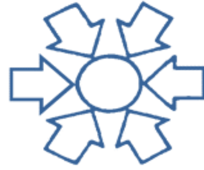

GSE Activity Report

Thursday, July 27, 2017

Keeping Our Eyes Under the Cover

Summary

The *FT* today includes a useful reminder of the important role covered bonds play in Canada as well as to U.S. forces that could renew interest here in comparable constructs. To date, ultra-low rates have combined with regulatory factors and a more than liquid agency securitization option to constrain covered-bond appetite here, but changing times warrant renewed consideration.

Impact

As a refresher, covered bonds are a centuries-old fixture of European financial markets in which assets stay on a bank's books and investors buy bonds on which they receive principal-and-interest payments until the loans amortize, taking the credit and interest-rate risk on the loans even though the assets do not transfer as in an MBS. In essence, the investor buys a revenue stream from mortgages and takes risk only if the issuing bank goes bust and thereafter the mortgage collateral (with a deep hair-cut at issuance) is insufficient to repay principal. During the days in which there were minimal bank regulatory-capital standards, this was a great deal for all concerned; now, it's less advantageous for issuing banks but still so desirable that Canada in 2012 made covered bonds expressly legal.

The EU covered-bond market now is supported by the ECB, which owns about one-third of all EU covered bonds through its QE program. At the same time, EU banks have reduced covered-bond issuance because of severe balance-sheet constraints. EU prices for available bonds thus has risen sharply, with Canadian issuers tapping the EU market to considerable advantage as a result. As we have noted before, Canadian banks issue covered bonds not only for Canadian mortgages, but also for U.S. ones originated by U.S. affiliates, providing a stream of bonds now in compliance with Canadian and U.S. law (see below) that takes advantage of robust at-home and EU demand. Are U.S. mortgage originators next?

There was a flurry of experimentation with U.S. covered bonds in the mid-2000s by WaMu and BofA that the FDIC shut down in a hurry. Despite strong pressure from then-Treasury Secretary Paulson (who saw covered bonds as a way around the GSEs), the FDIC barred most covered bonds because – as would surely have proved the case with WaMu and even for BofA – it feared that it would be stuck with billions in bad mortgages on which investors enjoyed P&I payments up till the day the bank ended up in the FDIC's lap, after which the investor – not the FDIC – would own the good mortgage collateral.

This covered-bond ban lasted until 2016, when the FDIC revised the "safe harbor" for covered bonds that insured depositories may issue to conform to the QRM definition. The QRM of course was earlier

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conformed to the QM, carving a far wider – if not exactly generous – path for covered bonds on mortgages – e.g., jumbos – that meet the QM criteria that are not suitable for agency purchase. Risk-retention requirements also do not apply to covered bonds because, as noted, the assets stay put and the definition of "securitization" therefore does not apply.

So, why no covered bonds so far? First, there remain market demands for additional and sometimes costly credit enhancement, procedural obstacles facing bank issuers not adept at working with the FDIC, and additional barriers for any issuer unwilling or unable to issue what is still "story paper" in the U.S. Secondly, there have been a couple of covered bonds in recent years, principally from JPMorgan. More fundamentally, current interest-rate, capital, and stress-test standards favor portfolio holdings of non-agency QMs.

Changing circumstances will change these incentives, especially as the new TLAC-issuance requirements kick in for the very largest U.S. banks. As we have noted before, covered bonds are eligible long-term debt for purposes of issuing the significant amounts of loss-absorbing capacity now required for U.S. GSIBs and foreign banks operating in this country whose parent banks are also designated as systemically important.

Outlook

When this Congress kicked off, we drew your attention to a statement from the chairman of the House FinServ Capital Markets Subcommittee, Bill Huizenga (R-MI), who included covered bonds in his work plan. We questioned then how serious this was—his predecessor, Scott Garrett, was a huge covered-bond fan and held hearing after hearing on the point which may have left it simply as a hold-over for the 115th Congress rather than a genuine interest of the new leadership line-up.

As Paulson before the crisis and Garrett thereafter noted, covered bonds are an alternative securitization channel that adds a lot of private capital. Even if one cannot resolve the FDIC's concerns, issuance by any non-bank with portfolio capacity – e.g., an insurer – could make a lot of issuer and investor sense. Garrett included extensive covered-bond language in the Hensarling GSE-reform bill in 2014. We expect it to resurface there even in his absence, but it could well be a factor beforehand as Senate Banking gets down to drafting.

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