

Can Covered Bonds Compete with Fannie and Freddie?

A presentation by

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at a conference at the

American Enterprise Institute

September 19, 2008

Can Covered Bonds Compete with Fannie and Freddie?

Yes, they can

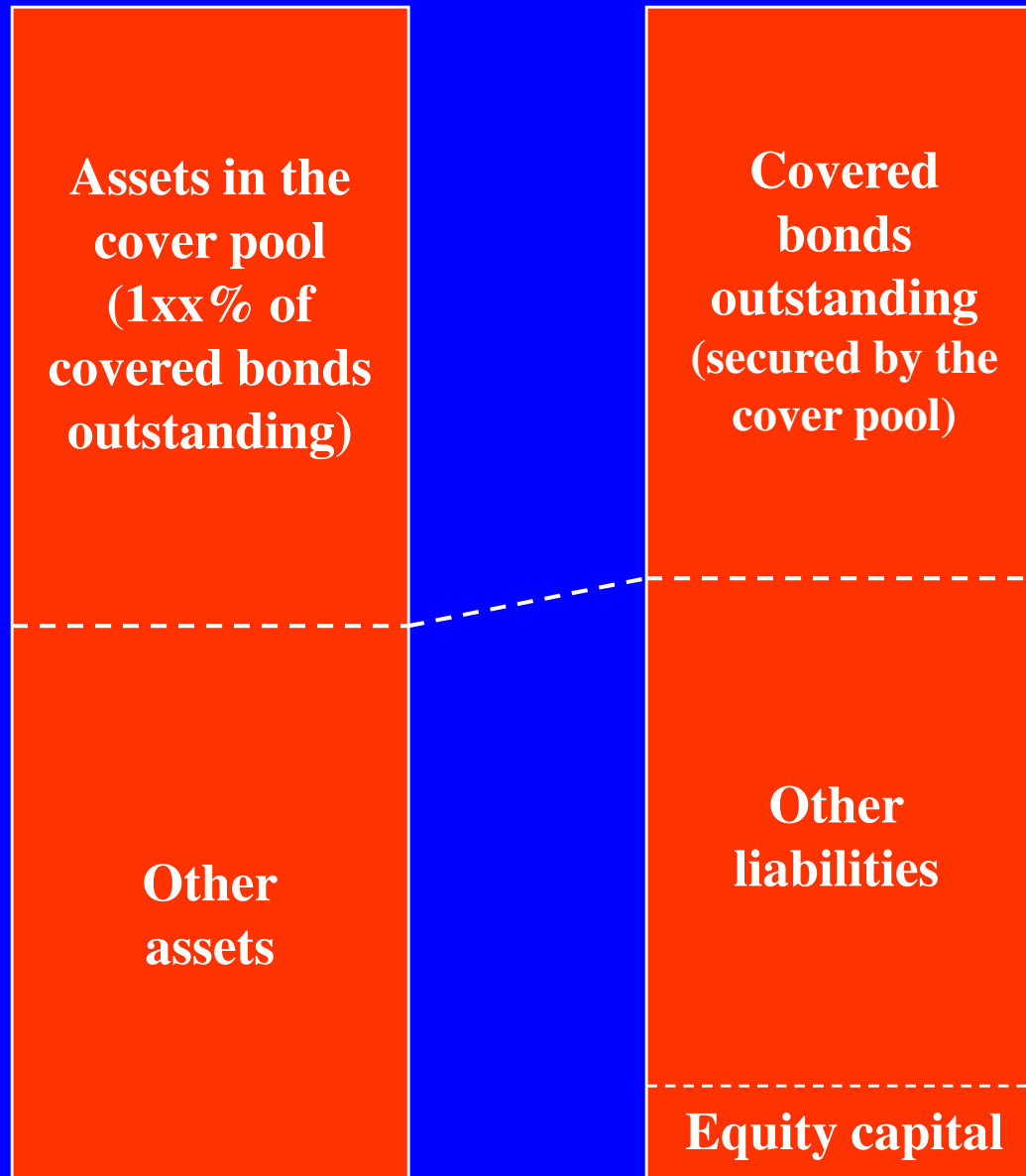
And here is why

**The key feature of a
covered bond – it is an
on-balance-sheet borrowing
secured at all times
by specifically
identified assets**

