



March 10, 2011

Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett:

The National Multi Housing Council (NMHC) and National Apartment Association (NAA) applaud your leadership and that of the Subcommittee for exploring alternative sources of capital to support housing and, in particular, covered bonds. We believe that covered bonds could indeed provide some degree of additional liquidity to U.S. multifamily finance. We caution, however, that it is quite unlikely that covered bonds could provide the capacity, flexibility or pricing superiority necessary to adequately replace any of the U.S.'s traditional sources of multifamily mortgage credit.

NMHC and NAA represent the nation's leading apartment firms. Our combined memberships are engaged in all aspects of the industry, including ownership, development, management and finance. NMHC represents the principal officers of the industry's largest and most prominent firms. NAA is the largest national federation of state and local apartment associations with 170 state and local affiliates comprised of more than 50,000 members. Together we represent approximately six million apartment homes.

One-third of American households rent, and over 14 percent of households—16.7 million households—live in a rental apartment (buildings with five or more units). Our industry's ability to meet the nation's rental housing needs depends on reliable and sufficient sources of capital. To understand the role or impact covered bonds might have on the apartment industry's access to credit, it is necessary first to have a broad understanding of the apartment industry's current capital sources—both before and during the crisis.

For more than two years after the onset of the financial meltdown, virtually all private mortgage lenders abandoned the market, leaving the apartment industry to rely heavily on credit either insured or guaranteed by the federal government. An estimated 70 percent of apartment loans issued in 2010 had some form of government credit behind them, namely FHA, Fannie Mae or Freddie Mac. Even as the private debt markets improve, the FHA and Government Sponsored Enterprises (GSEs) are expected to account for half to two-thirds of the \$60-\$75 billion in credit provided to the apartment sector this year.

Historically, however, the apartment industry has enjoyed access to mortgage credit from a variety of capital sources. In addition to the FHA and GSEs, banks and thrifts, life insurance companies, pension funds and the commercial mortgage-backed securities market have all provided significant amounts of mortgage capital to the apartment industry. Prior to the financial crisis, these capital sources provided our sector with \$100-\$150 billion annually, reaching as high as \$225 billion, to develop, refinance, purchase, renovate and preserve apartment properties.

As policymakers consider the causes of, and solutions to, the single-family meltdown, it is important to distinguish between the finance systems supporting the single-family sector and the multifamily

sector. The apartment industry did not overbuild in the housing boom. The discipline shown by the apartment industry has translated into stronger portfolio performance as well. Overall loan performance in the \$853 billion multifamily sector remains relatively healthy, with delinquencies and default rates only a fraction of those seen in single-family.

Covered Bonds and the Multifamily Credit Market

As stated earlier, the apartment industry welcomes Congressional efforts to create a framework for covered bonds so they may serve as an additional source of capital for apartments. As outlined in our assessment conducted in 2010 (attached), it is clear that covered bonds offer some advantages to issuers and investors. They give issuers access to lower-cost funding for mortgage and other asset-backed credit with more favorable risk-based capital requirements than whole loans held in their portfolio. For investors, they offer high credit quality, solid yield, low-risk and diversified investments. They also offer both issuer and investor the ability to substitute bond assets in the collateral pools if there is a problem with an individual loan or mortgage, thus reducing overall risk. Under the right conditions and circumstances, covered bonds could serve as an added credit option for our sector by augmenting banks' mortgage credit activity.

For numerous reasons, though, it is quite unlikely that covered bonds could provide the capacity, flexibility or pricing superiority necessary to adequately replace the U.S.'s existing sources of multifamily mortgage credit. It is unclear whether covered bonds would actually increase the amount of credit banks would make available to apartment firms. The covered bond structure limits issuer lending volumes by requiring them to hold loans on the issuer's balance sheet and retain capital reserves in case of losses. It is also possible that banks could simply replace some of their whole loans activities with covered bonds, which would not increase lending capacity except as it relates to how risk-based capital reserves are held by banks.

Covered bonds could allow banks to compete with other credit sources such as life companies, thrifts, commercial mortgage-backed securities (CMBS) and the current multifamily government – sponsored enterprise (GSE) 10 year mortgage product because the loan term for covered bonds is longer (10-year terms) than the traditional five-year term banks typically provide. Even then, however, larger banks that are anticipated to be a major source of covered bond issuance may choose not to issue covered loans for multifamily mortgages because many of these banks originate such mortgages for the GSEs or CMBS market and thereby avoid any balance sheet liability.

