

Congress Should Improve Regulatory Clarity for Covered Bonds

MBA RECOMMENDS

Congress should enact legislation providing clarity regarding covered bond transaction requirements and establishing parity between depository and nondepository financial institutions.

WHAT ARE COVERED BONDS?

Covered bonds are a useful resource for increasing the flow of funds for housing finance. In a covered bond transaction, a bank borrows money from an investor and offers a pool of mortgages as collateral (i.e. the bond). Covered bonds perform the same function as mortgage backed securities (MBS), but they have features that make them more appealing to investors who may have lost confidence in other mortgage-related investments. For example, in a covered bond transaction, the bank replaces nonperforming mortgages in the pool to ensure the pool always contains performing loans to satisfy the claims of investors. In a covered bond transaction, investors have dual recourse so that if a covered bond is repaid at an amount less than what is owed, the investors retain a claim on the issuer. Also, in the event the issuer bank fails, covered bond investors have a priority claim to the covered bond's collateral over other unsecured investors.

Other characteristics of covered bond transactions provide enhanced clarity regarding risk management responsibilities. For example, in a MBS transaction, the pool of mortgages is taken off the bank's balance sheet, and the bank is not required to hold additional capital as a cushion against the MBS' nonperformance. In a covered bond transaction, the pool remains on the issuer's balance sheet, as well as the required capital cushion.

WHERE IS THERE A CURRENT COVERED BOND MARKET?

Nearly all European countries have adopted covered bonds into their financial system. Depending on the jurisdiction, they may be governed by specific legislation or contract law. In countries with similar regulatory attributes as the United States, the legislative framework is preferred because there is certainty with respect to regulatory oversight and compliance. A legislative framework would also establish standards that would result in transactional efficiencies and cost savings.

COVERED BONDS IN THE U.S.

Recently, there has been increased attention paid to the development of a covered bond market in the United States. In July of 2008 the Treasury Department issued guidance and a best practices document in the hopes of generating interest among financial institutions. Treasury's best practices provide a general framework for market participants in several key areas such as: collateral and disclosure requirements, asset coverage tests and other compliance issues. However, financial institutions engaging in covered bonds in the U.S. believe legislation is necessary to provide clarity on other issues.

Covered bonds so far have been limited to large financial institutions, but MBA believes added legal and regulatory certainty would make it cost-effective for smaller ones as well. Any legislative or regulatory advantages should be made available to private issuers as well as regulated depository institutions. This is particularly appropriate in light of proposals to regulate mortgage bankers more directly at the Federal level. Furthermore, although covered bond transactions are not currently in widespread use, prospective revisions to accounting regulations, and an improvement in market spreads could provide further incentive for their increased use. In short, MBA believes covered bonds represent one of the cheapest wholesale funding instruments for financial institution asset-liability-management.

BENEFITS OF A COVERED BOND MARKET

Currently, Fannie Mae, Freddie Mac and the Federal Housing Administration generate roughly 80 percent of secondary market transactions because of the reluctance of other organizations to issue their own private label securities. Therefore, covered bond transactions would alleviate some of the systemic risk associated with the limited number of secondary market participants. Moreover, while the future structure and activities of the private mortgage securitization market is not clear, covered bonds may be a safe initial method to open up this market.



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