

In conclusion, the ongoing credit crisis presents enormous challenges for the commercial real estate sector. With traditional sources of credit such as CMBS developing slowly due to technical and regulatory hurdles, financial institutions need all tools to raise capital for commercial real estate and other asset classes in a sound manner.

Accordingly, we urge Congress to include in reform legislation a framework for covered bonds in order to promote global competitiveness and to give U.S. consumers and businesses access to the same sources of credit availability.

Thank you for your leadership on these issues. CMSA stands ready to assist you.

[The prepared statement of Mr. Hoeffel can be found on page 50 of the appendix.]

The CHAIRMAN. Thank you. Let me begin, Mr. Hoeffel, and I apologize for mispronouncing your name earlier.

I was struck because there was this concern about commercial real estate. But you have found the combined efforts of the Treasury and the Federal Reserve to be useful?

Mr. HOEFFEL. They have been useful in creating demand for securities, so that there has been active secondary trading in commercial mortgage-backed securities, both investment grade, or triple-A and below. Credit spreads have come in.

So it has been very valuable, I think, in clearing bank balance sheets, in creating liquidity, and in helping shore-up demand for the securities. It has not, however, inspired new lending. So there has been no incremental credit offering—

The CHAIRMAN. I understand that, but to the extent that it has had an effect, it has been a beneficial effect. Because there have been people who have been very critical.

Are these efforts ongoing? Would you have them stop them now?

Mr. HOEFFEL. I think that they have created investor demand, and they don't need to continue indefinitely. We have started to see a very few—

The CHAIRMAN. Well, indefinitely, I would agree. Nothing should continue indefinitely, like this hearing.

[laughter]

The CHAIRMAN. But what about, would you stop them now? When would you stop them?

Mr. HOEFFEL. Well, I wouldn't stop them now because—

The CHAIRMAN. Okay—

Mr. HOEFFEL. You said you're not going to stop them now. You need to carry through with the original term.

The CHAIRMAN. I appreciate that. Thank you.

Mr. Ely, again on some of the issues, I'm struck by, on page 7 of your written testimony, your proposal that the Federal Reserve Bank of New York should lend on a collateralized basis to the covered bond trust, etc. We haven't heard many calls for a greater role for the Federal Reserve Bank of New York. So I thought we would draw on this.

They would be allowed to lend their funds, Federal Reserve funds, it says, "to make timely payments on principal and interest." This would be if the trustee was somehow unable to do that temporarily? Is that the issue?

Mr. ELY. Yes. First of all, I think it would be a rarely used borrowing power. An alternative that has been suggested as—

The CHAIRMAN. Well, let's not talk about the alternative. Let's talk about what you propose.

Mr. ELY. Okay.

The CHAIRMAN. I want to see how it works.

Mr. ELY. The situation would arise where for some reason the assets in the cover pool backing the covered bonds weren't generating enough cash flow in a period of time to cover the interest and principal payments due on the covered bonds that were secured by

those assets. Only in effect, it would be a short-term bridging type of loan.

The CHAIRMAN. Well, the Federal Reserve would be able to step in and lend the money to cover the shortfall?

Mr. ELY. Yes. But it would obviously have a secured interest in—

The CHAIRMAN. Yes. Then there are some who would say that was a bailout by the Federal Reserve, of short duration. But it would have to be collateralized.

But the principle allowing the Federal Reserve to being sufficiently collateralized isn't a problem for me. That makes sense here.

Mr. ELY. I would not consider it to be a bailout, but rather a short-term secured, interest-bearing loan—

The CHAIRMAN. But they would step in, there would be a shortfall in the private sector's ability to make these payments. And the Federal Reserve Bank of New York would step in and advance money to carry them over that shortfall. Correct?

Mr. ELY. Yes, it's a bridging loan.

The CHAIRMAN. Okay. Thank you.

And the only other point I would make is to note that I welcome the acknowledgement that sometimes we can look at European—the gentleman from Illinois said it, he said kiddingly, but it's a very important point, because there have been, during our most recent debate, people who said, "Look, forget about Europe, this is America," and the notion that there is nothing to be gained from others' experience, or that we have no need to do things in parallel, I think, is gravely mistaken.

So I am struck by the unanimity that the European experience has been a good one, that it is instructive for us, that it gives us lessons, and that this is a case where acknowledging that something has been done in Europe has some useful lessons for us, we ought to go forward.

So I appreciate that.

And I will tell you, Mr. Boyce, that the Majority Leader will appreciate your invocation of Denmark. He often notes that he is the only Dane serving in Congress. And this cultural reinforcement, I'm sure, if and when we get to legislation, will help us get him to schedule it.

Mr. ELY. Mr. Chairman?

The CHAIRMAN. Yes.

Mr. ELY. If I could pick up on what you said about learning from Europe, I think it is important to pick up on their experience. The key thing is that in many ways, the European mortgage market is a more privatized market because of covered bonds. And I think that it has demonstrated that it can work very well—

The CHAIRMAN. I agree, it is privatized and we would have a privatized one until and unless the private market got in trouble, and then the Federal Reserve Bank of New York could step in and help them out.

The gentleman from New Jersey?

Mr. GARRETT. I thank the Chair. And my understanding is that the Speaker is traveling to Europe later this week for the specific purposes of examining the covered bond market.

To the last point, Mr. Ely, can you inform me, though, what is the backstop, if you will, in the European model?

Mr. ELY. I'm sorry?

Mr. GARRETT. What is the backstop in the European model? You suggested a reserve instead of the Federal financing bank here.

Mr. ELY. There have been, as I understand it—and there may be others on the panel who can speak to this more specifically—that there have been some situations where there has been some ad hoc mechanism created to deal with short-term cash flow and market problems.

Mr. GARRETT. Does anybody else want to chime in on that? Yes, sure, Mr. Boyce?

Mr. BOYCE. The assumption was that in the event that the covered bond matured and the cash flows from the assets were insufficient, the assumption was that assets would be able to be sold, or that the covered bond issuer would be able to raise other liabilities.

Last year, what happened was that sovereign governments of Ireland, the United Kingdom, The Netherlands, Belgium, and Germany had to rescue the financial institutions. That was the backstop.

Mr. GARRETT. Mm-hmm. But prior to that, there was not?

Mr. BOYCE. No.

Mr. GARRETT. Right. And so—because over there, there was no statutory framework for it, right? That was specifically touched upon, that point, as you say, "The assumption was," or I guess you would say priced into the model of it, then, that's how they would assume that they would be covered. So that was in the pricing mechanism.

So—and I'll have to delve into this a little bit deeper. But I guess you could also put that, if the statutory framework here was just the contrary here, as far as not having the backstop, then I guess that would just be part of the pricing of the project as well.

Would it not?

Mr. STENGEL. Congressman Garrett, if I could speak to that?

Mr. GARRETT. Sure.

Mr. STENGEL. I agree completely. One concern that has existed, trying to transplant the covered bond system in the United States, is to make crystal clear here that there is neither an explicit or implicit guarantee from the government.

I think what we found in Europe was silence in the legislative frameworks on what would happen when the issuer defaulted, a separate resolution process began for this cover pool.

It was silent at that point. And I think some in the market thought that implied a guarantee from the government.

And so by providing liability only, no credit risk—so the same kind of borrowing that banks can get from the discount window—the notion, at least in the Council's view, is that this kind of clear borrowing only for liability, only until cash comes in from the assets themselves, is critical.

Mr. GARRETT. Okay. Oh, yes, we have had that problem here, of course, in other areas where there was an implicit guarantee, that some people thought was an explicit guarantee. And then it turned out to be an explicit guarantee.

Mr. ELY. And Mr. Garrett, if I could just add to that?

Mr. GARRETT. Sure.

Mr. ELY. My proposal as I talked about it in my statement, is again just following up on Mr. Stengel's comments, that it is strictly a liability support, comparable to banks borrowing from the Fed discount window, with no loss intended for the taxpayer.

Mr. GARRETT. Okay.

I will just run down the line, if anybody wants to make any comments. In our proposal, there is language there with regard to a wider array of asset classes, one being commercial properties. And you addressed that issue.

The European model does not have that. Do you just want to comment on if there's a reason why you saw that is not in that model, and why that is a benefit to our model? I think you touched about the benefit here—

Mr. HOEFFEL. Well, there are commercial mortgages in the European model. In fact, I think one of the reasons—

Mr. GARRETT. I'm sorry. I should say it's not in the U.S. model, what has begun over here, I should have said.

Mr. HOEFFEL. Well, it hasn't been. And thank you, you have been very supportive in trying to add commercial real estate to the legislation, so we're thankful for that.

Mr. GARRETT. Right.

Mr. HOEFFEL. We see no reason not to include it. It has been a viable asset class in Europe, and in fact, it has been probably the prevalent source of commercial mortgage financing from banks in Europe.

Mr. GARRETT. Okay. And from anyone on the panel, what is the timeframe, assuming that we have a hearing today, and then a markup soon, and this legislation moves expeditiously through the House and the Senate, how quickly can this market actually blossom and grow into something of a sizeable nature?

I have heard all sorts of, not just timeframes, but size of the market. But how quickly can this really grow here in the United States?

Mr. HOEFFEL. Congressman, I think the market needs to start quickly, and we need to enact this quickly in order for it to have the best benefit. Because right now, the traditional securitization markets are somewhere impeded. And covered bonds, we're not thinking are going to be a replacement for securitization, but an additional tool for banks.

So to the extent that we can get the legislation out quickly, I think banks will take very good advantage of it in the near term.

As securitization markets recover and we have some basis for new issuance, I think covered bonds will be another tool, but may not be the predominant tool.

The CHAIRMAN. The gentleman from North Carolina?

Mr. WATT. Thank you, Mr. Chairman. Since we have a classified briefing coming up, and Mr. Foster has been active in this area, I'm going to yield my time to him, if it's okay—

The CHAIRMAN. The gentleman from Illinois is recognized for 5 minutes.

Mr. FOSTER. Thank you.

The CHAIRMAN. I'm not going to make the classified briefing. I'll wait and read about it tomorrow.

Mr. FOSTER. Thank you.

You mentioned that the European covered bond market froze at least temporarily in the crisis last year. It's my understanding that the covered bond market in Denmark did not, and this is at least partially attributable to the principle of balance.

I was wondering if any of you could elucidate on how the different segments of the covered bond market responded to the crisis?

I guess, starting with Mr. Boyce.

Mr. BOYCE. The last covered bond issued in Europe last year was the week before the Lehman Brothers bankruptcy. The most severe pressure in the global financial markets was in October. Every day in the fall of 2008, the Danish mortgage market, which is funded by the issuance of standardized covered bonds, functioned.

I would say that the European covered bond market has performed rather well recently, but it has come back earlier this year, and was still quite limited. And it was the announced purchase intentions of the ECB in May of the purpose of 60 billion Euros worth of covered bonds that really got their market going.

So I would say that the lessons that we should take from that are that the transparency and asset liability mismatches, the two things that were the biggest vectors of problems in the European covered bond market, should be avoided when we set up ours.

Mr. FOSTER. Thank you. And in terms of generating an efficient market, which ultimately yields a good deal for consumers and better mortgage rates, and so on, how do the different variations of covered bond markets compare historically and during the crisis?

Whoever wants to answer.

Mr. PHOA. We're happy dealing with different covered bond frameworks.

What we require as investors is: first, enough disclosure and transparency, so that we can carry out our own due diligence within whatever framework; second, a market that however it is structured, is well-regulated and well-supervised; and third, legislative clarity about what the rights and duties of the different parties are, if an issuer fails.

Mr. FOSTER. Yes. But have there been differences within the different flavors of covered bond markets, in terms of the spread?

Mr. PHOA. Yes, in Europe there has been considerable differentiation between spreads and behavior of markets, particularly between the U.K. jurisdiction, where there is no, or there had been no established covered bond legislation, and the European jurisdictions, such as Germany and France, where there had been a long-established legislative framework.

Mr. FOSTER. Okay. So the lesson to be drawn there is that a strong legislative framework is important to preserving a good deal for consumers, especially in bad times?

Mr. PHOA. Yes.

Mr. FOSTER. Are there any other comments?

Mr. BOYCE. I can back that up. Before the financial crisis, I would say that all covered bonds in Europe traded at very tight spreads to each other, that the bond market did not significantly differentiate between specialized and general law, and between the types of collateral and the specifics of the law. Since then, I would

say general covered bond law, covered bonds, have widened out by 30 or 40 basis points on average.

Mr. ELY. If I could add to that, I think one of the things we have to keep in mind is that in Europe, you have a number of different countries, with varying covered bond laws.

