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Fixing Mortgage Financing

Active U.S. **Covered Bond** Market: Key Role for Housing

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ALTHOUGH FEW can point to an actual start date for the financial crisis, most Americans are aware that it began with the failure of the subprime mortgage market and spread quickly to the housing market generally.

BY ANNA T. PINEDO

In the fall of 2007, knowledgeable mortgage finance experts agreed that the residential real estate market was in the midst of a correction. In the ensuing four years, the correction has come to be viewed as something altogether different. Simply stated, residential mortgage lending was broken, parts of the foundation upon which it was built were irretrievably damaged, and a modified housing finance framework will have to emerge.

As it is unlikely that there is a magic bullet that will address all of the issues, there is broad recognition that it may take a variety of initiatives, in combination, to restore investor confidence. This is why there has been continuous discussion of the need to develop a covered bond market in the United States.

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In Europe, covered bonds have a well established history of facilitating mortgage lending. The European experience has demonstrated the potential significance of covered bonds to U.S. mortgage lending.

The issuance of approximately $30 billion of covered bonds into the United States in 2010 and nearly $17 billion thus far in 2011 by foreign banks evidences that there is a U.S. market for covered bonds. However, until recently, a consensus had not been reached that legislation was essential to the development of a robust covered bond market in the United States.

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Background

Covered bonds are debt instruments that have recourse either to the issuing entity or to an affiliated group to which the issuing entity belongs or both, and, upon an issuer default also have recourse to a pool of collateral (the cover pool) separate from the issuer's other assets. The cover pool may consist of residential mortgage loans, commercial mortgage loans, or public sector loans. The cover pool assets are subject to strict criteria and must be replaced if they no longer satisfy them. Typically, the cover pool provides for overcollateralization in order to enhance the chance for a complete recovery by the investor in the event of an issuer insolvency.

Covered bonds have been used in Europe since the 18th century, beginning with the "pfandbrief" in Germany (the pfandbrief is a mostly triple-A rated German bank debenture). Most European jurisdictions, including, for example, France, Italy, Germany and Spain, have legislation that prescribes a framework for covered bonds.

The statutory regime in each jurisdiction differs, but all incorporate certain basic principles. First, covered bonds must be secured by high quality assets. Second, management of the cover pools must be supervised, and third, covered bondholders are first in priority upon an issuer bankruptcy.

Legislation provides certainty regarding the treatment of covered bonds in an insolvency. Covered bonds issued in jurisdictions having a legislative framework are referred to as "legislative" or "statutory" covered bonds.

The covered bond market has grown rapidly in recent years, with an estimated €3 trillion in outstanding bonds. European depository institutions find that covered bonds provide relatively cheap and accessible financing. Covered bond investors include central banks, pension funds, insurance companies, asset managers and bank treasuries that are attracted by the liquid market and by the ratings and covenants of these instruments.

Covered bonds typically bear a higher yield than government or agency bonds and are investment-grade rated. More recently, since introduction of various proposed bank resolution schemes that would impose bail-in features on unsecured holders of bank-issued debt securities, investors have been eagerly buying covered bonds, which are excluded from bail-in.

American Housing Finance

The history of covered bonds in the United States is brief.

Despite the many benefits associated with them, a covered bond market did not develop organically. Given the value placed on home ownership in the United States, a unique housing finance framework evolved to promote home ownership through mortgage lending. Central to this structure were the government sponsored entities, or GSEs, like Fannie Mae, Freddie Mac and Ginnie Mae.

The GSEs functioned as buyers for already originated mortgage loans or pools of loans, freeing up bank balance sheets so banks could originate new loans. GSEs, with their implicit government guarantee, were able to access the capital markets on a cost-efficient basis in order to fund their mortgage loan purchases.

GSEs were the first to securitize. Although GSE sponsored securitization led to the development of a robust private securitization market, the GSEs continued to play an essential role in securitization.

Securitization permitted mortgage loan originators to transfer or sell mortgage loans to securitization vehicles, which, in turn, offered and sold securities in the capital markets. Securitization exposures were off-balance sheet for mortgage loan originators, and, as a result, securitization effectively permitted mortgage loan originators to "recycle" their balance sheets.

