Still waiting on a US covered bond statute

by Jerry R. Marlatt, Morrison & Foerster LLP

A year on from 2011's update and we are still waiting on the enactment of a covered bond statute in the US. There was good progress in 2011, but there is still a considerable legislative distance to go. And 2012 does not look like the year that will see covered bond legislation passed. 2012 is a presidential election year and therefore a difficult year for the passage of any legislation. However, there is a glimmer of promise in the strong bi-partisan support that covered bond legislation seems to enjoy and therefore the possibility that if the parties are looking to achieve something this year, covered bond legislation might benefit.

House of representatives

In June 2011, the Financial Services Committee (FSC) of the US House of Representatives voted 44 to 7 to approve H.R. 940, US Covered Bond Act of 2011, sending the bill to the full House for a vote. H.R. 940 is similar in many respects to the bill introduced in 2010 by Congressman Scott Garrett. While the Committee adopted a number of amendments to H.R. 940 in passing the bill, the substance of the bill remains pretty much the same. The basic structure of the bill provides for the direct issuance of covered bonds by a bank or other institution. The cover pool is a part of the bank's assets. If the bank defaults or becomes insolvent, the cover pool is separated from the bank and administered separately for the benefit of the holders of the covered bonds.

Although H.R. 940 was voted out of the committee by the FSC, there is more to the process. When the bill was introduced, it was assigned to both the FSC and the Ways and Means Committee (WMC). The WMC asserted jurisdiction over the bill because of its provisions that are designed to protect the cover pool after it is separated from the estate of the issuing bank from being subject to federal income tax.

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The WMC has not yet acted on the bill and requested an extension of time for its consideration. We understand the Committee's interest to be technical rather than substantive, which should make the review by the Committee relatively straight forward, but no action has been taken to date.

Until the bill is passed out of the WMC, it cannot be taken up for a vote by the full House.

The Senate

In order to become law, a bill must pass both houses of the legislature in the US. In November 2011, S.1835 was introduced in the Senate by Senators Hagan and Corker, co-sponsored by Senators Schumer and Crapo. The Senate bill tracks very closely the language of H.R. 940 in the House. The Senate bill adds broker-dealers and insurance companies to the definition of 'eligible issuer' and omits the tax provisions of the House bill that are designed to protect a separated cover pool from US federal income taxation. We understand that this was a strategic decision related to the legislative process and that the tax provisions will be included in the final version of the bill when enacted by the Senate. To date no hearings have been held or scheduled in the Senate on the bill, although it is expected that hearings could be held this spring.

The fact that Senator Schumer is a co-sponsor of the bill is significant. Senator Schumer is a senior member of the Banking Committee and is the senior Senator from New York. He is very influential on the Committee and his co-sponsorship lends considerable support to the bill and enhances the likelihood of passage.

Election year prospects

Because 2012 is a presidential election year in the US, the two major parties are jockeying for advantage with various sectors of the electorate by establishing records that may appeal to them. This environment is not conducive to the bi-partisan effort needed to pass major pieces of legislation and minor pieces of legislation, even if there is bi-partisan support, they are usually unable to attract sufficient attention or focus to be passed. Nevertheless, some bills will be passed in 2012. Bills that are designed to create jobs or stimulate hiring will likely be viewed favourably by both parties because jobs are a primary area of concern to voters. Also, bills that may assist the housing sector could also be attractive for similar reasons. Covered bond legislation is unlikely to be viewed as creating jobs or leading directly to an improvement in the housing sector and its prospects for passage in 2012's election year as independent legislation are dim.

In an environment like this, the best prospects for passing covered bond legislation must rest with the possibility of attaching the bill to another piece of legislation that has a high likelihood of passage, preferably a bill no one can vote against.

This was the approach taken in the middle of March 2012. The candidate legislation chosen for attachment of the covered bond legislation was H.R. 3606, a bill designed to encourage small business formation, including the relaxation of certain federal requirements for raising capital. The amendment of H.R. 3606 to include covered bond legislation was made in the Senate, not the House, because the amendment rules are more liberal in the Senate, not requiring a direct relationship of the amendment to the bill being considered.