It is also unclear to what extent banks would use covered bonds for multifamily lending since so many asset classes qualify for covered bonds. H.R. 940, "The United States Covered Bond Act of 2011," would allow covered bonds to be used for single-family mortgages and equity loans, commercial and multifamily real estate mortgages, auto loans and leases, loans for public facilities and activities, student loans, small business loans and credit card and revolving credit loans to consumers. We question the capacity of covered bonds to meet the demand from all of these loan categories.

In Europe, the majority of real estate-related covered bond debt has been for public purposes and residential home mortgages. Unless there are allocations and diversification requirements for covered bond issuers, we expect the U.S. experience would be similar, with most of the additional credit created by covered bonds directed to the residential mortgage market and other consumer and loan assets and not toward rental housing.

It is also important to understand that the European experience with covered bonds for multifamily properties is not translatable to the U.S. In Europe, the rental markets operate on a condominium model comprised of small investors buying individual units and renting them out. For instance, in the United Kingdom, 73 percent of the rental stock is owned by "mom-and-pop" operators, and there is

minimal institutional investment. There is little existing data or analysis determining to what degree European covered bonds actually finance commercially developed rental housing.

In addition to these issues, it also remains unclear whether the covered bond structure can become sufficiently flexible to accommodate broad-based public-sector participation in the U.S. affordable-housing finance arena. For instance, a significant proportion of apartment production in recent decades has been financed through Low-Income Housing Tax Credit (LIHTC) equity investments and various structures of tax-exempt or otherwise subsidized bonded debt. These specialized loans may not be able to gain access to covered bond credit capital.

Likewise, questions remain about whether a purely private American covered bond market could become a critical “backstop” capital source during periods of financial instability. While Europe’s covered bond market came to something of a standstill during the global financial crisis, in the U.S. the GSEs, Fannie Mae and Freddie Mac, remained a critical liquidity source in the domestic multifamily finance field. They have served this role during other capital market dislocations, including the Russian economic collapse in the late 1990s, which caused a collapse of the U.S. commercial mortgage conduit market, and during the 2001-2003 recession.

Although the European covered bond market remained liquid longer than many other wholesale funding markets, it was ultimately rendered dormant for several months during the last quarter of 2008. In the wake of Lehman Brothers’ collapse in September 2008, the European covered bond market went without a public issuance until early 2009.

For all these reasons, we can only conclude that a covered bond market might augment—but would not adequately replace—any of the active components of the U.S. multifamily finance marketplace, including “conduit” financing through mortgage-backed securities issued by the existing GSEs and private Wall Street firms, along with mortgages funded by life companies, banks and other balance sheet lenders.

We greatly appreciate your efforts and look forward to working with the Subcommittee on this effort. Should you require any assistance, please contact David Cardwell at 202/974-2336 or via e-mail at DCardwell@nmhc.org.

Sincerely yours,



Douglas M. Bibby
President
National Multi Housing Council



Douglas S. Culkin, CAE
President
National Apartment Association

cc: Ranking Member Waters and Members of the Committee

Attachment: NMHC Analysis: Credit Capacity of Covered Bonds, July 2010



WHITE PAPER

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Analysis: Credit Capacity of Covered Bonds

- Covered bonds are similar to asset-backed securities, but some differences improve security for the bond buyer. The underlying security interests remain on the balance sheet of the issuing bank, and bondholders retain security interests even if the issuer becomes insolvent.
- Covered bonds are a \$3 trillion marketplace in Europe, and some suggest that they should be used in American multifamily finance as well.
- This white paper gives background on covered bonds and provides a framework for understanding the risks, benefits and limitations inherent in establishing a similar market in the United States.
- NMHC/NAA's conclusion: A prospective U.S. covered bond market should not be considered an alternative or a replacement for, but rather a supplement to, the current secondary multifamily mortgage system and the GSEs.

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For more than 30 years, the National Multi Housing Council (NMHC) has provided strategic leadership to the apartment industry. Through its highly effective government affairs program, its business guidance and re-search reports, and its sought-after industry meetings, NMHC has developed a reputation as the apartment executive's best ally.

Based in Washington, DC, NMHC represents the largest and most prominent firms in the apartment industry, including owners, developers, managers, lenders and brokers. The Council benefits from a focused agenda and a membership that includes the principal officers of the most distinguished real estate organizations in the United States. With its joint legislative partner, the National Apartment Association, NMHC serves as the apartment industry's primary advocate on legislative and regulatory matters, such as housing policy, finance, tax, technology, property management, environmental issues and building codes.

In addition to providing leadership on public policy issues, NMHC is acknowledged as the preeminent source of apartment-related information. The Council is committed to expanding the scope of industry research by conducting and sponsoring research on such critical issues as apartment market conditions, resident demo-graphics, owning versus renting, industry structure and the impact of policy on market supply and demand. For more information on joining NMHC, contact the Council at 202/974-2300 or visit www.nmhc.org.