Depository institutions in the United States also have had access to the Federal Home Loan Bank system (FHLB), which was established to support the housing market by advancing funds to member banks that originate mortgages.

Over the last year, it has become clear that the role of the GSEs will have to undergo significant change and that new private sector housing finance solutions will be an essential component of the recovery. The increasing awareness of this reality has been essential to building support for covered bond legislation in the United States.

Domestic Covered Bond Use

One of the basic requirements for covered bonds is a statutory or a contractual framework that ring fences the cover pool from unsecured creditor claims and directs payment to covered bond holders.

Prior to the financial crisis, only two U.S. depository institutions experimented with covered bond programs as a means of diversifying their funding sources. These institutions accessed the market using structures that rely on securitization principles and attempted to replicate through contractual relationships the features associated with covered bond legislation. These are referred to as "contractual" or "structured" covered bonds.

The U.S. structure used in 2006 and 2007 is two-tiered, with a special purpose vehicle, or SPV, not a bank, serving as the covered bond issuer. In this structure, an important issue is preventing the potential acceleration of mortgage bonds from affecting holders of the covered bonds.

Covered bondholders do not expect an acceleration of their covered bonds unless both the issuer defaults and the collateral is insufficient to cover the cash flows. This result was achieved by providing that upon a mortgage bond default, cover pool proceeds are invested in guaranteed investment contracts, or GICs, by the covered bond indenture trustee, and GIC proceeds are paid to a swap provider in exchange for interest and principal due on the covered bonds.

'Contractual' Drawbacks

Prior to the financial crisis, contractual covered bonds proved popular with investors. However, these structures have embedded additional costs, and result in certain other funding disadvantages.

The European Central Bank, or ECB, classifies securities for repurchase agreement purposes (a repurchase agreement, or "repo," is the sale of securities together with an agreement for the seller to buy back the securities at a later date). Banks, which comprise a significant portion of the covered bond investor base, hold covered bonds as collateral for their repo activities. For these purposes, the ECB follows the covered bond definition used in the EU's Undertakings for Collective Investment and Transferable Securities (or UCITS) directive for collective investment vehicles.

In order to have an EU recognized "covered bond" regime, a country must implement the requirements of Article 22(4) of the UCITS directive, which essentially includes only statutory covered bonds. For repo purposes, covered bonds are discounted at 1 percent to 7.5 percent, depending on maturity; bank debt is discounted at 1.5 percent to 9 percent; and securitizations are discounted at 2 percent to 12 percent. Structured covered bonds are classified as bank debt.

Similarly, for bank regulatory risk weighting purposes, statutory covered bonds achieve a lower risk weighting. Covered bonds meeting the UCITS Article 22(4) criteria benefit from a 10 percent risk weighting. Contractual covered bonds are subject to a 20 percent risk weighting. The European Union's Capital Requirements Directive, which implements the Basel II regulatory capital framework, also makes it more attractive for banks to invest in statutory covered bonds.

In the two-tiered U.S. structure described above, there also is embedded expense as a result of the various ancillary arrangements, such as the GIC and the swap agreements, necessary to replicate the statutory structure. In addition, the complexity of the current structure and its resemblance to securitization structures is off-putting to potential investors. A contractual covered bond market will not develop given current market dynamics.

Status of U.S. Legislation

Until relatively recently, the FDIC had not provided any guidance regarding the regulatory treatment of covered bonds in a receivership scenario. As a result, there had been concern that upon a default by the sponsor bank in receivership, the FDIC would seek to avoid covered bond obligations.

An amendment to the bank insolvency laws, which requires an automatic stay for as long as 90 days of any attempt to foreclose on a failed bank's property or to affect its rights under contract, added to the confusion.

In 2007, development of the nascent U.S. covered bond market was put on hold as the financial crisis unfolded. Regulatory efforts in 2008 to encourage development of the covered bonds market, including the FDIC's Final Policy Statement on covered bonds and the U.S. Treasury's Best Practices, were well received.

However, these efforts were not enough to launch a U.S. covered bond market, both because the efforts did not allay investor concerns regarding the FDIC's treatment of covered bonds upon the insolvency of an issuing bank, and because most prospective covered bond issuers were unable to act given the extreme dislocation of the capital and credit markets.

