European financing tool may finally cross the pond

All three options recommend a drastically reduced role for the government in the housing finance market. ICBA has published its own recommendations to create a cooperative housing finance structure based on the Federal Home Loan Bank system (see Washington Watch in the April issue of ICBA Independent Banker). Regardless of which housing finance version emerges, it’s certain that private lenders will be assuming the bulk of the origination and, more important, the ownership of mortgages.

Also mentioned in the February document is Federal Home Loan Bank system reform. Experts expect that the various FHLBs will have reduced capacity to lend. Restrictions are anticipated on their investment portfolios and their ability to lend to large institutions. This development will increase the need for alternative financing sources.

How they’re different: Enter the covered bond, already the financing tool of choice in Europe, which doesn’t have an FHLB-type alternative. There is a well-defined market for issuing and trading—at interest rate levels that allow for efficient flow of monies. In fact, critics of the government-sponsored enterprises have long cited the covered bond market as proof that Fannie and Freddie are simply government largesse benefiting a few private shareholders.

The protection for buyers of covered bonds is quite good. Unlike an American-style securitization, there is an ever-changing pool of assets designated as collateral for a given issue. These assets are known as the cover pool and stay on the books of the lender/issuer.

If the cover pool’s market value declines or performance deteriorates, the issuer is obligated to replace the underperformers with more and better collateral. Overcollateralization is also required. The covered
bonds themselves do not amortize, so there is continual monitoring of the collateral to ensure sufficiency.

Another reason covered bonds are superior to the U.S. private-label security model: Covered bonds are further guaranteed by the issuer itself, so there is a double-barreled aspect to an issue. The interest payments on the bonds are not covered by the collateral but are obligations solely of the lender/issuer.

**FDIC benefits:** New FDIC regulations call for a 50 basis point assessment for banks that own unsecured debt of other FDIC-insured institutions to the extent the investment in aggregate exceeds 3 percent of Tier 1 capital. For example, if a bank has $25 million in Tier 1 capital, it can own up to $750,000 in unsecured debt of other FDIC-insured banks without the additional charge. Amounts greater than the 3 percent limit will be subject to the 50 basis point assessment.

Most community banks have little or no corporate bonds in portfolio, so this may seem moot. However, what is likely to happen over the next few years is that corporate debt will become a much more visible sector of bank portfolios as Fannie’s, Freddie’s and even the FHLLBs’ balance sheets shrink substantially.

**Market indications:** To date, only two U.S. banks have issued covered bonds: Washington Mutual, which has been assumed by J.P. Morgan Chase, and Bank of America. We can expect this roster to grow in the near future.

Because covered bonds offer protection over and above traditional unsecured debt, they have lower yields. In early March, a Bank of America covered bond rated Aa2/AA and maturing in June 2012 was priced to yield about 1.11 percent. At the same time, a Bank of America debenture rated A2/A and maturing in September 2012 was priced to yield about 1.36 percent.

Stay tuned to developments related to separate but related story lines of keen interest to community bankers everywhere: the wind-down of the GSEs and the kick-start of the covered bond market. This column will continue to help keep you abreast of key events in these groundbreaking proceedings.

**Bond Insight**

ICBA Securities’ clearing broker, Vining Sparks, publishes a weekly market letter, *Corporate Credit Weekly*, that analyzes the corporate bond market. For access to this report, contact your ICBA Securities sales rep or visit [www.icbasecurities.com](http://www.icbasecurities.com).

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Quote: Debra Miles, Dart Bank, Mason, MI

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