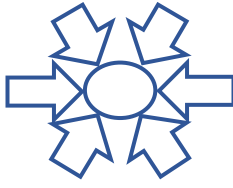

GSE Activity Report

Monday, April 3, 2023

This Looks Like a Job for Super-GSE

Summary

We have written from time to time about covered bonds. We bring this up again because these instruments are playing an important role in helping EU banks through the post SVB/CS funding crisis and could do the same in the U.S. as well as enhance housing credit if anyone cared to do so.

Impact

A brief refresher: Covered bonds are a $3.35 trillion EU market in which they sort-of substitute for securitization. Unlike sales to the secondary market, covered bonds do not provide complete capital relief to originating lenders because the assets covered by the bond remain on the lender's balance sheet. The creditor is thus at risk only for P&I payment shortfalls due to default or delinquency and to failure of the bank that plunges their claim on collateralizing assets into who knows what priority in whatever resolution is applicable to the issuing bank. As a result, covered bonds are usually enhanced by third-party guarantors or third-party liquidity lines. When the guarantor covers credit risk and is eligible under the Basel rules (and all in this market are), the bank receives significant capital relief even though assets remain on portfolio. In addition, the sale of the bond provides significant liquidity in return for the lender's pledge to forward specified portions of P&I payments to the bond holder.

In addition to the capital cost associated with covered bonds (higher in the U.S.), these instruments haven't garnered recent attention in the U.S. because they require a balance sheet and nonbank lenders generally don't have one. Banks of size sufficient to float covered bonds either rely on agency securitization or hold nonconforming loans on portfolio.

However, this isn't to say that there's no U.S. interest in covered bonds. There was a major push to issue them at the height of the pre-2008 mortgage boom, a movement the FDIC shut down out of reasonable fears that bank lenders would adversely select loans that remained on the books in covered bonds versus those the secondary market was willing to purchase. Initially, the FDIC wanted flatly to ban covered bonds; ultimately, it conceded slightly by setting qualified residential mortgage (QRM) standards initially aligned so closely with GSE and Ginnie underwriting requirements that no one wanted to do covered bonds. Now, QMs have strayed from the initial QRM restrictions and the FDIC also allows QMs to comply as long as they are also QRMs. QRM rules ultimately played no more role in the market than as base-case standards for the risk-retention rules subsequently mandated by the Dodd-Frank Act. Various lobbying campaigns were launched to facilitate covered bonds, but none ever passed and thus it is.

Now, banks face significant liquidity problems as deposits run off to MMFs and new instruments may have considerable appeal if the U.S. recrafts covered bonds to meet current market and policy conditions. Ways to do so include giving Fannie and Freddie a new gig as covered-bond guarantors,

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a mission-relevant role for loans – e.g., low-balance obligations – suitable for bank balance sheets but not secondary-market sales. Home Loan Banks looking for a new way to serve members as fallout from SVB and other failures rears its head could also find guarantees a lower cost offering than direct advances.

None of this will work if the FDIC doesn't allow it, but the FDIC could well come to do so if guarantees – not contemplated when the FDIC quashed covered bonds – give the FDIC a claim on the guarantee in the event of bank failure. The FDIC could then assume the claims of bond holders for underlying assets and settle these in due course, but it would not be put at undue risk because the guarantor would protect it from a cherry-picking bank.

Further, various deal structures could ameliorate both FDIC concerns and guarantor exposure. For example, covered bonds could involve loan participations in which the banks hold at least a ten percent pro-rata portion of the assets, an option that would also satisfy the statutory requirement for third-party credit enhancement applicable to over-80 GSE purchases.

Outlook

Except for instances in which large banks see the benefits of covered bonds for QMs they don't want on their books – and there may well be more than a few – credit-enhanced covered bonds are of most immediate use to smaller banks facing depositor flight and thus the Home Loan Banks are best suited to quickly work out terms that might satisfy the FDIC. In 2020, the FDIC significantly changed disclosure rules associated with bank covered bonds, making it easier to issue covered bonds without asset-level SEC disclosures. Now-FDIC Chairman Gruenberg voted against this change, but it's the rule, one likely to stand for a considerable period of time even if covered-bond issuances spike given both their likely structure and just how much else the FDIC now has on its hands.

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