TESTIMONY OF SCOTT A. STENGEL
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Hearing on
"Covered Bonds: Potential Uses and Regulatory Issues"

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Chairman Dodd, Ranking Member Shelby, 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 contributing to our economic recovery.

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**). The Council is a collaborative forum comprised of investors, issuers, dealers, and other participants in the covered-bond market, and we strive to develop policies and practices that harmonize the views of these different constituencies and that promote a vibrant market for U.S. covered bonds.[1]

The precarious state of our nation's economy has become all too apparent. Weakness persists in the labor market, with almost 17% of Americans still unemployed or underemployed. More than half of small-business owners are experiencing cash flow issues and are expecting economic conditions to remain unfavorable for at least the next six months. Home prices in the United States have fallen 34% since their peak in 2006, and nearly one out of every four homeowners is underwater on a mortgage. The delinquency rate on loans backing commercial mortgage-backed securities has increased to a record 8.92%, even though more loans have been modified in 2010 than in the prior two years combined. 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. While the Dodd-Frank Act has supplied some important structural elements, there remains a considerable need for long-term and cost-effective funding that is sourced from diverse parts of the private-sector capital markets and that can be translated into meaningful credit for households, small businesses, and the public sector.

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.

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

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. With maturities that typically range from 2 to 10 years and that can extend out to 15 years or more, they provide a natural complement to the short- and medium-term funding that is available through the Federal Home Loan Banks and the securitization and repo markets. This kind of stable liquidity, moreover, 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 continued challenges in the securitization market, have made lending far more expensive. Spreads on long-term unsecured debt, moreover, are substantially wider than the short-term rates that have been pushed down to historically low levels by recent government initiatives, and these long-term rates could move even higher as the federal government exits those initiatives and competes for funding to finance its own budget deficits.

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

Equally important, covered bonds deliver funding from the private-sector capital markets without any reliance on U.S. taxpayers for support. The ongoing debate about GSE reform is a stark reminder of how dependent some parts of the financial system remain 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 along on government support to one that is able to stand and thrive on its own.

Two other features of covered bonds bear mention. First, in contrast to securitization, a financial 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. Because covered bonds are ultimately constrained by the balance sheets of issuers, however, they cannot be called a silver bullet, and action still needs to be taken to resuscitate securitization and other parts of the financial markets. But, like some of the measures in the Dodd-Frank Act, covered bonds represent a critical first step – and one that, in this constrained credit environment, is urgently needed now.

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**) in 2008 when they collaborated to issue, respectively, Best Practices for Residential Covered Bonds and a Final Covered Bond Policy Statement. Regulators and market participants alike hoped that, in the absence of a legislative framework, these regulatory initiatives might serve as an adequate substitute and foster the growth of U.S. covered bonds.

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

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

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

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

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

Equally troubling to investors and other market participants is the fact that this optionality resides with the FDIC, which has a rather clear conflict of interest because of its fiduciary duty to depositors and the deposit-insurance fund. The conflict was recently highlighted by the FDIC's repeated calls for legislation that would force secured creditors like covered bondholders to take a haircut even if their claims are fully collateralized – a development which, to our knowledge, would be unprecedented in the history of credit.[2]

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

Although this proposal was not adopted as part of the Dodd-Frank Act, the FDIC's advocacy was sufficiently vigorous to prompt a wide-ranging study on the subject.[3]

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

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

We are confident, moreover, that such a framework could be constructed in a way to fully protect the interests of an issuer's other creditors (including, in the case of a bank, the deposit-insurance fund) as well as any conservator, receiver, or bankruptcy trustee. Taking a bank receivership as an example once again, we would support a period of up to 180 days for the FDIC to transfer an affected covered-bond program to another eligible issuer so long as all monetary and nonmonetary obligations were performed during that time.[4] If such a transfer turned out to be impossible or inadvisable and the covered-bond program were moved to a separate estate for administration, we believe that the receivership's equity in that estate should take the form of a residual interest that the FDIC could sell or otherwise monetize immediately for the benefit of other creditors and the deposit-insurance fund. We also could support the holder of that equity interest being afforded consent rights over the selection of any servicer or administrator for the estate.

The absence of a legislative framework for U.S. covered bonds is already coming at a cost. European and other non-U.S. issuers have been taking advantage of favorable laws in their home countries and filling the vacuum. Thus far in 2010, over $18 billion in U.S. Dollar covered bonds have been targeted to investors in the United States. With governments in Europe providing the requisite legal certainty for covered bonds issued by their domestic institutions, we fear that the playing field could grow increasingly uneven in the fierce competition among banks for less expensive and more stable sources of funding.

Deposit Insurance Corporation, Statement on Systemic Regulation, Prudential Measures, Resolution Authority, and Securitization before the U.S. House Committee on Financial Services (October 29, 2009).

[3] *See* Section 215 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

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

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

The Council, therefore, fully supports the kind of comprehensive covered-bond legislation that was proposed by Congressman Garrett and the other House conferees during the House-Senate conference on the Dodd-Frank Act.

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 (the **UCITS Directive**). 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 and preferential treatment by the European Central Bank in Eurosystem credit operations.

  We therefore support a framework that includes the following: The Comptroller of the Currency or another U.S. government agency – excluding the FDIC because of its conflict of interest – would be appointed as the Covered Bond Regulator, which would have as its mission the protection of covered bondholders. The Covered Bond Regulator, in consultation with other applicable primary federal regulators, would ensure compliance with legislative requirements and would establish additional regulatory requirements that are tailored to the different kinds of covered-bond programs. Covered bonds would fall under the legislative framework only if issued under a covered-bond program that has been approved by the Covered Bond Regulator in consultation 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, savings and loan holding companies, and their subsidiaries, (3) nonbank financial companies that are approved by the Covered Bond Regulator and other applicable primary federal regulators, and (4) issuing entities that are sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis.

- *Covered Bonds* – To ensure that covered bonds retain their essential attributes as the market evolves, we support a framework that includes the following: A covered bond would be defined as a 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 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 requisite credit 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 in consultation with other applicable primary federal regulators.

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

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

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

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

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

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

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

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

If another conservator, receiver, liquidator, or bankruptcy trustee were appointed for an issuer before a default on its covered bonds results in the creation of an estate or if the FDIC as conservator or receiver did not transfer a covered-bond program to another eligible issuer within the allowed time, a separate estate would be created that is comprised of the applicable cover pool and that assumes liability for the covered bonds and related obligations. The conservator, receiver, liquidating agent, or bankruptcy court would be required to estimate and allow any contingent deficiency claim against the issuer. The conservator, receiver, liquidating agent, or bankruptcy trustee would receive a residual interest that represents the right to any surplus from the cover pool. The conservator, receiver, liquidating agent, or bankruptcy trustee would be obligated to release applicable books, records, and files and, at the election of the Covered Bond Regulator, to continue servicing the cover pool for 120 days.

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

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

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

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

On behalf of the Council, I want to thank Chairman Dodd for holding this hearing and Senator Corker and Congressman Garrett for their leadership on U.S. covered bonds.

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