If Congress enacts one law and there is one regulator, given the potential size of a U.S. covered bond market, which could easily be several trillion dollars or more, just the sheer size of that market operating under one set of rules rather than a number of different sets of rules would provide liquidity and depth to the market, and, if you will, interchangeability among various covered bond instruments, that would go a long way toward maintaining the liquidity of the market, even in crisis times.

Mr. STENGEL. If I could add, from the Council's perspective, I think one primary factor has been the depth of the domestic market.

German investors were willing to invest in German covered bonds, French investors in French covered bonds, and certainly one focus of the Council has been a development of a deep U.S. domestic market, and we find the demand is there.

Mr. FOSTER. And could you talk briefly about a possible role for local community banks? How do they relate to the covered bond market in Europe, for example?

Mr. STENGEL. Lending from community banks in the United States is critical. And so there are a couple of places in the legislative framework where they have a role.

One is a system for them to issue pooled covered bonds. They would issue their own, and then create diversity in the underlying pool, so that they could match it and mark it in size, and issue competitively.

The CHAIRMAN. We do have the briefing, so I appreciate it. If you can elaborate on that in writing, it would be helpful.

The time has expired. The gentleman from Texas is recognized for 5 minutes.

Mr. MARCHANT. Mr. Chairman, my first question is, in a resolution such as bankruptcy or an FDIC proceeding or under the legislation that was just passed, a resolution from the new agency, what is the standing in recovered bond as opposed to preferred shares or other bonds that are issued by that entity?

Mr. STENGEL. Under current law, covered bonds are secured debt, so they would rank equally with other secured lenders in any bankruptcy or receivership. The one issue that's created under current law, however, is that there is a standstill, a stay, while either the bankruptcy court or the FDIC decides what to do with the broader resolution. And that kind of delay and that kind of uncertainty, the discretion given to managing the broader receivership or bankruptcy case, creates a lot of uncertainty for the investment community in what is supposed to be a high-grade and defensive investment. And so, the proposed legislative framework would lift out the covered bond program to be resolved separately with only one exception, and that being if the FDIC is appointed as conservator/receiver, having a reasonable period of time to transfer the entire program to another eligible issuer, much like Washington Mutuals was transferred to JPMorgan Chase.

Mr. MARCHANT. So the legislation, as it is written or proposed, would alleviate the FDIC's concerns?

Mr. STENGEL. I believe so, and in two different ways. One, this is about maximizing the value of the collateral. And the FDIC's largest concern is losing the value of any equity or surplus collateral in that pool and by having it separately managed, having uninterrupted servicing of that pool, that's going to maximize the value. There's also a residual interest that's automatically created that represents that residual that would be in the form of a security that could be sold or otherwise monetized so the FDIC or creditors don't have to wait around while covered bonds pay off and the program winds down. They would have something immediately that could be monetized. So, I think both of those should assuage the FDIC's concerns.

Mr. MARCHANT. My next question is, do all the bonds in the offering have the same status or are there tranches similar to mortgage bank security?

Mr. STENGEL. There are no tranches. It could be that a bank decides to set up multiple covered bond programs. One for residential mortgages, another for commercial mortgages, another for student loans. There would be no mixing of those collateral; they would all be separate. There could be multiple covered bond programs but all bonds have equal access to the assets in the covered pool that are securing them.

Mr. MARCHANT. Mr. Phoa, in a mature covered bond market, what is the right spread over a comparable treasury?

Mr. PHOA. That tends to vary a lot of the cycle. For example, a spread of say, 45, 50, 60 basis points might be observed during calm periods. And spreads will tend to widen during periods of market turbulence, but certainly much less so than spreads on unsecured debt. I think in Europe, we have seen spread volatility of covered bonds being a small percentage of that of unsecured debt.

Mr. MARCHANT. And Mr. Ely, last question. Would it have the effect of taking the more conservatively unwritten loans out of the market and have them packaged with covered bonds, leaving the more risky loans to be underwritten and written by the government?

Mr. ELY. No, I think that it is conceivable to establish covered bond programs that can deal with loans of all degrees of risk. What you would have is, obviously, for a covered bond would be an overcollateralization requirement that would have to be adjusted according to the risk, with a riskier pool of loans backing a covered bond issuance having a higher over collateralization requirement than would be the case with safer loans.

So, my assessment is that covered bonds can deal, and have the potential to deal with loans of not only different types, but also different degrees of credit risk.

Mr. MARCHANT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. This covered bond business is new for me, but I do have one question as I'm trying to digest all of the information that you're providing. Last summer, former Secretary Paulson actually endorsed this entire concept of covered bonds and I'm just wondering why, and maybe you can't

even answer this question, why the initiative was not brought forth by the Administration? If the Secretary of the Treasury was strongly supportive of it, do any of you have any idea why that was not done? The Secretary made a speech about best practices and talked about this, so?

Mr. STENGEL. I think from the market's perspective, the market did try to act on the initiatives that were provided by both the Treasury and the FDIC. What was learned, not only through the crisis associated with Lehman and liquidity disruptions throughout our entire financial system, but what was found was, the legal certainty and the public supervision that is found in legislative frameworks is critical to this deep and liquid market that's needed for covered bonds.

And so I think, at least from the Council's perspective, there has been a conclusion that without legislation, without the legal certainty provided, and without the public supervision provided through legislation, that this kind of market, which really needs to be deep and liquid, can develop. It can't start with just a couple of issuances and have sporadic issuance, have shallow trading; it needs to be deep and liquid in a very short order.

Mr. ELY. Mr. Cleaver, my understanding is along that line, too, which is why other countries that didn't have a covered bond statute have moved in that direction, the U.K. being one. We have seen, for instance in Canada, a couple of the major banks either have issued or are about to issue covered bonds without a statute, but at the same time, Canada is working on a covered bond statute. So, the global experience seems to indicate, from the market's perspective, that in order to get a really good, sustainable market going, there has to be a strong legislative framework that establishes the certainty that investors in AAA bonds need to have.

Mr. CLEAVER. So, this is going to go global, you think?

Mr. ELY. Yes.

Mr. BOYCE. Yes. Just to add to those comments. One of the things that was learned from last fall's crisis in Europe was that significant asset liability mismatches were a source of problems, so the rating agencies have all come out with very clear guidance and S&P is the last one that should come out soon requiring substantially minimized asset liability mismatches.

Mr. ELY. And the good news is that, particularly when you have the strong legal environment, you can have long-term covered bonds of maturities of 10, 15, 20 years or more and that the long maturity of these bonds is what is key to minimizing maturity mismatch. But again, for that long-term debt to be out there, for the investors to buy it, you have to have the legal certainty that can only come from statutory law.

Mr. CLEAVER. All right. Thank you. That's all, Mr. Chairman.

The CHAIRMAN. Would the gentleman yield? Mr. Boyce, I want to make sure I understood you. You're saying that the rating agencies learned as a result of their experience that a severe mismatch between assets and liabilities was a bad thing? Is that what they learned last year?

Mr. BOYCE. You are correct.

The CHAIRMAN. Wow. The gentleman from New York.

Mr. LEE. Thank you. I also am weaving my way through this and came down here to understand a little bit more about the covered bond market. I'm thinking that maybe I'll start with Mr. Stengel on this question and you can help educate me. And it has to do more with, obviously, secured creditors. In the bill that was passed last week, there had been an amendment inserted, the Miller-Moore amendment, with regards to a provision in that bill that would allow the FDIC to impose a 10 percent haircut to secured creditors.

My concern is over this, how this would play out in a covered bond market? And what impact would it have?

Mr. STENGEL. I think the market was very concerned about that particular amendment. It really threw off the playing field with which creditors have interacted with borrowers. I think we were grateful to see that was scaled back on the House Floor to debt that is under 30 days in length. So, very, very short term debt is now covered by that amendment, although that is still somewhat concerning to the capital markets.

With covered bonds having very long maturities, 2 to 10 years or more, and at least in the proposed legislation, by definition, at least one year, I don't think, at least the Miller-Moore amendment in its current form, would pose any issue for covered bonds.

Mr. LEE. Do you think it's going to restrict investors coming into the market knowing that potential liability stick is out there?

Mr. STENGEL. I think the market, and again, just speaking for myself here, not the entire market, but I think there is market concern when the government suggests that secured creditors should not be entitled to all of their collateral. It really creates uncertainty and disruption in expectations. And so I think when Chairman Bair first made that suggestion some time ago, there was quite a quick market reaction to that suggestion. I think when the amendment was introduced, another reaction as well. And so, I think if that is going to be part of our law going forward, it's going to take some getting used to, but I think it is somewhat concerning for the market.

Mr. LEE. I would completely agree. With that, I'll yield back. Thank you.

The CHAIRMAN. The hearing is now adjourned. I appreciate the witnesses and any further information, obviously, with questions, if you want to elaborate on any of the answers, we would welcome that. This is a subject that the committee will be dealing with next year.

[Whereupon, at 11:13 a.m., the hearing was adjourned.]

A P P E N D I X

December 15, 2009

December 15, 2009
Statement by the Honorable Kenny Marchant
Committee on Financial Services
Hearing on "Covered Bonds: Prospects for a US Market Going Forward"

Thank you Mr Chairman for working with the gentleman from New Jersey to put this hearing together. Covered bonds have the potential to be an important tool in rebuilding the credit markets in this country. As has been stated before, these instruments address many of the concerns brought up by Members during this crisis: aligning incentives in the borrower- issuer-investor relationship, having issuers "eat their own cooking", and easier modification of troubled mortgage loans just to name a few.

However the main issue I'd like to address is stemming the tide of government intervention in the mortgage lending business. I believe fostering the creation of a covered bond market would help. The vast majority of mortgages in this country are now back by Uncle Sam in some way, shape or form. The only way to get a loan these days is if it's FHA, Freddie or Fannie backed. And of course the FHA fund is in terrible shape, while Fannie and Freddie already went under. In addition, one of the starkest examples of the affect of the government in the mortgage markets is the complete lack of jumbo mortgage financing in this country. That's because the government doesn't back these loans.

Jump starting the covered bond market by providing for a statutory framework would be a big step toward reversing this trend.

I'm not suggesting that covered bonds are a 'silver bullet', but they could be an important new cog in the machinery of our credit markets. I'm looking forward to hearing from our witnesses about the challenges and opportunities these debt instruments provide.

Testimony of

Alan Boyce
before the
House Committee on Financial Services
December 15, 2009

Mr. Chairman, Ranking Member Bachus, Representative Garrett, Representative Kanjorski and other Members of this Committee, I very much appreciate the chance to testify today on the issue of covered bonds. Covered bonds are an important and useful financial tool, and the Committee is right to be considering how best to ensure that investors and borrowers have access to the benefits of this approach.

In my testimony today, I would like to do three things. First, I will discuss the general benefits of covered bonds, particularly in light of our recent financial crisis and our ongoing financial challenges. I will then discuss some important issues concerning the drafting of the covered bond legislation currently before the Committee. Specifically, I will advocate for more specialized and rigorous requirements for covered bonds, as those requirements are key to realizing the great gains these instruments can offer. Finally, I will briefly discuss a few innovations that can make the covered bond approach even more effective in addressing the challenges facing mortgage finance.

I am the Chief Executive Officer of Absalon, a joint venture between George Soros and the Danish financial system that is assisting in the organization of a standardized mortgage-backed securities market in Mexico and elsewhere. I have worked for the past three decades on a range of financial, mortgage, and bond market issues, and I am pleased to offer the Committee my personal opinions on these policy issues today.

The benefits of covered bonds

Covered bonds are on-balance sheet, asset-backed financing instruments. They are viewed as highly secure "gilt-edged" investments. Investors have dual recourse, both to the pool of pledged assets that collateralize, or cover, the bond and to the issuer if the proceeds realized from the cover pool are inadequate. Covered bonds differ by country, with the features being determined by both law and regulation. Several countries around the world are working to introduce enabling covered bond legislation, which will assist the product as a new mortgage funding option.

Covered bonds offer several potential advantages and address several concerns arising from the past several years.

First, and perhaps most important, covered bonds keep the interests of the issuing institution better aligned with those of the borrowers and investors. In the recent past, issuers of loans sold into asset backed securities were less concerned than they should have been about the quality of those loans, since they were often completely "off the hook" within a few weeks of making the loans. Many loans were made that should never have been made. By requiring the issuing institution to retain the loan on its balance sheet, this misalignment of interest is substantially mitigated.

Second, covered bonds can help promote simpler and better allocation of risk over time. From the first financial institutions until today, a key challenge has been the mismatch between the long term loans desired by borrowers and the short term liabilities desired by depositors. A well designed system accomplishes this goal by appropriately managing interest rate risks, refinancing risks and other variables. In the recent past, asset backed securitization structures appeared to offer innovative methods to spread and price these risks. The complex, idiosyncratic, and opaque design of these instruments, however, led to catastrophic problems – particularly when combined with complex institutional and contractual relationships between issuers, servicers, and GSE guarantors.

