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June 23, 2008

Via email to comments@FDIC.gov

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
555 17th Street, N.W.
Washington, D.C. 20429

Re: Comments on Interim Final Covered Bond Policy Statement

Dear Mr. Feldman:

I am writing to offer my comments on the Interim Final Covered Bond Policy Statement as published in the Federal Register on April 23, 2008; Vol. 73, No. 79, pages. 21949 to 21953. I am submitting this comment letter on behalf of myself and not on behalf of any client or other party.

Covered bonds represent a long over-due advance in the funding of fixed-rate home mortgages and other long term, fixed-rate financial assets. Covered bonds offer several extremely important public policy advantages over mortgage securitization that far transcend the FDIC's concerns, namely (1) covered bonds will permit banks and thrifts to hold fixed-rate mortgages on-balance-sheet without creating a significant maturity mismatch, greatly reducing their incentive to sell mortgages into the securitization marketplace. (2) Banks and thrifts will be more conservative in evaluating the credit risk of mortgages and other financial assets they hold in portfolio and fund with covered bonds than they have been for mortgages and other assets they originate with the intent of selling. (3) Given that covered bonds usually are structured to be rated AAA, the relatively low interest rate on covered bonds will help to lower home mortgage rates. (4) Reducing the quantity of securitized assets in the economy, coupled with the reduced maturity mismatching of financial assets, will greatly enhance systemic stability within the U.S. and global financial systems while avoiding the moral-hazard risk inherent in asset securitizations.

While this policy statement represents a positive step forward by the FDIC, the Interim Final statement contains serious shortcomings that will impede the utilization of covered bonds by U.S. banks and thrifts while imposing unnecessary costs and restrictions on issuers. Given that the FDIC has stated that it seeks to "reduce market uncertainty and the costs of U.S. covered bond transactions," it should seek to completely eliminate market uncertainty as to what it will do in a failed-bank situation so as to reduce covered-bond transaction costs to the absolute minimum. If retained in the final version of the policy statement, these shortcomings will deter the issuance of covered bonds while unnecessarily boosting the interest rate on bank-issued covered bonds, a cost that will be passed through to homeowners and other borrowers.

Specific shortcomings in the draft policy statement are as follows:

No need to limit covered-bond issuance The FDIC proposes to limit the amount of a bank's outstanding covered bonds to 4% of the bank's total liabilities at the time the bonds are issued. The FDIC apparently is concerned that "covered bonds could excessively increase the proportion of secured liabilities on [bank] balance sheets at the expense of the Deposit Insurance Fund" (DIF). While this concern has some validity, it is greatly exaggerated, for several reasons:

(1) Federal Home Loan Bank (FHLB) advances, which are secured by bank assets, have no comparable limitation. To the extent covered bonds replace FHLB advances, there will be no change in the ratio of a bank's secured liabilities to its total liabilities.

(2) To the extent that utilizing covered bonds improves bank asset quality (since covered bonds must be backed, or "covered," by high-quality assets), covered bonds will promote increased bank soundness by incenting banks to hold more high-quality assets on-balance-sheet.

(3) Any increase in a failed bank's insolvency loss percentage attributable to an increase in the ratio of a bank's secured liabilities to domestic deposits could be offset with a modest increase in deposit-insurance premiums. However, failure probabilities for sound banks – those rated CAMELS 1 and 2 – are so low that it hardly seems worthwhile to charge those institutions any additional premium for any of their secured borrowings, whether repos, covered bonds, or FHLB advances.

In this regard, it is useful to estimate the premium-rate increases needed to fully compensate the DIF for any increased risk of loss due to secured borrowings of any type. The spreadsheet at the end of this letter illustrates this estimation process. For example, if 50% of a bank's total liabilities are covered bonds or other secured borrowings (Case 5 – the shaded column on the right), 11% of the bank's funding comes from equity capital and liabilities subordinate to domestic deposits, there is a .01% probability (1 in 10,000) of the bank failing in any one year, and should the bank fail, its insolvency loss equaled 15% of its assets, a miniscule .044 basis point premium increase (bolded on the spreadsheet in the shaded row) would fully compensate the DIF for the increased risk of loss posed by the bank's covered bonds. Given that Congress has mandated that regulators act promptly in dealing with troubled banks (under FDICIA's Prompt Corrective Action provisions), which are intended to minimize bank insolvency losses, failed banks and thrifts should not have insolvency losses exceeding 15% of the failed institution's assets.

