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News Bulletin

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Covered Bonds: 2011 – The House

2010 saw about $30 billion of covered bonds issued in the U.S. by foreign banks. 2011 is starting off strong with approximately $17 billion issued so far. But, no U.S. banks are issuing covered bonds. In the absence of a U.S. covered bond statute, the quasi-securitization structure used by U.S. banks before the financial crisis is now too expensive and not favored by investors. Accordingly, U.S. banks and other potential issuers are following with interest the legislation introduced by Congressman Scott Garrett (R-NJ) on March 8, 2011, entitled "United States Covered Bond Act of 2011" (H.R. 940).[1] The bill was co-sponsored by Congresswoman Carolyn Maloney (D-NY) and was referred to the Financial Services Committee and to the Ways and Means Committee. The bill is similar in most respects to the bill (H.R. 5823)[2] introduced by Congressman Garrett last summer that was approved by the House Financial Services Committee and sent to the floor of the House for a vote.[3] However, the full House did not take up the bill last year.

Initial Hearing

There are therefore high expectations for the early approval of H.R. 940 by the Financial Services Committee. This process began on March 11 with a hearing before the Capital Markets Subcommittee, which is chaired by Congressman Garrett. There was strong bi-partisan support for the bill, although several Subcommittee members showed through their questions that they are still trying to understand the mechanics of covered bonds and the role they might play in housing finance.

Five witnesses[4] testified before the Committee, with four supporting the enactment of the bill and the creation of a covered bond market in the U.S. The fifth witness, Mr. Andrews of the Bank of Alameda, expressed a concern[5] that enactment of the bill would lead to a further concentration of the banking industry into the major money center banks and would competitively disadvantage community banks.

The FDIC also raised concerns,[6] as it did last year, that covered bond issuances could in some cases subordinate depositors and lead to increased draws on the deposit insurance fund. The agency stated that holders of covered bonds would be given rights by the bill that are not enjoyed by other bank creditors. Since the FDIC's mission is to protect and administer the deposit insurance fund, its concern is understandable, but its statement is

[1] A copy of H.R. 940 is available here.
[2] A copy of H.R. 5823 is available here.
[3] See our Client Alert on the Committee action here.
[4] The witnesses were: Mr. Scott Stengel, Partner, King & Spaulding LLP, on behalf of the United States Covered Bond Council; Mr. Bert Ely, Ely & Company, Inc.; Mr. Tim Skeet, Chairman, Committee of Regional Representatives, International Capital Markets Association; Mr. Ralph Daloisio, Managing Director, Natixis, on behalf of the American Securitization Forum; and Mr. Stephen G. Andrews, President and Chief Executive Officer, Bank of Alameda.
[5] Mr. Andrews's written statement is available here.
[6] The FDIC submitted a written statement but did not testify. The statement is available here.

somewhat inaccurate and also fails to recognize the benefit to banks of improving their asset liability management through the use of covered bonds.

Two classes of creditors of insured banks enjoy rights similar to those covered bondholders would be granted under H.R. 940. Federal Home Loan Banks enjoy a super priority lien over bank assets to secure any advance to a bank and in the event of a bank insolvency are entitled to a “make whole” payment representing the difference between the return on reinvestment of the funds from the advance and the interest the bank would have paid on the advance. That is, the Federal Home Loan Banks would receive all of the interest that they would have received if the bank had continued to make payments on the advance.

Counterparties under swap agreements and repurchase agreements with insured banks enjoy similar rights. Under a standard ISDA contract or a standard Master Repurchase Agreement, when a bank becomes insolvent the counterparty is protected from the automatic stay under the FDIA and is entitled to close out the contract immediately and to receive from collateral securing the contract an amount sufficient to obtain a replacement contract in the market. With a replacement contract, a counterparty will receive all of the interest it would have received if the bank had continued to make payments on the ISDA contract.

These two classes of creditors are entitled therefore to protection from the early termination of their agreements, similar to the rights of covered bondholders to continue to receive scheduled payments on a covered bond following an insolvency of the issuing bank, instead of receiving an accelerated payment on the bond and the loss of interest that would have been paid by the bank from the date of the receivership through the maturity date of the bond.

