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08 May 2009 www.bbh.com/fx

Covered Bonds: Back to the Future

The European Central Bank seems to surprise the market once a year. Last July the ECB surprised the market and arguably common sense when it hiked interest rates at the peak in commodities, especially oil, just as the region's economy and other major industrialized economies were about to fall off a cliff. It appears to have gotten this year's surprise out of the way with its May 7th decision to purchase covered bonds.

Ironically within hours of the meeting, Bundesbank President and ECB member Axel Weber seemed to play down what for investors was unexpected. Weber thought the more important decision was not the 25 bp cut in the refi rate, or the narrowing of the band within which it moves which seemed contentious last month. Instead Weber drew attention to the extension of the duration of refi operations from six months to 12 months, as investors had widely expected.

Regarding the purchases of covered bonds, Weber said that the ECB agreed to buy a small amount of them. A small amount indeed! While the ECB has agreed in principle to purchase 60 bln euros of covered bonds, it hopes to buy a mere 10 bln euros worth by the end of the year. ECB President Jean-Claude Trichet indicated that additional details about the purchases will be announced early next month.

Covered Bonds

This will ensure that covered bonds will remain more prominently in the news. The ECB might succeed where former US Treasury Secretary Hank Paulson, Fed Chairman Benjamin Bernanke, and FDIC Chair Sheila Bair failed last summer to convince US financial institutions to take more seriously covered bonds as a means to re-start the securitization process.

Even though many investors associate financial engineering with Anglo-American economies, covered bonds are a particularly continental European innovation. The structure is a couple of centuries old. It is similar but different in some key ways to instruments that Americans are already familiar with, like a mortgage-backed security.

The typical covered bond is issued by a financial institution and is collateralized by a pool of mortgages. In this regard it is similar to MBS. Functionally they both are ways that illiquid mortgages can be transformed into a funding source for the banks. However, in a covered bond, the mortgages in the collateral pool remain on the financial institution's balance sheet, which also must hold some capital reserves against it. In the United States, once securitized, the bond can be removed from the balance sheet, against which no capital reserve is required.

In the United States, these mortgage-backed securities provided an efficient way for investors to gain exposure to the real estate market. Covered bonds, on the other hand, do not really offer exposure to the real estate market even though they are backed by mortgages. The interest and principal is the obligation of the issuer. It does not depend on the cash flow from mortgages.

If a mortgage defaults (or is pre-paid), the issuer is obligated to replace the mortgage in the pool. If the issuer itself becomes insolvent, the loans in the pool are separated from the other assets and used only to service the covered bond holder. Part of the challenge in the US is that securitized mortgages are not backed by the capital of the loan's originator.

Can it Work Here?

According to industry figures, the covered bond market in Europe is valued between $2 and $3 trillion. However, they practically do not exist in the United States. Germany alone accounts for about 60% of the market for covered bonds, which it calls Pfandbriefe, and has enacted special legislation that lays out the rights and responsibilities. France is the second largest market for covered bonds. Except for Spain, other countries in the euro-zone under economic or financial pressure, like Portugal, Ireland, Italy and Greece do not have very large covered bond markets.

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One of the obstacles to the development of a covered bond market in the US is the legal and regulatory environment. When a US bank fails or is taken over by the FDIC, the depositors are the first to be made whole. The covered bond requires that the pool of mortgages is used to pay the bond holders not depositors.

The FDIC tried addressing this issue last summer with a ruling whose name only a bureaucrat can love: “Covered Bond Policy Statement: Final Statement of Policy”. If the covered bond is structured in a certain way, such as the collateral pool is composed of geographically diversified, first lien, one-to-four family residential mortgages and having a loan-to-value ratio not exceeding 80%, the FDIC will not seize the collateral pool should the bank fail or be put into receivership. At the same time, in order to protect depositors in the case of insolvency of the bank, the FDIC limited to 4% percentage the share of bank’s liabilities that can be accounted for by covered bonds.

Last July the US Treasury also issued a note: Best Practices for Residential Covered Bonds. It sought to increase the transparency by “suggesting” that issuers of covered bonds issue monthly updates on the changes in the composition and value of the pool of mortgage collateral. The US Treasury also favored the covered bond issuers to “stress test” the collateral performance under varying adverse conditions.

What Needs to be Done

Nevertheless without a legislative action, the regulatory environment remains too uncertain to engender confidence among potential issuers and investors. Another deterrent may be the opaqueness of the rating of covered bonds. An investor’s first and primary exposure is to the issuer and only if it defaults does the exposure to the collateral pool become relevant. If the solvency of the issuer and collateral pool are truly independent then the chances of both failing, which is what is required for the covered bond to default, will be less than either one defaulting, leading to a counter-intuitive conclusion that the covered bond could have a higher rating than either the issuer or the collateral pool. One lesson which investors seem to have to learn again and again is that if it is too good to be true, it probably isn’t true.

Yet another obstacle to the wider acceptance of covered bonds in the US is, as noted earlier, the issuing institution must hold capital reserves against it. As long as there is a hope that the securitization process American-style can be re-started, then financial institutions may likely be reluctant to embrace covered bonds. Besides using moral suasion to try to convince banks to issue covered bonds, the government should adopt a two-prong strategy: provide the necessary legislation and set an example by having the government-sponsored agencies like Fannie and Freddie issue covered bonds.

Covered bonds could still point to the direction of potential reforms that provide an alternative to complexity and moral hazards of the originate-and-distribute securitization model, while maintaining many of the benefits of securitization. To be sure, covered bonds are no substitute to prudent risk management.

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