Balance sheet of a covered-bond issuer

Assets

= Liabilities + Capital



Other features of covered bonds

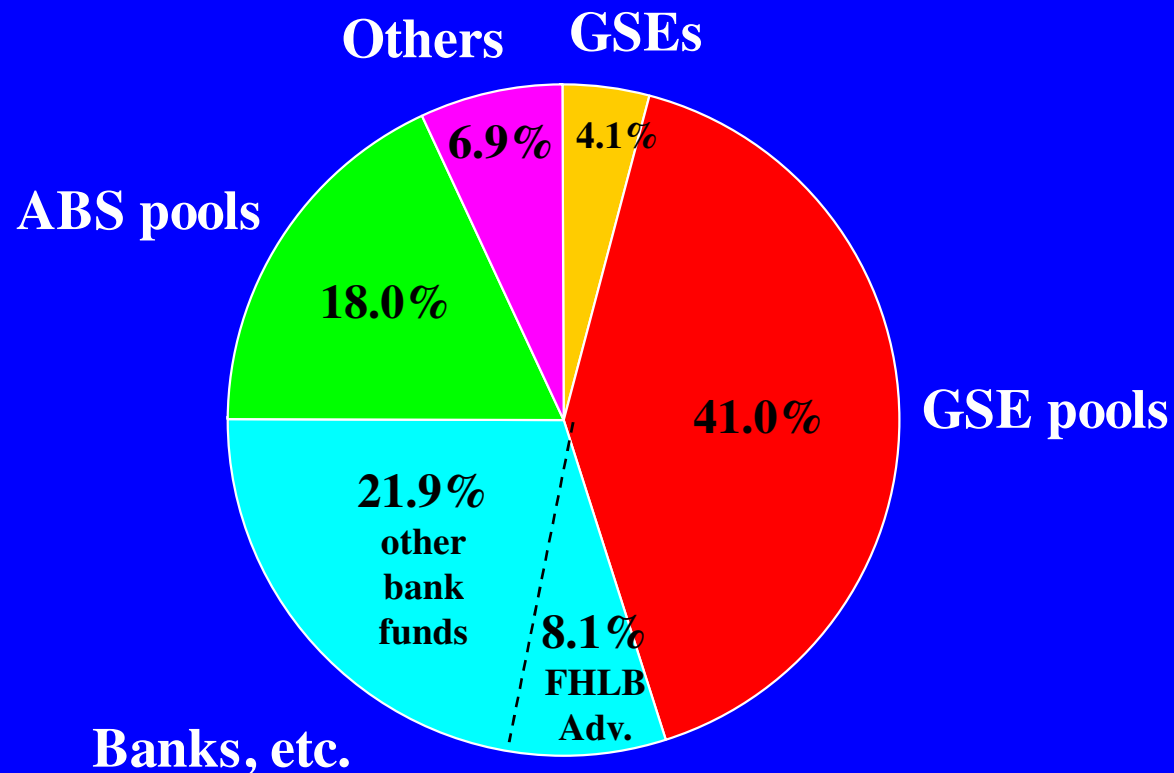
- Covered bonds can be long-term – up to 50 years
 - Ideal for funding 30-year fixed-rate mortgages
- The amount of assets in the bonds’ “cover pool” always must exceed the covered bonds outstanding by a specified percentage
- At all times every cover-pool asset must meet specified performance criteria
- If a cover-pool asset ceases to meet the specified criteria, it must be replaced by an asset which does
 - This “evergreen” requirement is key to covered bonds’ high credit ratings – usually AAA
- An independent asset monitor ensures asset quality

