Covered Bonds*

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Our housing finance system depends upon raising funds for mortgages through several channels. Institutions that hold mortgages in portfolio can raise the necessary funds through deposits and by pledging mortgages to secure advances from the Federal Home Loan Bank System. Other mortgage lenders raise funds by selling loans to Fannie Mae or Freddie Mac, and the Government Sponsored Entities, in turn, raise funds from investors by selling mortgage backed securities. Mortgages that do not qualify for purchase by the GSEs, for example, because they exceed the limitations on the size of loans that are eligible for GSE purchase, were traditionally securitized by private companies. These mortgage backed bonds are known as Private Label Securities, and they provided a significant source of funding for loans made in many higher cost markets. However, while the Federal Home Loan Banks and Fannie and Freddie continue to provide much needed capital for housing finance, the Private Label Securitization market has not yet recovered from the recent financial crisis. In light of this fact, there has been renewed interest both in Congress and in the Administration to establish a covered bond market in the U.S. This article will provide an explanation of covered bonds and an overview of the current status of the efforts to establish such a market for U.S. banking institutions.

What is a "Covered Bond?"

A covered bond is a debt instrument issued by a financial institution that is secured by a pool of performing assets (the cover pool) and is guaranteed by the issuing institution. The concept originated in Germany in the 18th Century, and soon spread to the rest of Europe and even beyond. A recent report by the European Central Bank described the covered bond market as "the most important privately issued bond segment in Europe's capital markets."

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The current proposals seek to initiate a U.S. covered bond market primarily for mortgages, but other assets could also be used to collateralize the covered bond. Unlike asset-backed securities, the loans remain on the balance sheet of the issuing company, and therefore the issuer must hold regulatory capital against these mortgages.

The payments on the covered bonds are made from the general cash flows of the issuer, and are not limited to the income from the assets in the cover pool. In the event of an issuer bankruptcy, however, the bondholders continue to receive regular payments on their bonds from the assets and income generated by the cover pool. If the cover pool is insufficient to make such payments, the investors also have rights against the issuer, but only have the priority of a general creditor in a bankruptcy or receivership situation.

The assets in the cover pool are required to be performing and to meet pre-determined underwriting criteria. The issuer will actively manage the assets in the cover pool, and will be contractually required to replace non-performing loans with performing assets. Finally, the contractual arrangements require that the value of the assets in the cover pool exceed the par value of the covered bonds ("over collateralization").

Advantages of Covered Bonds

Covered bonds provide an attractive source of funding for issuing institutions. Because the bonds are protected by a specific pool of performing assets as well as the credit of the issuing institution, they are considered to be an extremely safe investment. It is not unusual for a covered bond to receive a higher rating than the issuing institution. The risks of prepayment are mitigated by the covered bond structure, a key feature for investors. Covered bonds typically mature on pre-established dates, permitting issuers to match the duration of liabilities and assets. In addition, covered bonds that meet minimum regulatory requirements receive preferential treatment under EU laws governing permissible investments for regulated companies. Because the assets securing covered bonds remain on the balance sheet of the issuing institution, the interests of the issuers are aligned with the interests of investors. Issuers have 100 percent "skin in the game." Covered bonds meeting certain requirements are recognized as a liquid asset under the Basel III framework, but are subject to a 15 percent haircut and a 40 percent overall cap. In January of this year, the European Commission an-

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nounced that it would study the treatment of covered bonds in the Basel liquidity framework, and may recommend adjustments that would further reduce the "liquidity costs" of holding covered bonds.

Disadvantages of Covered Bonds

Since the assets in the cover pool are pledged, but not sold, they remain on the balance sheet of the issuer. Therefore, the issuing company will be required to hold capital against those assets to the same extent as other balance sheet assets. Since covered bonds require an over collateralized cover pool, they reduce the assets available to be pledged for other sources of funding, such as the Fed's discount window. Further, since the cover pool is actively managed, poorly performing assets will constantly be replaced with higher quality assets, resulting in lowering the overall quality of the institution's unencumbered asset base. Finally, unlike asset-backed securities, the amount of covered bonds an institution can issue is limited by the size of the issuer's balance sheet.

