FedFin Client Report

Wednesday, September 15, 2010

Covered Bonds Come Out to Mixed Reviews

Client Report: **COVEREDBOND5**

Executive Summary

Yesterday, Senate Banking Committee Chairman Dodd (CT) held a hearing on covered bonds, fulfilling a promise made to Rep. Garrett (R-NJ) and Sen. Corker (R-TN) during the conference negotiations on financial regulatory reform, when language dealing with covered bonds was dropped from the Dodd-Frank Act. House action on Rep. Garrett's covered bond legislation, H.R. 5823, is pending (see Client Report **COVEREDBOND4**) in the full House. Sen. Dodd cautioned during the hearing that he doesn't intend to resolve the matter quickly. FedFin expects any action on covered bonds to be postponed until at least after the Midterm election and, more likely, until the next Congress. As detailed in this client report, covered bonds are complex and raise an array of concerns at the OCC and FDIC despite strong industry backing for the concept.

Analysis

Opening Statements

Chairman Dodd stated that covered bonds could be an additional option to the two dominant funding mechanisms in the U.S. marketplace: securitization and the portfolio-lender model. Proponents of covered bonds point to their transparency and that, while U.S. banks are not prohibited from issuing covered bonds, few currently do so. Sen. Dodd stated that there is some concern about covered bonds if an issuer goes into conservatorship or receivership, and stated that he believes legislation and agency rulemaking are needed to provide clarity.

Ranking Member Shelby (AL) stated that, when implemented under certain circumstances, covered bonds have proved to be useful. He added that covered bonds have been tried before in this country and did not achieve a high degree of success.

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Witness Statements

Panel One

Rep. Garrett stated that it is important to find ways to encourage private investment back into the capital markets without any government guarantees or subsidies, and that the covered bond market would further this goal. Mr. Garrett stated that consumers will experience lower loan rates because of additional liquidity. He stated that he wanted to try and pass H.R. 5823 out of the House within the next several weeks.

Panel Two

Julie Williams, Senior Deputy Comptroller and Chief Counsel of the OCC, stated that covered bonds are a promising funding mechanism and could serve as a new source of liquidity. She stated that they might require less collateral, and that they might attract another type of investor that might otherwise not invest in bank debt. However, new accounting rules, capital requirements and the “skin in the game” provisions in the Dodd-Frank Act (see FSM Report **ABS17**) are all factors that could affect the relative advantages and disadvantages of covered bonds versus other funding alternatives. She stated that she believes limiting entities to those already subject to federal supervision will ensure that dedicated supervisors will monitor and control the growth of covered bonds. The OCC supports a federal financial regulator that operates under a single, uniform set of standards.

Michael Krimminger, Deputy to the Chairman of the FDIC, stated that covered bonds are a potential source of bank liquidity, but noted significant concerns with the Garrett legislation. H.R. 5823 would, the FDIC fears, provide investors rights that no creditor is given under any other U.S. law. The FDIC also believes that the proposed federal framework creates an implicit guarantee akin to that of the GSEs and that thus should be avoided in favor of covered bonds in which investors take risks they understand and FDIC and other receivership rights are appropriately protected, especially through an indirect subsidy.

Scott Stengel, on behalf of the U.S. Covered Bond Council, said that covered bonds can increase transparency, but that there needs to be public supervision, as well as a separate resolution process that is clear and unequivocal.

Kenneth Snowden, Professor at UNC-Greensboro, stated that the past failures of covered bonds were due to bad timing and ineffective regulation. He added that regulation should not be abandoned just because there were past failures.

Ric Campo, CEO of Camden Property Trust, stated that it is unlikely that covered bonds could provide the capacity, flexibility, or price superiority necessary to adequately replace any of the U.S. sources of multifamily mortgage credit.

Q and A

Sen. Corker asked Rep. Garrett about improvements to the covered bond bill passed by the House FinServ Committee. Rep. Garrett responded that one was with respect to asset classes. Mr. Garrett stated that it has not been extended to a carte blanche. Mr. Corker asked Mr. Stengel about whether the solution proposed by Mr. Krimminger would create a viable covered bond market, and he responded that a covered bond program could be created if they were treated like qualified financial contracts, and that there is a lot of middle ground to compromise on. Mr. Krimminger responded that treating covered bonds like QFCs was not what was being proposed.

Chairman Dodd asked about implied guarantees, and Mr. Krimminger stated that, under the proposed legislation, the regulator would be responsible for removing a trustee that would be used over a separate estate. Mr. Dodd asked Mr. Stengel about a bank failure that issued covered bonds. Mr. Stengel responded that the covered bond council's concern was fragmentation of the market. He stated that the council could be supportive of Treasury writing the rules of the road, and then implementation by the individual prudential regulators. Chairman Dodd also asked about the most important considerations that the committee should keep in mind. Mr. Krimminger stated that it was important not to create a superclass of investments.

Sen. Reed (D-RI) asked whether higher capital was required, and Ms. Williams agreed. Mr. Krimminger added that there would likely be higher FDIC assessments. Mr. Reed asked whether there was a disguised subsidy, and Mr. Stengel responded that he would not characterize the programs that the covered bond council has proposed as including a government subsidy of any kind.

Sen. Merkley (D-OR) asked whether covered bonds could also end up being full of multilayered complexity that makes it difficult to understand the true nature of the collateral. Mr. Stengel responded that it would be a single eligible asset class which would be loans, backing a single issuance of covered bonds. Sen. Merkley also asked whether firms would be able to hedge their risks by purchasing insurance on covered bonds, and Mr. Stengel responded that banks might hedge their risks. Sen. Merkley also asked about an FDIC rule in 2008 that limited covered bonds to 4 percent of capitalization, and Mr. Krimminger stated that it was modeled on other European countries, and that it was expected that it could be expanded as the market developed.

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