

## US covered bond legislation proposal – where is the promised change?

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Covered bonds are a proven and useful tool in Europe – and Congress is right to be considering legislation to start such a market the US. But the bill introduced by Congressman Garrett in the House needs to be changed if it is to restore investor trust and provide needed new liquidity to real estate markets. Covered bonds work when they are simple, conservative and transparent. These principles, not the interests of bankers or intermediaries, should drive legislative design.

Covered bond laws often come from crises. The deep German real estate and banking crisis of the 1890s helped create the Pfandbriefe; the bankruptcy in the 1990s of the Credit Foncier de France, Europe's oldest mortgage bank founded in 1852 led to the Obligations Foncières. The new laws always required very secure cover assets (high quality real estate or state guarantees) and conservative lending practices. The simple, yet clearly defined design of covered bonds limits the number of counterparties involved and keeps issuers accountable. As a result, covered bonds became attractive for generations of European investors and required no external ratings until very recently.

There are varying types of European covered bonds, and they performed very differently last year. Denmark's Realkreditobligationer, a pass-through bond basically unchanged since 1850, survived the financial crisis without tapping government support. More common portfolio covered bonds require regular rolling over because of the mismatch in maturity between the cover assets and the bond; many of these ran into trouble last year. Governments and ratings agencies are taking notice.

Covered bonds weren't exempt in Europe from the liberalization trend of the past decades. Issuers tried take a free ride on the existing simple and accepted bond products, introducing loans secured by movable assets or securities as cover assets. However, such departures from the basic concept of the bonds were occasional and did not alter the character of backing by either high-quality real estate or state guarantees.

The current US bill in contrast seems to disregard many lessons learned from the financial crisis in the US proper and ignore the bias for conservativeness needed to build investor trust when a new product is launched. The program seems designed to solve a wide range of pressing asset refinancing problems facing banks, not to create a market that will last decades or centuries to come.

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The bill allows for an unusual menu of eligible collateral in the cover pool, including securities that may introduce legal and agency (rating) risk, financial assets not backed by real estate or public guarantees, and short-term assets that can be perfectly financed by deposits. Even home equity loans, a symbol of irresponsible lending practices, have found their way into the bill.

The present bill leaves lending standards – for real estate and other purposes - to the primary regulator's discretion and even allows ex-post inclusions of financial assets underwritten under historic standards. It ignores the importance of low loan-to-value ratios and specific real estate valuation standards. Clear standards have featured prominently in European legislation; they are particularly relevant for a jurisdiction recovering from the financial fallout of large residential and commercial real estate price cycles.

Moreover, the proposed transparency requirements over the cover pool assets fall behind established US standards. And the absence of a clear definition of the basic asset-liability management principles renders market and liquidity risk exposure of issuer and cover pool an unknown, left de-facto to the discretion of his primary regulator. Precisely those aspects of bonds that proved problematic last year are encouraged or ignored by the legislation; the best practices of the Danish balance principle are unnoticed.

A potentially unlimited range of counterparties involved in derivative and insurance protection of the cover translates into an ambiguous credit support structure that can vary from issuer to issuer and is hard to analyze for investors. Bonds issued under the bill, in fact, will be closer in character to so-called 'structured' covered bonds, bonds that were created as arbitrage products in Europe allowing for lower precision of design, than to general law-based covered bonds. These bonds faced even greater problems through the crisis.

Because of loosened standards on asset eligibility, risk management and counterparty selection, high amounts of overcollateralization will be required by the market to render the product palatable for investors. These promise to highly subordinate bank depositors and unsecured bondholders, and also raise the likelihood that insufficient funding liquidity will be available to a trustee appointed in insolvency. The result is an increased reliance on, and adverse selection of, public insurers of first and last resort, i.e. the Federal Deposit Insurance Corporation and the Federal Reserve System (even though an explicit role for the Federal Reserve System in liquidity provision, such as present in the case of Fannie Mae and Freddie Mac, has been avoided at the last moment).

A bond with such an unusually high level of implicit government support will still be only mildly attractive for large, too-big-to-fail US banks who can save issuance costs by relying on unsecured bonds. However, it will be very strongly so for mid-sized banks that currently face strict market discipline through the threat of FDIC intervention, including possible clawbacks of securitized or pledged assets, and by implication high unsecured and even occasionally secured funding costs. In its current version, the law in effect promises to just throw the rope of implicit federal guarantees for the US financial system farther.

The US would be better off with a bill that tries to truly lay the foundations for a new private bank bond gold standard based on high-quality assets and restoring market discipline in a vital sector of the economy, real estate finance. Legacy problems with shaky assets of all colours or bank balance sheets should be solved via bad banks and/or bank insolvency and restructuring.

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