The transparency and simplicity of covered bonds is a clear advantage, especially for investors with limited analytical resources in mortgage finance and limited trust in ratings agencies. Covered bonds help banks more cleanly manage interest risk and match long term assets with long term liabilities. The long term liabilities of well structured covered bonds allow the issuing bank to reduce its interest rate risk. (Indeed, by exactly matching the terms of the underlying loans with the term of the covered bond, interest rate risk for the issuing bank can even be eliminated.) Substantial risks do, of course, remain. Refinancing or "roll risk" remains a challenge for covered bonds, as was seen recently in Europe.

Finally, covered bonds can offer a much needed low cost form of private financing, particularly in the context of an appropriate regulatory and legal framework. A well-designed covered bond program makes the loans very secure. When security is high, the buyers of the underlying bonds will accept low interest rates. As I will emphasize more than once, covered bonds work best when they are structured consistently, conservatively, and transparently. Covered bonds with these characteristics have a long and successful track record in Europe.

Covered bonds could thus be of particular help as we address the current problems in the mortgage industry and, perhaps, in other securitization markets as well. As the Congress considers how to restructure the GSEs and how to restart private mortgage lending with more limited government guarantees, covered bonds should be carefully considered.

How best to design a covered bond system

This Committee, the Congress, the Administration and regulators face a series of important decisions when deciding how best to achieve the benefits that covered bonds offer the financial system. While many of these issues are quite technical, I would like to focus now on four more

thematic issues: the need for specialized as opposed to general law-based legislation; the need to limit eligible cover assets to long term secured lending such as mortgages; the need to have strict rules govern asset liability management for the issuers; and the need for specific procedures to address both issuer and cover pool credit problems when they arise.

The need for specialized legislation

One issue facing the Committee is whether to have general law-based or more specialized covered bond laws. To achieve the benefit of being low cost, covered bonds must be viewed as "gilt-edged" securities. Standardization and transparency tend to be associated with specialized covered bond laws. General law based covered bonds may allow more flexibility for the issuers. In the past two years in Europe, however, general law based covered bonds issuance has declined, as the investor base has preferred the transparency that comes with more specific legislation. In addition, opaque and idiosyncratic bonds that come from increased differentiation have resulted in lower market liquidity for those bonds.

In the last year, the spread between specialized-law and general law covered bonds in Europe has widened significantly. Investors have higher comfort levels from the specialized covered bond laws and the higher level of specific regulatory requirements associated with such legislation. In particular, more specific legislation often includes restrictions on collateral type, loan to value requirements, and appraisal standards. In addition, investors' ability to assess the product characteristics are enhanced by the standardization and transparency offered by more specific legislation.

The need to limit eligible cover assets to long term secured lending

As discussed above, two central virtues of covered bonds are interest alignment and long term interest rate protection for banks. It is my view that in starting a covered bond program, cover assets should be limited to well underwritten, conservative loan to value ratio, first lien mortgages. This is the asset class where the benefits of this approach are greatest. Well underwritten mortgages have physical assets behind those loans, which reduce their risk. Other asset classes could be considered later on the basis of experience.

The 200 year success of the European covered bond market is due to its consistently conservative approach. The U.S. covered bond market should copy this and be started with high quality assets and strict standards. Short duration/floating rate assets do not in my opinion belong in covered bonds, at least to start. Home equity loans, student loans, credit cards and auto loans all fit well on a bank's balance sheet; these securitization asset classes were also the easiest to get restarted after the crisis began. Further, RMBS and CMBS have no place in a covered bond in my opinion. Their credit risk is already supported by their structures, and the added complexity and risks they bring would unduly complicate a nascent U.S. covered bond market.

The need to have strict rules govern asset liability management

Investors look to several risk mitigants to gain comfort in a covered bond's high credit quality. First, the credit quality of both the collateral and the issuer are of paramount importance. The credit crisis tested many assumptions, and it became clear that issuers were often more vulnerable than the high quality collateral backing the bonds. The basics of proper asset liability management were critical, and the Committee should pay careful attention to developing proposals to ensure such sound management in this market.

The European covered bond market came to a halt after the Lehman bankruptcy filing. Commercial and mortgage banks had to pay significantly higher interest rates than usual to raise funds. Banks that were reliant upon covered bond issuance for financing were forced to issue bonds with significantly shorter maturities, with many being unable to borrow at any price. The government of Ireland, Germany, Belgium, and the United Kingdom had to rescue credit institutions which were faced with mismatched asset/liability profiles. While the credit quality of the underlying cover pool assets had deteriorated, the significant factor was the inability of the issuer to raise new liabilities to pay off the maturing covered bonds.

There are several risks in 2010 which face the European covered bond market. The most significant risks are the possibilities of declining credit quality for both collateral and the issuers. It should be noted that both main risks are correlated to interest rate movements. If rates were to rise, both interest sensitive assets and issuers with mismatched asset liability management practices will experience significant pressure.

Given the recent experience and future threats to covered bonds from asset/liability management risks, the bond ratings agencies have proposed significant changes to their covered bond rating methodologies. Fitch is changing how it calculates its Discontinuity Factor by reducing the expected market value of covered assets and increasing the weighting attached to liquidity gaps. This has led to higher levels of overcollateralization. Moody's was the last of the big three to respond to the market's heightened fear of liquidity risk. It is requiring additional collateral based upon the relative change in collateral value versus the proceeds due on the bond.

S&P has made the most significant proposed changes, which center around assigning covered bonds to three categories based upon their inherent asset–liability mismatch. This forces a higher correlation between bond and issuer ratings as the maturity mismatches increase. Match-funded covered bonds, in which the issuer retains only the credit risk of the collateral but takes no interest rate risk (because the covered loans exactly match the terms of the bond), are significantly de-linked from the issuer rating. S&P plans to score each national market based upon the degree of support they offer. They will use recent history as a guide for the scenario analysis when trying to estimate market value of collateral.

The market price of covered bond collateral has declined, which has exacerbated asset/liability mismatches. Overcollateralization is one way to mitigate this problem, but a more direct route

would be to reduce or eliminate the cash flow mismatches from the process, as I will discuss in more detail later. In addition, unsecured deposit guarantors prefer minimal over-collateralization, as they are left with no assets in event of issuer insolvency.

The Committee should ensure that the full range of modern asset/liability management tools are brought to bear on covered bonds, whether through regulation or legislation. This should include restrictions on interest rate, options, and currency risks.

The need for specific procedures to address both issuer and cover pool credit problems

Successful covered bond programs have clear and definitive rules to deal with what happens when there are problems. The simplest problem arises when there is a bad loan in the cover pool. The best policy approach is to insist that cash be the only substitute for a bad loan. Bad cover assets need to be removed from the pool as soon as possible. By buying them out, the issuer is thus directly responsible for the consequences of its bad credit decisions. This can also act as an early warning signal of issuer specific risk and limit ultimate losses to the bond holder. Particularly in light of recent experience, it seems highly questionable to allow issuers to substitute new loans into the cover pool at par value. This opaque, non-market process will immediately be exposed by new rating agency procedures.

The legislation should include lending restrictions, which govern borrower underwriting criteria, appraisal criteria and specific loan to value ratio (LTV) limits. LTV limits should be hard ceilings, which vary by the riskiness of the underlying property type. New loans should carry full recourse, as the borrowers are benefitting from the ability to borrow at low rates that would otherwise be unavailable. Recourse and a simple and clear path to lender loss mitigation combine to lower long term mortgage credit costs.

Issuer insolvency creates other problems to be addressed by legislation. The rules for estate separation should be clearly defined, with a strong covered bond regulator empowered to make quick decisions. Issues to be resolved include assignment of cover pool to a new servicer and/or sponsor and the level of retention of over-collateralization that moves with the estate. A process should be established to register contingent claims on behalf of investors, which should be subject to netting rules. In the event of issuer insolvency, an acceleration event should be excluded. Covered bonds are best viewed as a rate product; an acceleration event triggered by issuer default subtracts value from the bond investor.

The Federal Financing Bank liquidity guarantee is quite positive, but should be associated with a very strong prudential regulation. The backstop should in no way be construed to mean federal credit insurance. By giving liquidity support, the Federal Financing Bank should not be construed to give Agency status to the covered bond issuer or estate. Liquidity support should always function in the interests of the covered bond investors.

An additional approach that complements covered bonds

I would like to conclude my testimony by briefly discussing a particular approach to covered bonds that creates significant benefits to homeowners, bondholders and covered bond issuers, and promotes financial stability as well. As we have seen, the benefits of covered bonds are maximized when the terms of the bond exactly match the terms of the underlying assets. This exact match both eliminates interest risk for the issuer and refinancing risk for the bond.

When each loan is exactly balanced by a portion of an identical, transparent, and tradable bond, this is called the Principle of Balance. They key word and backbone of this system is match-funding: there is a match between a loan and the bonds funding the loan. Markets that adhere to this principle offer substantial advantages. Indeed, this system has worked extraordinarily well in Denmark since 1797, and I would be eager to work with this Committee and others to discuss the practical issues that need to be addressed in order to move it forward in the U.S. I have attached to my testimony a brief paper outlining the proposal in more detail.

Despite historic turmoil in financial markets, Danish mortgage bonds have performed remarkably well. No government guarantees for mortgage bonds have been necessary in Denmark. Danish mortgage banks were able to continue lending activities throughout the entire crisis because new bonds were saleable. Consequently, Danish homeowners and companies seeking financing for properties did not experience any limitations attributable to the financial market turmoil. The Danish mortgage system has survived all economic downturns thanks to this strong foundation. Over the years, this foundation has contributed to stabilising the Danish economy.

For the purposes of today's testimony, I would like to argue in broad terms that instituting the Principle of Balance can allow for better aligned interests between borrowers, intermediaries, and investors. Further, when combined with optional redemption mortgages, this system can significantly limit the threat of foreclosures during housing busts.

Cleanly separating credit risk from interest rate risks allows institutions and investors to better align their activities. Mortgage issuers focus on evaluating individual credit risk; bond markets and their institutions focus on interest rates, yield curves, and volatility. The entire market is transparent, with people checking daily mortgage trading prices online the way stock investors check Yahoo finance today.

Optional redemption mortgages, like covered bonds, are a fairly simple idea, but they are unfamiliar to many here in this country. Just as many mortgages currently offer homeowners the option of prepaying and refinancing when interest rates drop, optional redemption mortgages offer the homeowners the option of refinancing when the value of a mortgage drops, due to a rise in interest rates. Many Americans now hold mortgages that are trading at far less than the par value owed on the mortgage; if they had optional redemption mortgages, they could refinance at lower principal and often maintain positive equity in their home.

In this sense, the optional redemption mortgage puts households more nearly in the same situation as corporate treasurers, who have the ability to purchase their own debt back at a lower value in the open market if the value of that debt falls.

This feature would profoundly improve the overall situation facing the housing market during housing price declines, by directly and substantially reducing the number of homeowners who are underwater.

Transitioning to a new, simpler and more stable system could be done efficiently and effectively by refinancing performing mortgage loans into new, standardized Principle of Balance loans. Many transition paths could be considered.

Conclusion

The U.S. government has become the "single payer" supporting the mortgage market. As such, it has profound ability to influence the design of the system moving forward. There should be added urgency to mortgage reform given the threat to rising interest rates from the embedded extension risk in the existing mortgage market. Waiting should not be an option as increases in interest rates may set off a self-reinforcing bond market decline.

Covered bonds can be an important part of the solution. Introducing a legislated covered bond market is a big step in rebuilding the market in a sound and sustainable fashion. A few additional changes can make this an even more effective step, and I urge the Committee to carefully examine the potential of a market in which standardized mortgages with optional redemption are funded through simple and transparent covered bonds.

Appendix

Principle of Balance Mortgage Lending: a Better Approach

The mortgage finance system in the United States needs to be rebuilt. Currently, nearly all new mortgages and a significant amount of the old loans depend upon some form of the financing or guarantee from the Federal Government. Policymakers thus have a unique opportunity to structure the market in a sound and sustainable fashion. We can do better than the old model. This plan enables homeowners to reduce principal owed and negative equity by providing capacity to repurchase their own loans when those loans are trading in the market at discounts. If this is pursued soon, this plan could help homeowners preserve equity in their homes. The goal is to create a standardized, transparent mortgage system which aligns the incentives of the homeowner, the bondholders and the intermediaries.