H.R. 3606 was taken up by the Senate after it passed the House. The bill appeared to have strong bi-partisan support in the House and passed by a vote of 390 – 23 on March 8, 2012. It had a logical relationship to covered bonds because one of the eligible asset classes in the covered bond legislation is loans established under programmes of the Small Business Administration, which is an agency established to assist in financing small businesses. These loans would be guaranteed by the agency and covered bonds utilising these loans would therefore be a form of public sector covered bonds. Thus passage of the covered bond legislation could have provided financing assistance for small businesses.

There were many amendments to H.R. 3606 because it was viewed as a bill that would be enacted. However, many, if not most, of these amendments were stricken during consideration of the bill, including, unfortunately, the covered bond amendment.

The result was not a surprise, although hope springs eternal. There have been no hearings on the covered bond legislation in the Senate since it was introduced in November. The objections of the Federal Insurance Corporation (FDIC) to the provisions of the legislation that would pre-empt its repudiation power are known. And the legislation is not a simple commendation or designation that lends itself to an up or down vote. The covered bond legislation overrides the Federal Deposit Insurance Act and the Bankruptcy Code to create preferential creditors somewhat like the special treatment of swap agreements and repurchase agreement contracts. The conditions for this special bankruptcy treatment may well be cause for debate and so attachment to another fast moving piece of legislation may not give time for the necessary discussion.

But, nevertheless, the amendment put covered bond legislation before the Senate again and brought political focus to covered bonds. So, while the covered bond proposal was not enacted, the concept of covered bonds as a private market means of financing commercial and residential mortgage loans, municipal loans and small business loans received further legislative attention.

US dollar covered bond market

Even without the passage of legislation in the US, the covered bond market here is developing nicely. The market reopened in 2010, following the financial crisis, with US$26bn of issuance of US dollar denominated covered bonds and 11 different issuers in the market. In 2011, the market again grew nicely with US$40bn of issuance from 18 different issuers. The investor base continues to grow and pricing has been very attractive. In September, Toronto-Dominion Bank issued a US$3bn five-year covered bond at 26 over mid-swaps, which was the envy of the market.

2012 opened strongly with about $25bn in 16 offerings through early May. The summer, however, has seen less activity due in part to lower issuance by Canadian banks. By mid-September the volume for the year stood at about US33bn in 24 offerings. The expectation now is for about US$45bn-US$50bn of issuance in the US market for the year.

One of the factors affecting issuance volume has been the Canadian covered bond legislation. The legislation was introduced in April 2012 when the Canadian budget was released. The legislation, enacted in June, prohibits the use in covered bond programmes of mortgage loans insured by the Canada Mortgage and Housing Corporation. All of the major Canadian banks, other than Royal Bank of Canada (RBC), use CMHC loans in their covered bond programmes and they have been major issuers in the US dollar covered bond market.

Accordingly, the covered bond programmes of those banks will need to be restructured. The prohibition on using CMHC-insured mortgage loans in the cover pool has prevented issuance of covered bonds under the existing programmes, although the banks are not yet able to establish new programmes under the legislation because CMHC, the new covered bond regulator, has not yet adopted implementing regulations for the establishment of a covered bond registry and the registration of issuers. It seems likely that the Canadian banks, other than RBC, will not issue until perhaps the spring of 2013.

In a significant development, however, RBC issued the first SEC-registered covered bond in the US September 2012. As the first publicly offered covered bond, the offering was watched closely to see how much benefit there was in SEC registration compared to a private placement. The expectation was that a public offering should substantially broaden the investor base and improve secondary market liquidity since the bonds are eligible for the various bond indices, leading to tighter pricing. RBC was not disappointed. The bonds priced exceptionally well at 35 over mid-swaps. The 1.2% five-year US$2.5bn offering attracted an order book twice that size and almost triple the number of investors in a non-registered offering. The other Canadian banks will now evaluate whether to establish their restructured programme as SEC-registered in anticipation of returning to the market in the spring and for some European banks SEC registration must now be a consideration.

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