Arguably, the FDIC could justify charging an additional premium to riskier banks and thrifts for the potential incremental risk of secured borrowings, but for one problem – the FDIC currently does not charge riskier institutions (those classified as Category II, III, or IV for deposit-insurance purposes) based on their individual risk characteristics. Instead, all banks and thrifts in each category are charged the same premium rate. Only if the FDIC begins charging risk-sensitive premiums to the higher-risk institutions, based on their individual risk characteristics, should it consider reflecting secured borrowings in that calculation.

10-business-day repudiation period unnecessary and counterproductive The FDIC has no need to exercise its statutory power to repudiate any covered bond obligation. As noted above, the additional risk of loss covered bonds pose to the DIF is not only quite modest, but to the extent that risk exists beyond the risk already posed by FHLB advances, it can be compensated for by a modest increase in a bank's DIF premium rate. The uncertainty posed by the 10-business-day repudiation period will only have the negative effect of boosting the cost of covered bonds to their issuers, a cost which will be passed through to homeowners and other borrowers. Further, it appears from the draft policy statement that the 10-business day repudiation period (i.e., 10 days after a "monetary default" on the bank's covered-bond payment obligation) or an actual repudiation ("as provided in a written notice by the conservator or receiver") can fall anywhere within the 45-day consent period after the appointment of a conservator or within the 90-day consent period after the appointment of a receiver, as provided in 12 U.S.C. Sec. 1821(e)(13)(C)(i). Arguably this 10-business-day provision does nothing to reduce the statutory uncertainty which would exist in the absence of the draft policy statement.

FDIC staff contended at the April 15 board meeting that the 10-day repudiation period "balances the needs of the market versus the needs of the receiver." Raising the DIF premium rate for riskier institutions for the slight additional risk covered bonds present to the DIF fully takes care of the "needs of the receiver," which means that the "needs of the market" can be fully addressed if the revised policy statement makes a positive categorical statement that under no circumstance will the FDIC repudiate or otherwise compromise for even a moment any covered bond issued by a bank or thrift for which a conservator or receiver has been appointed.

Covered-bond collateral limitations too restrictive The draft policy statement limits covered-bond collateral (i.e., assets eligible for inclusion in the covered bonds' cover pool) to "eligible mortgages" (as defined in the policy statement) and AAA-rated mortgage-backed securities (MBS), provided that the MBS constitute no more than 10% of the cover pool. While the FDIC has legitimate concerns about covered-bond collateral consisting of CDOs and other opaque debt instruments issued by securitization trusts, the draft policy statement's collateral limitation is far too restrictive, in two regards: (1) it excludes other types of loans the issuing bank originates and can hold in portfolio, for which credit risks are readily observable, and (2) it excludes Treasury securities and other types of high quality debt which can be used in the day-to-day management of the cover pool, as permitted under the covered-bond indenture. Accordingly, the revised policy statement should encompass a much broader range of covered-bond collateral, such as long-term, fixed-rate loans secured by office buildings or farmland.

Term limitation of covered bonds too restrictive The draft policy statement limits the term of permissible covered bonds to 10 years. While many covered bonds have terms of 10 years or less, there no reason why covered bonds with longer maturities cannot be authorized so as to give issuing banks greater flexibility in using covered bonds to (1) ladder bond maturities to better match the expected maturities and prepayments of long-term fixed-rate mortgages and (2) to fund longer-term financial assets with bullet-maturities which extend beyond 10 years. To the extent that longer-maturity covered bonds will materially increase risk to the DIF, that risk can be addressed through the issuing bank's DIF premium assessment.