The better and simpler system revolves around The Principle of Balance (PoB). The central difference of a Principal of Balance system is foundational – each performing mortgage is always exactly balanced by an identical and openly traded bond[1]. Mortgage Credit Institutions (MCIs) play critical roles and advisors. They help the homeowner understand and navigate the process. Most important, MCIs bear the credit risk of the mortgage – they remain "on the hook" in the event of delinquency or default. They are mortgage credit insurers. In Denmark, where this system is in place, the MCI originator bears full responsibility for timely payments from the homeowner. If a homeowner falls behind on payments, the mortgage is removed from the bond by the MCI at the lower of the market price or par. The MCI deals with all ensuing credit and collection issues.

This system cleanly separates credit risk (the risk an individual homeowner will not repay) and interest risk (the risk that changes in interest rates will raise or shrink the value of the mortgage) and manages them appropriately. Mortgage advisors have an incentive to get homeowners only into those loans that make sense for that family. Mortgage credit issuers develop expertise on understanding who can repay their loans. Meanwhile, bond investors worry about only interest rate risk, with complete insurance on any credit related issues. A good mortgage system will properly identify, minimize, and efficiently allocate these risks.

A main benefit of this system is that it offers performing homeowners the ability to buy back their own mortgages when the price of those mortgages drops in the open market. When

[1] The mechanics of this system are simple, if unfamiliar. When a homeowner qualifies for a new mortgage, the Mortgage Credit Intermediary adds that mortgage to a pool of identical mortgages – 30 year fixed mortgages expiring in 2039 with a 4.75% rate, for example. This pool is financed by investors through bond purchases. The bond series is "open" while new mortgages are being issued into it. Once these mortgages are no longer being issued (for example, when 30 year mortgages come due in 2040), the bond series is closed. Throughout the process the bonds trade openly. Thus the mortgage loan is not made by a bank; it is made by the bond market, with the MCI facilitating. Since all of the mortgages in a given bond series are identical, it is possible to directly balance a performing mortgage – on the basis of its face value as a percentage of the face value of all mortgages in the pool – against an equal share of the trading value of the bond series.

interest rates rise, the value of existing mortgages drops. This optional redemption feature -- akin to refinancing when interest rates drop -- is then available to homeowners who are current in their payments. The homeowner directs his/her mortgage company to purchase the correct current face value amount of the bond at its discounted price and use it to redeem the existing home mortgage loan. This is paid for by the simultaneous issuance of a new loan, for a smaller face amount, often at prevailing higher mortgage rates. This feature radically reduces the threat of foreclosures by eliminating the systemic risk to homeowner equity due to rising rates.

Right now many mortgages are trading for 60 cents on the dollar in the bond market. Even though the homeowner owes the face value of the mortgage, say $100,000, that mortgage can be bought by an investor from the market for $60,000. Why shouldn't the homeowner be allowed to purchase the mortgage at this lower price? This optional redemption is of particularly great value at times, as in 2009, when home prices and mortgage values decline in tandem. The ability of the homeowner to reduce his mortgage liability reduces the chance that he will be underwater when home prices fall due to changes in interest rates.

Transitioning to a new, simpler system could be done efficiently and effectively by refinancing all performing mortgage loans into new, standardized Principle of Balance loans. Many transition paths could be considered. In the current U.S. environment, it may make sense to use the GSE's to lead this process by offering large scale, streamlined refinancings of all performing mortgages into full recourse PoB loans backed by federal guarantees. The GSEs could then transition into a pure insurance role – as the loans would no longer be on their balance sheets. This approach would run cash through existing non-agency securitizations, which is the most effective way to clean them up. We would need to expand underwriting criteria to include currently ineligible borrowers AND allow for higher loan to value ratio (LTV) during the transition period. Loan limits could be raised readily to cover 99% of mortgages.

Alternatively, this could be done entirely through private institutions. The key issue is moving now, when the basic instruments and institutions of mortgage finance are being reviewed and rebuilt. Four elements are key to the success of this new approach.

Highly Standardized Loans

All loans guaranteed under the new system need to have highly standardized characteristics so that each resultant bond series is made up of exactly identical loans. There can be different types of mortgages pooled into different bonds, but all the mortgages in a specific bond series (for example, the series made up of 30 Year fixed, 4.5% loans expiring in 2039) must be identical. This standardization allows for the Principle of Balance (PoB) – through which each performing mortgage is always and exactly balanced against an equal and redeemable share of a bond series. Given that all of the loans are identical (and the individual credit risk is fully borne by the MCI), a homeowner can easily identify and repurchase an amount of the bond equal to the value of his or her mortgage. New loans will carry full recourse, enforced by an agency of the U.S. Treasury Dept.

Highly Transparent Securitization

The system needs to have transparency built in. The moment a mortgage is issued, it is sold into a bond series of mortgages with identical terms. The mortgage obligation never vanishes into a complex web of securitizations. Daily information is published on bond trades and how many loans were funded by bond issuance. Weekly information is published on prepayment option exercise. Quarterly information is published on credit metrics of each bond series. In Denmark, bondholders and investors go online as stockholders do here – they check the price, fundamentals, trades, and news about their mortgage series on NASDAQ OMX (http://www.nasdaqomxnordic.com/bonds/denmark/). It is an open system, where all are treated equally on a level playing field. Well tested systems are easy to transfer, monitor and regulate.

Well Aligned Interests

Separation of credit risk from interest risk allows each set of financial markets and professionals to operate effectively, efficiently, and with well aligned interests. MCIs are shielded from any and all risks other than credit risk. MCIs become mortgage insurance companies that do the paperwork. They make sure that bad loans are NOT produced, thus eliminating the fundamental problem vexing global financial markets. MCIs act as "liability advisors" to the homeowners, with every incentive to get each person into the mortgage most likely to be repaid and no incentive to drive volume when rates fall.

MCI's become transparent information processors and fee for service providers. MCIs are incentivized to: survey the bond market for risk reducing transactions, advise and assist the homeowner in executing the mortgage refinancing transactions. By helping the homeowner, the MCI is able to also reduce the value at risk of the mortgage credit insurance.

MCIs must make all efforts to have their bond series trade as well as those of competitors. Homeowners have clear and transparent incentives to refinance with the MCI whose bonds trade at the highest prices.

MCIs must also make all efforts to make the prepayment characteristics of its bond series no worse than that of its competitors for investors. This creates an incentive for MCIs to make loans to those homeowners who have a lower probability of refinancing, including first time homeowners and others who have been underserved in the past.

The bond market does not face credit risks when a loan is non-performing because it is removed from the bond series. The market deals only with pricing, allocating and hedging interest risk. The terms of the bond match the terms of the liability by definition[2].

[2] This is a benefit compared to a more standard covered bond approach, where the term of the covered bond is not tied to the term of the included mortgages. Standard covered bonds can create a threat of being unable to roll forward financing at the expiration of their term; Principle of Balance systems avoid this risk.

Counter-Cyclical Properties

When interest rates rise, mortgage prices fall as do housing prices. The Principal of Balance allows homeowners to redeem their mortgage and refinance at a lower principal. If interest rates were to fall again, the homeowner would be allowed to exercise his/her imbedded call option and refinance into a lower rate loan. This is a very effective, markets-based approach that reduces long-term interest rate volatility.

Mortgages are callable, which provides the most effective mechanism for the transmission of monetary easing into stimulation of aggregate demand. Callable loans are also an effective way to reduce inter-generational moral hazards and accounting issues.

The correlation between interest rate risk and credit risk is reversed by following the PoB. This provides a counter-cyclical income stream for banks.

Capitalization of the margin between the loan and the bond is prohibited. This practice leads to a misalignment of interests and encumbers future credit events. Variable margins allow future unforeseen credit costs to be shared among the beneficiaries of the system rather than future taxpayers. This is the main reason that mortgage servicing rights (MSRs) should not be capitalized and booked as upfront income.

The PoB system acts outside of bank's balance sheets – we need "thinner" institutions that perform clear and indentified functions, with stronger and "thicker" markets of standardized products.

Conclusion

The U.S. government has become the "single payer" supporting the mortgage market. As such, it has profound ability to influence the design of the system moving forward. MCIs should be required to remain "on the hook" for the first 10% of any credit losses associated with their bond issuance. Mortgages should come with full recourse from the Federal government. Bond holders should be responsible for managing interest rate risks. We can build and transition to the Principal of Balance system now. Doing so should be a priority, even as we continue to work to clean up the problems of the previous system.

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

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

A brief description of covered bonds

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

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

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

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

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

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

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

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

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

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

(dollars in billions)

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

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

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

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

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

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

Better lending will be one of the principal benefits of covered bonds because covered bonds will be back by loans that lenders make and then keep on their balance sheet rather than selling those loans into the securitization marketplace. Lenders keeping the loans they make will eliminate the moral hazard inherent in the securitization process in which lenders shift all of the credit risk of the loans being securitized to investors in the liabilities issued by securitization trusts.

Pending financial-reform legislation would require lenders selling mortgages into the securitization process to retain a small portion – 5% to 10% – of the credit risk associated with those mortgages. However, when a lender keeps the mortgages and other loans its makes by funding them with covered bonds, it retains 100% of the credit risk. That is far preferable to a 5% or 10% risk retention as the lender is then on the hook for 100% of his lending mistakes.

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

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

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

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

Better borrower protection

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

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

If needed, loan modifications are much less complicated

If a lender retains 100% of the credit risk of the loans it makes – the case with loans funded with covered bonds – the lender can more easily modify a loan should the borrower experience financial difficulty. As recent experience has taught repeatedly, loan modification becomes extremely complicated when the lender no longer owns the loan yet the lender or a loan servicer must contend with the legal complexities of modifying a loan owned by a securitization trust which has scores or hundreds of investors, usually in different tranches, and often where some of the interests in that trust having been 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.

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 shrinks in the face of tougher asset-securitization standards and the growth of covered bonds as a funding source for financial assets. To put this point another way, as covered-bonds grow as a highly rated class of debt, funds will flow to covered bonds as the supply of other types of heretofore highly rate debt shrinks.

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

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

The international appeal of covered bonds

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

It is especially important that U.S.-issued covered bonds gain international investor acceptance and appeal as international investors supply a steadily increasing amount of the credit demand in the U.S. economy. As Figure 2 illustrates, the Rest of the World, i.e., non-U.S. investors, now supply about one-seventh of the total credit outstanding to U.S. borrowers – public and private. According to Federal Reserve Flow of Funds data, foreign investors provided $7.73 trillion, or 14.7% of the credit outstanding in the U.S. economy on September 30 of this year.[4] Given the trade deficits the United States continues to run, that dollar amount and percentage will continue rising for the foreseeable future. Therefore, U.S. borrowers need to increase the supply of highly-rate debt paper they sell to the rest of the world. Covered bonds represent an excellent, efficient way to do so.

Creating the appropriate legal structure for covered bonds

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

The statutory foundation for covered bonds

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

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

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

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

Specific statutory provisions should include the following:

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

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

Regulatory oversight of the covered-bond marketplace

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

[5] Moody's Week Credit Outlook, 14 December 2009, pp.17-18.

