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News Bulletin

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Senate Committee Hearing on Covered Bonds

The Committee on Banking, Housing and Urban Affairs of the U.S. Senate held a hearing on covered bonds on September 15. At this writing, no covered bond legislation has been introduced in the Senate. Nevertheless, the Committee held a hearing on the potential uses of and regulatory issues posed by covered bonds. Committee Chairman Dodd had promised during the conference committee hearings on the Dodd-Frank Act when the amendment for covered bonds was rejected that the Banking committee would hold a hearing.

There were two panels of witnesses.[1] The first panel was Congressman Scott Garrett (R-NJ), the author of the covered bond bill in the House. Congressman Garrett spoke of the benefits of covered bonds and the need to put U.S. banks on equal footing with foreign banks who have been selling covered bonds in the United States. He noted that foreign banks have offered almost $20 billion of covered bonds to U.S. investors in 2010. U.S. banks, of course, have issued no covered bonds in this period. He was warmly thanked by the committee for his efforts to develop covered bond legislation.

The second panel consisted of five witnesses who represented a wide variety of interests. Ms. Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency, spoke generally in support of covered bonds while noting that covered bond legislation would need to balance a number of competing interests. She described covered bonds as a "promising funding option for financial institutions . . . and could be a new source of funds for lending and an alternative source of liquidity."

Mr. Michael H. Krimminger, Deputy to Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair, listed a number of concerns the FDIC had with the House legislation. In particular, Mr. Krimminger stated that it was crucial that the FDIC preserve its flexibility in dealing with failed institutions and that the FDIC needed the ability to accelerate covered bonds and recover the cover pool and the value represented by the over-collateralization of the covered bonds. He stated that in the event that the FDIC repudiated covered bonds, it would pay bondholders outstanding principal plus interest through the date of payment. This is an improvement over the FDIC's position under existing law, which would pay interest only through the date that the FDIC became the receiver or conservator, not through the repudiation date.

A representative speaking on behalf of the United States Covered Bond Council (USCBC) pointed out in his remarks that several creditors already had super-priority status in the case of a bank receivership. He mentioned counterparties to "qualified financial contracts" (QFC) and the Federal Home Loan Banks (FHLB) as lenders to a

[1] The witness for Panel I was: The Honorable Scott Garrett, of New Jersey. The witnesses for Panel II were: Ms. Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency; Mr. Michael H. Krimminger, Deputy to the Chairman, Federal Deposit Insurance Corporation; Mr. Scott A. Stengel, Partner, Orrick, Herrington & Sutcliffe LLP, on behalf of the U.S. Covered Bond Council, Securities Industry and Financial Markets Association; Professor Kenneth A. Snowden, University of North Carolina at Greensboro; and Mr. Ric Campo, CEO, Camden Property Trust, on behalf of National Multi-Housing Council.

failed bank. In both cases, he said, the third party would be entitled to a "make whole" payment. In the case of a QFC, the payment would be an amount sufficient for the counterparty to obtain a replacement contract in the market. In the case of an FHLB, the payment would be the present value of the difference between the contract rate on the loan and the current reinvestment rate in the market.

Professor Kenneth Snowden noted that the U.S. has experimented with covered bonds[2] several times between 1870 and 1935. He said that in the period from 1870 to 1890 covered bonds were introduced without any regulatory framework when western farm mortgage companies began issuing covered bonds secured by mortgages instead of selling the loans outright. Many of these companies failed during the general farm mortgage crisis of the 1890s.[3] In the period 1900 to 1935, Congress developed a covered bonds system in the U.S. Professor Snowden reported that "the 63rd and 64th Congresses benefitted from an extensive investigation of covered bond systems in Europe before creating the Federal Farm Loan Bank System in 1916. This system was comprised of both public and private institutions, and both relied on covered bonds to fund mortgages." He also reported that the 73rd Congress authorized the creation of a privately-financed, federally-regulated covered residential mortgage bond program to provide a liquid market for the FHA-insured mortgage loans, but that no private institutions were ever chartered under this authority.