Disposition of covered bonds and related cover-pool assets in a failed bank needs clarification The draft policy statement does not explicitly address the actions the FDIC, as the conservator or receiver of a failed bank, can take to preserve the value of covered bonds which have been issued by a failed bank, beyond stating that the FDIC will "grant consent to access pledged covered bond

collateral." In order to maximize that value, the FDIC should positively commit to use its best efforts to transfer *en bloc* the covered-bond liability of a failed bank and the pool of assets collateralizing those bonds to another bank or thrift so as to bar any perceived need to prepay or defease the bonds in a manner that will impair their market value. Presumably the acquiring bank would manage the cover pool in a dynamic manner, as provided by the covered-bond indenture.

It is quite possible that in executing the transfer of a covered-bond liability and the related cover pool the FDIC can sell the differential between the value of the bonds and the carrying value of the cover pool for a premium, which will reduce the FDIC's loss in resolving the failed bank. This premium would be comparable to the premium acquirers willingly pay when assuming the deposits of a failed bank or thrift. In the case of covered bonds, the premium would derive from the fact that the acquirer of the cover pool, upon the assumption of the liability for the covered bonds secured by that cover pool, would not incur the underwriting expense for those bonds and would gain the customer relationships represented by the mortgages and other assets in the cover pool. In effect, the cover pool and the related covered bonds would have a going-concern value the FDIC could capture through an *en bloc* sale of the cover pool and its related liability – the whole would be greater than the sum of its parts.

An example will illustrate this point. A failed bank has $100 million of covered bonds outstanding which are secured by cover-pool assets of $105 million. Another bank willing to assume the liability for the covered bonds would pay the FDIC $5 million (the differential between the book value of the covered bonds and the value of the cover pool) plus a premium which might equal several percent of the covered bonds assumed. A 2% premium, for example, would bring an additional $2 million to the FDIC ($100 million x .02) while a 5% premium would bring the FDIC an additional $5 million ($100 million x .05). Whatever premium the FDIC collected would reduce the cost of the failure. Such an *en bloc* sale would be far better for the FDIC's bottom line than using the cover pool to pay off or defease the covered bonds and then selling the remaining assets in the cover pool.

I have appreciated the opportunity to comment on this extremely important policy statement. FDIC staff should not hesitate to contact me, at 703-836-4101 or by email, at bert@ely-co.com, if there is any aspect of this comment letter that the staff wishes to discuss with me.

Very truly yours,

/s/ Bert Ely

Bert Ely

Impact of secured borrowings (covered bonds, FHLB advances) on deposit-insurance premiums

