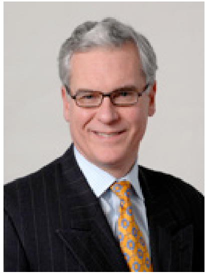
Covered Bonds Redux



By Rick Jones

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Senators Kaye Hagan and Bob Corker's co-sponsorship of Chuck Schumer and Mike Crappo (who says we all can't get along) filed "The United States Covered Bond Act of 2011." I almost think this bill gets support because no one can figure out a compelling reason to be for or against it, so why not show a little whiff of bi-partisanship? The new bill broadly tracks the bill that Congressman Garrett introduced into the House earlier this year, HR-940. We've written about this before (it is getting to be quite a list, see here, here, here, here, here, here, here, here, here, here and even as a Golden Turkey), and, I gotta say, my views have not materially changed. This remains an answer to a question no one has. Please, someone, tell me why this is important and useful!?

Oh, don't get me wrong, I'm a serious fan. Representing issuers on this product will be fun. While this has been a booming business in Europe for a while (like, the last 300 years), it does not translate well in the US. In Europe, broadly, every mortgage loan is originated with the expectation that all or a part of it will be financed in the covered bond market (in German parlance, the Pfandbrief market), that reflects the capital markets environment in Europe where covered bonds are a critical part of every financial institution's capital structure.

That's not what we've got here. US banks have the benefit of robust deposits, of deep equity markets and unsecured borrowing to provide needed capital. The fundamental economic problem for this product here in the United States is that, if an institution is sufficiently highly rated so that the co-dependency problem when the institution issues covered bonds will not be overwhelming, it could raise money more efficiently in the unsecured debt market. Consequently, covered bonds are negatively accretive to the cost of funds. On the other hand, if the covered bond economics are accretive, the bank's unsecured ratings are probably insufficiently high to support the structure. So we have a Goldilocks problem. One issuer is too good and one issuer is too bad, is there one in the middle? Maybe, but it can't be a big market. Compounding this problem is the hostility of the equity analysts who don't cotton to ring-walling assets away from the general creditors of the institution, and of the FDIC, which broadly hates the whole thing. From the FDIC's viewpoint, covered bonds dip into its pocket to steal assets from the rainy day fund. There's been some potential compromise discussed with the FDIC, but it will remain a daunting roadblock to getting something done.

Net, net, I'm not holding my breath for birth of a real covered bond market here in the United States. But if anyone can explain to me the compelling need to which this is a compelling answer, I would love to hear it. In the meantime, maybe it's simply worth enjoying the fact that our elected representatives have found an issue on which they can just get along.