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

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

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

Covered-bond indentures

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

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

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

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

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

Figure 1

Balance sheet of a covered-bond issuer

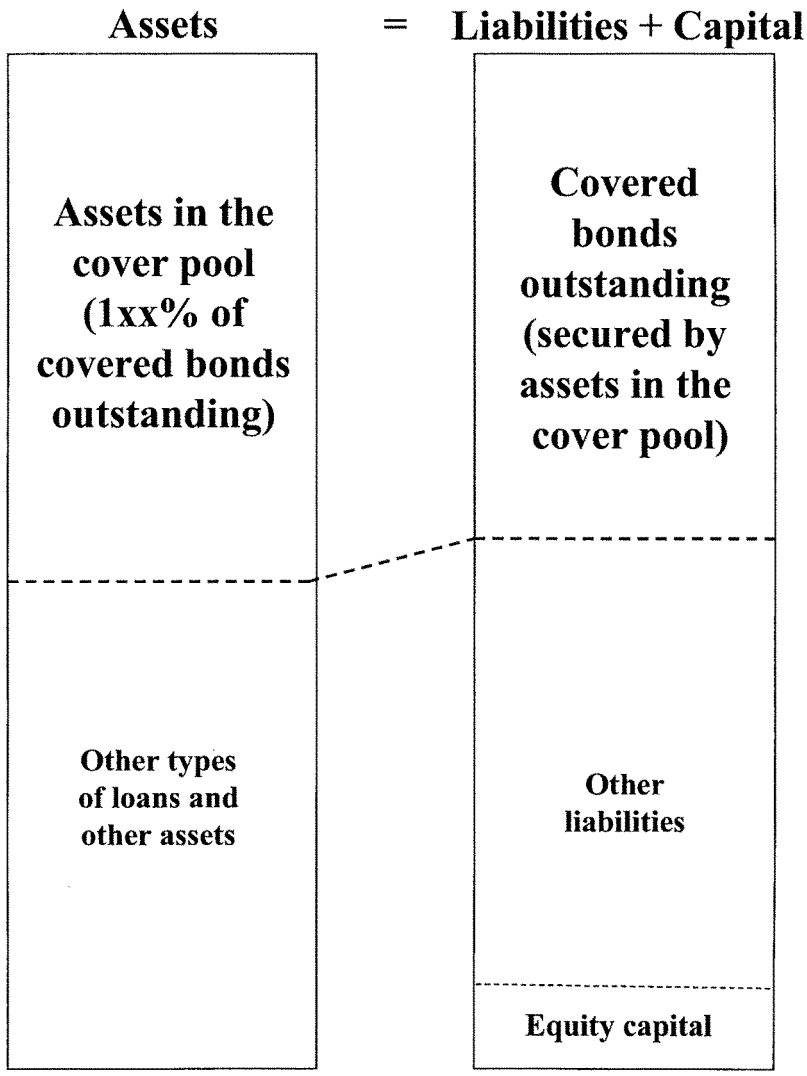
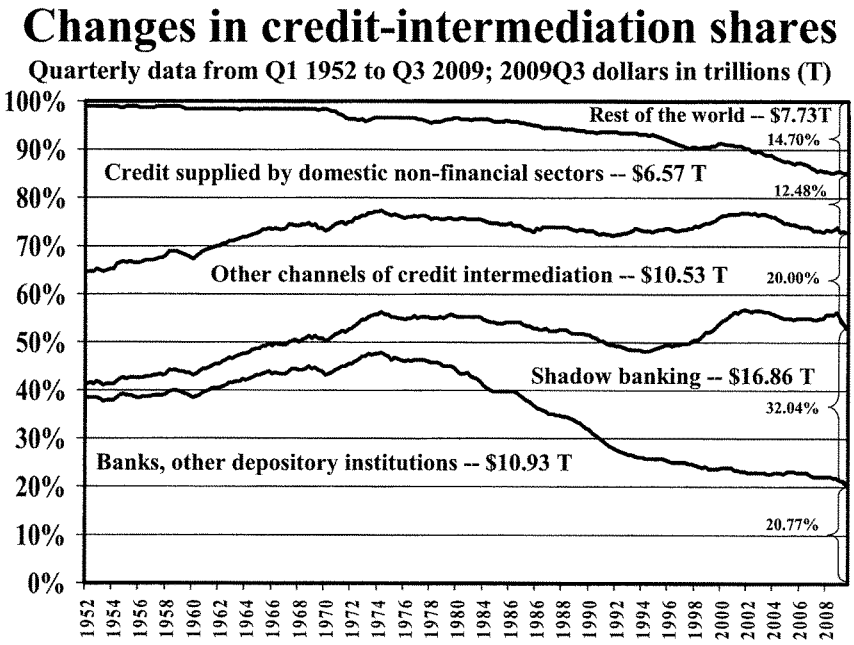


Figure 2


Changes in credit-intermediation shares
Quarterly data from Q1 1952 to Q3 2009; 2009Q3 dollars in trillions (T)
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Rest of the world -- $7.73T
14.70%
Credit supplied by domestic non-financial sectors -- $6.57 T
12.48%
Other channels of credit intermediation -- $10.53 T
20.00%
Shadow banking -- $16.86 T
32.04%
Banks, other depository institutions -- $10.93 T
20.77%
1952
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Biographical sketch for Bert Ely

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

Bert continuously monitors conditions in the banking industry as well as monetary policy. In recent years, he has focused increased attention on the GSEs, notably Fannie Mae, Freddie Mac, and the Farm Credit System. He has co-authored a monograph on how to privatize the three housing-finance GSEs. Currently, Bert is focusing his attention on banking problems, the crisis in housing and housing finance and the entire U.S. financial system, and the resolution of the Fannie and Freddie conservatorships.

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

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

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Commercial Mortgage Securities Association™ (CMSA)

TESTIMONY OF J. CHRISTOPHER HOEFFEL

ON BEHALF OF THE

COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

Hearing on "Covered Bonds: Prospects for a U.S. Market Going Forward"

December 15, 2009

Overview

The Commercial Mortgage Securities Association ("CMSA")[1] is grateful to Chairman Frank, Ranking Member Bachus, and the Members of the Committee for giving CMSA the opportunity to share its views concerning the future prospects for a covered bond market in the United States. Our members believe that covered bonds can provide a powerful additional source of liquidity for financial institutions, particularly at the present time, given that capital markets remain largely dormant for many asset classes, despite significant borrower demand.

Given severely limited credit availability in the commercial real estate ("CRE") market, we applaud this hearing and extraordinarily timely legislative proposals, offered by Capital Markets Subcommittee Ranking Member Scott Garrett and Chairman Paul Kanjorski, that would include high-quality commercial mortgages and highly-rated commercial mortgage-backed securities ("CMBS") as eligible collateral in their proposed framework to facilitate a covered

[1] CMSA is a global trade organization representing the full range of commercial real estate market finance participants, including investment and commercial banks; rating agencies; accounting firms, servicers; other service providers; and investors such as insurance companies, pension funds, and money managers. CMSA is a leader in the development of standardized practices and in ensuring transparency in the commercial real estate capital markets.

bond market. Significantly, commercial mortgages and CMBS are already permitted in covered bond pools in most European jurisdictions[2], which also accord the appropriate and necessary regulatory treatment, including capital requirements, with respect to covered bonds to facilitate the market and to better serve consumers and businesses seeking access to credit. It follows that in order to be globally competitive, any U.S. covered bond regime should include commercial mortgages and CMBS, and that the overall regulatory framework should be closely aligned with the approach used by our European counterparts. Such a framework will give U.S. consumers and businesses access to the same sources of credit availability, supporting our overall recovery.

While covered bonds should not and cannot replace CMBS as a capital source for the CRE mortgage market, facilitating a commercial covered bond market will be additive. Covered bonds can provide yet another source of liquidity for financial institutions to help raise much needed capital to fund CRE loans, and in turn, ease the current CRE credit crisis, which persists despite high borrower demand. Indeed, in the current environment, covered bonds could be a helpful means of raising capital relative to CMBS, particularly today as the cost of capital related to a covered bond deal could be less volatile than for CMBS. Such conditions also could assist financial institutions in aggregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being experienced in the CMBS market.[3]

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[2] Legislative frameworks for covered bonds in the following countries specifically permit the use of commercial mortgage loans as collateral: Austria, Bulgaria, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Latvia, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Spain, Sweden, the United Kingdom. In addition, all European jurisdictions that permit the use of residential mortgage-backed securities ("RMBS") in cover pools also permit the use of CMBS.

[3] One of the difficulties that has hindered the re-start of securitization is that institutions no longer have sufficient short- or long-term balance sheet capacity to take on aggregation risks – the non-credit risks (like interest rate changes) they must currently bear between the time a loan is made and when it can be securitized (a process that takes months across a pool of loans).

It has been widely acknowledged by market participants and financial policymakers that no government economic recovery plan will succeed without re-starting the securitization markets, and covered bonds should be viewed in the same light – that is, as an important and timely component of any economic recovery plan. Legislation will be needed to create a robust covered bond market; however, as only legislation will offer the degree of assurance the markets need that the assets securing covered bonds will go to bondholders, as contractually required, rather than to the Federal Deposit Insurance Corporation ("FDIC"), in the event that an issuing bank is taken over by FDIC and defaults on a covered bond obligation.

For these reasons, we applaud the Committee for considering a legislative proposal to facilitate establishment of a covered bond market that includes commercial real estate mortgages and CMBS. Additionally, CMSA urges financial policymakers to incorporate the much needed tools that would provide this regulatory framework in the financial regulatory reform legislation in order to support consumers and businesses that are critical to our economic recovery.

The Current State of the CRE Market

Because CMSA's membership consists of all constituencies across the entire market, CMSA has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. For example, our members continue to work closely with policymakers in Congress, the Administration, and financial regulators, providing support and practical feedback on measures designed to restore liquidity and facilitate lending in the commercial mortgage market (such as the Term Asset-Backed Securities Loan Facility ("TALF") and the Public-Private Investment Program ("PPIP")). CMSA also actively participates in the public policy debates that impact the commercial real estate capital markets.

The CMBS market is a responsible and key contributor to the overall economy that historically has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. CMBS helps support the commercial real estate markets that fuel our country's economic growth. The loans that are financed through those markets help provide jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings.

However, the recent turmoil in the financial markets coupled with the overall downturn in the U.S. economy brought the CMBS market to a standstill earlier this year, and while the market is now showing a few signs of life, it is far from recovering. These circumstances create many pressing challenges, specifically:

- Little to no liquidity or lending – While the CMBS market provided approximately $240 billion in commercial real estate financing in 2007 (nearly 50% of all commercial lending), CMBS issuance fell to $12 billion in 2008, despite strong credit performance and high borrower demand. There has been approximately $1 billion of private label CMBS issuance in 2009, as the lending markets remain sluggish;
- Significant loan maturities through 2010 – At the same time, there are significant commercial real estate loan maturities this year and next – amounting to hundreds of billions of dollars – but the capital necessary to re-finance these loans remains largely unavailable and loan extensions are difficult to achieve; and
- The U.S. economic downturn persists – The U.S. recession continues to negatively affect unemployment as well as consumer and business confidence, which impacts commercial and multifamily occupancy rates and rental income, as well as business performance and property values.

The economic recession that began as a crisis of liquidity in some sectors transformed into a crisis in confidence that affected all sectors, and it was only a matter of time before CMBS was affected under the above conditions. This unfortunate combination of circumstances leaves the CRE sector and the CMBS market with several overarching problems: 1) a liquidity gap (the difference between borrowers' demand for credit and the nearly non-existent supply of credit); 2) an equity gap (the difference between the current market value of commercial properties and

what is owed on them, which will be extremely difficult to refinance as current loans mature); and 3) there is general apprehension among CMBS sponsors to aggregate loans for securitization, since they do not have the short or long-term balance sheet for this risk,[4] and there is no definite assurance that private sector investors will buy the securities, all of which serves to simply perpetuate the cycle of severely constrained credit markets.

We believe that the development of a robust covered bond market in the United States can assist in easing the CRE credit crisis, as covered bonds can provide banks with a means to allocate capital that can be used to fund CRE mortgages among others. While covered bonds cannot replace CMBS as a capital source because of the more circumscribed nature of covered bonds (e.g., limitations on quality of collateral, and the fact that covered bond transactions remain on-balance sheet), the effect of a covered bond market as another financing tool will be beneficial overall.

The additional source of liquidity for the CRE market that covered bonds can provide will be all the more important because recent changes in accounting rules and other regulatory changes may further erode liquidity and hamper lending in the commercial sector, even as the rest of the economy attempts to recover. The challenges for the CRE sector highlight the importance of the amendments the Committee has adopted to help support a recovery in the CMBS market and the overall CRE sector. These amendments to the securitization reform bill include a reduction in the maximum risk retention (i.e., "skin-in-the-game") requirement from 10% to 5%, and customization of the risk retention provisions to reflect the unique nature of the

[4] As previously noted, in the absence of a warehouse lending facility or similar mechanism to facilitate aggregation of loans for pooling in a securitization, CMBS sponsors have been reluctant to securitize. This is especially true now when there still is uncertainty as to whether there will be willing investors at the end of the process.

CMBS market[5], which utilizes a third-party investor who purchases the first-loss position and re-underwrites all loans during the pre-issuance period.[6] We commend the Committee for its foresight, and for its continued consideration of other tools, like covered bonds, that could aid the recovery of the CRE market.

The FDIC has already established a policy to facilitate a covered bond market in the residential mortgage sector. The current difficulty in securitizing commercial real estate mortgages and the overall state of the CRE market reflect that now, more than ever, the additional source of liquidity that covered bonds could provide is needed, and should be permitted, for the CRE mortgage market.

A Primer on Covered Bonds

Covered bonds originated in Europe, and are securities issued by a financial institution and backed by a specified pool of loans known as the "cover pool," to which bondholders have a

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[5] There are significant differences between CMBS and other asset-backed securities markets, including:

1. the borrower (sophisticated business with income producing property who has a non-recourse loan);
2. the structure of CMBS (100-300 loans in a CMBS bond; non-statistical analysis performed on CMBS pools; rating agencies and investors gather and review information about the property, loan and business);
3. the existence of third-party investor, or "B-piece buyer", who purchases the first-loss position, conducts extensive due diligence, and re-underwrites proposed loans in a potential pool (with "kickout" rights);
4. greater transparency (CMBS market participants have access to loan, property and bond-level information at issuance and while securities are outstanding through the CMSA Investor Reporting Package®).

