Testimony of

Alan Boyce
before the
House Committee on Financial Services
December 15, 2009

Mr. Chairman, Ranking Member Bachus, Representative Garrett, Representative Kanjorski and other Members of this Committee, I very much appreciate the chance to testify today on the issue of covered bonds. Covered bonds are an important and useful financial tool, and the Committee is right to be considering how best to ensure that investors and borrowers have access to the benefits of this approach.

In my testimony today, I would like to do three things. First, I will discuss the general benefits of covered bonds, particularly in light of our recent financial crisis and our ongoing financial challenges. I will then discuss some important issues concerning the drafting of the covered bond legislation currently before the Committee. Specifically, I will advocate for more specialized and rigorous requirements for covered bonds, as those requirements are key to realizing the great gains these instruments can offer. Finally, I will briefly discuss a few innovations that can make the covered bond approach even more effective in addressing the challenges facing mortgage finance.

I am the Chief Executive Officer of Absalon, a joint venture between George Soros and the Danish financial system that is assisting in the organization of a standardized mortgage-backed securities market in Mexico and elsewhere. I have worked for the past three decades on a range of financial, mortgage, and bond market issues, and I am pleased to offer the Committee my personal opinions on these policy issues today.

The benefits of covered bonds

Covered bonds are on-balance sheet, asset-backed financing instruments. They are viewed as highly secure “gilt-edged” investments. Investors have dual recourse, both to the pool of pledged assets that collateralize, or cover, the bond and to the issuer if the proceeds realized from the cover pool are inadequate. Covered bonds differ by country, with the features being determined by both law and regulation. Several countries around the world are working to introduce enabling covered bond legislation, which will assist the product as a new mortgage funding option.

Covered bonds offer several potential advantages and address several concerns arising from the past several years.

First, and perhaps most important, covered bonds keep the interests of the issuing institution better aligned with those of the borrowers and investors. In the recent past, issuers of loans sold into asset backed securities were less concerned than they should have been about the quality of those loans, since they were often completely “off the hook” within a few weeks of making the loans. Many loans were made that should never have been made. By requiring the issuing institution to retain the loan on its balance sheet, this misalignment of interest is substantially mitigated.

Second, covered bonds can help promote simpler and better allocation of risk over time. From the first financial institutions until today, a key challenge has been the mismatch between the long term loans desired by borrowers and the short term liabilities desired by depositors. A well designed system accomplishes this goal by appropriately managing interest rate risks, refinancing risks and other variables. In the recent past, asset backed securitization structures appeared to offer innovative methods to spread and price these risks. The complex, idiosyncratic, and opaque design of these instruments, however, led to catastrophic problems – particularly when combined with complex institutional and contractual relationships between issuers, servicers, and GSE guarantors.

The transparency and simplicity of covered bonds is a clear advantage, especially for investors with limited analytical resources in mortgage finance and limited trust in ratings agencies. Covered bonds help banks more cleanly manage interest risk and match long term assets with long term liabilities. The long term liabilities of well structured covered bonds allow the issuing bank to reduce its interest rate risk. (Indeed, by exactly matching the terms of the underlying loans with the term of the covered bond, interest rate risk for the issuing bank can even be eliminated.) Substantial risks do, of course, remain. Refinancing or “roll risk” remains a challenge for covered bonds, as was seen recently in Europe.

Finally, covered bonds can offer a much needed low cost form of private financing, particularly in the context of an appropriate regulatory and legal framework. A well-designed covered bond program makes the loans very secure. When security is high, the buyers of the underlying bonds will accept low interest rates. As I will emphasize more than once, covered bonds work best when they are structured consistently, conservatively, and transparently. Covered bonds with these characteristics have a long and successful track record in Europe.

Covered bonds could thus be of particular help as we address the current problems in the mortgage industry and, perhaps, in other securitization markets as well. As the Congress considers how to restructure the GSEs and how to restart private mortgage lending with more limited government guarantees, covered bonds should be carefully considered.

