Covered Bonds: An Alternative to Securitization for Funding Mortgages

Edward V. Murphy
Specialist in Financial Economics

December 3, 2009

Congressional Research Service
7-5700
www.crs.gov
RS22925

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Covered bonds are a relatively common method of funding mortgages in Europe, but uncommon in the United States. A covered bond is a recourse debt obligation that is secured by a pool of assets, in this case mortgages. The holders of the bond are given additional protection in the event of the bankruptcy or insolvency of the issuing lender. Covered bonds have some features, such as pooled mortgages, that resemble securitization, but the original lenders maintain a continuing interest in the performance of the loans. Because some believe that the subprime mortgage turmoil may have been influenced by poor incentives for lenders using the securitization process, some policymakers have recommended covered bonds as an alternative for U.S. mortgage markets.

Since issuing banks do not sell mortgage assets to securitization trusts, accounting features of covered bonds may provide more readily accessible information to potential purchasers of the covered bonds and to the shareholders of the banks issuing the covered bonds. The last Bush Administration Treasury Secretary, Henry Paulson, stated in public remarks on March 13, 2008 that covered bonds could bring more certainty and more competition to mortgage markets, and the Treasury Department subsequently released a best practices guide for covered bonds on July 28, 2008.

However, some features of American banking regulations may have to be clarified to facilitate the use of this finance instrument. For example, the Federal Deposit Insurance Corporation (FDIC) issued two new policy statements in 2008, Financial Institution Letter (FIL) 34-2008 and FIL 73-2008, clarifying its obligations to the holders of covered bonds if an FDIC-insured institution is placed in FDIC receivership or conservatorship.

The Equal Treatment for Covered Bonds Act of 2009, H.R. 2896, introduced by Congressman Garrett on June 16, 2009, would define a covered bond as a nondeposit recourse debt with a term to maturity of at least one year and secured by specifically identified assets. H.R. 2896 also calls for rulemaking regarding covered bonds to be conducted jointly by financial regulators. On November 18, 2009, Congressman Garrett proposed an amendment related to covered bonds during markup of the Financial Stability Improvement Act of 2009, H.R. 3996, but subsequently withdrew the amendment.

This report will be updated as conditions warrant.

Contents

Financial Structure of Covered Bonds 2
FDIC Rulemaking Affecting Covered Bonds 3
Equal Treatment for Covered Bonds Act of 2009, H.R. 2896 4
Covered Bonds and the European Union 5

Tables

Table 1. Comparing the Structure of Securitization and Covered Bonds 2

Contacts

Author Contact Information 6
Acknowledgments 6

In response to recent mortgage market turmoil, the Treasury Department and the Federal Deposit Insurance Corporation (FDIC) have considered rulemaking to encourage the use of covered bonds as an alternative to mortgage securitization. The volume of private-label mortgage securitizations, in which mortgages are pooled into trusts and then divided into securities for sale to investors, declined significantly following the subprime mortgage turmoil.[1]

In typical private-label securitizations, neither the original lender nor the mortgage-backed security (MBS) issuer has a continuing duty to the purchasers of the securities. It might be argued that this divorce of mortgage funding from loan origination contributed to weak underwriting standards in U.S. mortgage markets.[2] Covered bonds, which are more common in Europe, especially the German Pfandbrief market, also pool mortgages, but the issuing banks continue to stand behind the performance of the loan pool.

On March 13, 2008, then Treasury Secretary Paulson suggested the increased use of covered bonds as one option to restore confidence in mortgage finance:

> Covered bonds, which allow banks to retain originated mortgage loans while accessing financial market funding, are another alternative worth considering. Covered bonds may address the current lack of liquidity in, and bring more competition to, mortgage securitization. Rule-making, not legislation, is needed to facilitate the issuance of covered bonds. Through clarification of covered bonds' status in the event of a bank-issuer's insolvency, the FDIC can reduce uncertainty and consider appropriate measures that will protect the deposit insurance fund. These steps would encourage a covered bond market in the U.S.; similar changes in Europe have resulted in more covered bond activity.[3]

