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Covered Bonds: The Basics of a Potential, New Funding Option for Community Banks

For community banks in the business of making residential mortgages, the credit crisis has made such financing certainly more challenging. While the so-called “originate-to-distribute” business model for mortgage finance was not likely a significant driver of mortgage lending among smaller, community-centered financial institutions, funding long-term residential mortgage loans without a functioning private label securitization market, or more ominously, with severely restricted or increasingly non-existent access to the “market-making” capabilities of government-sponsored enterprises (GSE) Fannie Mae or Freddie Mac, has underscored the importance of viable, on-balance sheet liquidity sources and strategies. Traditionally, community banks originating fixed rate 30 year mortgages have relied upon some combination of (shorter-term) customer deposits, other, unsecured wholesale borrowings, and collateralized advances from the Federal Home Loan Bank (FHLB) system. The deepening credit crisis has prompted industry leaders, regulators, and policy makers to become open to alternative, even unconventional approaches to funding bank balance sheets. One such approach, used successfully and robustly in Europe since the mid-18th Century is Covered Bonds.

Essentially, a covered bond is debt instrument paying a fixed rate of interest with principal repaid at maturity. All payments are collateralized by a pool of specific assets, with bondholders having the senior most position with respect to claims to these assets in the event of default by the issuer. Collateral pools are to be at least equal to the par value of the principal outstanding of the bonds issued under a covered program. As described below, the Treasury Department is recommending over-collateralization of at least 5 percent of the outstanding principal balance to be calibrated on a monthly basis via an asset coverage test. If collateral assigned to cover issued bonds prepays or defaults, the issuing institution will be required to re-assign other, qualifying assets to ensure that collateral pool remains “whole” at all times.

According to the *Wall Street Journal*, Europe’s covered bond market is \$2.75 trillion and represents the primary source of mortgage lending for European banks.¹ In early 2007, Washington Mutual and Bank of America issued approximately \$13 billion in covered bonds, the only two U.S. institutions to have participated in this fledgling U.S. market. On July 28, 2008, following the issuance of the *Final Covered Bond Policy Statement* on July 15th by the Federal Deposit Insurance Corporation (FDIC), Treasury Secretary Henry Paulson announced the release of “best practices” for issuing residential covered bonds, with an eye towards substantially bolstering and standardizing the market for covered bonds in the U.S.² Joining Secretary Paulson that afternoon were representatives of the four largest banks in the United States, including Bank of America, Citigroup, JP Morgan

Chase & Company, and Wells Fargo, who in a joint statement released that afternoon, confirmed a willingness to “being leading issuers as the U.S. covered market develops.”³

One reason the U.S. has not developed a more vibrant covered bond market is the absence of a well-defined and comprehensive legislative framework or, in lieu of legislation, clearly-defined and standardized contracts for both issuers and investors. The FDIC, beginning last April, and through the final version of its Policy Statement issued in July, has assumed a leading role, along with the Treasury Department, in advancing the development of this market by defining terms and characteristics of covered bonds from both an issuer and investor perspective. In addition, the FDIC has clarified key structural and operational characteristics including the treatment of covered bonds and recourse options for investors should issuers be taken into conservatorship or receivership by the FDIC.

For a better understanding of how a covered bond program would work, consistent with “best practices” as articulated by Secretary Paulson and FDIC guidance, let us review the specifics of issuer, maturity, collateral, regulatory authorization and issue limitations:

Issuer and Maturity Characteristics – Both the Treasury Department and FDIC define an issuer as a depository institution, or a subsidiary wholly-owned by a depository institution. Moreover, a “bankruptcy remote” special purpose vehicle (SPV) can be created to facilitate issuance of covered bonds. Maturity of covered bonds can be as short as one year and as long as 30 years, while Treasury notes that most of the initial issuances likely will be in the one to ten year range.

Collateral Requirements – both the FDIC and Treasury have proposed very specific collateral requirements for bonds issued under a covered program, including:

- Only performing mortgages on one-four family residential properties;
- Only mortgages underwritten at the fully-indexed rate;
- Only mortgages underwritten with documented income;
- Only current mortgages can be added to the pool, with any mortgages that are more than 60 days past due requiring replacement;
- Only first lien mortgages;
- Bondholders have a perfected security interest in eligible mortgages included in the collateral pool;
- Eligible substitution collateral would include cash and Treasury and agency securities.
- An over-collateralization buffer of 5 percent minimum of outstanding principal balance at all times, with only loans with a maximum loan-to-value ratio of 80 percent receiving full collateral credit.

Regulatory Authorization and Issue Limitations – Not surprisingly, prospective issuers of covered bonds would require approval from their primary federal regulator before

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initiating or participating in such a targeted funding program. Moreover, in order to manage the deposit insurance fund's exposure, covered bonds may not comprise more than four percent of an issuer's total liabilities after issuance. A report issued by the Federal Reserve Bank of Chicago predicted that risk to the FDIC deposit insurance fund would increase if banks used covered bond financing to either replace existing uninsured deposit funding or increase lending, a likely occurrence given the potentially favorable economics of deploying a covered bond initiative to fund balance sheet growth from a bank perspective.⁴

As the covered bond market develops and evolves, community banks may very well find themselves participating in this market to fund their long-term residential mortgage originations. From a pricing perspective, and assuming the inclusion of features as put forth by Treasury and the FDIC, market analysts predict covered bond yields to be 25 to 100 basis points lower than unsecured bank debt.

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¹ Deborah Solomon, 2008, "Banks Act to Aid Mortgage Lending," *Wall Street Journal*, July 29.

² Federal Deposit Insurance Corporation, *Covered Bond Policy Statement, Final Statement of Policy*, <http://www.fdic.gov/news/news/press/2008/pr08060a.html>, and United States Department of the Treasury, *Best Practices for Residential Covered Bonds*, <http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf>.

³ Greg Robb, 2008, "Four Big Banks to Kick-Start Covered Bond Market," *MarketWatch*, July 29.

⁴ Richard J. Rosen, "What are Covered Bonds?," *Chicago Fed Letter*, December 2008.