How best to design a covered bond system

This Committee, the Congress, the Administration and regulators face a series of important decisions when deciding how best to achieve the benefits that covered bonds offer the financial system. While many of these issues are quite technical, I would like to focus now on four more thematic issues: the need for specialized as opposed to general law-based legislation; the need to limit eligible cover assets to long term secured lending such as mortgages; the need to have strict rules govern asset liability management for the issuers; and the need for specific procedures to address both issuer and cover pool credit problems when they arise.

The need for specialized legislation

One issue facing the Committee is whether to have general law-based or more specialized covered bond laws. To achieve the benefit of being low cost, covered bonds must be viewed as "gilt-edged" securities. Standardization and transparency tend to be associated with specialized covered bond laws. General law based covered bonds may allow more flexibility for the issuers. In the past two years in Europe, however, general law based covered bonds issuance has declined, as the investor base has preferred the transparency that comes with more specific legislation. In addition, opaque and idiosyncratic bonds that come from increased differentiation have resulted in lower market liquidity for those bonds.

In the last year, the spread between specialized-law and general law covered bonds in Europe has widened significantly. Investors have higher comfort levels from the specialized covered bond laws and the higher level of specific regulatory requirements associated with such legislation. In particular, more specific legislation often includes restrictions on collateral type, loan to value requirements, and appraisal standards. In addition, investors' ability to assess the product characteristics are enhanced by the standardization and transparency offered by more specific legislation.

The need to limit eligible cover assets to long term secured lending

As discussed above, two central virtues of covered bonds are interest alignment and long term interest rate protection for banks. It is my view that in starting a covered bond program, cover assets should be limited to well underwritten, conservative loan to value ratio, first lien mortgages. This is the asset class where the benefits of this approach are greatest. Well underwritten mortgages have physical assets behind those loans, which reduce their risk. Other asset classes could be considered later on the basis of experience.

The 200 year success of the European covered bond market is due to its consistently conservative approach. The U.S. covered bond market should copy this and be started with high quality assets and strict standards. Short duration/floating rate assets do not in my opinion belong in covered bonds, at least to start. Home equity loans, student loans, credit cards and auto loans all fit well on a bank's balance sheet; these securitization asset classes were also the easiest to get restarted after the crisis began. Further, RMBS and CMBS have no place in a covered bond in my opinion. Their credit risk is already supported by their structures, and the added complexity and risks they bring would unduly complicate a nascent U.S. covered bond market.

The need to have strict rules govern asset liability management

Investors look to several risk mitigants to gain comfort in a covered bond's high credit quality. First, the credit quality of both the collateral and the issuer are of paramount importance. The credit crisis tested many assumptions, and it became clear that issuers were often more vulnerable than the high quality collateral backing the bonds. The basics of proper asset liability management were critical, and the Committee should pay careful attention to developing proposals to ensure such sound management in this market.

The European covered bond market came to a halt after the Lehman bankruptcy filing. Commercial and mortgage banks had to pay significantly higher interest rates than usual to raise funds. Banks that were reliant upon covered bond issuance for financing were forced to issue bonds with significantly shorter maturities, with many being unable to borrow at any price. The government of Ireland, Germany, Belgium, and the United Kingdom had to rescue credit institutions which were faced with mismatched asset/liability profiles. While the credit quality of the underlying cover pool assets had deteriorated, the significant factor was the inability of the issuer to raise new liabilities to pay off the maturing covered bonds.

There are several risks in 2010 which face the European covered bond market. The most significant risks are the possibilities of declining credit quality for both collateral and the issuers. It should be noted that both main risks are correlated to interest rate movements. If rates were to rise, both interest sensitive assets and issuers with mismatched asset liability management practices will experience significant pressure.

Given the recent experience and future threats to covered bonds from asset/liability management risks, the bond ratings agencies have proposed significant changes to their covered bond rating methodologies. Fitch is changing how it calculates its Discontinuity Factor by reducing the expected market value of covered assets and increasing the weighting attached to liquidity gaps. This has led to higher levels of overcollateralization. Moody's was the last of the big three to respond to the market's heightened fear of liquidity risk. It is requiring additional collateral based upon the relative change in collateral value versus the proceeds due on the bond.