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EXECUTIVE SUMMARY

In response to the financial crisis and its severe impact on the U.S. residential and commercial/multifamily mortgage markets, some observers have suggested establishing a covered bond market similar to the European model as a means of improving liquidity in the real estate finance arena.

A careful analysis concludes that a thriving domestic covered bond market might indeed provide some additional liquidity to the mortgage marketplace. However the analysis also reveals that efforts to comprehensively replace prevailing multifamily mortgage financing mechanisms with a covered bond system would provide limited benefits at best.

Most notably it doesn't appear a covered bond marketplace would offer the flexibility and variety of loan structures, terms and rates that U.S. multifamily and commercial borrowers demand. Nor would it likely boost liquidity by a truly significant extent, given the need for bond issuers to retain the underlying mortgages on their balance sheets.

The European experience indicates that covered bonds, as a secondary-market mortgage financing mechanism, do indeed provide numerous benefits to various participating parties. Investors earn attractive risk-adjusted yields on instruments featuring low-risk "second recourse" security. Financial institutions that issue the bonds benefit from attractively priced funds and reduced risk-based capital requirements, along with meaningful collateral substitution capabilities.

These characteristics can combine to minimize borrowing costs to multifamily and commercial property borrowers. And any additional liquidity a covered bond market generates would boost the market's overall lending capacity.

But again for numerous reasons this report will detail, it is quite unlikely covered bonds could provide the capacity, flexibility or pricing superiority necessary to adequately replace the U.S.'s existing sources of multifamily mortgage credit.

Among the most significant:

- In contrast to U.S. commercial mortgage lenders' broad flexibility with respect to term and rate structures, the covered bond market is characterized as far more uniform and commoditized;
- In contrast to the U.S.'s generally thriving secondary mortgage markets, which allow originating lenders to remove loans from their balance sheets, the covered bond structure limits issuer lending volumes by requiring them to hold loans in portfolios and retain capital reserves in case of losses;
- In contrast to European markets, life insurers and other active U.S. apartment mortgage lenders would compete aggressively with covered bond issuers with regard to interest rates and loan terms;
- In contrast to the short-term lengths and consequential "balloon" repayment requirements associated with covered bonds, American apartment investors are accustomed to a variety of term choices including 10-year balloon loans and longer-term fully amortizing structures; and
- In contrast to covered bond issuers' prohibitions (or extreme limitations) of additional financing subordinate to first-priority mortgage debt, U.S. borrowers have seen lenders compete by allowing various secondary financing structures.

In addition to these issues, it also remains unclear whether the covered bond structure can become sufficiently flexible to accommodate broad-based public-sector participation in the U.S. affordable-housing finance arena. For instance a significant proportion of apartment production in recent decades has been financed through Low-

Income Housing Tax Credit (LIHTC) equity investments, and various structures of tax-exempt or otherwise subsidized bonded debt.

Likewise questions remain about whether a purely private American covered bond market could become a critical “back-stop” capital source during periods of financial instability. While Europe’s covered bond market came to something of a standstill during the global financial crisis, the U.S. government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac remained a critical liquidity source in the domestic multifamily finance field.

Nor does the evidence suggest a covered bond market would provide more attractive multifamily borrowing rates and terms, nor any greater financial security to American taxpayers.

For all these reasons, our analysis can only conclude that a covered bond market might augment – but would not adequately replace – any of the active components of the U.S. multifamily finance marketplace, including “conduit” financing through mortgage-backed securities issued by the GSEs and private Wall Street firms, along with mortgages funded by life companies, banks and other balance-sheet lenders.

INTRODUCTION

This analysis provides background information on the nearly \$3 trillion European covered bond marketplace, and assesses prospects for extending it into the U.S. multifamily finance arena. Its primary intent is to provide a framework for understanding the risks, benefits and limitations inherent in establishing a similar market in the United States.

In addition to defining covered bonds, their key features and market trends, this study details the history of the European covered bond market and discusses how this fully established market fared during the 2008 financial crisis.

In July of 2008, the U.S. Department of the Treasury, in cooperation with numerous large banks, announced that Treasury would begin establishing regulations aimed at jump-starting a covered bond market in the U.S. The purpose of the initiative was communicated as a means to provide an alternative form of residential mortgage-backed securities.

Several regulatory agencies have been promoting the covered bond model in an effort to “increase availability, and lower the cost of mortgage financing, to accelerate the return of normal home buying and refinancing activity,” as former Treasury Secretary Henry M. Paulson put it.