[6] CMSA supports retention provisions that are customized to reflect the unique nature of the CMBS market, which utilizes a third-party investor who purchases the first-loss position and re-underwrites all loans during the pre-issuance period. Such language would maintain and strengthen the safeguards that exist in the CMBS market by explicitly recognizing the important role of third-party investors who purchase the first-loss position and provide extensive due diligence. Additionally, it would not preclude retention by the originator/issuer, but instead grant additional flexibility to allow a third-party investor to satisfy the retention requirement. The retention issue is of particular concern in light of new accounting standards, FAS 166 and 167, which could result in significantly less credit availability.

preferential contractual claim in the event of the issuer's insolvency. In the United States, a typical covered bond transaction involves an insured depository institution ("IDI") selling mortgage bonds, secured by the cover pool, to a trust or similar entity (known as a "special purpose vehicle" or "SPV"). The pledged mortgages remain on the IDI's balance sheet securing the IDI's promise to make payments on the bond, and the SPV sells "covered bonds," secured by the mortgage bonds, to investors. In this fashion, the IDI generates more capital which can be used, in turn, to make more loans or provide financial institutions with a bigger cushion for their regulatory capitalization requirements. In sum, covered bonds are an elegant mechanism for generating more liquidity in the capital markets.

A problem arises, however, if the IDI becomes insolvent and the FDIC assumes control as a receiver or conservator. Once the FDIC takes over, there can be uncertainty about whether the FDIC would continue to pay on the bond obligation according to the bond's terms, or whether it will repudiate the transaction. If the IDI is also in default on the bond, there also can be uncertainty regarding the amount that investors would repaid, or at the very least, delay in allowing investors access to the bond collateral. The transactions can be hedged to alleviate some of these risks, but this increases transaction costs. In the face of such risks, investors were reluctant to invest in covered bonds to any significant degree; the FDIC reported in July 2008 that only two banks had issued covered bonds.

The FDIC recognized that covered bonds could be a "useful liquidity tool" for IDIs and the importance of "diversification of sources of liquidity."[7] Therefore, to provide a measure of certainty to encourage investment in covered bonds, the FDIC issued a Policy Statement in 2008 setting forth directives explaining how it would handle certain types of covered bond obligations

[7] Covered Bond Policy Statement, Final Statement of Policy, FDIC, 73 Fed. Reg. 43754, 43754 (July 28, 2008).

where it has assumed control of an IDI. Unfortunately, the FDIC limited the scope of its Policy Statement to covered bonds secured by "eligible assets," and limited the definition of "eligible assets" to residential mortgages. As a result, a market for covered bonds in the CRE mortgage sector has not developed.

A Potential "Additive" Financing and Liquidity Tool for the CRE Market

CMSA believes that legislation is needed to create a robust covered bond market because only legislation will offer the degree of assurance the markets need that the assets securing covered bonds will go to bondholders, as contractually required, rather than to the FDIC if an insolvent IDI in receivership defaults on a covered bond obligation.

Furthermore, incorporating highly rated CMBS and high quality commercial mortgage loans as collateral for covered bonds will help generate additional liquidity for the CRE mortgage market; thus, supporting other initiatives such as TALF and PPIP that have already been undertaken by the government to ease the credit crisis. Covered bonds clearly cannot take the place of the securitized credit markets (such as CMBS) but covered bonds will undoubtedly be a useful adjunct to securitization.

Banks require adequate liquidity and funding sources for commercial mortgage loans just as they do for residential mortgage loans. As of September 30, 2009, FDIC insured institutions held approximately $1,089,900,000,000 of commercial mortgage loans.[8] The origination of commercial mortgage loans is part of the core lending business of IDIs. Moreover, the funding of commercial mortgage loans is vital to the U.S. economy. IDIs have frequently looked to securitization as a source of funds for commercial mortgage lending. However, as FDIC Chairman Bair noted in testimony before the Senate Committee on Banking, Housing and Urban

[8] Source: FDIC quarterly banking profile. Includes "non-farm non-residential" loans only; does not include construction and development loans or loans held by foreign branches of domestic banks.

Affairs on March 4, 2008, "upheavals that began in residential markets now affect commercial real estate capital markets, resulting in sharply curtailed liquidity....Securitizing commercial real estate loans has become difficult." For these reasons, covered bonds can create a much needed supplemental source of funding in the current market.

Moreover, covered bonds will provide a desirable additional funding strategy even following a recovery of the securitized credit markets for commercial real estate. Covered bonds are typically rated "AAA" or "AA." Their high rating, as well as the combination of high quality securities and the fact that there are dual sources of repayment (i.e. both the issuing entity and the cover pool) generally attract a different, more conservative class of investors than securitization, thereby expanding the pool of capital available to fund commercial mortgage loans. An expanded capital pool means greater lending capacity, which can only help ease the current credit crisis and help avoid or minimize future ones.

Further, the higher rating of covered bonds generally translates into a lower cost of funding for the issuer, which ultimately has a positive effect on the availability of credit. Covered bonds also can supply capital to banks in a form that offers substantial benefits from a risk management perspective. As Chairman Bair has emphasized, on-balance-sheet funding tools like covered bonds encourage especially strong underwriting. This is equally true with respect to underwriting of commercial mortgage loans.

Beyond the opportunities for the CRE market, it should be kept in mind that a covered bond market can do the same for other types of asset-backed securities, such as auto loans, student loans, small business loans, residential mortgages and credit card receivables. Equally important, a broader covered bond market would be extraordinarily helpful to smaller banks that do not have ready access to securitized credit markets because these institutions lack a critical

mass of collateral in one asset category. The ability to use diverse asset cover pools that could be available through a broad covered bond regime will give smaller banks a useful new source of capital. As such, we commend the Committee for considering a covered bond proposal that expands eligible collateral to other ABS classes in addition to CRE mortgages and CMBS.

Finally, we note that European nations' experience with covered bonds is instructive, and can provide guidance to policymakers that a comprehensive covered bond market will support the nation's economic system. As mentioned, covered bonds originated in Europe, and have a long, stable history of expanding credit opportunities for consumers and businesses.

European banking regulations reflect a considerable degree of confidence in the soundness of covered bonds. Indeed, these regulations (known as the CRD Directive) give qualifying covered bonds a significantly more favorable risk weighting treatment (generally two to three times more favorable, depending on the applicable risk-weighting scheme) than other senior debt issued by the same institution. The overseas regulations also include loan eligibility standards for covered bonds that permit unlimited use of commercial mortgage loans that meet the required eligibility standards, and permit use of CMBS to the same extent as use of RMBS. In fact, a 2007 Fitch Ratings study of 61 cover pools issued by 48 issuers in 11 countries found that commercial mortgage loans constituted 11% of the assets in all mortgage cover pools reviewed in the study; a similar study in 2006 (51 cover pools, 38 issuers) found that commercial mortgage loans constituted 29% of the assets in reviewed mortgage cover pools. The use of commercial mortgage loans as covered bond collateral is so well-established in Europe that the European Covered Bond Council, in preparing tables showing collateral types for its Covered Bond Fact Book, does not differentiate between residential and commercial mortgage loans but treats them as a single category.

Critically, however, in order for any U.S. covered bond market to be successful and globally competitive, U.S. regulatory requirements pertaining to covered bonds need to be on equal footing with regulatory requirements in Europe so that U.S. financial institutions, as well as consumers and businesses that benefit from such credit, are not at a competitive disadvantage. Specifically, for example, we would recommend that regulatory policymakers adopt capital requirements for covered bonds similar to what our European counterparts have adopted, fostering the same type of regulatory convergence that policymakers have attempted to achieve in other areas, such as accounting standards.

As a result of the widespread use of commercial mortgage loans to secure covered bonds in Europe, rating agencies that rate covered bonds are familiar with and experienced in rating covered bonds with cover pools that include commercial mortgages. Moreover, a cover pool with a mix of commercial and residential mortgage loans as well as CMBS and RMBS may have positive implications on the rating process because it diversifies the risk profile of the cover pool. This would add to the viability of a robust U.S. covered bond market. Accordingly, we applaud legislative proposals that incorporate high-quality commercial mortgages and highly-rated CMBS in the definition of "eligible mortgage," as well as other types of assets, and that will improve the ability of financial institutions to utilize covered bonds as part of a prudent liquidity management framework for their loan portfolios.

Conclusion

The commercial real estate sector continues to face enormous challenges. Our members appreciate the efforts that have already been undertaken by policymakers to help bring capital and liquidity back to the CRE mortgage market. To enhance these efforts, CMSA urges Congress to pass a legislative framework for a covered bond market in a timely manner in order

to provide a level playing field for U.S. institutions globally, and to offer a degree of assurance needed by investors that the assets securing covered bonds, including CRE mortgages and CMBS, will go to bondholders as contractually required, if an issuing bank is taken over by the FDIC.

Today, financial markets overseas have this regulatory framework that has provided an important and additional tool that promotes the efficient allocation of capital and overall lending. Such a framework is much needed in the Unites States to give consumers and businesses the opportunity to benefit from the same sources of credit availability, and to support our overall economic recovery.

Written testimony of Wesley Phoa

Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. My name is Wesley Phoa, and I am a senior vice president, investment analyst and bond portfolio manager at the Capital Group Companies, a privetely owned investment management firm. Thank you for the invitation to appear before you today.

I appreciate your interest in investigating the covered bond market and how it may play a role in your broader efforts to ensure that we develop a stable and well functioning financial system. And I welcome the opportunity to give you an investor's perspective on this market, and to answer your questions.

A little background. My firm invests money on behalf of mutual fund shareholders, pension funds, endowments and other institutional investors. We were founded in 1931, and pursue a very traditional style of investing. Our clients have entrusted a total of about a trillion dollars to us, which we invest in stocks and bonds. We are active investors; we conduct extensive research on individual companies around the world, and on the economy as a whole, and make investment decisions on that basis.

I should say that my firm encourages diversity of opinion, and therefore the opinions expressed below are mine alone – though they are based on many internal discussions and long experience on the part of my fellow analysts and portfolio managers.

Investors have different needs, and we seek suitable investments from around the world that meet those various needs. Workers saving for retirement have to build their savings, and for them we try to purchase shares in good companies, whose price will rise over time. Retirees need a reliable income to support them, and so we try to find stocks and bonds that will generate the income they require. And almost everyone needs to protect a portion of their savings through hard economic times and difficult markets; so we must also find good, sound investments whose value will hold up in rough times; this means investing for safety, not just growth or income.

As you know, a covered bond is a bond issued by a bank or other financial firm, which is secured by a specified pool of assets on the bank's balance sheet. The bank must make principal and interest payments on the bond, and if the bank fails, then bond investors have recourse to the collateral.

An active, well designed covered bond market would enable financial firms to issue safe, desirable securities, letting them tap a broader base of investors in good times and bad. This would create a new source of funding for these firms, that they could rely on in difficult periods, which could reduce their need to turn to the Government for help.

And such a market could help serve our clients' needs in several ways. First, when investing for safety, we would be able to diversify beyond Government bonds and Government sponsored securities. Second, covered bond financing provides funding for loans that are retained on balance sheet, and this helps align issuers' interests with those of investors; such alignment of incentives is another stabilizing force. Third, by giving financial firms another funding option in difficult times, it should make them more likely to survive distress, and thus make them more attractive investments at all times. Fourth, it

should reduce firms' reliance on Government support, so that outcomes will depend less on discretionary policy decisions, which are very difficult to analyze. And it should help credit to flow more freely during difficult times, making the credit markets more robust during downturns, and lowering the cost of capital through the economic cycle.

Let me say a little bit more about each of these subjects.

On investing for safety. When times are hard and the system comes under severe stress, investors move to Government bonds. This has worked well, as it should, but not without costs. We sacrifice income, we sacrifice diversity, and we make our portfolios more sensitive to Government policy decisions. Private sector alternatives would be useful. In Europe, the covered bond market has been one such alternative. We've invested in *pfandbriefe* – German covered bonds – for two decades. They've been a sound investment and achieved their purpose. Firms which can tap this market have access to a broader and deeper base of debt investors. That makes them more robust in bad times and more efficient at all times.

On alignment of incentives. Covered bonds give financial firms who choose to retain loans on their balance sheets a way of funding them efficiently without selling them, via securitization or otherwise. When loans remain on balance sheet, the issuer continues to bear the full risk of credit losses, which imposes a useful discipline on lending. That creates a natural alignment of interests and incentives between financial firms and their investors; though clearly there are a variety of other ways to address this issue.

On funding in difficult times. If a firm gets into trouble – and one firm or another always will, from time to time – it often has to rely on secured funding to make it through. And investors are often willing to provide secured financing to a troubled firm even when the unsecured debt market is not available to them. The risks are lower, more readily analyzed, and thus easier to accept. A well developed, standardized covered bond market would hopefully give troubled firms reliable access to an important funding option, provided only that they have good assets to serve as collateral. This would help to alleviate the need to develop special programs or other initiatives that were necessary during the credit crisis to help stabilize financial institutions' access to funding.

