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News Bulletin

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Covered Bonds: 2011 – The House II

June 22nd Markup Hearing

At a markup hearing on Wednesday, June 22, 2011, the House Financial Services Committee once again passed covered bond legislation, sending it to the House floor for a vote of the full House.[1] The bill was approved by a comfortable margin of 44 to 7, reflecting the strong bi-partisan support for covered bonds, but this masked the tension and close voting on a pair of amendments sponsored by Congressman Barney Frank at the request of the FDIC. It seems, therefore, that the legislation stands a good chance of adoption by the full House if and when it is voted on.

Prior to the introduction of the Frank amendments, amendments were introduced by Congresswoman Carolyn Maloney[2] (D-NY), Congressman John Campbell (R-CA) and Congressman Scott Garrett (R-NJ).[3] Mrs. Maloney's amendment[4] responded to an FDIC concern by extending from 180 days to one year the period for the FDIC to find another bank to assume a covered bond program of a failed bank.

Mr. Campbell's amendment[5] added a provision requiring the covered bond regulator to adopt a limit based on total assets of the amount of covered bonds that an issuer may have outstanding. The provision would permit the regulator to adjust the limit as often as quarterly.

Mr. Garrett's amendment[6] made a number of technical changes and narrowed the eligibility of nonbank financial companies to issue covered bonds to those nonbank financial companies supervised by the Board of Governors of the Federal Reserve System and their subsidiaries.

These three amendments by Mrs. Maloney, Mr. Campbell and Mr. Garrett were adopted by voice vote with little discussion.

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[1] The House Financial Services Committee approved a covered bond bill on July 22, 2010, which was ultimately not voted upon by the full House (see our August 16, 2010, News Bulletin at http://www.mofo.com/files/Uploads/Images/100812CoveredBond.pdf). The full text of the United States Covered Bond Act of 2011 (H.R. 940) as considered by the Committee is available at http://financialservices.house.gov/UploadedFiles/HR940_REPSUBCOM_xml.pdf. The 2011 Act was introduced by Congressman Scott Garrett on March 8, 2011. The bill was approved by the Capital Markets Subcommittee on May 3, 2011. (See our News Bulletin at http://www.mofo.com/files/Uploads/Images/110517-Covered-Bonds-2011.pdf.)

[2] Mrs. Maloney is a co-sponsor of the bill.

[3] Mr. Garrett is Chairman of the Capital Markets Subcommittee where the bill originated and a co-sponsor of the bill.

[4] Mrs. Maloney's amendment is available at http://financialservices.house.gov/UploadedFiles/062211hr940maloneyam.pdf.

[5] Mr. Campbell's amendment is available at http://financialservices.house.gov/UploadedFiles/062211hr940campbellam.pdf.

[6] Mr. Garrett's amendment is available at http://financialservices.house.gov/UploadedFiles/062211hr940garrettam.pdf.

The first of Mr. Frank's amendments[7] on behalf of the FDIC would have deleted 25 pages of the bill, essentially all of Section 4 dealing with the resolution of a covered bond upon default or insolvency of the issuer. In its place, the FDIC sought several significant changes to the resolution authority. First, in the case of the creation of a separate estate for the cover pool as a result of a default by the issuer prior to insolvency and receivership, if the FDIC were to be appointed receiver within 30 days of the creation of the separate estate, it would have the right for ten days to cure the default and dissolve the separate estate. Second, the FDIC would have the right, as it does under existing law, to repudiate the covered bonds of an issuer in receivership by paying the outstanding principal amount of the bonds plus accrued interest through the date of payment. Third, under the amendment there would be no deadline for FDIC action. There could therefore be an indefinite period of uncertainty before bondholders discovered whether their bonds had been repudiated, assumed or a separate estate had been created. This amendment was defeated 28 to 26 mostly along party lines in a roll call vote.

The second of Mr. Frank's amendments[8] on behalf of the FDIC would have required the covered bond regulators to establish a joint covered bond oversight program. The oversight program would establish standards for eligible assets, require covered bond programs to be maintained in a manner that is consistent with safe and sound asset-liability and other financial practices, and require that a separate estate be administered to maximize the value and proceeds of the cover pool. Additionally, the oversight program would adopt rules for covered bond program limits, eligibility standards for issuers, disclosure and other issuance standards, structural and cover pool related requirements, asset coverage tests, maximum over-collateralization amounts and limits on the amount of substitute assets in the cover pool. The oversight program would also require that the approval of the covered bond programs consider safety and soundness and other supervisory factors and the joint determination of the covered bond regulator and the FDIC that the covered bond program would not increase the risk of loss or actual losses to the deposit insurance fund. And the oversight program would authorize a covered bond regulator to issue an order to a covered bond issuer to cease issuing covered bonds if the covered bond program were not maintained in a manner consistent with the covered bond statute. This amendment was also defeated 28 to 26 mostly along party lines in a roll call vote.