Performance During the Recent Financial Crisis

According to the European Central Bank, the covered bond market was highly resilient to the financial turmoil until the failure of Lehman Brothers in 2008. The ability to withstand the initial stages of the crisis is attributed to the fact that the markets attributed a very low credit risk to covered bonds, in light of the protection afforded by the over collateralized cover pool and the fact that bond holders had recourse against the issuers. Nevertheless, following the Lehman Brothers failure spreads widened, and the issuance of new covered bonds declined. Liquidity in the secondary markets was also reduced. The crisis became more pronounced in 2009. In response to these conditions, the European Central Bank announced on May 7, 2009 that it will begin a program to purchase covered bonds over a 12 month period. The program was initiated on July 6, 2009, and terminated June 30, 2010, after the European Central Bank acquired approximately 60 billion euro ($89 billion) of covered bonds. These purchases were successful in narrowing the spread between covered bonds and "risk free" benchmarks, increasing covered bond liquidity, and encouraging the issuance of new covered bonds.

Since then, the covered bond market has seen robust growth. In 2010, the amount of covered bond issuances was approximately 222 billion Euros

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($ 329 billion) and global issuance in the first quarter of 2011was a record at 119 billion Euros ($173.12 billion). Both European and non-European issuers have been successful in issuing covered bonds, and the U.S. markets are now being targeted by foreign issuers.

Status of Covered Bonds in the United States

In the United States, the ability of a U.S. financial institution to issue covered bonds is limited by the current regulatory and statutory framework. The only two U.S. financial institutions that issued covered bonds to date, Washington Mutual and Bank of America, N.A., did so in Europe, with bonds denominated in Euros.

Under current Federal banking law, the FDIC is appointed the receiver or conservator of a troubled or failed insured depository institution, and under the Dodd-Frank Act, the FDIC would also be appointed the receiver of a non-bank financial institution whose failure presents systemic risks to the country. When so appointed, an automatic stay goes into effect, preventing bondholders from asserting their rights against the cover pool unless the FDIC consents to waive the stay. The automatic stay is 45 days in a conservatorship and 90 days in a receivership. As conservator or receiver the FDIC has the ability to repudiate the covered bond agreement and pay the bondholders the lesser of the par value of the bonds or the fair value of the assets in the cover pool. If the fair value of the assets is less than the par value of the bonds, bondholders would have an unsecured claim against the remaining assets of the issuer. In addition, interest on the bonds would only accrue to the date of the appointment of the FDIC as conservator or receiver, and not to the date of payment. From an investor's point of view, these provisions undermine some of the key benefits of covered bonds, and make them a less attractive alternative to other investments.

In the summer of 2008, in an attempt to encourage the growth of a covered bond market for U.S. institutions, the FDIC issued a "Policy Statement on Covered Bonds," and the Treasury Department issued a "Best Practices" document. In its policy statement, the FDIC announced that it would lift the automatic stay after 10 days, thereby giving bondholders access to the assets in the cover pool. The policy statement only applied to covered bonds collateralized by very high quality residential mortgages and AAA rated mortgage-backed securities (limited to 10 percent of the cover pool). The total amount of covered bonds issued could not exceed 4 percent of the

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issuer's total liabilities. The Treasury's Best Practices document provided guidance as to an appropriate covered bond structure.

While the FDIC shortened the automatic stay for covered bonds that met the underwriting and other requirements contained in the Policy Statement, it did not address the ability of the FDIC to repudiate the agreement, reduce the bondholders claim to the fair value of the assets, the prepayment risk created by the FDIC's resolution process, and other uncertainties. Thus, the Policy Statement has been unsuccessful in starting a domestic covered bond market. Some experts in this area believe a covered bond market will not develop unless appropriate legislative changes are made to ensure that bondholders will be protected in the event of an issuer default or insolvency.

