Written testimony of Wesley Phoa

Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. My name is Wesley Phoa, and I am a senior vice president, investment analyst and bond portfolio manager at the Capital Group Companies, a privetely owned investment management firm. Thank you for the invitation to appear before you today.

I appreciate your interest in investigating the covered bond market and how it may play a role in your broader efforts to ensure that we develop a stable and well functioning financial system. And I welcome the opportunity to give you an investor's perspective on this market, and to answer your questions.

A little background. My firm invests money on behalf of mutual fund shareholders, pension funds, endowments and other institutional investors. We were founded in 1931, and pursue a very traditional style of investing. Our clients have entrusted a total of about a trillion dollars to us, which we invest in stocks and bonds. We are active investors; we conduct extensive research on individual companies around the world, and on the economy as a whole, and make investment decisions on that basis.

I should say that my firm encourages diversity of opinion, and therefore the opinions expressed below are mine alone – though they are based on many internal discussions and long experience on the part of my fellow analysts and portfolio managers.

Investors have different needs, and we seek suitable investments from around the world that meet those various needs. Workers saving for retirement have to build their savings, and for them we try to purchase shares in good companies, whose price will rise over time. Retirees need a reliable income to support them, and so we try to find stocks and bonds that will generate the income they require. And almost everyone needs to protect a portion of their savings through hard economic times and difficult markets; so we must also find good, sound investments whose value will hold up in rough times; this means investing for safety, not just growth or income.

As you know, a covered bond is a bond issued by a bank or other financial firm, which is secured by a specified pool of assets on the bank's balance sheet. The bank must make principal and interest payments on the bond, and if the bank fails, then bond investors have recourse to the collateral.

An active, well designed covered bond market would enable financial firms to issue safe, desirable securities, letting them tap a broader base of investors in good times and bad. This would create a new source of funding for these firms, that they could rely on in difficult periods, which could reduce their need to turn to the Government for help.

And such a market could help serve our clients' needs in several ways. First, when investing for safety, we would be able to diversify beyond Government bonds and Government sponsored securities. Second, covered bond financing provides funding for loans that are retained on balance sheet, and this helps align issuers' interests with those of investors; such alignment of incentives is another stabilizing force. Third, by giving financial firms another funding option in difficult times, it should make them more likely to survive distress, and thus make them more attractive investments at all times. Fourth, it should reduce firms' reliance on Government support, so that outcomes will depend less on discretionary policy decisions, which are very difficult to analyze. And it should help credit to flow more freely during difficult times, making the credit markets more robust during downturns, and lowering the cost of capital through the economic cycle.

Let me say a little bit more about each of these subjects.

On investing for safety. When times are hard and the system comes under severe stress, investors move to Government bonds. This has worked well, as it should, but not without costs. We sacrifice income, we sacrifice diversity, and we make our portfolios more sensitive to Government policy decisions. Private sector alternatives would be useful. In Europe, the covered bond market has been one such alternative. We've invested in *pfandbriefe* – German covered bonds – for two decades. They've been a sound investment and achieved their purpose. Firms which can tap this market have access to a broader and deeper base of debt investors. That makes them more robust in bad times and more efficient at all times.

On alignment of incentives. Covered bonds give financial firms who choose to retain loans on their balance sheets a way of funding them efficiently without selling them, via securitization or otherwise. When loans remain on balance sheet, the issuer continues to bear the full risk of credit losses, which imposes a useful discipline on lending. That creates a natural alignment of interests and incentives between financial firms and their investors; though clearly there are a variety of other ways to address this issue.

On funding in difficult times. If a firm gets into trouble – and one firm or another always will, from time to time – it often has to rely on secured funding to make it through. And investors are often willing to provide secured financing to a troubled firm even when the unsecured debt market is not available to them. The risks are lower, more readily analyzed, and thus easier to accept. A well developed, standardized covered bond market would hopefully give troubled firms reliable access to an important funding option, provided only that they have good assets to serve as collateral. This would help to alleviate the need to develop special programs or other initiatives that were necessary during the credit crisis to help stabilize financial institutions' access to funding.

On Government support and policy decisions. During the course of the financial crisis, the Federal Reserve, the regulators, the Administration and Congress all intervened at various times and in various ways to help support the financial system. There are compelling arguments that many of these actions were unavoidable and necessary. However, as an investor, it is difficult or impossible to anticipate *ad hoc* policy responses to crisis situations. This creates uncertainty.

Investors may respond to this in two different ways. If they are prudent, they demand higher returns to accept this kind of uncertainty. That is, when the future of firms depends on policy decisions that are very hard to analyze, both raising equity and obtaining debt finance tend to be more expensive and less certain. The cost of capital in the economy rises more than it should.

On the other hand, investors may be complacent, and assume that the Government will always ride to the rescue. This is not a good thing. It creates moral hazard problems which, in the end, can be even more costly.

Ultimately, in the last resort, the Government should always retain the power to step in if it so chooses, when there is a sufficiently severe crisis. But the less often this happens, and the more predictable the process is, the lower the uncertainty overall, and the lower the economic costs. Thus, it is desirable to have more robust private sector mechanisms.

Finally, on the robustness of credit markets and the cost of capital. When markets are more robust, when investors face less uncertainty and thus demand lower risk premia, the whole economy operates more efficiently. This seems to be one important goal of financial reform, and if a covered bond market can give firms a new, reliable funding option, it can play a useful role there.

I should now turn to our recent experience with the covered bond market.