On Government support and policy decisions. During the course of the financial crisis, the Federal Reserve, the regulators, the Administration and Congress all intervened at various times and in various ways to help support the financial system. There are compelling arguments that many of these actions were unavoidable and necessary. However, as an investor, it is difficult or impossible to anticipate *ad hoc* policy responses to crisis situations. This creates uncertainty.

Investors may respond to this in two different ways. If they are prudent, they demand higher returns to accept this kind of uncertainty. That is, when the future of firms depends on policy decisions that are very hard to analyze, both raising equity and obtaining debt finance tend to be more expensive and less certain. The cost of capital in the economy rises more than it should.

Written testimony of Wesley Phoa

On the other hand, investors may be complacent, and assume that the Government will always ride to the rescue. This is not a good thing. It creates moral hazard problems which, in the end, can be even more costly.

Ultimately, in the last resort, the Government should always retain the power to step in if it so chooses, when there is a sufficiently severe crisis. But the less often this happens, and the more predictable the process is, the lower the uncertainty overall, and the lower the economic costs. Thus, it is desirable to have more robust private sector mechanisms.

Finally, on the robustness of credit markets and the cost of capital. When markets are more robust, when investors face less uncertainty and thus demand lower risk premia, the whole economy operates more efficiently. This seems to be one important goal of financial reform, and if a covered bond market can give firms a new, reliable funding option, it can play a useful role there.

I should now turn to our recent experience with the covered bond market.

As I mentioned before, we have been long-standing investors in the European covered bond market. In the United States, an active covered bond market has never become established. Mortgage finance has relied more heavily on Government sponsorship, via Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, as well as the Federal Housing Administration. In addition, in more recent years, securitization had played an increasingly important role. So while structures resembling covered bonds had existed in the past – the old mortgage-backed bonds which were issued by thrifts when they encountered liquidity problems in the late 1970s – this did not become a permanent feature of our domestic bond market.

I was very encouraged when a US covered bond market started to emerge in the years immediately before the crisis. While only two US financial institutions raised covered bond financing, a number of European banks also tapped the US dollar markets, and it looked as if a reasonably diverse market was starting to evolve.

Unfortunately, the global financial crisis intervened. As you know, this severely affected all parts of the private sector bond market. The European covered bond market actually weathered the crisis reasonably well, though liquidity declined as dealers' ability to make markets was adversely affected. The new issue market went away for a while, but as crisis conditions abated, European banks were able to resume issuing covered bonds well before they could issue new unsecured debt with no Government guarantee.

The nascent US covered bond market did not fare as well. I believe there were a number of related reasons for this. First, it was immature, and thus suffered disproportionately as investors lost their taste for anything new or different. Second, the investor base was still fairly narrow at the time the crisis struck, as most investors were still evaluating the market from an economic, legal and regulatory point of view. Third, liquidity deteriorated much more sharply than in the European market. And finally, uncertainty about decisions being taken by policymakers and regulators, especially in insolvency resolution, weighted quite heavily on investors' minds. The legal framework under which

the US covered bond market was established offered us significantly less clarity than the more specific principles enshrined in European covered bond legislation.

During the course of 2008, the authorities did take a number of actions to mitigate some of these concerns: notably the FDIC's Policy Statement, the Treasury Department's Best Practices document, and the favorable treatment of covered bonds (in contrast to unsecured debt) in the resolution of Washington Mutual. But administrative and regulatory actions did not suffice to dispel investors' uncertainty.

Investors can live with economic uncertainty. That's our job. But uncertainty about institutions and policies is problematic. Sound investment analysis relies on a clearly defined framework of rights and duties. That's a critical element of investor confidence.

At this point, then, it would be extremely helpful for this market to make a fresh start on a sound legislative basis. Our experience in European jurisdictions suggests that such a market would be appealing, and the prospects for success are bright. Past disappointments have by no means discouraged us for good. Rather, if an improved market structure emerges, it's our duty to our clients and mutual fund shareholders to evaluate it and, if it helps us meet their needs, to be significant, long-term investors.

We're also investors in banks and other financial firms, and I should say a word about how covered bond financing could help those firms to make loans and manage their businesses prudently, especially through difficult economic environments, since that matters a great deal to investors.

It's possible to issue covered bonds of varying maturities, from short to long. This would help banks match their wholesale funding to their long-term assets more closely, reducing their balance sheet risks. The assets securing the bonds are retained on balance sheet, so issuers can continue to work cooperatively with borrowers who are in trouble, in contrast to securitization where the scope for loan modifications is much more restricted. And as I mentioned, the retention of loans on balance sheet is one way to reduce potential conflicts of interest between lenders, borrowers and investors – a key criticism of the originate-to-distribute model that became widespread in the pre-crisis period.

Most importantly, the ability to issue covered bonds will enable banks to tap a broader base of debt investors. Banks will be able to fund themselves more efficiently in good times, fewer banks will fail in bad times, and banks will retain more flexibility to meet the needs of their customers and to mitigate their own credit losses by helping borrowers through rough patches. It should also mean a more level playing field for debt finance, which should help smaller banks retain access to bond financing in difficult markets.

The potential benefits are greater if covered bonds can be used to finance various different kinds of loans rather than simply mortgages. Traditionally, European covered bonds had only been used to finance residential mortgages and loans to public sector entities. But there's no reason in principle why they shouldn't be collateralized by other kinds of consumer loans, or by loans to small businesses. This may make the covered bond market an even more helpful financing tool.

Written testimony of Wesley Phoa

So what do investors look for in a covered bond market? What would make it function effectively as an attractive place to invest?

First, fundamental soundness. The bonds should be backed by enough collateral, and the collateral should consist of good loans. That's the basic principle of covered bonds.

Second, liquidity. We have to be able to buy and sell these securities freely, in good and bad markets. I believe that's something that the private sector can sort out for itself.

Third, an adequate return. As safe as these bonds may be, we can't invest in them without doing our own due diligence. We'd therefore require them to have better returns than Government bonds, though we should logically accept lower returns – and lower risk – than for unsecured debt.

Fourth, good oversight. Appropriate regulation is important. It's played a key role in helping covered bond markets to thrive in other jurisdictions. Good regulation includes disclosure, transparency, and clear standards that issuers must meet.

Fifth, and crucially, legal and policy certainty. We need to be sure about the legal standing of our investments. We need to know what will happen when an issuer fails. And we need to be reasonably confident that we know what legal rights the various parties have, and what procedures will be followed when an issuer fails. We understand that no investment comes without its own risks; but we need to have enough clarity so that we can analyze those risks and be confident about our conclusions.

If these conditions are met, I think the potential investor base is very broad.

A word on timing. It takes time for a market to establish itself, and it takes time for investors to become familiar with new kinds of securities and to find a place for them in their portfolios. A deep and liquid covered bond market won't spring into existence overnight. But I think it's important to make a start as soon as possible. And today's environment, where there are plenty of savings looking for a conservative home, is, I think, quite conducive to the development of this market.

To sum up, it's good for the economy and good for investors if we have a private sector financial system that's stable and robust, that can stand on its own two feet during recessions – even severe ones – and continue lending freely, on prudent terms, to households and small businesses. A healthy covered bond market established on a firm legal basis should make an important contribution towards this goal.

Again, I appreciate the opportunity to testify before the Committee, and I hope my remarks have been of some assistance.

TESTIMONY OF SCOTT A. STENGEL
BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES

Hearing on
"Covered Bonds: Prospects for a U.S. Market Going Forward"

December 15, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee, 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 funding the needs of consumers, small businesses, and State and local governments.

I am a partner in the Washington, D.C., office of Orrick, Herrington & Sutcliffe LLP and a member of the Steering Committee for the U.S. Covered Bond 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 an efficient market for U.S. covered bonds.[1]

Recent reports have confirmed what we are seeing on the ground: Our nation's economic recovery remains slow and uneven, and the foundations of our financial system are not yet fully repaired. Weakness persists in the labor market, with over 17% of Americans being either unemployed or underemployed. Nearly one out of every four U.S. homeowners is underwater on a mortgage, and some economists are projecting that home prices now will not reach bottom until 2011. Multi-family and other commercial real estate is also suffering as property values continue their precipitous decline and loans mature without clear options for refinancing. In this volatile environment, credit remains relatively tight for both families and small businesses, public-sector resources are increasingly strained, and consumers are understandably cautious.

In the Council's view, sustained economic growth begins with a stable financial system. This, in turn, requires an ample supply of 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**) and the American Securitization Forum (**ASF**).

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, visit www.sifma.org.

ASF is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory, and market practice issues. ASF members include over 340 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education, and training on a range of securitization market issues and topics through industry conferences, seminars, and similar initiatives. For more information about ASF, its members, and activities, please go to www.americansecuritization.com.

We believe that U.S. covered bonds are an untapped but proven resource that could be invaluable in meeting this need. We also believe that, with the success of a fragile economic recovery hanging in the balance, the time for U.S. covered bonds is now.

Much has been written about U.S. covered bonds in the last year, 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. They have maturities that typically range from 2 to 10 years and that can even extend out to 15 years or more. This kind of stable funding allows banks 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 disruptions 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 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 supplying 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 shift their allocation of already existing sources. Such diversification, not only in the kinds but in the sources of liquidity, is crucial to reducing systemic risk and securing the financial system.

Equally important, covered bonds deliver funding from the private-sector capital markets without any reliance on U.S. taxpayers for support. Secretary Geithner's decision last week to extend his authority under TARP is a stark reminder of how dependent the financial system remains on government intervention. That kind of intervention not only exposes the taxpayers to risk but also creates dislocations in the market that inhibit the private-sector economy from generating a self-sustaining recovery. Covered bonds, which have demonstrated resilience even

in distressed market conditions, can serve as an important bridge from an economy that is limping and requires 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 institution 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. Covered bonds, of course, are not 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 adopted by this Committee and the House as part of the Wall Street Reform and Consumer Protection Act of 2009, covered bonds represent a critical first step – and one that, in this constrained credit environment, is urgently needed now.

To function successfully, however, 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 (**Treasury**) and the Federal Deposit Insurance Corporation (**FDIC**) last year 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 this past year, 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.

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 does not allow for ambiguity on the rights and remedies available at law, especially in the event of the issuing institution's insolvency.

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 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 non-monetary 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 do not exist under the legislative frameworks found in Europe, and investor concerns are only exacerbated by the lack of any public supervision focused solely on their interests. Such a legal environment simply cannot support a long-term, high-grade instrument that benefits the issuing institution – and ultimately consumers, small businesses, and the public sector – with cost efficiencies that cannot be realized through senior unsecured debt or other forms of financing.

Of equal concern to market participants is an inability in the United States, under current resolution schemes and other existing law, to manage the cover pool and maximize its value if the issuer were to default or become insolvent. In the absence of a covered-bond regulator and a specialized resolution process, covered bondholders are left with no alternative but to conduct their own fire sale of the cover pool at a time when conditions may be far from ideal. This unnecessarily exposes them to levels of market and liquidity risk that increase the likelihood of losses being realized and that, quite simply, are unacceptable.

For these reasons, the Council has concluded that a well-functioning market for U.S. covered bonds cannot develop without a legislative framework.

This is not to say, however, that the resulting vacuum would remain unfilled. European issuers that can take advantage of legislative frameworks in their home countries will continue to

capture the investor demand for covered bonds that is growing in the United States. With governments in Europe providing the requisite legal certainty for covered bonds issued by their domestic institutions, the playing field would grow increasingly uneven in the fierce competition among banks for less expensive and more stable sources of funding. U.S. financial institutions also would lose the valuable liquidity buffer that covered bonds can provide and that, just last week, was highlighted by the Committee of European Banking Supervisors in its Guidelines on Liquidity Buffers and Survival Periods.

The cost of such an outcome, of course, would 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 would need to be passed along to them; when not, credit would need to be denied altogether. Neither result can be described as at all desirable.

The Council, therefore, fully supports the kind of comprehensive covered-bond legislation that Congressman Garrett offered in this Committee's mark up of the Wall Street Reform and Consumer Protection Act of 2009.

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 22(4) of the Directive on Undertakings for Collective Investment in Transferable Securities (**UCITS**). Compliance with Article 22(4) is what gives covered bonds their unique status in Europe, including privileged risk weighting under the EU's Capital Requirements Directive (**CRD**) and preferential treatment by the European Central Bank in Eurosystem credit operations.

