

Where are US covered bonds?

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US BANKS CAME TO MARKET WITH GREAT FANFARE IN 2006 WITH THE INAUGURAL COVERED BOND OFFERING BY WASHINGTON MUTUAL, FOLLOWED SOON THEREAFTER BY BANK OF AMERICA. THE EMERGENCE OF THE AMERICAN BANKS IN THE EUROPEAN COVERED BOND MARKET PRODUCED HEADLINES. THE WASHINGTON MUTUAL OFFERING WAS 'DEAL OF THE YEAR'. NEARLY FIVE YEARS LATER, HOWEVER, THERE IS NO COVERED BOND ISSUANCE ACTIVITY BY US BANKS. ALTHOUGH EUROPEAN BANKS ISSUED ALMOST US\$30BN OF COVERED BONDS IN THE US IN 2010, NO US BANKS ARE ISSUING. WHY?

The absence of US banks from the covered bond market is due to a combination of factors, many related to the financial crisis, including lack of a statutory scheme for covered bonds in the US and high issuance costs without a statute; Federal Deposit Insurance Corporation (FDIC) concerns with the proposed statute; continuing declining prices in the US housing market; high cash balances at US banks; the uncertainty generated by the Dodd-Frank Act, accounting rule changes and Basel III; and the continued heavy presence in the housing finance market of the government sponsored enterprises (GSEs), particularly the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Housing Administration (FHA) – about 95% of all new mortgage loans last year were financed by GSEs.

Prospects in the House of Representatives

Despite the somewhat daunting conditions, the prospects for enactment of a covered bond statute in the US appear to be looking up. With the ascendance of the Republicans in the House of Representatives as a result of the

November 2010 elections and the convening of the 112th Congress, there will be significant changes in the key positions of some important House committees. Representative Scott Garrett (R-NJ), who has been the Congressional champion of a covered bond statute, has assumed the chair of the Capital Markets Subcommittee. Rep. Spencer Bachus (R-AL), who co-sponsored covered bond legislation 2010 with Congressman Garrett, has



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assumed the chair of the Financial Services Committee in the House. These changes have put Rep. Bachus and Rep. Garrett in positions to move legislation for covered bonds in the House. In 2010, covered bond legislation introduced by Rep. Garrett (H.R. 5823, co-sponsored by Rep. Bachus and Rep. Kanjorski) passed the Financial Services Committee in July, although it was not acted upon by the full House. With this prior action, it appears safe to predict that covered bond legislation will be introduced quickly and move rapidly through the Financial Services Committee to the floor of the House for a vote.

Prospects in the Senate

In the Senate, while the outlook is not as rosy as in the House, there would appear to be good prospects for passage of covered bond legislation this year. No covered bond bill was introduced in the Senate in 2010, although Senator Bob Corker (R-TN) introduced covered bond legislation as an amendment to an early form of the financial reform legislation in the Senate, but the amendment was dropped and never considered by the Senate Banking Committee. Also the Committee held a hearing on covered bonds in September that evidenced strong bi-partisan support. Chairman Christopher Dodd (D-CT), who led the hearing, retired in January 2011 and Tim Johnson (D-SD) succeeded Senator Dodd as the chair of the Committee with the start of the 112th Congress. While Senator Dodd was supportive of covered bonds, Senator Bob Corker (R-TN) has shown the most interest in covered bonds and has been active in seeking a middle ground with industry proponents and the FDIC. It seems reasonable, therefore, to expect Senator Corker to introduce covered bond legislation early in 2011.

The FDIC's concerns

The only apparent opposition to covered bond legislation comes from the FDIC. Last summer, the FDIC raised objections to H.R. 5823, the legislation that was subsequently passed by the House Financial Services Committee, expressing concerns about the possible effect of covered bond issuances on the deposit insurance fund.

Michael Krimminger, now General Counsel of the FDIC, expressed similar concerns at the September Banking Committee hearing on covered bonds. The FDIC stresses the need to preserve its option to repudiate the debt of a failed bank, and recover the collateral pledged in a cover pool, as essential to its mission of protecting depositors and the deposit insurance fund.

Repudiation of a covered bond by the FDIC effectively would accelerate the bond, resulting in premature payment of the bond. If the FDIC prevails in retaining the option to repudiate covered bonds, a statute would do little to improve the status of covered bond holders compared to the existing contractual structure used by US banks to issue covered bonds and would do little to reduce the excessive cost to issuing banks under the current structure. If the option to repudiate continues to exist under legislation, the existing two-tier structure would continue to be necessary in order to protect bondholders from acceleration of their bonds. This two-tier structure is cumbersome, costly to issuers and disfavoured by investors. Thus a statute that preserved the FDIC's option to repudiate would achieve little.

