

Viewpoint: Unleashing Covered Bonds in the U.S.

By Bert Ely

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The Federal Deposit Insurance Corp. has published for public comment a policy statement with extremely important implications for financing U.S. home mortgages as well as promoting global financial stability.

Called the Interim Final Covered Bond Policy Statement, comments on it are due June 23.

Bankers, regulators, the Treasury Department, and others should, in the strongest possible terms, urge the FDIC to issue a final policy statement that stimulates covered-bond issuance. The policy statement, though a step in the right direction, does not give, as now written, sufficient certainty to potential covered-bond investors.

Covered bonds have been issued in Europe for more than two centuries to finance home mortgages, public infrastructure, and other long-term purposes. About \$3 trillion of covered bonds are outstanding globally, yet they are virtually unknown in the United States. So far, only Bank of America and Washington Mutual have issued covered bonds, for a total of just \$20 billion.

Covered bonds have several important characteristics. First, they are a senior secured, on-balance-sheet liability of the issuing bank or thrift.

Second, they are secured by a "cover pool" of assets that remain on the issuer's balance sheet. Rather than securitizing mortgages and other loans it originates, a bank or thrift continues to own these assets, thereby retaining their credit risk. It is now widely recognized that moral hazard in the lending process is reduced greatly when lenders retain credit risk rather than shift that risk to third parties through securitizations.

Third, the cover pool must at all times overcollateralize the covered bonds by a specified percentage with high-quality assets that meet certain criteria, such as mortgages no more than 30 days past due. As soon as an asset in the cover pool ceases to meet the criteria, it must be replaced by another asset that does.

This self-correcting cover-pool management is far superior to asset securitizations backed by static pools of assets. If the assets in a securitization trust slip in credit quality, the credit rating of the securities backed by those assets inevitably declines, too.

Largely because of a cover pool's continuing high credit quality, covered bonds are highly rated (generally triple-A), even if the issuer has a lower credit rating. That is, a covered-bond credit rating reflects both the creditworthiness of the issuer and the strength of the bonds' collateral protection, with the collateral protections arguably the more important factor. European experience suggests that triple-A covered bonds trading in a well-developed U.S. market should carry yields that approximate yields on government-sponsored enterprise debt.

Covered bonds usually are issued for maturities that approximate the maturities of the assets in the cover pool. Five- and ten-year bullet maturities are quite common, but covered bonds can be issued for longer periods. Hence, banks and thrifts can use the bonds to safely fund long-term, fixed-rate mortgages, rather than selling those mortgages, because covered bonds minimize maturity mismatches.

Credit-risk retention by lenders coupled with maturity-matching covered bonds will bring tremendous stability to the U.S. mortgage market and therefore to the global financial system. The FDIC's excess caution and parochial concerns about covered bonds must not trump the banking efficiencies and stabilizing influence of substantial covered-bond issuance by U.S. banks and thrifts.

The FDIC is the pivotal player in bringing covered-bond financing to the United States because it is the receiver for failed banks and thrifts. As receiver, the FDIC has extensive statutory power to compromise contracts entered into by the failed institution.

Specifically, the FDIC can delay payments to covered-bond investors or otherwise repudiate covered bonds for up to 90 days after it becomes a failed institution's receiver. The agency has proposed to trim this period to 10 business days. However, even that short a delay creates uncertainties that will force covered-bond issuers to obtain costly hedges to protect against FDIC delay.

FDIC staff members have argued that the 10-day repudiation period "balances the needs of the markets versus the needs of the receiver," but the agency has vastly overstated its needs. Its policy statement should unambiguously state that under no circumstance will it, in any way, compromise the rights of covered-bond investors should the issuing institution later fail.

The policy statement also needs other substantial revisions. First, it proposes to limit an institution's covered-bond issuance to 4% of its total liabilities. Because of covered-bond collateral requirements, no percentage limit is justified. In fact, public policy should promote rapid growth of covered-bond issuance so as to quickly develop a deep secondary market in the United States for covered bonds.

Second, the policy statement is far too restrictive as to eligible covered-bond collateral — home mortgages, as defined by the policy statement, and triple-A mortgage-backed securities, provided the securities do not exceed 10% of the cover pool. Covered bonds should be a funding source for other types of long-term bank loans.

Third, the proposed 10-year limit on covered-bond maturities is too short. If bank assets warrant longer-term covered-bond funding, then that should be permitted.

The FDIC claims it needs these limitations to protect its Deposit Insurance Fund from additional loss should banks and thrifts become substantial covered-bond issuers. An analysis I have given to the FDIC staff shows that the impact of covered bonds on the fund's losses will be nil for stronger banks and thrifts.

If anything, covered bonds should improve bank soundness. However, for riskier institutions, slightly higher deposit insurance premiums will fully compensate the FDIC for any incremental loss attributable to their covered bonds.

Bankers and policymakers need to urge the FDIC to unleash the potentials covered bonds offer.

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