In an effort to provide clarity to the U.S. covered bond market, the Treasury Department issued a *Best Practices for Residential Covered Bonds* document on July 28, 2008.[4] This guide was designed to function as a complement to the FDIC's April 30 and August 4, 2008 policy statements on covered bonds (discussed below), and was developed through consultation with the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Securities and Exchange Commission, as well as with international financial regulators and a variety of market participants. In particular, the Treasury Department outlined numerous standards for covered bond programs to follow in order to be consistent with this *Best Practices* template, including that (1) issuers be either newly created bankruptcy-remote special purpose vehicles or depository institutions; (2) the maturity for covered bonds be greater than 1 year, and no more than 30 years; (3) issuers hold an overcollateralization value of at least 5% of the outstanding covered bond principal balance; (4) the covered bonds not account for greater than 4% of an issuer's liabilities after issuance; and (5) each covered bond issued have a specified investment contract.[5]

---

[1] Private-label securitizations refer to mortgage-backed securities that are issued by firms other than the government-sponsored enterprises, Fannie Mae and Freddie Mac.

[2] CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

[3] "Remarks by Secretary Henry M. Paulson Jr. on Recommendations from the President's Working Group on Financial Markets," Press Release, U.S. Department of Treasury, March 13, 2008, available at http://www.treas.gov/press/releases/hp1102.htm.

[4] "Treasury Releases Best Practices to Encourage Additional Form of Mortgage Finance," Press Release, U.S. Department of Treasury, July 28, 2008, available at http://www.treas.gov/press/releases/hp1102.htm.

[5] "Best Practices for Residential Covered Bonds", U.S. Department of Treasury, July 2008, available at
(continued...)

Financial Structure of Covered Bonds

A covered bond is a bank-issued debt that is backed by a pool of loans, often mortgages. In finance-speak, a covered bond is thus a recourse debt obligation that is secured by a pool of assets. Unlike typical private securitizations in the United States, the bondholders' claims extend to the issuing bank's assets if the underlying mortgages default. If the underlying mortgages continue to perform but the issuing bank becomes insolvent, the bondholders retain full claim on the pooled mortgages in subsequent bankruptcy or insolvency proceedings. The bonds are covered by both the pledged mortgages and the issuing bank. **Table 1** compares selected features of covered bonds to typical private securitization of U.S. mortgages.

Table 1. Comparing the Structure of Securitization and Covered Bonds

	Private Securitization	Covered Bonds
Structure	Issuer gathers mortgages (or other assets) from one or more banks in a pool and sells securities which represent claims on the cash flow of the pool.	A single bank puts its own mortgages (or other assets) in a pool, sells interest in the pool, and stands ready to cover losses if the pool does not perform.
Claims of bondholders against mortgage pool	Bondholders have claim against mortgages in pool.	Bondholders have claim against mortgages in pool.
Claims of bondholders against loan originator	Bondholders do not have claim against other assets of loan originators (exception if originator provides credit enhancement).	If mortgage pool exhausted, bondholders retain claim against loan originator.
Balance sheet treatment	Usually not recorded as a liability of the originator.	Usually recorded as a liability of the originator.
Loan originator record of sale on assets	Gain on sale when transfer to trust, subject to accounting standards.	The mortgages are not sold so no gain to record.
Servicing the loan	Originators sold the loans so servicing is an independent relationship, but originator can service loan under contract.	No isolation of originator from mortgage assets, so servicing relationship unaffected.
Originator bankruptcy	Mortgages in the pool are remote from bankruptcy of the loan originator.	Bondholders have full claims on mortgages in pool even if loan originator is in insolvency proceedings.
Ratings agencies	Assess only the risk of the assets and credit enhancement in the mortgage pool.	Must assess risk of assets in pool but also the risk of the issuing bank as a whole.

Source: Vinod Kothari, *Securitization: Financial Instrument of the Future* (New Jersey: John Wiley & Sons, 2006), p. 357.

The structure of a covered bond may encourage transparency. Unlike a typical private securitization of U.S. mortgages, the issuing bank of a covered bond does not sell the mortgages to a pass-through trust administering the payments to the investors. Because there is no sale, the

(...continued)

http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf.

issuing bank continues to report the loans on its balance sheet. When evaluating the riskiness of a covered bond, a rating agency must account for both the quality of the underlying mortgages and the financial condition of the issuing bank that covers the bonds.