How covered bonds differ from asset securitization

- Covered bonds are an on-balance-sheet liability of a lender who also is the covered-bond issuer
 - Securitization-trust liabilities are “off-balance-sheet”
- The covered-bond issuer retains all credit and maturity mismatch risk of the assets financed by the bonds
 - Securitization moves those risks off the lender’s balance sheet – out into the ether?
- Cover-pool assets subject to regulatory capital requirements
 - Market forces determine the amount of explicit or implicit capital supporting the securitized assets
- Covered bonds have greater transparency than MBS
- Asset securitization incurs greater transaction costs
- **Conclusion: Covered bonds will be very competitive against asset securitization for funding financial assets**

Covered bonds offer a tremendous potential to fund home mortgages

Funding sources for \$11.254 trillion of U.S. home mortgages at June 30, 2008



Directly and indirectly, the three housing-finance GSEs funded 53.2% of all home-mortgage debt. A 10% market share for covered bonds would equal \$1.1 trillion of covered bonds outstanding.

Other types of financial assets covered bonds can finance

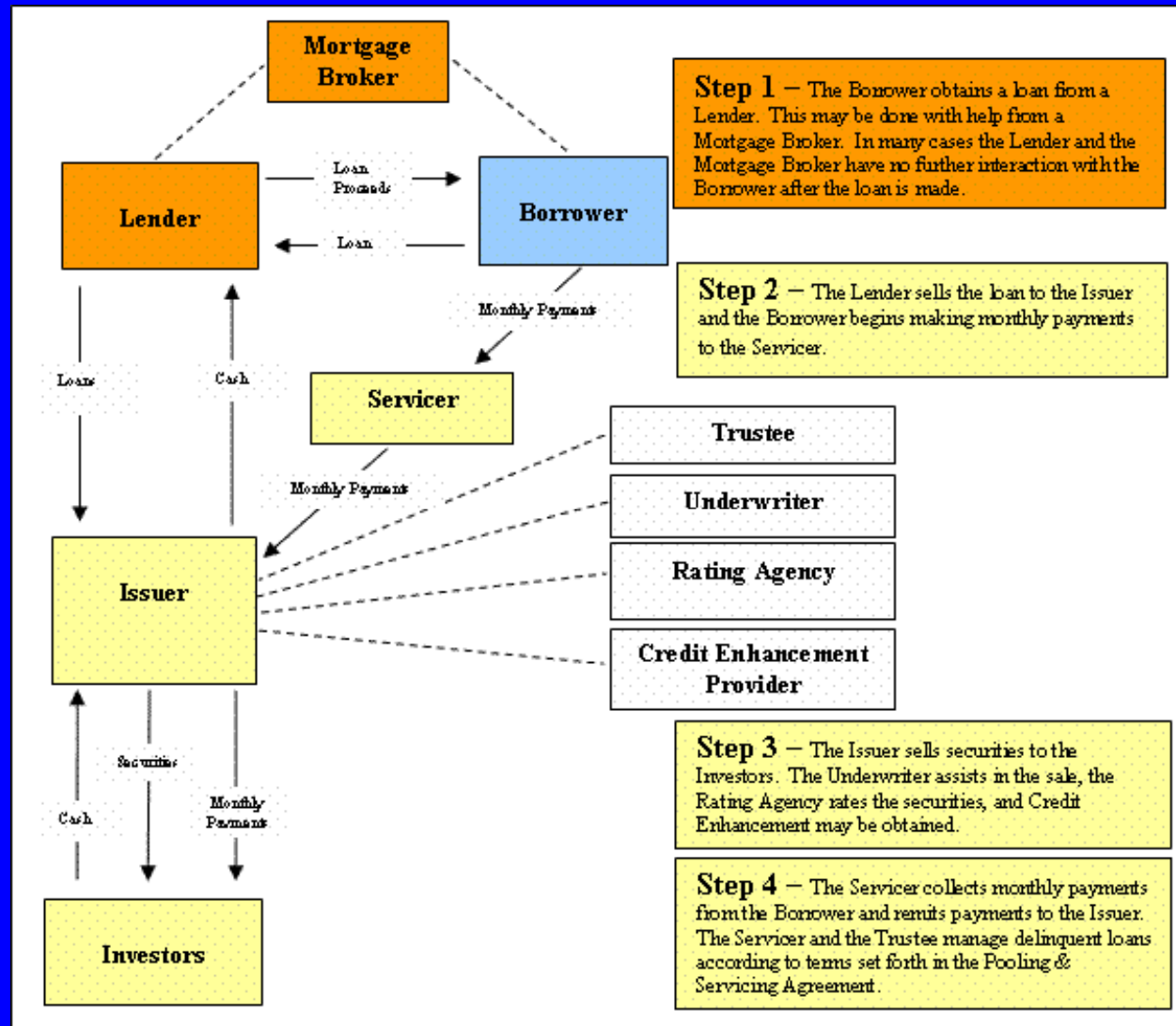
- Apartment buildings
- Office buildings and other commercial structures
- Automobiles, other types of motor vehicles
- Equipment
- Ships, airplanes, railroad rolling stock
- Utility plants
- Student loans
- Public infrastructure
 - The income tax exemption for municipal bonds could flow through the lender to tax-exempt covered bonds
- Other types of assets