One of the stated concerns of the FDIC is that H.R. 5823 would give covered bondholders a super priority lien on bank assets, a right the FDIC says other creditors do not have. However, this claim is a little simplistic. First, Federal Home Loan Bank advances to a bank are protected by a super priority lien on all bank assets and a right to a 'make whole' payment from the failed bank equal to the difference between the interest rate on the advance and prevailing market interest rates. Swap counterparties are also protected under standard International Swaps and Derivatives Association (ISDA) agreements by a right to a 'cost to cover' payment from a failed bank, sufficient to obtain a replacement swap agreement in the market. Thus at least two significant classes of creditors already have rights similar to the proposed rights of a covered bondholder under H.R. 5823.

Moreover, from a risk-based capital perspective, covered bonds are often similar to a securitisation and the effect on the deposit insurance fund is also similar. Acting as servicer in a securitisation and retaining a first loss

security, both typical of bank securitisations, would produce an exposure for the deposit insurance fund in many ways similar to the exposure created by the issuance of a covered bond. Thus covered bonds should not be viewed as creating any new risks for the insurance fund.

It should also be noted that the covered bond investor base tends to consist predominantly of other banks and central banks. Perhaps from a policy perspective it is not such a bad thing for these investors to have a preferred status. It could reduce some of the fragility in the banking system.

If, however, the FDIC continues to press its concerns in spite of the above points, perhaps one possible answer is to utilise a separate, special purpose bank subsidiary to issue the covered bonds, similar to the French *sociétés de crédit foncier* model. The subsidiary could originate mortgage loans or purchase the loans from its parent, but it would not accept retail deposits that would be covered by the deposit insurance fund. The subsidiary would be separately capitalised and funded, including with unsecured senior debt in addition to covered bonds.

Or, in a different approach, there could be a limit on the level of overcollateralisation permitted in a covered bond programme that could not be increased without the express consent of the covered bond regulator. Thus the regulator would be in a position to prevent the level of overcollateralisation from creating excessive risk for the insurance fund. A limit on overcollateralisation could also be combined with a limit on the size of approved covered bond programmes to help manage the levels of risk.

But high levels of overcollateralisation are due in large part to the uncertainty under current law about what the FDIC will do in the case of the insolvency of a covered bond issuing bank. There are three possibilities:

- (i) the FDIC can repudiate the debt and pay ‘actual, direct compensatory damages’, but not in excess of the value of the cover pool;
- (ii) the FDIC can arrange for another bank to assume the obligation on the covered bonds (as it did in the case of Washington Mutual); or

- (iii) the FDIC can allow the bonds to default, in which case the bond trustee is obligated to liquidate the entire cover pool in the adverse climate produced by the bank’s insolvency.

Thus significant market risk is introduced in the first and third option. With H.R. 5823 this market risk is largely eliminated since there would be no requirement to liquidate or value the pool when the bank becomes insolvent, which should result in lower levels of overcollateralisation.

Additionally, the provisions of the Dodd-Frank Act covering mortgage loan origination will tighten origination standards, resulting in more creditworthy loan pools and lower levels of overcollateralisation resulting from credit risk. Reduced overcollateralisation will reduce the risk to the insurance fund.

Another possible approach might be to create a covered bond insurance fund, funded by covered bond issuing banks, which would reimburse the deposit insurance fund for losses caused by the creation of a separate estate from a cover pool in the event of an insolvency of an issuing bank. Losses would be deemed to arise to the extent that the overcollateralisation in the covered pool exceeded the amount of capital carried against the cover pool. This reimbursement would only occur if the FDIC was unable to find a bank to assume the obligation on the covered bonds.

There are probably numerous other ways to address the FDIC’s concerns. All of the above approaches would add cost to the issuance of covered bonds solely to address the FDIC’s concerns that appear to be misplaced or overemphasised.

Benefits of covered bonds

There appears to be general agreement, including at the FDIC, that covered bonds would provide some important benefits to US banks. First, covered bonds would be sold to an investor base that is distinct from the investor base that buys unsecured senior debt or mortgage-backed securities (MBS) and therefore would bring important additional diversity to bank funding. Covered bonds are not

an instrument that would cannibalise other bank funding. The investor base is primarily banks, central banks, insurance companies and funds that buy sovereign and agency debt. The absence of acceleration risk is an essential attribute of their investment choices.