Compared to securitization, the structure of a covered bond simplifies the relationship between mortgage pools and mortgage servicers. For a covered bond, the issuing bank continues to service the pooled loans (or contract out servicing), in the same manner as it would for loans that it has not issued as covered bonds. This preserves the issuing bank's discretion to modify loans in times of distress. In securitization, however, the discretion of servicers to modify loans can be limited by loan servicing contracts that can be difficult to adjust in changing circumstances.[6]

FDIC Rulemaking Affecting Covered Bonds

While the covered bond market has a long tradition in Europe, the United States has much less experience with this product. In June 2007, Bank of America became the first U.S. depository institution to issue a domestic covered bond, with a $2 billion offering. Since then, industry specialists and policymakers have been evaluating American banking regulation to see what kinds of modifications might be required to adapt this European debt instrument to U.S. financial markets.

In the United States, financial problems of banks with insured deposits are often resolved through actions of the FDIC. In order to adapt covered bonds to the U.S. system, therefore, FDIC rules for resolving claims against insolvent banks that have outstanding covered bonds might have to be modified. The FDIC issued Financial Institution Letter (FIL) 34-2008, *FDIC Policy Statement on Covered Bonds*, on April 30, 2008. FIL 34 provides more regulatory clarity by "giving expedited access to covered bond collateral if the issuing institution fails or is placed in conservatorship and meets certain criteria." Its expressed intent is to "reduce market uncertainty and allow for evaluation of the benefits and questions about covered bonds as the market develops in the United States."

The FDIC issued a final policy statement for covered bonds, FIL 73-2008, on August 4, 2008. The policy statement defines a covered bond as

> a non-deposit, recourse debt obligation of an IDI [Insured depository Institution] with a term greater than one year and no more than thirty years, that is secured directly or indirectly by perfected security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages, or AAA-rated mortgage-backed securities secured by eligible mortgages if for no more than ten percent of the collateral for any covered bond issuance or series.[7]

The FDIC limited the covered bond policy statement only to those circumstances in which the covered bonds would comprise no more than 4% of the issuer's total liabilities. The FDIC statement did not require that issuers of covered bonds use a special purpose vehicle (SPV), which was a common financial device used in securitization.

---

[6] CRS Report RL34386, *Could Securitization Obstruct Voluntary Loan Modifications and Payment Freezes?*, by Edward V. Murphy.

[7] "FDIC Policy Statement on Covered Bonds," FIL 73-2008, FDIC, August 4, 2008, available at http://www.fdic.gov/news/news/financial/2008/fil08073.html.

On January 16, 2009, the FDIC announced that it would propose rule changes to its Temporary Liquidity Guarantee Program (TLGP) that extended the maturity of guarantee for some assets from 3 to 10 years.[8] Since covered bonds possess longer maturities, this announcement was perceived as a move by the FDIC to accommodate this type of senior unsecured bank debt under the TLGP.[9] However, in May 2009 it was reported that FDIC Chairwoman Sheila Baird had decided to delay the implementation of this initiative.[10]

Equal Treatment for Covered Bonds Act of 2009, H.R. 2896

H.R. 2896, the Equal Treatment for Covered Bonds Act of 2009, was introduced by Congressman Garrett on June 16, 2009.[11] The definition of a covered bond is similar to the definition used in the FDIC rulemaking. The bill defines a covered bond as a "nondeposit recourse debt obligation of an insured depository institution, with a term to maturity of at least 1 year, which is secured by specifically identified assets which are performing in accordance with the terms of the contracts which created the assets." (Section 2b.) Although similar to the FDIC definition, H.R. 2896 does not require that a covered bond be used for mortgages or for AAA-rated securities. Also, the bill does not limit the term of maturity of the assets to 30 years, which would allow covered bonds to fund 40-year mortgages.

The bill also specifies the regulatory authority of federal financial regulators for covered bonds. (Section 2d). In order to be applicable to covered bonds, federal banking regulations must be jointly prescribed by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and the Board of Directors of the FDIC. Of the members of the Federal Financial Institutions Examinations Council, the National Credit Union Administration is absent.

