

New Rules Reigniting Covered-Bond Efforts

Talk has surfaced yet again that U.S. banks are working to issue covered bonds. The latest indications are that deals could start flowing within the next six months, as **Bank of America, Citigroup, J.P. Morgan, Wells Fargo** and other institutions look for ways to fund their mortgage-lending activities. Those same companies had taken an interest in such transactions after the market for traditional mortgage securitizations fell apart in 2007, but eventually placed those efforts on the back burner.

Now, their attraction to covered bonds is being renewed by concerns that proposed regulations would drive up the costs of issuing mortgage-backed securities. Partly at issue are risk-retention provisions in the financial-reform package introduced by **Senate Banking Committee Chairman Chris Dodd** (D-Conn.) last month. Those rules would require banks to keep “skin in the game” by maintaining exposures to structured products they sell. The House passed a similar measure in December.

And on April 7, the **SEC** approved a rule that would force operators of registered shelf entities to retain exposures to each class of their securitizations. It’s now taking comments on the initiative.

In each case, issuers would lose the ability to gain “truesale” status for their securitized assets — meaning they would have to hold regulatory capital against them. They’ve recently let investors know that under such requirements, they might as well arrange their deals as covered bonds. Like mortgage-backed securities, covered bonds are underpinned by pools of home loans. However, the obligations are supported directly by the issuer’s creditworthiness and the underlying receivables remain on its balance sheet. “If you’re not going to get sale treatment anyway, then a covered bond becomes an alternative,” one buysider said.

Meanwhile, a proposed **FDIC** rule would allow traditional securitizations of mortgages only after the loans have been seasoned about a year. That would further increase funding costs for issuers.

Covered bonds could also get a boost from the United States Covered Bond Act, which **Rep. Scott Garrett** (D-N.J.) introduced March 18 with co-sponsors **Rep. Paul Kanjorski** (D-Pa.) and **Rep. Spencer Bachus** (R-Ala.). The legislation, which has been in the works for some time, would create a legal framework for such deals in the U.S.

Garrett is shooting for June for the House and Senate to vote on his proposal. It contains a measure that would keep funding costs down for covered-bond issuers by capping over-collateralization requirements, along with provisions for the creation of FDIC policies that would insulate collateral from issuer insolvencies. But the banks may move forward regardless of whether it passes.

The thinking is that either one of Dodd’s bill or the SEC rule would place securitization costs about on par with those of issuing covered bonds under current law. If both pass, covered bonds would gain a considerable advantage. “If assets are going to be on balance sheet, you’ll probably do a covered bond,” **Morrison & Foerster** attorney **Jerry Marlatt** said. Marlatt is also a member of **Sifma’s** covered-bond council.

While prospective issuers in the U.S. have been concerned that investors at home might find covered bonds unappealing, those worries are fading. Several hedge fund managers have signaled demand for the paper, and interest has been sufficient enough for some foreign issuers to recently place deals in the States. For example, **Royal Bank of Canada** sold a \$1.5 billion transaction to American buyers on April 7. “We’ve been investors in covered bonds for over a decade,” said **Cliff Corso**, chief executive of **MBIA** subsidiary **Cutwater Asset Management**.

The U.S. banks’ covered-bond deals would be backed by new jumbo mortgages. While originations in that area have been slow, banks say there are plenty of prospective borrowers they could work with — if

they could find a viable financing outlet. “As a potential issuer, our view is that covered bonds provide an attractive, private, stable and diversified funding source,” said **Brad Brown**, a senior vice president in BofA’s corporate treasury office.