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**TESTIMONY OF**  
**JULIE L. WILLIAMS**  
**CHIEF COUNSEL AND FIRST SENIOR DEPUTY COMPTROLLER**  
**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

**BEFORE THE**  
**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**

**UNITED STATES SENATE**

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The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## **Introduction**

Chairman Dodd, Ranking Member Shelby, and members of the Committee, my name is Julie Williams and I am the Chief Counsel and First Senior Deputy Comptroller at the Office of the Comptroller of the Currency (OCC). I appreciate the opportunity to testify on behalf of the OCC today about covered bonds, their potential uses and key issues that they present for policymakers.

The OCC recognizes that covered bonds can play a role in an institution's overall funding strategy, offer a new source of funds for lending activities, and provide an alternative source of liquidity for financial institutions. Over the past few years, the OCC has supported efforts to remove obstacles to the development of this market.

My testimony today first briefly reviews the characteristics of covered bonds and their pros and cons relative to other funding options. The second portion of my testimony focuses on a set of key issues that would define the essential framework for a statutory covered bond program.

## **Part I. General Information on Covered Bonds**

Covered bonds are debt obligations issued by a financial institution. The bonds are backed both by the institution's promise to pay and by a dynamic pool of assets pledged as collateral that comprise what is referred to as the "cover pool." The underlying assets are typically high quality assets, subject to various eligibility criteria and must be replaced by the institution should they fail to meet specified criteria. Investors look first to the institution to make payments on the bonds, but investors also have a claim against the cover pool that has priority over unsecured creditors of the

institution. This is commonly referred to as the “dual recourse” feature of covered bonds. There is no single definition of a covered bond, however. Covered bonds have been issued using different transaction structures and sold with varying features in many European countries for centuries.

Covered bonds may provide financial institutions, including depository institutions, an alternative to securitization and other funding options. For the banking system, covered bonds provide a funding source that is longer-term and more stable, and potentially less expensive than currently available alternatives, and may also require less collateral or accommodate broader types of collateral than current options. Because the bank retains the credit risk on the collateral for a covered bond, it has a strong incentive to maintain prudent underwriting standards for those loan assets. The structure of risk associated with covered bonds also may attract types of investors that would not otherwise invest in general bank debt.

Covered bonds are well-established in Europe as a means for facilitating mortgage financing. Many European jurisdictions have a public supervisor specifically dedicated to set uniform standards and regulate covered bonds. A statutory structure for covered bonds in the U.S. would potentially remove one obstacle to growth of a U.S. covered bond market.

#### ***A. Comparison with Securitization***

Covered bonds differ from typical securitizations in ways that offer benefits and disadvantages. Investors may have more confidence in covered bonds because they are less complex and more transparent.<sup>1</sup> As noted above, covered bonds provide investors dual recourse against the issuer and the cover pool, which is segregated and managed

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<sup>1</sup> Covered bonds have no credit risk tranching as is the case with securitizations.

exclusively for the benefit of the covered bond holders. In contrast, securitizations in the past typically have been off balance sheet transactions and provide investors fewer sources of repayment.

The collateral underlying covered bonds is dynamic – underperforming or prepaid assets must be substituted with performing assets. Assets underlying securitizations are typically static, with the notable exception of credit cards. In the case of default, covered bonds are structured to avoid prepayment prior to maturity, whereas securitization investors are subject to prepayment risk in the event of a default on an asset held as collateral or prepayment of such assets.

Covered bond issuers typically have a longer-term interest in the performance of the assets underlying the cover pool than issuers in typical securitizations because of the bonds' structure and dual recourse features. In addition, the cover pool typically remains on the financial institution's balance sheet, whereas the assets backing a securitization usually do not. This may give investors more confidence in covered bonds because it creates an incentive for the institution issuing the covered bond to adhere to strong underwriting standards. This feature also may enhance the transparency of covered bonds because covered bonds are not structured into complex tranches.

Covered bonds also permit issuers to lengthen the maturity profile of their liabilities by issuing bonds with long-dated maturities to support long-dated assets. This may enhance the ability of banks to avoid maturity mismatches in their assets and liabilities. But, compared to securitizations, an increased reliance on covered bonds also could increase maturity mismatch risks because of the difficulty in forecasting with certainty the actual maturity of many loan products. In contrast, for securitizations, banks

can sell their longer term assets and avoid maturity mismatch risks associated with longer-dated mortgages and other similar assets.