During the November 18, 2009 House Financial Services Committee initial markup session of H.R. 3996, the Financial Stability Improvement Act of 2009, Congressman Garrett offered an amendment related to covered bonds.[12] While reflecting the intent of H.R. 2896, this proposal offered a more detailed statutory framework for the U.S. covered bonds market. For instance, Congressman Garrett's amendment outlined the various eligible covered bond asset classes, designated the Treasury Secretary as the covered bond regulator, and detailed procedures to be implemented in the instance of default or failure of an issuer or covered bond issuance. While Congressman Garrett subsequently withdrew this amendment during markup, Chairman Barney Frank has indicated that the House Financial Services Committee would convene a future hearing to examine covered bonds.[13]

[8] "Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America," Press Release, FDIC, January 16, 2009, available at http://www.fdic.gov/news/news/press/2009/pr09004.html.

[9] Alison Vekshin, "FDIC Adding Covered Bonds to Liquidity Guarantee Program," Bloomberg News, January 16, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=acuw6oiWXLvw&refer=home.

[10] Rebecca Christie, "FDIC Won't Extend Bank-Debt Guarantee Plan," Boston Globe, May 16, 2009, available at http://www.boston.com/business/articles/2009/05/16/fdic_wont_extend_bank_debt_guarantee_plan.

[11] During the 110th Congress, Congressman Garrett introduced a bill with identical legislative text; the Equal Treatment for Covered Bonds Act of 2008, H.R. 6659.

[12] "Garret Introduces Covered Bond Amendment," Press Release, Office of U.S. Congressman Scott Garrett, November 18, 2009, available at http://garrett.house.gov/News/DocumentQuery.aspx?DocumentTypeID=569.

[13] Al Yoon, "U.S. Covered Bond Amendment May Have Legs," Reuters, November 19, 2009, available at http://www.reuters.com/article/marketsnews/idusn2023230620091120?RPC=49.

Covered Bonds and the European Union

In contrast to the United States, the European Union (EU) covered bond market has long been a traditional part of Europe's capital markets. At of the end of 2008, there was approximately EUR 2.38 trillion in outstanding EU covered bonds.[14] There are various kinds of covered bonds in the EU market, but they can be categorized into two main types: regulated and structured. Regulated covered bonds are governed by specific legislation including European directives, national legislation, and secondary legislation. Structured covered bonds operate outside any dedicated laws.[15] This distinction between regulated and structured European covered bonds is important because regulated covered bonds are subject to privileged financial market regulation, while their structured counterparts are not. Within the EU regulatory framework, two primary laws outlining the minimum requirements for a regulated covered bond are Article 22(4) of the 1988 Directive on Undertakings for Collective Investments in Transferable Securities (UCITS), and the Capital Requirements Directive (CRD).[16]

Due to the recent expansion of the covered bond market in Europe, covered bonds have received significant attention from the European Central Bank (ECB). In particular, the ECB's Banking Supervision Committee (BSC) released a study in December 2008, *Covered Bonds in the EU Financial System*, which examined the impact of covered bonds on the stability of the EU financial system.[17] The BSC concluded in this report that EU covered bonds appeared relatively resilient to the recent global financial market turmoil, although covered bonds were adversely affected following the intensification of financial turbulence in September 2008. In an effort to assist European capital markets, the ECB in July 2009 began a one-year purchase program of approximately EUR 60 billion in covered bonds in both primary and secondary markets.[18]

[14] "ECBC Covered Bond Statistics for 2008," European Covered Bond Council, available at http://www.hypo.org/DocShareNoFrame/docs/2/KBMNBDGCAANJIAHPHIOKEAPOPDBG9DBYA1TE4Q/EMF/Docs/DLS/2009-00135.pdf.

[15] For a comparative analysis of legal-based and structured bonds, see "Covered Bonds in the EU Financial System," European Central Bank, December 2008, available at http://www.ecb.int/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf.

[16] The legislative text of both Article 22(4) of UCITS and the CRD are available at http://ecbc.hypo.org/content/default.asp?PageID=317.

[17] "Covered Bonds in the EU Financial System," European Central Bank, December 2008, available at http://www.ecb.int/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf.

[18] "Purchase Programme for Covered Bonds," Press Release, European Central Bank, June 4, 2009, available at http://www.ecb.int/press/pr/date/2009/html/pr090604_1.en.html.

Author Contact Information

Edward V. Murphy
Specialist in Financial Economics
tmurphy@crs.loc.gov, 7-6201

Acknowledgments

This report was updated with the assistance of Andrew Hanna.