There is a real benefit from covered bonds in managing asset-liability mismatches. Covered bonds are typically issued in the five- to 10-year maturity range, and recently in the UK there were some well-received issuances at 15-year maturities. For 30-year U.S. mortgage loans, these tenors are very attractive in managing the asset-liability mismatch, particularly considering that the weighted average maturity of 30-year mortgage loans is typically in the five- to seven-year range.

As noted above, the other witnesses were all supportive of covered bonds. Mr. Deloisio of Natixis, who is the chairman of the American Securitization Forum, spoke strongly in favor of covered bonds.[7] He pointed out that the FDIC was granted additional assessment powers under the Dodd-Frank Wall Street Reform and Consumer Protection Act and would be assessing banks for outstanding covered bonds. It was his view that the additional powers were more than enough to enable the FDIC to protect the deposit insurance fund.

Mr. Ely testified[8] that he had calculated how much in additional funds the FDIC would receive from imposing a deposit insurance fee assessment on covered bonds, and concluded that the FDIC would most likely be generating a profit if banks issued covered bonds. This assessment power is a change from the past position of the FDIC because last summer the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the FDIC’s assessment power to cover all liabilities of a bank.

Mr. Stengel, testifying[9] on behalf of the United States Covered Bond Council, set out the benefits to banks and to housing finance of establishing a covered bond framework by statute.

Mr. Skeet, testifying[10] on behalf of the International Capital Markets Association, described the experience of the European covered bond market during the recent financial crisis and emphasized the continued

[7] Mr. Daloisio’s written statement is available here.
[8] Mr. Ely’s written statement is available here.
[9] Mr. Stengel’s written statement is available here.
[10] Mr. Skeet’s written statement is available here.

availability of that market. In response to a question, he stated that many smaller banks in Europe issued covered bonds.

Markup Hearing

On May 3, 2011, the Subcommittee held a markup hearing on H.R. 940. Two amendments were considered at the hearing. After discussion, both amendments were adopted by voice vote and the amended bill was referred to the full Financial Services Committee for consideration.

The first amendment was offered by Congresswoman Maloney.[11] This amendment (i) adds a provision to the bill that would authorize the covered bond regulator for a covered bond issuer to issue a cease and desist order if the issuer's covered bond program is not maintained in a manner that is consistent with the Covered Bond Act, (ii) adds a provision to the bill requiring covered bond regulators to take into account safety and soundness considerations in evaluating covered bond programs for approval, (iii) adds a provision to the bill that authorizes each covered bond regulator to establish a separate scheme of registration, disclosure and reporting obligations for covered bond programs, and (iv) eliminates home equity loans from the definition of eligible assets that can be included in a cover pool. The amendment also made a number of technical changes.

The second amendment was offered by Chairman Garrett.[12] This amendment made mostly technical and clarifying changes to the bill. The amendment also eliminated an express requirement for an asset coverage test.

Both Chairman Garrett and Congressman Maloney acknowledged the concerns raised by the FDIC, and the Chairman stated that he would work with members of both parties to resolve the concerns.

The lone dissenting voice came from Congressman John Campbell (R-CA) who raised concerns similar to some of the FDIC's concerns. He did not, however, offer an amendment of any kind.

Next Steps

The bill will now be considered by the full Financial Services Committee in much the same form that was marked up by that Committee last year and amended in several respects.[13] No hearing has been scheduled yet by the full Committee. However, the chairman of the full Committee is now Congressman Spencer Bachus (R-AL), who was the co-sponsor of the bill last year. Accordingly, it seems likely that the bill will receive an early hearing. Assuming passage by the full Committee, the bill would then have to be considered by the full House, so there is much to be done still in the House.

To date, no covered bond legislation has been introduced in the Senate, notwithstanding recent favorable comments on the possibility of covered bond legislation before the Senate Banking Committee by Treasury Secretary Geithner and by Senator Charles Schumer (D-NY) in March.[14] Introduction of legislation in the Senate is probably the critical next step in the process for enactment of covered bond legislation.

[11] The text of the Maloney amendment is available here.
[12] The text of the Garrett amendment is available here.
[13] In particular, the definition of "eligible assets" was narrowed considerably at the markup hearing by the full Committee last year.
[14] See a Reuters news report here.

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