Covered bonds

From Prussia with love

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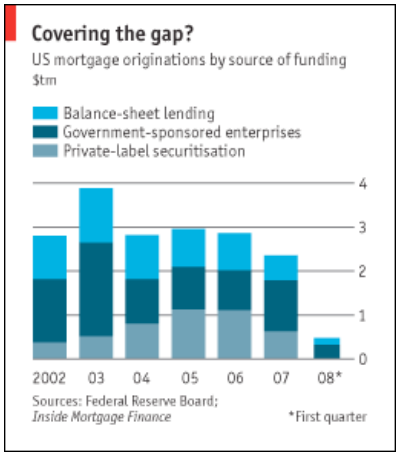
An ancient debt instrument may help America after Fannie and Freddie



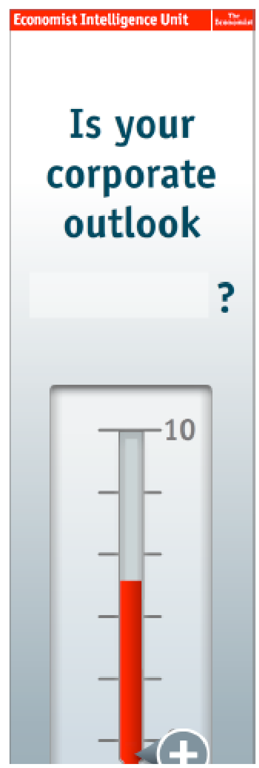
FROM Freddie Mac to Frederick the Great? Fannie Mae and its brother are the central pillars of America's mortgage market. Their role has become even more important during the credit crisis, thanks to the moribund private-securitisation market (see chart). If they were eventually to disappear, what might take their place? One alternative is covered bonds—Prussia's legacy to modern finance.

First issued by the German kingdom in 1770, covered bonds have grown into a $3 trillion asset class, dominated by issuers in Europe. The instrument is a form of senior debt that is paid back from the issuer's cash flows but is also secured against a ring-fenced pool of assets, such as mortgage loans, in the event of default. That makes it safer than unsecured debt. But covered bonds also offer more protection to investors than asset-backed securities, because the issuer retains the credit risk, rather than securitising it away, and must also keep the cover pool up to snuff by replacing non-performing loans with performing ones. For extra safety, the pool contains more collateral than the value of the bond.

The attractions to policymakers in America are obvious. For jittery investors, these are instruments that offer safer exposure to America's mortgage market. For issuers, the costs of funding are lower than raising unsecured debt, and issuance does not depend on the revival of the securitisation markets. Only two covered bonds have been issued in America to date, both of them before the crunch, but a concerted effort is under way to kick-start things.

In July Hank Paulson, America's ubiquitous treasury secretary, unveiled a set of stringent guidelines detailing what kind of mortgage collateral can be used to secure the bonds. In tandem, Bank of America, Citigroup, JPMorgan Chase and Wells Fargo have announced plans to issue covered bonds. According to Tim Skeet at Merrill Lynch, the first issues could well happen before the end of the year.

It is too soon to say how big the market might eventually be. There are several



constraints on growth. The
most obvious are regulatory. The Federal Deposit Insurance Corporation, which is responsible for reimbursing depositors when banks fail, does not want its claims on assets to be subordinated to others and has (initially) capped covered-bond issuance at just 4% of banks' liabilities. Strict criteria on what assets can be used in the cover pool are necessary to reassure investors, but will leave many mortgage loans out in the cold.

The markets are another source of uncertainty. Promoting the merits of a new mortgage-backed debt instrument is not the easiest sell at the moment. Issuers might find that other sources of funding, such as advances from America's 12 Federal Home Loan Banks, are cheaper. Moreover, keeping mortgages on the books, rather than securitising them, means that banks have to deal with headaches like "prepayment risk", when mortgage borrowers refinance their policies and fail to generate the expected return. "Anything that helps to open up the mortgage market is a good thing at this point," says Sharon Haas of Fitch, a rating agency. Just do not expect Prussian-style dominance.