S&P has made the most significant proposed changes, which center around assigning covered bonds to three categories based upon their inherent asset–liability mismatch. This forces a higher correlation between bond and issuer ratings as the maturity mismatches increase. Match-funded covered bonds, in which the issuer retains only the credit risk of the collateral but takes no interest rate risk (because the covered loans exactly match the terms of the bond), are significantly de-linked from the issuer rating. S&P plans to score each national market based upon the degree of support they offer. They will use recent history as a guide for the scenario analysis when trying to estimate market value of collateral.

The market price of covered bond collateral has declined, which has exacerbated asset/liability mismatches. Overcollateralization is one way to mitigate this problem, but a more direct route would be to reduce or eliminate the cash flow mismatches from the process, as I will discuss in more detail later. In addition, unsecured deposit guarantors prefer minimal over-collateralization, as they are left with no assets in event of issuer insolvency.

The Committee should ensure that the full range of modern asset/liability management tools are brought to bear on covered bonds, whether through regulation or legislation. This should include restrictions on interest rate, options, and currency risks.

<u>The need for specific procedures to address both issuer and cover pool credit problems</u>

Successful covered bond programs have clear and definitive rules to deal with what happens when there are problems. The simplest problem arises when there is a bad loan in the cover pool. The best policy approach is to insist that cash be the only substitute for a bad loan. Bad cover assets need to be removed from the pool as soon as possible. By buying them out, the issuer is thus directly responsible for the consequences of its bad credit decisions. This can also act as an early warning signal of issuer specific risk and limit ultimate losses to the bond holder. Particularly in light of recent experience, it seems highly questionable to allow issuers to substitute new loans into the cover pool at par value. This opaque, non-market process will immediately be exposed by new rating agency procedures.

The legislation should include lending restrictions, which govern borrower underwriting criteria, appraisal criteria and specific loan to value ratio (LTV) limits. LTV limits should be hard ceilings, which vary by the riskiness of the underlying property type. New loans should carry full recourse, as the borrowers are benefitting from the ability to borrow at low rates that would otherwise be unavailable. Recourse and a simple and clear path to lender loss mitigation combine to lower long term mortgage credit costs.

Issuer insolvency creates other problems to be addressed by legislation. The rules for estate separation should be clearly defined, with a strong covered bond regulator empowered to make quick decisions. Issues to be resolved include assignment of cover pool to a new servicer and/or sponsor and the level of retention of over-collateralization that moves with the estate. A process should be established to register contingent claims on behalf of investors, which should be subject to netting rules. In the event of issuer insolvency, an acceleration event should be excluded. Covered bonds are best viewed as a rate product; an acceleration event triggered by issuer default subtracts value from the bond investor.

The Federal Financing Bank liquidity guarantee is quite positive, but should be associated with a very strong prudential regulation. The backstop should in no way be construed to mean federal credit insurance. By giving liquidity support, the Federal Financing Bank should not be construed to give Agency status to the covered bond issuer or estate. Liquidity support should always function in the interests of the covered bond investors.

An additional approach that complements covered bonds

I would like to conclude my testimony by briefly discussing a particular approach to covered bonds that creates significant benefits to homeowners, bondholders and covered bond issuers, and promotes financial stability as well. As we have seen, the benefits of covered bonds are maximized when the terms of the bond exactly match the terms of the underlying assets. This exact match both eliminates interest risk for the issuer and refinancing risk for the bond.

When each loan is exactly balanced by a portion of an identical, transparent, and tradable bond, this is called the Principle of Balance. They key word and backbone of this system is match-funding: there is a match between a loan and the bonds funding the loan. Markets that adhere to this principle offer substantial advantages. Indeed, this system has worked extraordinarily well in Denmark since 1797, and I would be eager to work with this Committee and others to discuss the practical issues that need to be addressed in order to move it forward in the U.S. I have attached to my testimony a brief paper outlining the proposal in more detail.

