RSC Republican Study Committee
Financial Services Working Group
Congressman Scott Garrett (R-NJ), Chairman
Congressman Tom Price (R-GA), RSC Chairman
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Covered Bonds
The Answer to Investment Security?

What is a Covered Bond?

A covered bond is a form of high-grade senior debt that is issued by a regulated financial institution and that is secured – or "covered" – by a dynamic cover pool of financial assets which is continually replenished. Today, almost 30 countries across Europe have adopted national legislation to govern covered bonds. These include Germany, France, the United Kingdom, the Netherlands, Spain, Italy, Russia, Denmark, Ireland, Portugal, the Czech Republic, the Slovak Republic, Austria, Hungary, Slovenia, Switzerland, Luxembourg, Sweden, Finland, Norway, Poland, Latvia, Lithuania, Ukraine, Romania, Bulgaria, Greece, Armenia, and Turkey.

Covered Bonds Coming Across the Pond?

Today the Financial Services Committee will mark up H.R. 5823, the U.S. Covered Bonds Act, legislative framework to encourage a robust U.S. covered bond market.

The framework will enable credit to flow more readily from the capital markets to households, small businesses, and state and local governments in a way that enhances the stability of the broader financial system.

With this framework in place, covered bonds:

- Can infuse stable, longer term liquidity into the credit markets and reduce refinancing risks.
- Can generate less expensive and more available credit for borrowers of all kinds.
- Can mitigate systemic risk by enabling financial institutions to draw liquidity from a separate investor base that would not otherwise make funds available through the unsecured-debt or securitization markets.
- Can supply private-sector funding, even in distressed market conditions, without relying on U.S. taxpayers for support.
- Can align incentives relating to loan underwriting, performance, and modification because of the issuer's retention of 100% "skin in the game."
- Can increase transparency and uniformity in the capital markets with their straightforward structure.

The core elements of the legislative framework are legal certainty for covered bonds programs and public supervision by a covered bond regulator.

The legal status of covered bonds is settled by specifying the categories of eligible issuers and eligible cover-pool assets, mandating an asset coverage test for cover pools and audits by an independent asset monitor, and clarifying securities and tax matters. Most important, since covered bonds are distinguished from other forms of secured debt by their mechanism for managing (rather than liquidating) the cover pool upon the issuer's default or insolvency and continuing scheduled (rather than accelerated) payments, the framework creates a separate resolution process for covered bond programs.

Public supervision designed to protect covered bondholders is supplied by appointing a covered bond regulator. The Regulator is directed to issue regulations establishing a covered bond regulatory oversight program and is required, in consultation with each issuer's primary regulator, to approve and maintain a public registry of all covered bond programs.

The Economist

Unnecessary evils

The next big task of financial reform: dismantling Fannie and Freddie

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DIAGNOSIS is often much simpler than treatment. The failures of Fannie Mae and Freddie Mac, America's housing-finance giants, are glaringly obvious. The two firms, which own or guarantee more than half of the country's $10.7 trillion of mortgages, are awash in red ink. The Congressional Budget Office reckoned in August 2009 that the twosome's cost to taxpayers could go as high as $400 billion. With housing showing renewed weakness, that number may rise.

It is also easy to see why the firms got into such a mess. These "government-sponsored enterprises" (GSEs) occupied a grey area between state and private ownership, benefiting from an implicit government guarantee on their own debt at the same time as they sought to maximise profits for shareholders. That hybrid model granted the GSEs access to cheap funding and gave them the incentive to load their retained portfolios with subprime mortgages whilst maintaining capital levels scanty enough to make investment banks blush.

Although everybody agrees on the need to overhaul Fannie and Freddie, nobody is rushing to do much about it. America's thumping financial-reform bill, which was signed into law by Barack Obama on July 21st, found room in its 2,319 pages to create "Offices of Minority and Women Inclusion" in various federal agencies, but did nothing on Fannie and Freddie. The two were taken into "conservatorship", a form of government ownership, in 2008 and have been put to work ever since. Virtually the only mortgages investors will buy are those guaranteed by the GSEs and other federal agencies. More than nine in every ten new mortgages written in America during the first quarter of 2010 were government-backed. Policymakers are horrified by this level of intervention and terrified about withdrawing it. The Treasury says it will put out proposals on the future of Fannie and Freddie early next year but there are few signs that politicians are prepared to get rid of them altogether.

They should. The GSEs' mission is to provide "liquidity, stability and affordability" to America's mortgage market. Set aside the fact that these aims tend to conflict: cheerleading for cheap mortgages is likely to produce instability, for example. The bigger question is why Fannie and Freddie are needed to achieve them. America's obsession with home ownership is itself questionable, especially now that the trap of negative equity has hampered workers' ability to move in search of jobs. Even if it were a valid goal, there are plenty of countries (Australia, Britain and Canada among them) that have similar or higher levels of home ownership with far less, and in some cases no, systemic government support (see article).

As for liquidity, the argument that America needs Fannie and Freddie because private securitisation markets do not exist to take their place is circular. The GSEs have guidelines for the types of home loans they can guarantee: these let Fannie and Freddie colonise the safest, "conforming" bits of the mortgage market (before expanding into dodgier bits), leaving private lenders to swerve around them into ever-riskier areas. If the GSEs were not there to securitise and guarantee prime American mortgages, private firms would take their place.

A long goodbye, but goodbye nonetheless

There is still the fear that investors would flee the market in times of stress if they did not have a federal guarantee, implicit or otherwise. But other changes can sharply reduce that risk. Tighter underwriting standards would ensure that originators of loans remain disciplined: Britain's plans for a more intrusive mortgage-lending regime provide one source of guidance. Better loan disclosure would help investors in mortgage-backed securities to do their own homework rather than just relying on guarantees. Funding instruments like covered bonds would give investors recourse to banks' balance-sheets as well as the mortgages themselves in times of crisis.

None of this means it makes sense to get rid of Fannie and Freddie in one go. A gradual withdrawal is needed. The first step is to run off or sell their retained portfolios of mortgages. A second would be to squeeze the definitions of conforming mortgages over time, so that bit by bit Fannie and Freddie lose control of chunks of the prime market. American housing would, unfortunately, still have lots of props—agencies such as the Federal Housing Administration and subsidies like tax relief on mortgage interest. But the GSEs should go.