Article

Covered Bonds: Idea of legislation in U.S. spawned

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Article

Relevance of Covered Bonds:

Covered bonds are a relatively common method of funding mortgages in Europe, but uncommon in the United States. A covered bond is a recourse debt obligation that is secured by a pool of assets, more often mortgages. The holders of the covered bonds are given additional protection in the event of bankruptcy or insolvency of the issuing lender. Covered bonds have some features, such as pooled mortgages, that resemble securitization, but the original lenders maintain a continuing interest in the performance of the loans. Here, it becomes pertinent to distinguish between the debt that serves as the collateral and the debt that is the bond itself. A covered bond is a debt in which a financial institution is the borrower. The primary collateral backing the covered bond is also debt, often mortgages in which the financial institution was the lender or has a close relationship with the lender. A covered bond typically uses mortgages (or other debt) as collateral for a bond that a financial institution sells to investors. Covered bonds are highly regarded by investors because they provide higher yield and more diversification, in comparison to the other debt instruments, having the same risk exposure.

Prevalent trend in the U.S. markets:

It is believed that the subprime mortgage turmoil may have been influenced by poor incentives for lenders using the securitization process, because of which some policymakers have recommended covered bonds as an alternative for U.S. mortgage markets. The U.S. entered the covered bond market in 2006 but the financial services sector meltdown of 2007-2009 slowed the market's potential growth. Although covered bond contracts are not prohibited in the United States, some policymakers believe that legislation and agency rulemaking could facilitate the growth of a domestic covered bond market.[1]

Role of GSE Reform:

GSE stands for Government Sponsored Enterprise and is generally used as a generic reference for organizations chartered by the government to facilitate the flow of money into mortgage products. GSE reform refers to the efforts by Congress and the administration to reform the institutions that help fund mortgages in the U.S. Few examples of GSEs are Fannie Mae, Freddie Mac and Ginnie Mae. Organizations like Fannie Mae and Freddie Mac buy mortgages from banks, bundle them and sell securities, in the form of shares. These mortgage backed securities are sold to investors around the

[1] Based on http://www.us-covered-bonds.com/2015/02/16/why-not-covered-bonds/

world. Those organizations then use the proceeds of the sale of securities to buy more mortgages. The market for mortgages and securities is referred to as the secondary mortgage market, which is run by those organizations. With the induction of private funding, the predominance of GSE reform would reduce considerably.

Ray of hope for the covered bonds market in the U.S.

The popularity of covered bonds is immense. It is even believed that covered bonds could become a widely prevalent private sector funding alternative for residential mortgage loans. They have been sold easily in the U.S. markets since the year 2010 and hence, investors are lured by its benefits, such as:

- They provide transparency to the regulators
- High credit quality and higher yield to the investors
- Low risk of acceleration as Covered bonds are designed to continue paying scheduled principal and interest resulting from cash flows from the cover pool if the issuer becomes insolvent. In addition, overcollateralisation and substitution requirements provide additional protections to investors
- Greater flexibility with respect to collaterals
- Easy to analyse for the purpose of investment
- It has global acceptance
- Originator gets the right to modify the loans for assisting borrowers in case of settling difficult loans

It is thus, the need of the hour to pass legislation for covered bonds in the U.S. There is barely any cost incurred by the Treasury and it is also easy to operate and manage the covered bonds market efficiently and effectively.