Potential covered-bond issuers

- Depository institutions
- Bank/financial holding companies
- Investment banks
- Insurance companies
- Leasing companies
- Captive finance companies
- Other types of financial intermediaries
- Businesses with discrete assets which meet specified quality criteria under an evergreen requirement

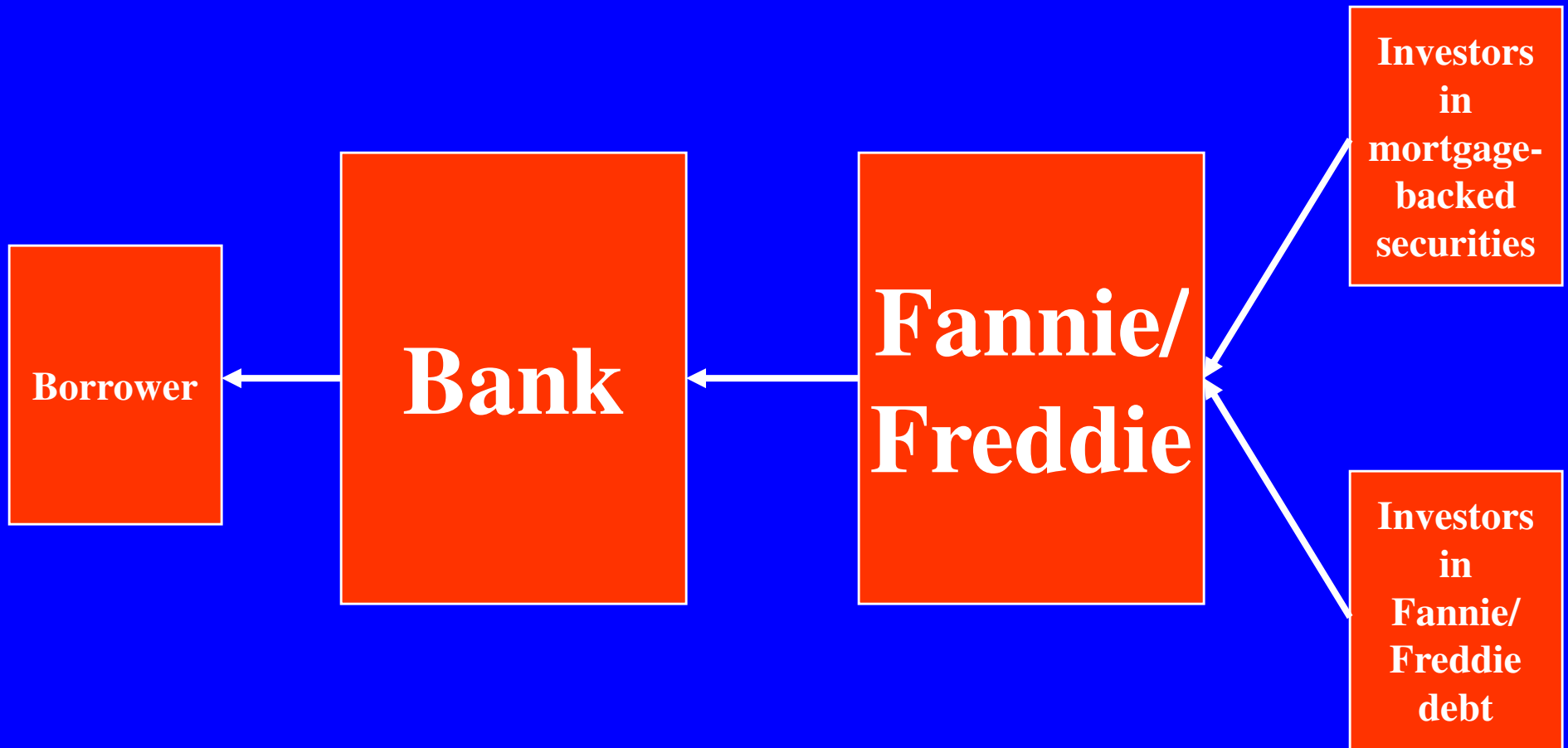
Covered bonds will provide more efficient mortgage funding than asset securitization or selling mortgages to Fannie and Freddie because of the bonds' simpler structure

