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Coming to America: Covered Bonds?

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On May 18, 2012, the Securities and Exchange Commission effectively announced that it would allow Royal Bank of Canada to register and publicly sell covered bonds in the U.S. market.[1] The offering marks the first time covered bonds will be sold to retail investors in the United States. Previously, only "qualified institutional investors" were permitted to purchase covered bonds. Meanwhile, separate bills now in the House of Representatives and Senate seek to establish a legal framework for covered bond issuance by U.S. banks.[2] This essay explains covered bonds, the motives for legislating a market for them, and the advantages and disadvantages of covered bonds versus asset-backed securities (ABS).

Covered bonds are a type of collateralized debt. The bond seller, typically a bank or other type of financial institution, maintains a "cover" pool of high-quality assets on its balance sheet to which the bond buyer has priority claim (ahead of any other creditors) should the seller default. Hence, the bond buyer has *dual recourse* to both the bond seller and the specific pool of assets backing the bond should the seller become delinquent on its payments.

While covered bonds are new to the United States, Europeans have used them for centuries. A 1769 executive order by Frederick II of Prussia established the first covered bonds (called *Pfandbriefe* in German, or literally "letter of pledge"), though they did not assume their current form until the German Mortgage Bank Law of 1899.

So why is there now a legislative effort to establish a covered bond market in the United States? Covered bonds have attracted the attention of U.S. lawmakers in the aftermath of the financial crisis primarily as an alternative to ABS, which have been widely blamed for providing perverse incentives to loan originators and fueling the recent housing bubble. Securitization, or the process of creating ABS by packaging assets together (such as loans) and selling their payment streams, potentially engenders a principal-agent problem. The principal-agent problem occurs when one party (the agent) is charged with making decisions on behalf of a second party (the principal), but the agent is not fully incentivized to act in the principal's best interest. In the securitization process, for example, the security buyer assumes all risks associated with the actual repayment of the loan. The bank that originated the loan faces no financial losses should the loan sour. As a result, the bank may have little incentive to make high-quality loans.

Ultimately, covered bonds and ABS are complements, not substitutes.

Providing the framework for U.S. banks to issue covered bonds has been proposed as one solution to the principal-agent problem associated with securitization. Covered bonds require the bond seller to hold the assets underlying the bond on its own books; thus the seller retains all exposure to the credit risk of the loans. Moreover, a covered bond seller must actively manage the cover pool to ensure the pool's value. All else equal, this should incentivize only high-quality loan origination. Another solution would be to force the banks that originate loans that become securitized to hold the "equity" tranche of the ABS issuance, as, for example, German law requires. The securities in the equity tranche are the first and hardest hit by any losses to the value of the underlying assets, so requiring banks to hold this tranche would force them to have "skin in the game," thereby alleviating the principal-agent problem.

Ultimately, covered bonds and ABS are complements, not substitutes. ABS are a vehicle for packaging and selling exposure to private credit risk, with the promise of the higher returns that holding such risk entails. Covered bonds are a means for banks to raise long-term funding at a lower cost than if they issued unsecured debt. The assets underlying a covered bond simply enhance the issuer's promise to pay back the loan and are not intended to offer exposure to the underlying pool of assets. These differences between the two instruments are reflected in their payment structure: ABS typically pay floating interest rates and pass through any early payments; covered bonds typically pay a fixed interest rate and mature on a fixed date, like any other type of bond.

Although there may be disadvantages to banks selling the loans that they originate, there are also advantages. Securitization increases the financial system's capacity to lend in a way that covered bonds do not. By moving loans off the originating bank's balance sheet, securitization reduces the amount of capital (reserves) that the bank must hold to back its loans. As a result, banks can make more loans with the same amount of capital. Covered bonds, which keep the loans on the banks' balance sheets, do not offer this benefit. ■

Notes

[1] See Alloway, Tracy. "SEC Move Set to Boost Covered Bonds in US." *Financial Times*, May 21, 2012; www.ft.com/cms/s/0/e936554e-a27a-11e1-a605-00144feabdc0.html.

[2] The House and Senate bills, respectively, are H.R. 940: United States Covered Bond Act of 2011 and S. 1835: United States Covered Bond Act.

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