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What did Frederick the great know about financial engineering? A survey of recent covered bond market developments and research

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ABSTRACT

This article is a survey of the covered bond market with a focus on recent developments in the U.S. Covered bonds are debt obligations secured by a pool of assets, usually consisting of residential mortgages or other public debt. The covered bond asset pool is ring-fenced, dynamically managed, and remains on the balance sheet of the issuer. The issuer replaces non-performing assets and maintains a minimum overcollateralization level. U.S. lawmakers, regulators, and financial institutions are currently working toward jump-starting a market for U.S. issued covered bonds. Recent academic research has focused on the determinants of covered bond spreads and whether these instruments can become an alternative source of mortgage financing in the U.S.

1. Introduction

A covered bond is a debt obligation that is secured by a pool of cover assets, typically consisting of residential mortgages. The key characteristic that differentiates covered bonds from traditional types of mortgage backed securities is that underlying cover assets are held on the balance sheet of the issuer. Covered bond holders thus retain dual-recourse, with claims against the issuer and the cover pool in the case of issuer insolvency.

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Covered bonds are used in European countries primarily to finance both private and commercial mortgages.[1] The European market for covered bonds is large, and has grown to represent nearly 20% of total EU private mortgages with a size of over 2.5 trillion Euros (European Covered Bond Council, 2011). Covered bonds have also been introduced in other parts of the world such as New Zealand, Australia, and Canada, all of which recently passed key legislation needed to jumpstart their own domestic markets.[2]

In 2006 and 2007, Washington Mutual and Bank of America became the first U.S. institutions to issue covered bonds.[3] In contrast to the long history of covered bonds in many European countries, they remain a relatively recent development in the U.S. If Wall Street is one of the biggest financial hubs of the world, then how is it possible that covered bonds are financing both private and commercial mortgages in a variety of countries, both in Europe and around the world, but not in the United States?[4] Though it is naïve to attribute this to one sole cause, a large barrier to the establishment of a U.S. covered bond market is the lack of good, clear, and easy to follow regulations that face potential issuers and investors.

To see why public covered bond markets require some sort of regulation to exist, it is helpful to first understand how the European market is set up.[5] In Europe, there are two types of frameworks under which covered bonds are issued. First, countries such as Germany, France, and Denmark have specific legislation set up for covered bonds. Financial institutions in these countries issue "legislative" covered bonds, which are issued under specific legislative frameworks that act to enforce a common set of rules and regulations over all traded covered bonds. These universal standards are good for a number of reasons, among them being the ability of investors to easily compare one covered bond with another (standardization), as well as the clarity afforded to investors regarding bankruptcy and default procedures. Second, financial institutions that operate in countries without specific covered bond legislation—for example the United States[6]—leave it to the covered bond issuers to set up the proper contracts and structures needed to replicate the ring-fencing of cover assets that is achieved through legislation in other countries. These are commonly referred to as "structured covered bonds", and although they lack the same level of standardization and clarity of recourse in the event of an issuer default, they do have the potential to be more flexible to the needs of issuers and investors.[7]

What if a U.S. bank wanted to start issuing covered bonds? Because there is no legislation in place, as of yet, any covered bonds issued in the United Sates would have to be created as structured covered bonds. Hitherto, there are four issues of covered bonds by U.S. banks, all of them coming before the financial crisis of 2007–2008.[8] There have, however, been a large number of European issuers marketing U.S. dollar denominated covered bonds to U.S. investors, with about $30 billion of covered bonds being issued in the U.S. in 2010 (Marlatt, 2011). Despite this investor demand and a seemingly strong interest among U.S. banks to issue covered bonds, these first four issues are, at the time of writing, also the last four covered bonds issued in recent history in the United States.

[1] Though primarily backed by private mortgages, cover pools are also commonly comprised of commercial mortgages, public sector debt, and ship loans. Some covered pools are comprised of a mix of these asset classes, and they can further be broken down by issue size, or Jumbos vs. Non-Jumbos (European Covered Bond Council [ECBC], 2011).

[2] Covered bond legislation was introduced to Canada in 2007, Australia in 2011, and New Zealand in 2012.

[3] Though issued by U.S. financial institutions, these first U.S. covered bonds were denominated in euros and marketed to European investors.

[4] A short list of covered bond issuing countries includes Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Finland, France, Germany Greece, Hungary, Ireland, Italy, Latvia, Luxebourg, the Netherlands, Norway, Poland, Portugal, Romania, Russia, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine, and the United Kingdom, as well as non-European countries such as Canada, Australia, and New Zealand (ECBC, 2011).

[5] In contrast to public sales, private placements allow banks to bypass financial regulatory institutions when issuing covered bonds to investors. This can be costly, however, when smaller investor pools and the related illiquidity costs are accounted for (McGee, 2012).

[6] Structured covered bonds have also been issued in some European countries before lawmakers enacted specific legislation (e.g. United Kingdom and the Netherlands), as well as alongside legislative covered bonds (e.g., Switzerland) (ECBC, 2011).

[7] Legislative covered bonds are subject to standardized restrictions on items such as collateral type, while structured covered bonds can be modified to include more unique assets (Schwarcz, 2011).

[8] Washington Mutual issued two covered bonds in 2006, and Bank of America followed by issuing two of its own in 2007. Although they were issued by U.S. banks, they were denominated in Euros and marketed mainly to European investors.