	Base case	Case 1	Case 2	Case 3	Case 4	Case 5
Key assumptions:						
Covered bonds or FHLB advances as percent of total liabilities	0%	4%	4%	20%	20%	50%
Uninsured deposits as a percentage of total deposits	40%	30%	60%	30%	60%	40%
Cover pool or overcollateralization percentage	105%	105%	105%	105%	105%	105%
Value of deposit franchise as a percent of domestic deposits	5%	5%	5%	5%	5%	5%
Balance sheet						
Assets						
Assets in covered-bond cover pool or securing advances	0	391	391	1,953	1,953	4,883
All other assets	10,000	9,609	9,609	8,047	8,047	5,118
Total assets	10,000	10,000	10,000	10,000	10,000	10,000
Liabilities plus capital						
Covered bonds or FHLB advances	0	372	372	1,860	1,860	4,650
Insured domestic deposits enjoying depositor preference	5,340	5,970	3,411	4,928	2,816	2,550
Uninsured domestic deposits enjoying depositor preference	3,560	2,558	5,117	2,112	4,224	1,700
Liabilities subordinate to domestic deposits (1)	400	400	400	400	400	400
Equity capital plus minority interests	700	700	700	700	700	700
Total liabilites plus capital	10,000	10,000	10,000	10,000	10,000	10,000
(1) Includes deposits in foreign branches, unsecured borrowings, subordinated debt, and all other unsecured liabilities.						
Loss given default (LGD)						
Asset loss percentage applicable to insured deposits if covered bonds and secured advances treated as if domestic deposits						
10% assumed asset loss percentage upon failure	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
15% assumed asset loss percentage upon failure	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
20% assumed asset loss percentage upon failure	5.11%	5.11%	5.11%	5.11%	5.11%	5.11%
25% assumed asset loss percentage upon failure	10.73%	10.73%	10.73%	10.73%	10.73%	10.73%
Increased in loss % applicable to insured deposits if covered bonds and secured borrowings treated as secured borrowings:						
10% assumed asset loss percentage upon failure	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
15% assumed asset loss percentage upon failure	0.00%	0.00%	0.00%	0.68%	0.68%	4.41%
20% assumed asset loss percentage upon failure	0.00%	0.44%	0.44%	2.67%	2.67%	11.06%
25% assumed asset loss percentage upon failure	0.00%	0.69%	0.69%	4.16%	4.16%	17.21%
Premium rate increase (bps) based on probability of failure (PF)						
0.10% annual probability of failure (1 in 1,000)						
10% assumed loss on assets upon failure		0.000	0.000	0.000	0.000	0.000
15% assumed loss on assets upon failure		0.000	0.000	0.068	0.068	0.441
20% assumed loss on assets upon failure		0.044	0.044	0.267	0.267	1.106
25% assumed loss on assets upon failure		0.069	0.069	0.416	0.416	1.721
0.01% annual probability of failure (1 in 10,000)						
10% assumed loss on assets upon failure		0.000	0.000	0.000	0.000	0.000
15% assumed loss on assets upon failure		0.000	0.000	0.007	0.007	**0.044**
20% assumed loss on assets upon failure		0.004	0.004	0.027	0.027	0.111
25% assumed loss on assets upon failure		0.007	0.007	0.042	0.042	0.172

	Base case	Case 1	Case 2	Case 3	Case 4	Case 5
Decline in the bank's FDIC premium cost, based on rate additions shown above plus a base premium rate of:					**2.0**	**bps**
0.10% annual probability of failure (1 in 1,000)						
10% assumed loss on assets upon failure		4.18%	4.18%	20.90%	20.90%	52.25%
15% assumed loss on assets upon failure		4.18%	4.18%	18.20%	18.20%	41.71%
20% assumed loss on assets upon failure		2.07%	2.07%	10.33%	10.33%	25.83%
25% assumed loss on assets upon failure		0.89%	0.89%	4.46%	4.46%	11.15%
0.01% annual probability of failure (1 in 10,000)						
10% assumed loss on assets upon failure		4.18%	4.18%	20.90%	20.90%	52.25%
15% assumed loss on assets upon failure		4.18%	4.18%	20.63%	20.63%	51.19%
20% assumed loss on assets upon failure		3.97%	3.97%	19.84%	19.84%	49.61%
25% assumed loss on assets upon failure		3.85%	3.85%	19.26%	19.26%	48.14%
Total premiums paid to the FDIC, in basis points per dollar of <u>insured</u> deposits:						
0.10% annual probability of failure (1 in 1,000)						
10% assumed loss on assets upon failure	3.33	2.86	5.00	2.86	5.00	3.33
15% assumed loss on assets upon failure	3.33	2.86	5.00	2.95	5.17	4.07
20% assumed loss on assets upon failure	3.33	2.92	5.11	3.24	5.67	5.18
25% assumed loss on assets upon failure	3.33	2.96	5.17	3.45	6.04	6.20
0.01% annual probability of failure (1 in 10,000)						
10% assumed loss on assets upon failure	3.33	2.86	5.00	2.86	5.00	3.33
15% assumed loss on assets upon failure	3.33	2.86	5.00	2.87	5.02	3.41
20% assumed loss on assets upon failure	3.33	2.86	5.01	2.90	5.07	3.52
25% assumed loss on assets upon failure	3.33	2.87	5.02	2.92	5.10	3.62