The market for covered bonds in Europe is around €3 trillion. Development of a similar sized market or larger in the US would not be a surprise. A new market of this size would therefore be a significant new source of funding for US banks.

And importantly, covered bond maturities are typically offered in the maturity range of three to 15 years. Funding at these maturities would help US banks manage their asset-liability mismatch on longer term assets such as residential and commercial mortgage loans. It would also help to extend the weighted average maturity of bank debt to more traditional tenors from tenors that are now near historic lows.

Covered bonds also address some of the concerns arising out of the recent financial crisis. Compared to the complexity of the instruments that contributed to the financial crisis, covered bonds provide welcome transparency and simplicity. Assets remain on balance sheet, bonds are issued in a single class and there are no complex cash flows to evaluate. And with the assets retained on balance sheet, the interests of the bank and the investors in the assets in the cover pool are fully aligned.

As in European jurisdictions with a covered bond market, it would be a natural development in the US for a strong private market to develop, separate from the jumbo market that money centre banks would issue into. As in Germany, for example, smaller banks could be expected to issue covered bonds in US\$50m–US\$100m size offerings to regional banks, insurance companies and funds that have the capacity to focus on issuing banks in their region. Regional banks could also benefit from pooled issuance, similar to the model used in Spain to enable smaller *cajas* to issue covered bonds. Pooled issuance could be expected to allow regional banks to issue in the same jumbo market that money centre banks will access.

While it is not anticipated that covered bonds would replace the government sponsored enterprises in the US like FNMA and FHLMC, by bringing a new funding source to US banks covered bonds would take some pressure off the need to continue using the GSEs to support US housing prices. At the moment, in the absence of a functioning residential mortgage-backed securities (RMBS) market and with the continued decline in housing prices there is a great deal of concern that any move to shrink the GSEs could create a disaster in housing. But the dual recourse nature of covered bonds and the more transparent and simple offering structure could be the critical features needed to help bring private funding back to the residential mortgage market.

Finally, public sector obligations would be eligible assets in a covered bond cover pool under H.R. 5823. Covered bonds therefore would also bring a new funding source to US municipalities who are currently facing very difficult funding prospects. Indeed, the public sector covered bond market might be the most important and the largest market to develop as a result of US covered bond legislation.

Benefits of legislation

US legislation for covered bonds would provide important benefits for issuing banks if the FDIC does not retain repudiation authority. First, a statute would remove considerable cost to covered bond issuer that is currently necessary to solve the risk of bond acceleration. Investors would obtain important certainty about covered bond protections and would be evaluating a much simpler issuance structure. This should reduce the interest rate demanded by investors and improve issuers' funding efficiency.

Secondly, a covered bond statute would enable US banks to issue covered bonds under Section 3(a)(2) of the Securities Act of 1933, as amended, which would permit the bonds to be included in bond indices, a development that would greatly improve the secondary market for the bonds. Currently US banks issue covered bonds under Rule 144A as privately issued securities. Many investors in

covered bonds are limited in the amount of Rule 144A securities they can hold, so issuance under Section 3(a)(2) would also have the effect of expanding investor capacity for covered bonds of US banks.

Third, a statute would resolve a number of market structure issues related to the existing contractual structure for US banks issuing covered bonds. A statute, for example, would remove the need for an exemption under the Investment Company Act of 1940, as amended, for the covered bond issuing trust. Also, H.R. 5823 provides that a covered bond would not be an asset-backed security (ABS) for purposes of both the Dodd-Frank Wall Street Reform and Consumer Protection Act and Regulation AB under the Securities Act.

Finally, a statute would put US banks on an equal footing with Canadian and European banks, who issued almost US\$30bn of covered bonds in the US in 2010, while US banks have refrained from issuing, in part because of the high cost of issuance under the existing structure. It would also provide US banks with cost-efficient access to the European market for covered bonds.

High cash balances

One of the reasons there has not been much pressure to enact a US covered bond statute is the lack of funding pressure at many US banks. US corporations have been reportedly sitting on historically high cash balances: levels of cash not seen in 60 years. Accordingly, with corporate borrowing from banks at low levels and because the GSEs are providing most of the support for housing finance (see following section), banks are also sitting on record cash balances. There is little pressure to finance residential mortgage loans not sold to the GSEs. This situation is beginning to change. In the last few weeks there has been increasing evidence of growth in bank loan activity and, not surprisingly, growth in the US economy. As cash balances are drawn down, there will be a re-emerging need to improve bank liquidity. Covered bonds could provide important assistance here, so expect to see increasing calls for covered bond legislation.