Which funding structure is simpler – this?

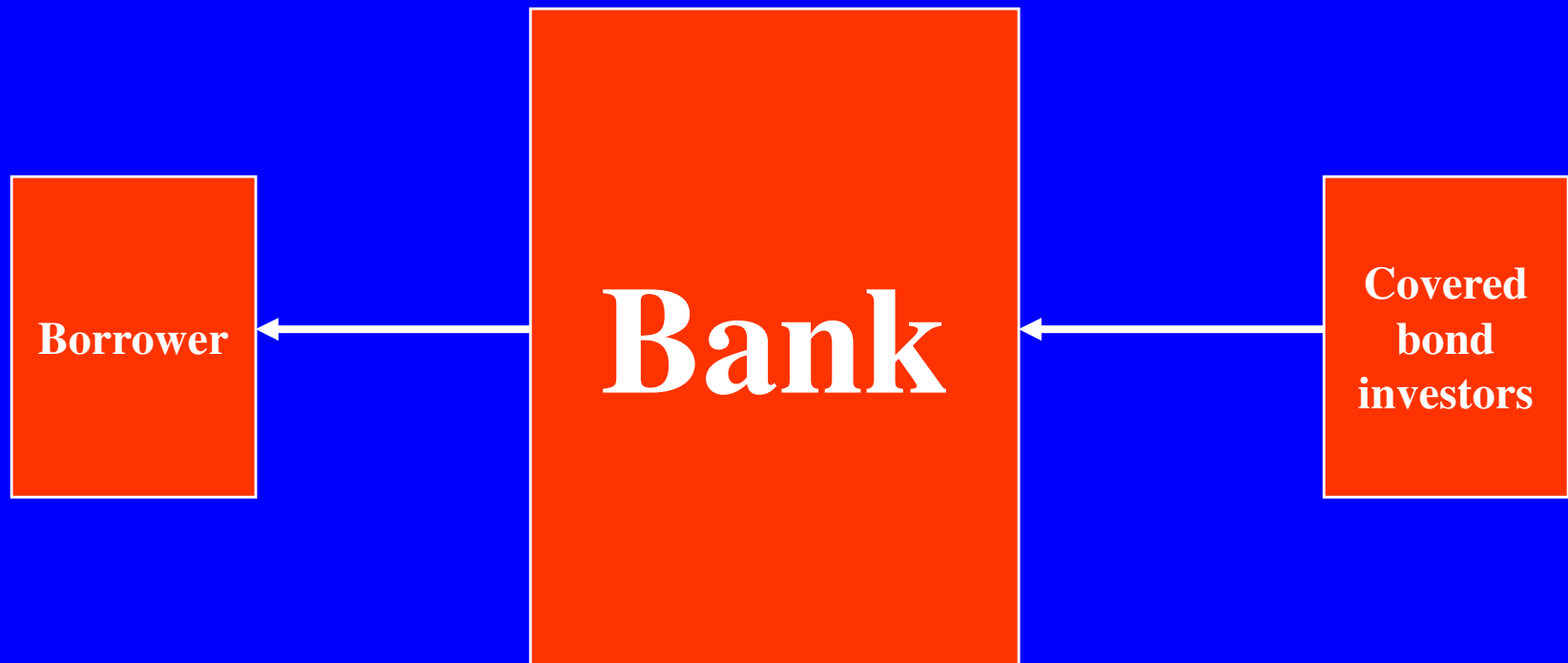


Source: Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Possible Responses to Rising Mortgage Foreclosures before the Committee on Financial Services, U.S. House of Representatives, April 17, 2007

... or this?



... or this?



