Will Covered Bonds Come to the Rescue?

Americans are partial to all things covered. They pay up for covered parking. They’ll eat chocolate-covered anything. A generous friend has got you “covered.” When a sudden thunderstorm hits, metaphorically or otherwise, we all run for cover.

So it’s not too surprising that some bankers and regulators have their eyes on Europe’s covered bonds, and they are trying to adapt them for their own use. This would require the creation of a new market, and that’s what Treasury Secretary Henry Paulson has asked the broker/dealer community to do. Therefore, it may be wise to, ahem, cover the basics of covered bonds.

American Equivalent

Let’s start at a spot that portfolio managers already understand very well: Federal Home Loan Bank (FHLBank) advances. FHLBank advances are effectively the covered bond market of the United States. Over the last 20 years, banks and examiners have become more comfortable financing balance sheets with collateralized borrowings as the pool of core deposits continues to dwindle.

As various regional FHLBanks have created new demand-driven advances, it has become easier to match fund or even repair an asset-liability gap using advances. Also, FHLBanks have gradually expanded their lists of acceptable collateral. Most portfolio managers would conclude that FHLBank advances have been both efficient and profitable to employ.

Borrowing Alternatives

In many cases a bank will simply sell, without recourse, its assets for cash, which can then be used to fund future loan demand or pay off current borrowings. The classic example of this is the secondary mortgage market, in which Fannie Mae and Freddie Mac post firm bid prices daily. While spreads on secondary market mortgages have widened dramatically this year, which has made the process potentially less profitable for the originators, this technique has served borrowers, lenders and investors well in the last quarter century or more. Small Business Administration 7(a) loans are also used in this profitable manner.

Furthermore, whether a bank realizes it or not, often it effectively funds itself by selling loans and then purchasing securities with the proceeds. The resulting bonds usually have lower risk weightings, allowing for more leveraging. They also have infinitely better liquidity, which can be more easily used for pledging or bond swaps or further sales.

European Model

The FHLBank System is unique; no other country has one. Likewise, there is no functioning secondary loan market overseas.
For centuries, banks that needed financing had to issue debt securities that were collateralized by assets already on the books and by the bank’s general credit. This created a different set of circumstances than what we’re accustomed to seeing.

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For one, the assets remain on the books of the debt issuer. For another, the double-barreled credit of covered bonds makes them very safe; there have been almost no defaults in recent history. For yet another, there is a functioning system for the pricing and distribution of these bonds. In other words, it is a covered bond market.

**Prospects for Community Banks**

The presence of the FHLBank System, a liquid secondary market for many loans and the complexities involved in creating a trading system make it very unclear if, or when, community banks may be able to participate in such a product as borrowers. To date, only the late Washington Mutual and Bank of America have issued covered bonds, and at rates that were not any more efficient than FHLBank levels.

Still, if the nascent market begins to deepen, it could well become efficient enough to allow smaller players to lower their borrowing costs from today’s levels. In recent years, the pooled Trust Preferred Securities (TRUPS) market rapidly dropped in scale to the point that a $75 million-asset bank could issue TRUPS at roughly the same level as money center banks.

Of course, the Trust Preferred market has been shuttered for the past year, which is one of the reasons the Treasury is looking to expand funding sources for all FDIC Insured institutions. The coming year will show whether institutional investors will grasp this new lending vehicle for banks. A lot will be determined by foreign investor involvement.

ICBA Securities will stay on top of the developments and will keep members informed through its normal distribution channels—this column, Webinars and Strategic Insight research reports. We also will be available to facilitate community bank issuance or pooling of covered bonds when the opportunity arises.

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