Because covered bonds remain on an institution's balance sheet, the institution must hold more capital than in a typical securitization. Thus, capital requirements could constrain the growth of the covered bond market. New accounting rules, upcoming changes in capital rules that may require higher levels of capital for assets held on a bank's balance sheet, and the "skin-in-the-game" securitization provisions in the recent Dodd-Frank Wall Street Reform and Consumer Protection Act, which require forms of risk retention for securitizers of loans, are among the factors that may have an impact going forward on the relative advantages and disadvantages of covered bonds and securitization for financial institutions.

#### ***B. Comparison with Other Funding Options***

Covered bonds also offer a potentially less expensive and more liquid funding source compared to senior, unsecured debt.

In contrast to Federal Home Loan Bank (FHLB) advances, for example, covered bonds offer issuers access to a potentially wider investor pool. Financial institutions may issue covered bonds without becoming a member of a FHLB. Covered bonds could offer more attractive pricing, transparency, and lower collateral levels than some FHLB requirements. The amount, type, and quality of collateral pledged to covered bond issuances also may provide institutions with additional options to obtain funding. The extent to which there are advantages will depend upon details of how the U.S. covered bond program is implemented as well as other regulatory developments mentioned above.

## **Part II. Key Issues for the Framework of a Covered Bond Program**

The U.S. does not have a specific statutory covered bond framework, although various legislative and regulatory efforts have emerged over the past few years, particularly in response to recent years' mortgage market turmoil. These proposals have included a variety of mechanisms for designing a U.S. covered bond regime. The appeal of establishing a statutory covered bond framework is to enable a sound and viable alternative funding option for financial institutions, which could enhance liquidity options and foster healthy competition in the funding markets. This needs to be done without compromising the safety and soundness of institutions participating in covered bond programs.

That said, development of such a framework for a U.S. covered bond program presents complex issues for consideration by policymakers. The remainder of my testimony focuses on a set of key issues and explores considerations for how those issues could be addressed.

### ***A. What Entities Are Eligible Issuers?***

A threshold issue in designing a statutory covered bond program is determining the type of entity eligible to issue covered bonds under the statutory program. Limiting eligible issuers to entities subject to supervision by federal financial regulators has the advantage of dedicated financial supervisors that can monitor and control the growth of covered bonds, react to emerging market issues, and generally act to promote safe and sound covered bond programs by their respective institutions. Expanding eligible issuers beyond such a group of federally supervised institutions, while expanding the number of

issuers and volume of issuances, has the disadvantage of issuers not being subject to the same level of oversight.

As provided for in recent legislative proposals, an “eligible issuer” could mean any insured depository institution or any subsidiary; any bank or savings and loan holding company and any subsidiary; any nonbank financial company that is approved by the primary federal financial regulator for the nonbank financial company; and any issuer that is sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis. Regarding the last category, a definition that recognizes the issuance of pooled covered bonds from appropriately regulated firms likely would provide greater access for regional and community banks to this market.

***B. What Agency or Agencies Should Regulate Covered Bond Issuers?***

Another key issue in designing a statutory covered bond program is determining the agency or agencies appropriate to regulate the covered bond issuers and programs. One agency, multiple regulatory agencies, or the Department of the Treasury, are options that have been suggested at various times. Our suggestion is for the federal financial regulators to be the covered bond regulators for their respective institutions, and to implement a single, uniform set of standards that are applicable to all covered bond issuers.

While having one designated U.S. covered bond regulator has an advantage of inherent uniformity with respect to all covered bond issuers and programs, it has the disadvantage of not utilizing existing supervisory knowledge and expertise of current federal financial regulators. Designation of a single covered bond regulator, particularly depending on the agency chosen (or created), also might incrementally enhance a market

misimpression of government backing of the financial performance of the covered bonds themselves.

Designating an eligible issuer's federal financial regulator takes advantage of that regulator's existing knowledge of an institution's operations. It would also be consistent with the current regulatory approach which provides financial regulatory agencies with responsibility for supervising covered bond programs by institutions under their jurisdiction.