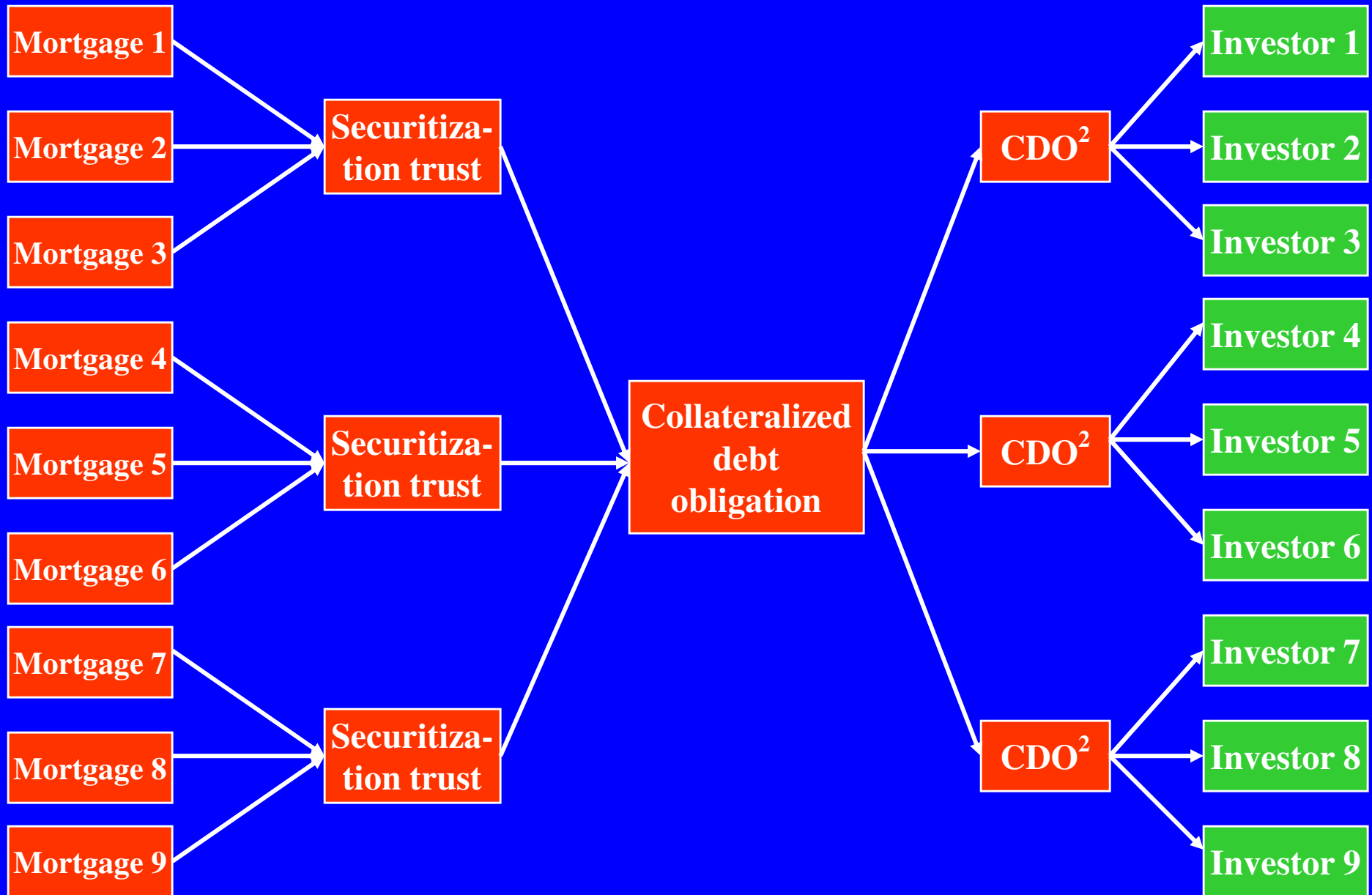
Other cost advantages of covered bonds

- Fewer parties in the transaction trying to maximize their fee income
 - Downside: Reduced income for bankers, lawyers, rating agencies, etc., etc., etc.
- Reduced hedging costs due to less maturity mismatching
 - Reduced maturity mismatching enhances systemic stability relative to Fannie's and Freddie's maturity-mismatched funding
 - Mark-to-market accounting should be less of an issue for assets securing covered bonds
- Lower credit losses due to lender keeping credit risk
 - Securitization bust will lead to higher loss allowances in interest rates on mortgages targeted for securitization
 - Higher Fannie, Freddie guarantee fees evidence of this

Covered bonds reduce moral hazard

- Credit risk remains with the lender
 - The lender is much more sensitive to credit risk if it cannot pass that risk to others
 - Securitization diffuses credit risk, which makes it harder for successor parties in the risk chain to assess that risk

How well does Investor 1 on the right understand the risk of Mortgage 1 on the left



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- Covered bonds less rating-agency dependent due to their simplified structure
 - Agencies not liable for their rating errors
 - Agencies rate the covered-bond structure and the issuer
- Mortgage restructuring is much easier if a mortgage has not been securitized
 - The present circumstances in the mortgage markets highlight the importance of having this flexibility

Addressing FDIC concerns about covered bonds

- The FDIC has a legitimate concern about covered bonds – substantial issuance of any type of secured funding by a bank increases the loss percentage for deposits and other unsecured liabilities should the bank later fail