In response to the first amendment introduced by Mr. Frank, Mr. Garrett recited a litany of meetings, discussions, proposals, amendments and changes made to try to address FDIC concerns and expressed disappointment that the FDIC had ceased responding to inquiries from his staff. He said that the amendment proposed by Mr. Frank would destroy the ability of U.S. issuers to issue covered bonds that would be acceptable to investors and urged defeat of the proposal. Mr. Garrett also spoke out against the second amendment proposed by Mr. Frank, and other members of the Committee cited letters from numerous organizations supporting the bill in the form considered by the Committee. These letters were entered into the record.

Commentary

Although he did not expressly cite the proposed repudiation authority, it appears that repudiation was the primary point of Mr. Garrett's concern. The repudiation of a covered bond by the FDIC would leave a covered bond investor in much the same position as any other secured creditor, i.e., the debt would be accelerated and the bondholder would face reinvestment risk with the funds received. In that case, the covered bond statute would achieve little, since banks and other potential issuers have authority under existing law to issue secured bonds. More importantly, if covered bonds are subject to repudiation, the covered bond investor base, which invests largely in sovereign debt and agency debt, would not invest in U.S. covered bonds. Covered bond investors generally avoid investment with acceleration risk. Accordingly, it should be expected that covered bonds subject to repudiation would be sold either to senior unsecured debt investors or ABS investors, potentially cannibalizing such investor classes. And, critically, U.S. issuers would lose the chance to broaden their investor base to include a large and deep investor group that has not previously provided financing to U.S. banks.

[7] Mr. Frank's first amendment is available at http://financialservices.house.gov/UploadedFiles/062211hr940frank231am.pdf.
[8] Mr. Frank's second amendment is available at http://financialservices.house.gov/UploadedFiles/062211hr940frankam.pdf.

The proposal in Mr. Frank's second amendment to limit the amount of covered bonds issued by an issuer creates a curious policy result. Banks engage in secured funding in many ways, including through the use of repurchase agreements and FHLB advances. Short-term financing through repurchase agreements was the immediate cause of the failure of Lehman Brothers because collateral requirements escalated and maturities of the repurchase agreements shortened as the crisis unfolded. By limiting covered bonds but not other forms of secured financing, the proposed amendment would have the effect of encouraging the use of other forms of secured financing, including repurchase agreements. Because covered bonds are used to fund longer term assets, limiting covered bonds would have the effect of encouraging the use of short-term financing for longer term assets, contrary to the prevailing wisdom of asset-liability management. That would suggest that the better approach would be to place a limit on all secured financings, other than borrowings from the Federal Reserve. This would allow banks to best balance their secured funding among different alternatives in managing their asset-liability mismatches.

Finally, the joint determination required of the covered bond regulator and the FDIC that approval of a program will not increase the risk of loss or the actual losses of the deposit insurance fund may be a determination that cannot be made. Any secured financing program that requires the replacement of bad assets with good assets, and any securitization with a retained first loss piece, will increase the risk of loss to the deposit insurance fund.

Remaining Agenda

Two big steps remain. First, H.R. 940 must be adopted by the House. Second, a covered bond bill must be introduced in the Senate, debated by the appropriate committees and approved by the full Senate. The length of the remaining legislative calendar has become a serious consideration, particularly for Senate action. The Senate has not previously considered a covered bond bill and, accordingly, there is much to be done for the Senate staff to be prepared to take informed positions on a bill. Perhaps the most important factor in moving a bill quickly through the Senate will be who sponsors the bill. As previously reported,[9] Senator Charles Schumer (D-NY), who is a key senator on the Senate Banking Committee, has said that he would consider introducing a covered bond statute. Sponsorship by Senator Schumer would greatly enhance the prospects for the bill moving quickly.

Prospects in the House for passage in this legislative calendar are considerably better. However, given the possibility of issues like raising the debt limit, Libya, the Greek debt crisis and other concerns to take control of the legislative agenda, uncertainty about the passage of H.R. 940 by the House remains.

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[9] See our May 17, 2011 News Bulletin, which is available at http://www.mofo.com/files/Uploads/Images/110517-Covered-Bonds-2011.pdf.

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