Recent legislative proposals have taken this approach to structuring a U.S. covered bond framework, proposing that the covered bond regulator be an eligible issuer's federal financial regulator. Thus, in the case of national banks and (going forward for federal thrifts), the covered bond regulator would be the OCC. For state-chartered, non-member banks and state chartered thrifts, it would be the FDIC; for state-chartered member banks, the Federal Reserve Board, and for any other issuers, it would be the Securities and Exchange Commission (SEC).

Under this framework, as discussed further in Section D below, the designated covered bond regulators would jointly issue a uniform set of regulations establishing a covered bond regulatory regime. The statutory framework could provide the covered bond regulators with authority to approve covered bond programs of their respective institutions, require the regulators to maintain a public registry of approved programs, and authorize an appropriate funding mechanism for the regulators' oversight of the programs.

In determining the parameters of the programs, the regulators could jointly establish reasonable and objective standards for the covered bond programs, including

eligibility standards for eligible assets, and other criteria as determined necessary. These considerations are discussed in more detail in Section D below.

***C. What Types of Assets Are Eligible for Covered Bonds?***

Another important component of a statutory covered bond program is the types of assets eligible to collateralize the covered bonds. Typically, in Europe, covered bonds are associated with high quality assets comprised of residential or commercial mortgage loans and public-sector debt. While some have advocated a broad statutory spectrum of U.S. asset types, including credit card, student, small business, and auto loans, more recent proposals have tended to narrow the eligible asset classes.

One approach to the question of asset eligibility would be to start with a relatively conservative scope. Thus, for example, policymakers could decide to have the statutory framework initially authorize certain asset classes that typically have more homogeneous product terms and credit risk profiles (e.g., residential mortgages). Authorization also could be provided for the covered bond regulators to expand the eligible classes going forward on an incremental basis as more experience is gained with covered bond programs and after careful review of relevant considerations. Asset classes with similar characteristics, e.g., credit cards, would be logical first candidates for expansion.

***D. What Standards Are Applicable to Issuances of Covered Bonds?***

The question of standards applicable to covered bonds and covered bond issuers has two facets: How are those standards set and what should the standards address?

For policymakers, determining the standards to be prescribed in the statutory framework versus those to be left to regulatory rulemaking involves a balance of factors. Providing detailed standards by statute offers the legal certainty of having the standards

set by law, but has the disadvantage of less flexibility for needed changes as covered bonds evolve and regulators ascertain strengths and weaknesses in covered bond programs and with issuers. Also, different standards may be appropriate for different asset classes. For those reasons, policymakers may wish to direct covered bond regulators to adopt standards to address particular key areas.

As noted in Section B above, while we suggest that federal financial regulators are best situated to serve as the covered bond regulators for the institutions subject to their jurisdiction, we strongly believe that those regulators should implement a common set of rules. Thus, the regulators could be charged with designing the detailed rules that govern covered bond programs, including any key areas that legislation specifically requires them to address. In order to avoid the risk of interagency gridlock, however, we also suggest that some mechanism be specified to ensure that rules are issued on a timely basis. One option that was considered in a recent legislative proposal was to provide by statute that the Treasury Department would issue the required rules if the covered bond regulators failed to jointly adopt rules within a prescribed time.

Various types of standards could be embodied in a covered bond regulatory framework. For example, all covered bonds, by asset class, should have minimum eligibility criteria setting asset quality standards to promote the inclusion of high quality assets in the cover pool. Most European jurisdictions prescribe asset quality criteria for the assets subject to the statutory covered bond program. Those standards in the U.S. could be set by statute or by the covered bond regulators through rulemaking. Given the likely detail involved, regulatory standards seem preferable.

It is also important to recognize that there are implications if a depository institution begins to use covered bonds extensively as a funding vehicle, as the institution may have an incentive to pledge stronger credit quality assets for collateral, thus giving investors the priority claim on the institution's best assets and leaving the institution, its shareholders, and ultimately, in the case of insolvency, the FDIC, with weaker quality assets. From this standpoint, regulatory or supervisory standards may be needed to address risk management issues similar to other funding vehicles, including an issuer bank's overall liquidity risk management framework and maintaining covered bond programs in a manner consistent with safe and sound banking practices.