Recent Developments

In September 2010, the Senate Committee on Banking held hearings on the potential uses of covered bonds and associated regulatory issues. In February of this year, the Administration released a white paper on reforming the housing finance system. In hearings on this white paper in March, Treasury Secretary Geithner testified that the Administration is considering proposing a legislative framework for a covered bond market. Soon thereafter, on March 8, 2011, Representatives Garrett and Maloney introduced the United States Covered Bond Act of 2011, H.R. 940. Senator Schumer has publicly indicated that he is planning on introducing a Senate version of this bill in the near future. H.R. 940 was marked-up in the House Financial Services Subcommittee on Capital Markets and GSEs on May 3, 2011, and was reported out on a voice vote for consideration by the full committee at a later time.

H.R. 940 provides that covered bonds could be issued in the U.S. under the regulatory authority of a "covered bond regulator," defined as the appropriate Federal banking agency for an insured bank, or the Secretary of the Treasury for other issuers. Assets that could support a covered bond include residential and commercial mortgages, home equity lines of credit, student loans, credit card loans, automobile loans, small business loans, among other assets. Covered bonds could only be issued after approval by the appropriate regulatory agency, applying standards established by the Secretary of the Treasury, including a minimum overcollateralization requirement. An independent asset manager will assure that the cover pool maintains the required amount of overcollateralization.

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If there is a default on the part of the issuer, for example, failure to maintain the required overcollateralization, an "estate" is automatically created by operation of law. All assets of the covered pool are transferred to the estate, as these assets are held free and clear from any claim by the issuer, or if the issuer is in conservatorship or receivership, free and clear of any claim by the conservator or receiver. Similar protection is provided in the event of a bankruptcy filing.

The estate is legally liable to pay the covered bond obligations and related agreements. If the estate is insufficient, covered bondholders may also file an unsecured claim against the issuer. When the estate is established, a "residual interest" is given to the issuer. This interest represents the rights to any assets in the estate after all claims of covered bondholders are satisfied.

If the FDIC or another conservator or receiver is appointed for the issuer before there is a default in the covered bond agreement (and, therefore, before an estate is created), the FDIC or other receiver will have 180 days to transfer the covered bond obligation and cover pool to another institution. During this 180 day period, the FDIC or other receiver will continue to perform on the covered bond obligations, and cure all defaults. If the covered bond obligation is not transferred by the end of the 180 day period, an estate will automatically be established to hold the cover pool and perform the obligations of the cover bond agreement.

If the Secretary of the Treasury and the Chairman of the FDIC jointly determine that the FDIC's bank insurance fund lost money because of the resolution of the covered bond program through a separate estate, the FDIC may assess such losses on other insured institutions.

Position of the FDIC

During a hearing on the Garrett legislation on March 11, 2011, the FDIC submitted a written statement that raised concerns about H.R. 940. The FDIC stated that the bill fails to maintain the important balance between investor protection and government exposure, providing lopsided benefits to investors at the direct expense of the FDIC. The FDIC also stated that the bill would establish an implied subsidy to financial institutions that does not exist for other privately issued securities.

The FDIC's concerns were based on the fact that the normally secured

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creditors only have a claim on the collateral up to the full amount of their claim at the time of default, and not claims on any amount that exceeds their current claim for payment. Any excess collateral is returned to the estate of the failed institution for the payment of unsecured creditors.

The FDIC noted that the protection afforded covered bond investors under the bill could lead to demands for ever increasing amounts of over collateralization as a bank becomes troubled. It also referred to the provision in the DoddFrank Act calling for a study on haircutting secured creditors in order to incent more market discipline. The covered bond legislation would have the opposite effect, since covered bond investors would be able to rely on the collateral rather than the creditworthiness of the issuer.

The FDIC concluded by stating that any covered bond legislation must preserve the ability of the FDIC to exercise all of its options in the event that an insured bank fails, including the option to repudiate the covered bond agreement. The FDIC would support legislation that clarifies that in the event of repudiation, the FDIC would be required to pay damages equal to the par value of the bonds plus accrued interest up until the date of payment (rather than the date of appointment of a receiver). However, the FDIC would not support legislation that interferes with its right to claim the collateral and resell it for the benefit of unsecured creditors.

Conclusion

There is considerable interest in both the private sector and the Administration for legislative changes that would lead to a covered bond market in the U.S. However, legislation that would establish a U.S. program based on the European model is strongly opposed by the FDIC. Without the support of the FDIC, the likelihood of Congress adopting such legislation is uncertain.

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