  We therefore support a framework that includes the following: The Treasury or another U.S. government agency would be appointed as the Covered Bond Regulator, which would have as its mission the protection of covered bondholders. The Covered Bond Regulator would work together with each issuer's primary federal regulator to 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 with the issuer's primary federal regulator. The Covered Bond Regulator would maintain a public registry of approved covered-bond programs.

- *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) FDIC-insured depository institutions and their subsidiaries, (2) bank holding companies and savings and loan holding companies, (3) regulated financial companies that are subject to stricter prudential standards and that are approved by the Covered Bond Regulator, 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 non-deposit senior recourse debt obligation of an eligible issuer that (1) has an original term to maturity of not less than one year, (2) is secured directly or indirectly by a perfected security interest in a cover pool which is owned directly or indirectly by the issuer, and (3) is issued under a covered-bond program that has been approved by the Covered Bond Regulator.

- *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 highest quality.

- *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.

- *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 and collection risks 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. In order to ensure that the cover pool's value is not lost because of temporary disruptions in the market, the estate should have access to a liquidity facility that is provided by the Federal Reserve Bank of New York or another U.S. government agency. Importantly, however, advances would be made under this facility only on terms that do not expose U.S. taxpayers to any credit risk.

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 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 or its creditors (including the FDIC) 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. 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) 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 15 days to transfer the covered-bond program to another eligible issuer. The FDIC as conservator or receiver would be required, during the 15-day period, to perform all monetary and non-monetary 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 15-day period, 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 (but subject to any right of repudiation or rejection), to continue servicing the cover pool for 120 days.

The Covered Bond Regulator would be appointed as the trustee of the estate and would be required to appoint a servicer and administrator for the cover pool. The servicer and administrator would be obligated to collect, realize on, and procure funds using the cover pool and to 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 entitled to borrow from the Federal Reserve Bank of

New York or another U.S. government agency to manage market and liquidity risks during the resolution.

- *Securities Law Provisions* – With the issuance of covered bonds being limited to regulated institutions and with covered-bond programs being subject to public supervision by a covered-bond regulator, we believe that the securities regulations promulgated by each issuer's primary federal regulator will be more than adequate. The reach of other federal securities laws, however, is not always clear, and because legal certainty for covered bonds is paramount, the legislative framework should address this subject. The legislation also should ensure that neither pooled issuances nor programs that utilize a bank subsidiary are disadvantaged in any way.

We therefore support a framework that includes the following: Covered bonds that are offered and sold to the public by a bank or a bank subsidiary would be subject to securities regulations issued by the primary federal regulator of that bank and applicable anti-fraud rules. Covered bonds that are offered and sold to the public by an issuing entity sponsored by one or more banks with the same primary federal regulator would be subject to securities regulations issued by that regulator and applicable anti-fraud rules. The Securities and Exchange Commission would be directed to develop a streamlined registration scheme for other covered bonds that are not otherwise exempted securities. Disclosure and reporting standards would be governed by the same applicable regulations and rules. All exemptions would extend to any estate that is created after default or insolvency and to any residual interest, and the estate would not be treated as an investment company under the 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. 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.

In addition to these elements of a legislative framework, the Council also believes that U.S. covered bonds should be assigned a favorable risk weighting like that found under the CRD in Europe. And because of the stability that the covered-bond market can supply through long-dated maturities and enhanced public supervision, we believe that U.S. covered bonds should be exempted from any haircuts or other limits that may be imposed on the claims or rights of secured creditors (such as those originally proposed in the Miller-Moore amendment to the Wall Street Reform and Consumer Protection Act of 2009).

TESTIMONY OF SCOTT A. STENGEL

On behalf of the Council, I want to thank Chairman Frank for holding this hearing and Congressman Garrett for his leadership in proposing a legislative framework for U.S. covered bonds.

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

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March 29, 2010

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

Re: December 15, 2009, hearing on covered bonds

Dear Mr. Chairman:

At the hearing the Committee held on December 15, 2009, titled Covered Bonds: Prospects for a U.S. Market Going Forward, you asked me a question regarding my recommendation, on page 7 of the written testimony I submitted to the Committee, that

> The Federal Reserve Bank of New York should be empowered to lend, on a collateralized basis, to the covered-bond trust or estate such funds as may be needed to enable the trustee to make timely payments of principal and interest on the covered bonds.

I am writing today to expand upon my answer, for inclusion in the record of the covered-bond hearing. However, in considering this recommendation further, I have concluded that this lending authority should apply to any Federal Reserve bank.

Essentially, statutorily implementing my recommendation would provide an important liquidity backstop to covered bonds without creating any taxpayer risk. The sole purpose of this backstop would be to ensure the timely payment of principal and interest on outstanding covered bonds. This backstop would greatly increase the likelihood that covered bonds issued under a covered-bonds statute will earn, and be able to retain over their life, an AAA credit rating. That AAA rating is key to achieving the lower mortgage interest rates covered-bond financing will deliver to borrowers.

The importance of a Fed liquidity backstop was reinforced by a revised rating methodology for covered bonds that Standard and Poor's (S&P) issued the day after I testified.[1] One element of the S&P methodology is the ability of a covered-bond program, under the law of the country where the program is domiciled, to raise funds through asset sales and/or "borrowing

[1] "Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds," Standard and Poor's, December 16, 2009.

from either banks or the central bank[2]" in order to obtain either a Category 1 or Category 2 rating. [emphasis supplied]

Covered bonds issued in a country with a Category 1 rating potentially could have an S&P credit rating for the covered bonds "uplifted," or boosted, by as much as "seven notches" above the credit rating of the covered-bond issuer. That is, the covered bonds could be rated AAA even if the issuer's credit rating was a low as BBB+. A covered-bond program in a Category 2 country (S&P's likely initial classification for the United States) could have a rating uplift of as much as six notches above the issuer's credit rating; i.e., a covered bond program could be rated AAA even if the issuer was rated as low as A-. This rating "uplift" will translate into lower borrowing costs for the simple reason that higher credit ratings produce lower interest rates. Based on current corporate-bond yields, there is approximately a one-percentage-point rate differential between an AAA-rated bond and a bond rated BBB+. That rating differential could mean the difference between a 5% rate on a 30-year fixed-rate mortgage and a 6% mortgage rate.

The use of this liquidity backstop would be an extremely rare event. However, should it be utilized, its use would pose no risk of loss to a Federal Reserve bank or to taxpayers, for the following reasons.

First, cover-pool overcollateralization, "evergreening" requirements that maintain the quality of the covered-bond collateral, and maturity mismatching limits should ensure that the assets in a covered-bond cover pool generate more than enough cash flow during a given time period to cover the debt servicing requirements of the covered bonds secured by those cover-pool assets. This will be the case because (1) the continuous monitoring of the cover-pool assets by an independent cover-pool monitor should ensure that at all times the book value of the cover-pool assets exceeds the principal balance of the covered bonds outstanding by the required minimum overcollateralization percentage, (2) the average interest rate on the assets in the cover pool, net of the cost of servicing those assets, almost certainly will be higher than the interest rate on the bonds, and (3) minimal maturity mismatching between the expected life of the cover-pool assets and the scheduled principal payments on the covered bonds.

An example, will illustrate this point. Assume an overcollateralization requirement of 106%; that is, for every $1,000 of covered bonds outstanding, the cover pool has to have at all times qualifying assets worth at least $1,060. Assume also that the interest rate on the bonds is 4%, the yield on the cover-pool assets averages 5%, loan servicing absorbs .25% of that asset yield, and the bonds pay off over ten years at approximately the same rate at which the mortgages in the cover pool amortize and prepay. In this example, the net cash flow generated by the cover-pool assets, on average, would be about 8% greater, for any given time period (e.g., for a year), than the debt-service requirement on the covered bonds. The net cash flow from the cover-pool assets, due to payment arrearages and loan defaults, would therefore have to shrink approximately 7% before that cash flow dropped below the debt-service payments due on the bonds. Such a shrinkage is unlikely over a short period of time.

If the covered bonds were "bullet bonds" with relatively infrequent maturities, such as at the end of three years, five years, seven years, and ten years, there would be an ample accumulation of assets within the cover pool between bond payment dates to meet the "lumpier," i.e., less frequent, covered-bond principal payments. Interest on the covered bonds most likely

[2] Ibid., page 12

would be paid semi-annually from the generally higher rate of interest flowing into the trust or estate from the assets securing the covered bonds while mortgage principal payments and prepayments would accumulate in the trust or estate to cover the periodic principal payments due on the covered bonds.

Second, should a covered-bond issuer be placed in a receivership or bankruptcy proceeding, the receiver or the bankruptcy court would be authorized to transfer *en masse* both the covered-bond liability and the related cover-pool assets to another covered-bond issuer. Because the cover-pool assets should be worth more than the balance due on the covered bonds, this transaction should net some cash for the receivership or bankruptcy estate. Therefore, it is quite likely that such a transaction would occur soon after the covered-bond issuer was placed in a receivership or bankruptcy so as to generate that cash. Essentially, such a transfer occurred when JP Morgan Chase assumed the outstanding covered bonds which previously had been issued by Washington Mutual

Third, should a quick sale of the cover-pool assets and transfer of the covered bonds not take place, the receiver or trustee would arrange for the continued servicing of the assets and timely payment of principal and interest on the covered bonds. As discussed above, the cover-pool assets should continue to generate more than enough cash flow to meet the payments due to the owners of the covered bonds. When appropriate, the receiver or trustee also could sell selected cover-pool assets to pay off maturing covered bonds.

Fourth, if for some unlikely reason the cash flows generated by the cover-pool assets were less than the principal and interest payments due to the covered-bond investors, then and only then would the receiver or trustee turn to a Federal Reserve bank to borrow sufficient funds to cover just that cash-flow shortfall. Such an interest-bearing borrowing would be comparable to the fully collateralized discount-window loans the Fed routinely makes to banks. That is, cover-pool assets would be pledged to the Fed, after the application of the Fed's collateral haircut, to secure the amount borrowed from the Fed. Most importantly, the covered-bond investors' claim on the collateral posted with the Fed would be junior to the Fed's claim.

Additionally, the Fed could require that the posted collateral be valued at current market values. Consequently, should any collateral backing a Fed borrowing fall in market value, the receiver or trustee of the estate or trust would be required to post sufficient additional collateral from among the assets of the estate or trust to restore the Fed's required overcollateralization percentage for its loans to the estate or trust.

The value of the assets in the cover pool would far exceed any borrowings from the Fed, so there would be absolutely no question that any borrowings from the Fed would be fully and conservatively collateralized. Put another way, there would not be any need whatsoever for any external support or backing for this covered-bond support mechanism – any borrowings from the Fed would be overcollateralized entirely by cover-pool assets. The Fed borrowings would be paid off in full at such time as (1) the cover-pool assets and the associated covered bonds were transferred *en masse* to another party or (2) the cover-pool assets were sold and the proceeds used to pay off the covered bonds, after any Fed borrowings were paid off.

All Fed loans to a covered-bond estate or trust would be interest-bearing, with that interest-income flowing through the Fed to the Treasury. Therefore, the taxpayer would be compensated for whatever risk the Fed took. However, that risk will be nil. As a sweetener, that

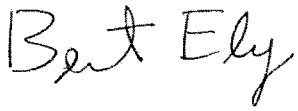
interest rate could have a slight penalty attached to it, just as the Fed now charges a higher interest rate on its "secondary credit" discount-window loans than its does on its "primary credit" discount-window loans.

This Fed borrowing authority would have a second powerful, systemic benefit – it would ensure that a cover pool was not liquidated at a time when the financial system was under extreme stress due to other asset liquidations. That is, the relatively modest Fed borrowings, used merely to cover short-term cash-flow shortfalls, would hold a substantial block of assets off the market, thereby avoiding the value-depressing effect of large, hurried asset sales and the mark-to-market losses such sales would impose on all financial firms. This positive systemic side effect of providing a Federal Reserve backstop for covered bonds, so as to prevent the forced selling of cover-pool assets, is perhaps reason enough to provide statutorily for this backstop, especially in an era of mark-to-market accounting.

Fifth, so that Congress could properly monitor Federal Reserve liquidity support for the covered-bond marketplace, any Federal Reserve bank advancing funds to a covered-bond estate or trust would report in a timely manner to Congress the amount lent, the interest rate on and other terms of the advance, and the circumstances (e.g., insufficient funds in the estate or trust to provide timely payment of principal and interest) which led the advance. Additionally, the Federal Reserve bank should certify to Congress that it will not absorb any credit or other type of loss by virtue of having made the advance. In this manner, the Fed would give Congress the assurance it needs that taxpayers will not suffer any loss in providing this most important liquidity support to the covered-bond marketplace.

I would welcome the opportunity to submit additional material for the record with regard to the question you posed to me and to meet with you or Committee staff to discuss this matter in greater depth.

Very truly yours,



Bert Ely

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