As I mentioned before, we have been long-standing investors in the European covered bond market. In the United States, an active covered bond market has never become established. Mortgage finance has relied more heavily on Government sponsorship, via Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, as well as the Federal Housing Administration. In addition, in more recent years, securitization had played an increasingly important role. So while structures resembling covered bonds had existed in the past – the old mortgage-backed bonds which were issued by thrifts when they encountered liquidity problems in the late 1970s – this did not become a permanent feature of our domestic bond market.

I was very encouraged when a US covered bond market started to emerge in the years immediately before the crisis. While only two US financial institutions raised covered bond financing, a number of European banks also tapped the US dollar markets, and it looked as if a reasonably diverse market was starting to evolve.

Unfortunately, the global financial crisis intervened. As you know, this severely affected all parts of the private sector bond market. The European covered bond market actually weathered the crisis reasonably well, though liquidity declined as dealers' ability to make markets was adversely affected. The new issue market went away for a while, but as crisis conditions abated, European banks were able to resume issuing covered bonds well before they could issue new unsecured debt with no Government guarantee.

The nascent US covered bond market did not fare as well. I believe there were a number of related reasons for this. First, it was immature, and thus suffered disproportionately as investors lost their taste for anything new or different. Second, the investor base was still fairly narrow at the time the crisis struck, as most investors were still evaluating the market from an economic, legal and regulatory point of view. Third, liquidity deteriorated much more sharply than in the European market. And finally, uncertainty about decisions being taken by policymakers and regulators, especially in insolvency resolution, weighted quite heavily on investors' minds. The legal framework under which the US covered bond market was established offered us significantly less clarity than the more specific principles enshrined in European covered bond legislation.

During the course of 2008, the authorities did take a number of actions to mitigate some of these concerns: notably the FDIC's Policy Statement, the Treasury Department's Best Practices document, and the favorable treatment of covered bonds (in contrast to unsecured debt) in the resolution of Washington Mutual. But administrative and regulatory actions did not suffice to dispel investors' uncertainty.

Investors can live with economic uncertainty. That's our job. But uncertainty about institutions and policies is problematic. Sound investment analysis relies on a clearly defined framework of rights and duties. That's a critical element of investor confidence.

At this point, then, it would be extremely helpful for this market to make a fresh start on a sound legislative basis. Our experience in European jurisdictions suggests that such a market would be appealing, and the prospects for success are bright. Past disappointments have by no means discouraged us for good. Rather, if an improved market structure emerges, it's our duty to our clients and mutual fund shareholders to evaluate it and, if it helps us meet their needs, to be significant, long-term investors.

We're also investors in banks and other financial firms, and I should say a word about how covered bond financing could help those firms to make loans and manage their businesses prudently, especially through difficult economic environments, since that matters a great deal to investors.

It's possible to issue covered bonds of varying maturities, from short to long. This would help banks match their wholesale funding to their long-term assets more closely, reducing their balance sheet risks. The assets securing the bonds are retained on balance sheet, so issuers can continue to work cooperatively with borrowers who are in trouble, in contrast to securitization where the scope for loan modifications is much more restricted. And as I mentioned, the retention of loans on balance sheet is one way to reduce potential conflicts of interest between lenders, borrowers and investors – a key criticism of the originate-to-distribute model that became widespread in the pre-crisis period.

Most importantly, the ability to issue covered bonds will enable banks to tap a broader base of debt investors. Banks will be able to fund themselves more efficiently in good times, fewer banks will fail in bad times, and banks will retain more flexibility to meet the needs of their customers and to mitigate their own credit losses by helping borrowers through rough patches. It should also mean a more level playing field for debt finance, which should help smaller banks retain access to bond financing in difficult markets.

The potential benefits are greater if covered bonds can be used to finance various different kinds of loans rather than simply mortgages. Traditionally, European covered bonds had only been used to finance residential mortgages and loans to public sector entities. But there's no reason in principle why they shouldn't be collateralized by other kinds of consumer loans, or by loans to small businesses. This may make the covered bond market an even more helpful financing tool.

So what do investors look for in a covered bond market? What would make it function effectively as an attractive place to invest?

First, fundamental soundness. The bonds should be backed by enough collateral, and the collateral should consist of good loans. That's the basic principle of covered bonds.

Second, liquidity. We have to be able to buy and sell these securities freely, in good and bad markets. I believe that's something that the private sector can sort out for itself.

Third, an adequate return. As safe as these bonds may be, we can't invest in them without doing our own due diligence. We'd therefore require them to have better returns than Government bonds, though we should logically accept lower returns – and lower risk – than for unsecured debt.

Fourth, good oversight. Appropriate regulation is important. It's played a key role in helping covered bond markets to thrive in other jurisdictions. Good regulation includes disclosure, transparency, and clear standards that issuers must meet.

Fifth, and crucially, legal and policy certainty. We need to be sure about the legal standing of our investments. We need to know what will happen when an issuer fails. And we need to be reasonably confident that we know what legal rights the various parties have, and what procedures will be followed when an issuer fails. We understand that no investment comes without its own risks; but we need to have enough clarity so that we can analyze those risks and be confident about our conclusions.

If these conditions are met, I think the potential investor base is very broad.

A word on timing. It takes time for a market to establish itself, and it takes time for investors to become familiar with new kinds of securities and to find a place for them in their portfolios. A deep and liquid covered bond market won't spring into existence overnight. But I think it's important to make a start as soon as possible. And today's environment, where there are plenty of savings looking for a conservative home, is, I think, quite conducive to the development of this market.

To sum up, it's good for the economy and good for investors if we have a private sector financial system that's stable and robust, that can stand on its own two feet during recessions – even severe ones – and continue lending freely, on prudent terms, to households and small businesses. A healthy covered bond market established on a firm legal basis should make an important contribution towards this goal.

Again, I appreciate the opportunity to testify before the Committee, and I hope my remarks have been of some assistance.