Despite historic turmoil in financial markets, Danish mortgage bonds have performed remarkably well. No government guarantees for mortgage bonds have been necessary in Denmark. Danish mortgage banks were able to continue lending activities throughout the entire crisis because new bonds were saleable. Consequently, Danish homeowners and companies seeking financing for properties did not experience any limitations attributable to the financial market turmoil. The Danish mortgage system has survived all economic downturns thanks to this strong foundation. Over the years, this foundation has contributed to stabilising the Danish economy.

For the purposes of today's testimony, I would like to argue in broad terms that instituting the Principle of Balance can allow for better aligned interests between borrowers, intermediaries, and investors. Further, when combined with optional redemption mortgages, this system can significantly limit the threat of foreclosures during housing busts.

Cleanly separating credit risk from interest rate risks allows institutions and investors to better align their activities. Mortgage issuers focus on evaluating individual credit risk; bond markets and their institutions focus on interest rates, yield curves, and volatility. The entire market is transparent, with people checking daily mortgage trading prices online the way stock investors check Yahoo finance today.

Optional redemption mortgages, like covered bonds, are a fairly simple idea, but they are unfamiliar to many here in this country. Just as many mortgages currently offer homeowners the option of prepaying and refinancing when interest rates drop, optional redemption mortgages offer the homeowners the option of refinancing when the value of a mortgage drops, due to a rise in interest rates. Many Americans now hold mortgages that are trading at far less than the par value owed on the mortgage; if they had optional redemption mortgages, they could refinance at lower principal and often maintain positive equity in their home.

In this sense, the optional redemption mortgage puts households more nearly in the same situation as corporate treasurers, who have the ability to purchase their own debt back at a lower value in the open market if the value of that debt falls.

This feature would profoundly improve the overall situation facing the housing market during housing price declines, by directly and substantially reducing the number of homeowners who are underwater.

Transitioning to a new, simpler and more stable system could be done efficiently and effectively by refinancing performing mortgage loans into new, standardized Principle of Balance loans. Many transition paths could be considered.

Conclusion

The U.S. government has become the "single payer" supporting the mortgage market. As such, it has profound ability to influence the design of the system moving forward. There should be added urgency to mortgage reform given the threat to rising interest rates from the embedded extension risk in the existing mortgage market. Waiting should not be an option as increases in interest rates may set off a self-reinforcing bond market decline.

Covered bonds can be an important part of the solution. Introducing a legislated covered bond market is a big step in rebuilding the market in a sound and sustainable fashion. A few additional changes can make this an even more effective step, and I urge the Committee to carefully examine the potential of a market in which standardized mortgages with optional redemption are funded through simple and transparent covered bonds.

Appendix

Principle of Balance Mortgage Lending: a Better Approach

The mortgage finance system in the United States needs to be rebuilt. Currently, nearly all new mortgages and a significant amount of the old loans depend upon some form of the financing or guarantee from the Federal Government. Policymakers thus have a unique opportunity to structure the market in a sound and sustainable fashion. We can do better than the old model. This plan enables homeowners to reduce principal owed and negative equity by providing capacity to repurchase their own loans when those loans are trading in the market at discounts. If this is pursued soon, this plan could help homeowners preserve equity in their homes. The goal is to create a standardized, transparent mortgage system which aligns the incentives of the homeowner, the bondholders and the intermediaries.

The better and simpler system revolves around The Principle of Balance (PoB). The central difference of a Principal of Balance system is foundational – each performing mortgage is always exactly balanced by an identical and openly traded bond[1]. Mortgage Credit Institutions (MCIs) play critical roles and advisors. They help the homeowner understand and navigate the process. Most important, MCIs bear the credit risk of the mortgage – they remain "on the hook" in the event of delinquency or default. They are mortgage credit insurers. In Denmark, where this system is in place, the MCI originator bears full responsibility for timely payments from the homeowner. If a homeowner falls behind on payments, the mortgage is removed from the bond by the MCI at the lower of the market price or par. The MCI deals with all ensuing credit and collection issues.