Covered bond regulators also should have the authority to impose a cap on the percentage of particular asset types that issuing institutions could use for the covered bond program. An issuer's total covered bond obligations as a percentage of the issuer's total liabilities also could be limited. Unrestricted growth in covered bonds could excessively increase the proportion of secured liabilities to unsecured liabilities at an institution, and thus present issues in the event the issuer becomes insolvent. As noted above, if the issuer is a depository institution, this creates concerns, notably with respect to potential losses to the Deposit Insurance Fund.

Another important standard is a designated minimum amount of overcollateralization. Typically the collateral for covered bonds has a market value in excess of the face amount of the covered bonds that it backs, *i.e.*, overcollateralization. Having sufficient overcollateralization helps to preserve the value of the covered bond holders' claims in the event of issuer distress, and the extent of overcollateralization should also affect the rate the covered bond issuer must pay to investors.

Covered bond legislation could authorize the covered bond regulators to establish minimum overcollateralization requirements for covered bonds backed by different eligible asset classes. As a related standard, legislation also could set forth a framework requiring each cover pool to satisfy an asset coverage test that assesses whether the minimum overcollateralization requirements are met, and obligates the issuer and an independent “Asset Monitor” to confirm on a periodic basis whether the asset coverage test is satisfied.

Legislation also could authorize covered bond regulators to establish certain types of standards viewed as the most necessary and prudent to start with, and then authorize regulators to adopt additional standards deemed appropriate for particular asset classes. This approach would permit covered bond regulators to revise standards as more experience is gained with covered bond programs and regulators obtain a fuller understanding of the relevant considerations.

***E. What Are the Consequences of a Default of a Covered Bond Issuance or Failure of a Covered Bond Issuer?***

A critical component in designing a U.S. statutory covered bond program is determining the consequences of a default of a covered bond issuance or the failure of a covered bond issuer. A key advantage typically associated with covered bonds in Europe is their continuing nature despite a default on the issuance or the insolvency of the issuing institution. Under European special law-based frameworks, usually there is a specific legal framework superseding the general insolvency law of the country. The general premise is that if an issuing institution of covered bonds becomes insolvent (or goes into bankruptcy), the cover pool is segregated and held for the benefit of the covered

bondholders. The covered bonds do not automatically accelerate when the credit institution goes insolvent, and the rights of the bondholders are protected.

Without a U.S. legal framework addressing the operation and management of the cover pool in the event of a default or insolvency, U.S. covered bonds will continue to lack predictability and clarity compared to other jurisdictions.

From a general standpoint, there are two distinct situations to be addressed: (1) a default on the covered bond issuance before the issuer enters conservatorship, receivership, liquidation, or bankruptcy; and (2) the insolvency of the issuer institution. When considering the default of a covered bond issuance, “default” should be clearly defined for this purpose, and also should clearly address what will happen to the cover pool and the rights of the covered bondholders if a default occurs.

One legislative approach is to define the term “uncured default” to mean a default on the covered bond that has not been cured within the time required by the transaction documents related to the covered bond. In that situation, a separate estate will automatically be created by operation of law and will exist and be administered separately from the issuing institution. The separate estate is comprised of the applicable cover pool and assumes liability for the covered bonds and any related obligations secured by that cover pool. Consideration also might be given to authorizing the covered bond regulators to establish minimum time periods for an “uncured default” in order to avoid “hair trigger” defaults.

Another area for consideration is statutory provisions addressing the preservation of deficiency claims against the issuer; the creation of a residual interest that represents the right to any surplus from the cover pool; and the obligation of the issuer to transfer

applicable books, records, files, and other documents to the covered bond regulator or another designee. Consideration also should be given to provisions that provide that the covered bond regulator may elect for an issuer to continue servicing the cover pool for some reasonable and operationally practical period of time.

The second situation to be addressed is the potential for insolvency of the covered bond issuing institution, and if the issuer is an insured depository institution, the FDIC's statutory role as conservator or receiver. Again here it is important to clarify and address what would happen to the cover pool and the rights of the bondholders.