Mr. Ric Campo, speaking on behalf of the National Multi-Housing Council and the National Apartment Association, supported covered bonds as an additional source of finance for U.S. multifamily finance. However, most of Mr. Campo's remarks were focused on preserving federal support for financing multifamily facilities. He also expressed a concern that covered bonds might not lead to an increase in lending by banks to support multifamily facilities. He stated that because the mortgage loans used in covered bonds would remain on the balance sheet of the lending bank, the bank's lending ability would be capital-constrained and a bank might simply shift some funding of mortgage loans from deposits to covered bonds.

The panel testimony and the rather detailed questioning that followed sharply defined the central impediment to passage of the legislation today: the FDIC's concern with preserving its ability to accelerate a covered bond and recover the collateral in exchange for payment of principal and interest due through the payment date on the bond.[4] The reinvestment risk created by acceleration would be borne by investors or met through some type of structured enhancement feature that would preserve the maturity of the bond.

From the viewpoint of the USCBC, this result would create uncertainty for investors about whether the bonds would be accelerated in the event of issuer insolvency; possibly add expensive structured features to a covered bond issuance to address such a risk; and present a much more difficult investment proposition for investors to evaluate, thus defeating much of the purpose of the legislation. This would result in issuers paying a significantly higher coupon on their covered bonds than their European counterparts; it would result in an unequal playing field for U.S. banks among both U.S. and foreign investors.

The FDIC argues that by requiring the transfer of the over-collateralization in the cover pool to a separate estate, the FDIC, as receiver, would have fewer assets to meet other obligations of a failed bank and this would increase the likelihood of drawing on the deposit insurance fund and perhaps ultimately on taxpayer support.

The USCBC responds that the FDIC already faces essentially the same risk with some other creditors, such as the FHLBs and QFC counterparties; the FDIC has other regulatory powers to address this risk; and ultimately, if the

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2 It was unclear from his remarks whether such covered bonds had the key feature of modern covered bonds, i.e., protection of the maturity of the bonds through separating the cover pool from the insolvency estate of the issuing bank and using the proceeds from the cover pool to continue making scheduled payments on the bonds through their maturity.

3 He attributes serious malfeasance during this period to the lack of regulation.

4 This is a bit of a "heads I win, tails you lose" strategy by the FDIC. If the collateral is worth less than the current amount due on the bonds, they would let it move to a separate estate. However, if the collateral were worth more than the current amount due on the bonds, they would pay the covered bondholder less than the value of the collateral, notwithstanding that the excess value of the collateral was part of the bargained-for investment.

deposit insurance fund is reduced below the required amount, it is the banks that would be required by assessment to replenish the fund. This is not a government fund; the deposit insurance risk falls on the entire banking community through the FDIC's power of assessment.

Senator Corker (R-TN) observed that he had had a number of meetings in his office with representatives of the FDIC and the USCBC and that he was looking forward to additional meetings with the hope of resolving this conflict of views.

So, we might ask, where are we now in the legislative process? Congress resumed on September 13 and is expected to recess on October 8 for the November elections. It is possible that there may be a "lame duck" session after the election to take up urgent matters, but it is quite unlikely that covered bonds will be taken up. So a significant step remains in the House. And if the bill is not voted upon before the final recess of this session, the bill would need to be reintroduced anew in the next session of Congress in January.

In the Senate, there is even more to be done. A covered bond bill has yet to be introduced in the Senate. Given the short session, it seems a foregone conclusion that we will not have final Senate action on a covered bond bill in this session, and, accordingly, the Senate will need to take up covered bonds in January. And, as in the House, a new session of Congress would require the introduction of a covered bond bill anew in the Senate in January.

If either of the Senate or the House passed a bill before the recess and the other did not, new bills would need to be introduced in each of the Senate and the House in the next session. If the Senate and the House passed differing versions of a bill before the recess, the differences would need to be resolved in a conference committee and the revised bill approved by both houses before the recess.

Accordingly, it seems most probable that covered bonds will need to be taken up by the next Congress.

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