This system cleanly separates credit risk (the risk an individual homeowner will not repay) and interest risk (the risk that changes in interest rates will raise or shrink the value of the mortgage) and manages them appropriately. Mortgage advisors have an incentive to get homeowners only into those loans that make sense for that family. Mortgage credit issuers develop expertise on understanding who can repay their loans. Meanwhile, bond investors worry about only interest rate risk, with complete insurance on any credit related issues. A good mortgage system will properly identify, minimize, and efficiently allocate these risks.

A main benefit of this system is that it offers performing homeowners the ability to buy back their own mortgages when the price of those mortgages drops in the open market. When

[1] The mechanics of this system are simple, if unfamiliar. When a homeowner qualifies for a new mortgage, the Mortgage Credit Intermediary adds that mortgage to a pool of identical mortgages – 30 year fixed mortgages expiring in 2039 with a 4.75% rate, for example. This pool is financed by investors through bond purchases. The bond series is "open" while new mortgages are being issued into it. Once these mortgages are no longer being issued (for example, when 30 year mortgages come due in 2040), the bond series is closed. Throughout the process the bonds trade openly. Thus the mortgage loan is not made by a bank; it is made by the bond market, with the MCI facilitating. Since all of the mortgages in a given bond series are identical, it is possible to directly balance a performing mortgage – on the basis of its face value as a percentage of the face value of all mortgages in the pool – against an equal share of the trading value of the bond series.

interest rates rise, the value of existing mortgages drops. This optional redemption feature – akin to refinancing when interest rates drop -- is then available to homeowners who are current in their payments. The homeowner directs his/her mortgage company to purchase the correct current face value amount of the bond at its discounted price and use it to redeem the existing home mortgage loan. This is paid for by the simultaneous issuance of a new loan, for a smaller face amount, often at prevailing higher mortgage rates. This feature radically reduces the threat of foreclosures by eliminating the systemic risk to homeowner equity due to rising rates.

Right now many mortgages are trading for 60 cents on the dollar in the bond market. Even though the homeowner owes the face value of the mortgage, say $100,000, that mortgage can be bought by an investor from the market for $60,000. Why shouldn't the homeowner be allowed to purchase the mortgage at this lower price? This optional redemption is of particularly great value at times, as in 2009, when home prices and mortgage values decline in tandem. The ability of the homeowner to reduce his mortgage liability reduces the chance that he will be underwater when home prices fall due to changes in interest rates.

Transitioning to a new, simpler system could be done efficiently and effectively by refinancing all performing mortgage loans into new, standardized Principle of Balance loans. Many transition paths could be considered. In the current U.S. environment, it may make sense to use the GSE's to lead this process by offering large scale, streamlined refinancings of all performing mortgages into full recourse PoB loans backed by federal guarantees. The GSEs could then transition into a pure insurance role – as the loans would no longer be on their balance sheets. This approach would run cash through existing non-agency securitizations, which is the most effective way to clean them up. We would need to expand underwriting criteria to include currently ineligible borrowers AND allow for higher loan to value ratio (LTV) during the transition period. Loan limits could be raised readily to cover 99% of mortgages.

Alternatively, this could be done entirely through private institutions. The key issue is moving now, when the basic instruments and institutions of mortgage finance are being reviewed and rebuilt. Four elements are key to the success of this new approach.

Highly Standardized Loans

All loans guaranteed under the new system need to have highly standardized characteristics so that each resultant bond series is made up of exactly identical loans. There can be different types of mortgages pooled into different bonds, but all the mortgages in a specific bond series (for example, the series made up of 30 Year fixed, 4.5% loans expiring in 2039) must be identical. This standardization allows for the Principle of Balance (PoB) – through which each performing mortgage is always and exactly balanced against an equal and redeemable share of a bond series. Given that all of the loans are identical (and the individual credit risk is fully borne by the MCI), a homeowner can easily identify and repurchase an amount of the bond equal to the value of his or her mortgage. New loans will carry full recourse, enforced by an agency of the U.S. Treasury Dept.