- Address this concern through risk-sensitive premiums that factor in secured borrowings of any type
- The premium impact of secured borrowings is minuscule in sound banks – a small fraction of one basis point
- The premium rate should rise significantly as the likelihood of a bank's failure increases
 - The FDIC needs to adopt bank-by-bank risk-sensitive premiums for riskier banks – those in FDIC risk categories II, III, and IV

Launching covered bonds

- Address the leverage-ratio capital deterrent to holding low-risk assets on bank balance sheets
- Develop standardized covered-bond documentation as to terms and conditions
 - Standardization increases secondary-market liquidity
- Develop an investor appetite for covered bonds
- Secondary-market trading in covered bonds must commence
 - Covered-bond pricing indices will emerge as trading increases
- Enactment of a covered-bond statute would be desirable but is not absolutely necessary

Covered bonds can compete against Fannie and Freddie

- Fannie and Freddie will not regain all of their pre-conservatorship competitive advantages
 - A privatized Fannie and Freddie most likely will not be able to compete successfully against covered bonds
- In a well-developed covered-bond market, covered bond spreads over Treasuries should approximate Fannie's and Freddie's spreads
- Covered bonds will enable banks and thrifts to avoid the costs of selling mortgages to Fannie and Freddie
- Covered bonds will give banks and thrifts greater flexibility in mortgage design and modification

Thank you

**I welcome your questions
and discussion**