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

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

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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).

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.