Highly Transparent Securitization

The system needs to have transparency built in. The moment a mortgage is issued, it is sold into a bond series of mortgages with identical terms. The mortgage obligation never vanishes into a complex web of securitizations. Daily information is published on bond trades and how many loans were funded by bond issuance. Weekly information is published on prepayment option exercise. Quarterly information is published on credit metrics of each bond series. In Denmark, bondholders and investors go online as stockholders do here – they check the price, fundamentals, trades, and news about their mortgage series on NASDAQ OMX (http://www.nasdaqomxnordic.com/bonds/denmark/). It is an open system, where all are treated equally on a level playing field. Well tested systems are easy to transfer, monitor and regulate.

Well Aligned Interests

Separation of credit risk from interest risk allows each set of financial markets and professionals to operate effectively, efficiently, and with well aligned interests. MCIs are shielded from any and all risks other than credit risk. MCIs become mortgage insurance companies that do the paperwork. They make sure that bad loans are NOT produced, thus eliminating the fundamental problem vexing global financial markets. MCIs act as "liability advisors" to the homeowners, with every incentive to get each person into the mortgage most likely to be repaid and no incentive to drive volume when rates fall.

MCI's become transparent information processors and fee for service providers. MCIs are incentivized to: survey the bond market for risk reducing transactions, advise and assist the homeowner in executing the mortgage refinancing transactions. By helping the homeowner, the MCI is able to also reduce the value at risk of the mortgage credit insurance.

MCIs must make all efforts to have their bond series trade as well as those of competitors. Homeowners have clear and transparent incentives to refinance with the MCI whose bonds trade at the highest prices.

MCIs must also make all efforts to make the prepayment characteristics of its bond series no worse than that of its competitors for investors. This creates an incentive for MCIs to make loans to those homeowners who have a lower probability of refinancing, including first time homeowners and others who have been underserved in the past.

The bond market does not face credit risks when a loan is non-performing because it is removed from the bond series. The market deals only with pricing, allocating and hedging interest risk. The terms of the bond match the terms of the liability by definition[2].

[2] This is a benefit compared to a more standard covered bond approach, where the term of the covered bond is not tied to the term of the included mortgages. Standard covered bonds can create a threat of being unable to roll forward financing at the expiration of their term; Principle of Balance systems avoid this risk.

Counter-Cyclical Properties

When interest rates rise, mortgage prices fall as do housing prices. The Principal of Balance allows homeowners to redeem their mortgage and refinance at a lower principal. If interest rates were to fall again, the homeowner would be allowed to exercise his/her imbedded call option and refinance into a lower rate loan. This is a very effective, markets-based approach that reduces long-term interest rate volatility.

Mortgages are callable, which provides the most effective mechanism for the transmission of monetary easing into stimulation of aggregate demand. Callable loans are also an effective way to reduce inter-generational moral hazards and accounting issues.

The correlation between interest rate risk and credit risk is reversed by following the PoB. This provides a counter-cyclical income stream for banks.

Capitalization of the margin between the loan and the bond is prohibited. This practice leads to a misalignment of interests and encumbers future credit events. Variable margins allow future unforeseen credit costs to be shared among the beneficiaries of the system rather than future taxpayers. This is the main reason that mortgage servicing rights (MSRs) should not be capitalized and booked as upfront income.

The PoB system acts outside of bank's balance sheets – we need "thinner" institutions that perform clear and indentified functions, with stronger and "thicker" markets of standardized products.

Conclusion

The U.S. government has become the "single payer" supporting the mortgage market. As such, it has profound ability to influence the design of the system moving forward.   MCIs should be required to remain "on the hook" for the first 10% of any credit losses associated with their bond issuance. Mortgages should come with full recourse from the Federal government. Bond holders should be responsible for managing interest rate risks. We can build and transition to the Principal of Balance system now. Doing so should be a priority, even as we continue to work to clean up the problems of the previous system.