Since July 2008, there have been various legislative proposals that would provide a framework for covered bonds. The bills were introduced originally by Representatives Scott Garrett (R–N.J.) and Paul Kanjorski (D–Pa.). The proposed legislation, which had been considered as an amendment to the financial regulatory reform legislation (The Dodd-Frank Act), was not approved by the House-Senate Conference Committee and was not incorporated as part of the final regulatory reform legislation. However, a version (HR 5823) was re-introduced in late 2010.

In March 2011, Representative Garrett introduced a new bill, the "United States Covered Bond Act of 2011" (HR 940), which is co-sponsored by Representative Carolyn Maloney (D–N.Y.). The proposed legislation would create a statutory structure for covered bonds issued by U.S. institutions similar to the structure used in Europe.

The key elements of the legislation are:

(1) a requirement that an independent asset monitor be appointed and that an asset coverage test be satisfied,

(2) separation of the cover pool from the issuer in the event of the insolvency or default of an issuer or transfer of the cover pool and the obligation on the covered bonds to an assuming bank in the event of the insolvency of an issuing bank, and

(3) designation of a covered bond regulator as the trustee of the separated cover pool to act for the benefit of the covered bondholders.

The bill will have to make its way through the House. To date, no covered bond legislation has been introduced in the Senate.

Why Nothing Enacted Yet?

Now that there is widespread recognition that the United States requires new approaches to housing finance, and that going forward the private sector will play a more significant role than the GSEs, one would assume that covered bond legislation should find many supporters.

Indeed, there has been broad support for the development of a covered bond market in the United States. However, there are a few important issues left to be tackled.

First, there is the FDIC. The FDIC continues to raise concerns that covered bond issuances could subordinate depositors and lead to increased draws on the deposit insurance fund. The FDIC's mission is to protect and administer the deposit insurance fund, and the deposit insurance fund is only now recovering from the strains imposed by the financial crisis.

However, it is important to recognize that there are other classes of creditors of depository institutions that enjoy special priority over depositors. For example, the FHLBs enjoy a super priority lien over bank assets to secure any advance to a member bank and in the event of a member bank failure are entitled to receive all of the interest that they would have received if the failed bank had continued to make payments on the FHLB advance.

Certain qualified financial contracts, like swaps, also benefit from special status in a receivership or conservatorship.

There are significant benefits associated with covered bonds that vastly outweigh the concerns related to the deposit insurance fund. Market participants also have suggested a number of measures that may be undertaken to mitigate the dangers posed to that fund.

Second, and perhaps more important, covered bond legislation is not perceived to have broad enough appeal.

Market participants anticipate that the larger U.S. banks will take an interest in covered bonds and access the market following adoption of legislation. However, smaller banks, including larger community banks and regional banks, as well as credit unions, have not expressed great interest in the legislation. This is particularly curious since these are the banks that stand to benefit most from it.

Larger banks historically have been able to access the unsecured debt market more easily and efficiently than smaller banks and have had a number of funding choices available to them that were not available to smaller banks. This is likely always to remain the case.

Covered bonds will add an important additional funding tool for them. Community and regional banks will continue to make mortgage loans and will need to supplement deposit-taking as a means of funding loan originations.

In Europe, there is ample precedent for covered bond issuances by smaller banks. Smaller European banks have issued in the private (non-jumbo) covered bond market. In various European jurisdictions multi-issuer programs have developed as has covered bond only banks. These precedents should be interesting to smaller U.S. banks.

Currently, the proposed covered bond legislation contemplates "pooled" approaches, but there are few specifics included in the legislation. Perhaps this leaves too much to the imagination and provides too little guidance for smaller banks to appreciate the various financing opportunities that a robust covered bond market would present to them.

Given the wariness of many legislators for measures that would seem to benefit only a handful of large banks, it is perhaps not surprising that the legislation has not received more attention and support.

Until it is well understood that our smaller banks will be important beneficiaries of covered bond legislation, the proposed bill may be deferred again. This would be unfortunate since it is clear that a U.S. covered bond market will not develop in the absence of legislation, and equally clear that there is conclusive proof of the concept that an active covered bond market can make a large contribution to financing mortgage lending and home ownership.