Near-term GSE prospects

The current trends in the US housing market are troubling to policy makers. US housing prices have suffered the sixth consecutive month of declines, notwithstanding extensive support from the GSEs. The GSEs are currently providing financing for about 95% of new mortgage loans. The GSEs are the US housing finance market in the US at the moment. So there is understandable concern from both Republicans and Democrats that any action to shrink activity at the GSEs could result in a precipitous decline in housing prices, which in the current climate could produce an economic calamity. It therefore seems unlikely that we will see any near-term change in the mission of the GSEs, even though the newly-resurgent Republicans in the House would dearly love to dismantle the private profit/public risk architecture of FNMA and FHLMC. With this situation and with next year being an election year, it may be 2013 before we see any significant changes in the GSEs. It would therefore seem to make sense to enact a covered bond statute and therefore see if it can take some pressure off the GSEs.

Covered bonds prospects if a statute passes

If a statute is enacted in 2011, what are the prospects for covered bonds in the US? Given current high cash balances at banks and the extensive efforts of the GSEs in residential mortgage finance, it may be that commercial mortgage loans will be the first sector to benefit from adoption of a statute. With heavy refinancing needs in 2011 and 2012 for commercial mortgage loans and a still troubled commercial real estate sector, dual recourse covered bonds could be an instrument to help rebuild the sector. Commercial mortgage loans are accepted assets for cover pools in Europe and should be popular in the US, perhaps especially for regional banks issuing to regional investors.

Multi-family mortgage loans are included as eligible assets together with commercial mortgage loans under H.R. 5823. Accordingly, covered bonds could provide important

assistance to a housing sector that is increasingly important after the implosion of the single family housing sector. Some Congressional leaders have expressed a desire to increase the focus on multi-family housing as the percentage of families owning single family homes declines. Enacting a covered bond statute would help further this wish.

As mentioned above, it is municipal finance that may be the biggest beneficiary of a covered bond statute. Covered bonds could provide municipalities with access to worldwide capital markets just at the time that they are in critical need of new financing. As dual recourse instruments, covered bonds would attract new investors to municipal finance at a propitious time.

While pooled issuance of covered bonds by smaller banks may take some time to develop, it should provide a channel of access to the capital markets for smaller banks. Previously smaller banks have been largely foreclosed from the capital markets except indirectly through borrowings from the Federal Home Loan Banks. Capital markets access will tend to improve the competitive position of smaller banks compared to the huge money centre banks, providing a bit of a counterbalance to the prevailing trend toward consolidation and concentration of financial services in the money centre banks.

And finally, covered bonds are expected to become a valuable source of housing finance for residential mortgage loans. Until the mission of the GSEs change, this will likely be restricted to non-conforming jumbo loans that cannot be sold to the GSEs, as the GSEs should always be able to finance mortgage loans more efficiently than the private sector since it has the benefit of a government guarantee. But as the focus of the GSEs shifts back to its historical purpose of supporting affordable housing and first time home buyers at lower income levels, covered bonds should become increasingly valuable as a new funding source. The recent changes to the accounting rules and the adoption of more stringent rules for securitisation will rebalance the choice of financing residential mortgage loans through securitisation or covered bonds. And the dual recourse nature of covered bonds should assist in restarting the moribund private mortgage market.

Late Developments

On March 8, 2011, Congressman Garrett introduced H.R. 940, the United States Covered Bonds Act of 2011. The legislation was co-sponsored by Congresswoman Carolyn Maloney (D-NY). On March 11, 2011, Mr. Garrett's Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing on the legislation. The FDIC submitted a statement repeating the concerns about the legislation that it had raised last year. Although the testimony before the Subcommittee generally provided strong support for covered bonds, Mr. Stephen G. Andrews, President and CEO of Bank of Alameda, testified that he believed that covered bond legislation would only benefit the large banks and accordingly would competitively disadvantage community banks and the Federal Home Loan Banks (FHLBs).

On March 15, 2011, Treasury Secretary Timothy Geithner, testifying before the Senate Banking Committee, called for the adoption of covered bond legislation while acknowledging the concerns of the FDIC. At the same hearing, Senator Charles E. Schumer (D-NY) stated he was considering introducing covered bond legislation in the Senate. Because Senator Schumer is a key Senator on the Banking Committee, this was an important endorsement of covered bonds.

It appears that covered bonds are gaining traction and momentum at an opportune time. The prospects for adoption of covered bond legislation in the United States have brightened considerably, although with the uncertainties of the legislative agenda the timing for enactment remains difficult to predict.

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