Similar to the default situation approach, a statutory framework could create a separate estate for the covered bond program similar to those in certain European jurisdictions. A recent legislative proposal creates a structure with the following general components when the FDIC is appointed as conservator or receiver for an insolvent issuer:

- Creation of a separate estate and provision to the FDIC of an exclusive right for 180 days to transfer the issuer's covered bond program to another eligible issuer.
- A requirement that the FDIC as conservator or receiver, during the 180-day period, perform all monetary and nonmonetary obligations of the issuer until the FDIC completes the transfer of the covered bond program, the FDIC elects to repudiate its continuing obligations to perform, or the FDIC fails to cure a default (other than the issuer's conservatorship or receivership).

If the FDIC as conservator or receiver, does not timely effect a transfer of the covered bond program to another eligible issuer, repudiates its continuing obligations to perform, or fails to cure a default, then the statutory framework could provide for the automatic

creation of a separate estate and attendant responsibilities, along the lines previously described.

A comprehensive approach for covered bonds that reflects a consistent and predictable process across the federal financial regulators would serve to provide certainty and predictability to investors and the marketplace in cases of default. This type of framework would require the covered bond regulator to act as or appoint a trustee of the separate estate and to appoint and oversee a servicer or administrator for the cover pool held by the estate. Given the nature of the events triggering this aspect of the covered bond framework, litigation by unhappy private parties could attempt to draw in the covered bond regulator. We therefore urge consideration of limitations on actions against, and recognition of sovereign immunity for, the covered bond regulator acting in its statutorily-designated capacities.

A further specific issue for policymakers is the appropriate treatment of any excess amounts from the cover pool once the covered bondholders have been paid in full. For example, a recent approach proposed that a residual interest would be created in the estate that represented the right to any surplus from the cover pool after the covered bonds and all other liabilities of the estate had been paid in full. The issue here is whether the FDIC, or the covered bond holders, receives the excess collateral.

***F. What Securities Disclosure Requirements Should Apply to Covered Bonds?***

The securities disclosure requirements applicable to covered bonds is the final issue I will highlight in this written statement. Requiring meaningful disclosures and making detailed information available about assets in a cover pool is essential to provide consistency and transparency across covered bond issuances. Required disclosures, along

with appropriate reporting, by different issuers should be standardized to permit comparison of current information by investors. This transparency and consistency are fundamental to the structure and discipline of covered bond programs.

To assure these goals, covered bond legislation could direct the covered bond regulators to adopt uniform disclosure and reporting standards for banks and other issuers. Those standards should cover a number of important areas. For example, covered bond issuers could be required to provide investors detailed information about the cover pool at the time of issuance and on a periodic (e.g., monthly) basis thereafter. The issuer could be required to provide updated cover pool information, for instance, if more than 10 percent of the cover pool is substituted within a month, or more than 20 percent within a quarter. Issuers also could be required to provide investors the results of monthly Asset Coverage Tests, which typically should validate collateral quality and the proper level of overcollateralization. Similarly, the results of any reviews by an Asset Monitor could be made available to investors, as well as any other relevant material information.

The SEC's disclosure requirements for asset-backed securities (ABS) under Regulation AB provide a useful starting point for developing disclosure and reporting requirements for covered bond programs. However, because covered bonds do not present the same structural complexities generally possible with ABS, it is probably more appropriate to select from, rather than duplicate, the disclosure requirements of Regulation AB in the case of covered bonds.<sup>2</sup> Thus, it would be important for policymakers to clarify that covered bonds are not "asset-backed securities" for such

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<sup>2</sup> Covered bonds issued by banks do not appear to fall within the definition of an asset-backed security under the Federal securities law. However, legislation clarifying that covered bonds are not asset-backed securities could provide certainty conducive to the development of covered bond markets.

purposes, and to the extent necessary should address the application of the federal securities laws to any U.S. covered bond program.

### **Conclusion**

We are encouraged by the continuing interest in establishing a statutory structure for covered bonds in the U.S. Such a step, prudently structured and implemented, holds promise as an additional, complementary funding source for financial institutions, and a catalyst for sound competition among the financial product funding alternatives available in the U.S. A complex combination of factors will determine the extent to which these goals are achieved.

I appreciate the opportunity to appear before the Committee today, and I would be happy to answer any questions. Thank you.