DEFINING COVERED BONDS

In recent years, covered bonds have become the dominant source of residential mortgage credit in Europe. Some countries there even look to covered bonds to help finance public infrastructure development. They have also been used to finance ships.

Covered bonds are similar in many ways to asset-backed securities, but some noteworthy differences improve bond buyer security and hence attract a broader investor base. Most notably, underlying security interests in the cover pool of mortgage loans remain on the balance sheet of the issuing bank – and bondholders retain security interests in the cover pool even if the issuer becomes insolvent.

Accordingly, covered bonds eliminate risks associated with mortgage-derived cash flows because principal and interest are paid by bond issuers. The mortgages in the cover pool, which are controlled by the issuer, serve only as collateral for investors rather than the source of cash flow necessary to ensure interest and principal payments.¹

¹ European Covered Bond Council Fact Book (2009), p. 325-335.
Analysis: Credit Capacity of Covered Bonds

The collateral risk may likewise be lower than with typical mortgage-backed securities due to asset substitution rules and other factors. But issuing banks must nevertheless reserve against potential losses associated with mortgage loans.

In contrast, mortgage- and other asset-backed securities are typically off-balance-sheet transactions. Lenders sell loans to special purpose vehicles (SPV) that issue bonds, thereby removing the credits, along with their risks, from lenders' balance sheets. Absent detection of fraud, investors have no recourse to banks that sell mortgages to SPVs.

Again, covered bond issuers' ability to alter loan pools in order to maintain targeted credit quality is another important distinction, as it further protects bondholder interests. Issuers can also modify certain loan terms in order to boost credit quality. Collateral substitutions and loan modifications historically have not been allowed with securitized commercial mortgages in the U.S.

Nor do covered bonds entail material refinance risk, as underlying loans are typically leveraged no more than 80 percent – a rate securitized U.S. residential mortgages have often exceeded. And even if the issuing bank ultimately becomes insolvent, the assets in the cover pool are separated from the issuer's other assets solely for the benefit of the covered bondholders.

Based on the high quality of the loans in the cover pool, the strength of the issuing banks and other security characteristics, most covered bonds receive high credit ratings of double-A or triple-A. Bond maturities generally range from two to 10 years, although there has been a recent trend toward maturities beyond 10 years (but typically not more than 20), with amortization periods of 20 to 30 years.



Current regulations of covered bonds in the U.S. differ somewhat from those in Europe. For instance, 26 of 31 European nations where covered bonds are allowed (as of December 2007) treat them under "special law"-based regulatory frameworks, while a handful oversee them through "general law"-based frameworks.

Under special law frameworks, standardized uniform regulations more clearly detail legal rights of bond holders, including certain regulated investors that might benefit from preferential risk weightings.

Several key regulatory provisions are common to both legal frameworks:

- Bond are issued by – or bondholders otherwise have full recourse to – a lender (credit institution) subject to public supervision and regulation;
- Bondholders' claims against pools of financial assets covered by the bonds are superior to the credit institutions' unsecured creditors;
- The credit institution is obligated to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times; and
- The obligations of the credit institution with respect to the cover pool are supervised by public or other independent bodies.²

According to the European Covered Bond Council (ECBC), the market for these instruments would be much smaller absent the regulatory frameworks. The ECBC states that without the general-law and special-law based frameworks, the volume of issued and outstanding covered bonds would be approximately 25% of what has been seen to date.

² European Covered Bond Council Fact Book (2009), p. 96

Regulations of covered bonds issued in the U.S. provide for additional bond holder access to pledged collateral in the event issuing institutions are taken over by the Federal Deposit Insurance Corp. or another regulator. Among those provisions:

- Cover pool assets must consist primarily of home mortgages (up to 10% of assets can be AAA-rated MBS);
- Covered bonds can account for no more than 4% of an issuer's total liabilities; and
- The covered bond asset pool's value must remain equal to or greater than the bond issue's outstanding principal balance.

KEY BENEFITS, LIMITATIONS

The fundamental benefit of covered bonds in theory is that they allow issuers to funnel bond sale proceeds into additional mortgage (and other) lending, while also providing investors with additional security protections not seen with traditional mortgage-backed securities. The other commonly noted benefits of covered bonds to investors include:

- Strong credit quality;
- Attractive yields suitable for conservative portfolios; and
- Exceptional security via the extra recourse layer upon issuer default.

Nevertheless, regulation and industry practices also create a number of less attractive characteristics that may well tend to limit the U.S. market for covered bonds. Among the most notable limitations:

- Holding covered bonds on issuer balance sheets limits issuance volume and in turn new loan originations;
- Consequences for bond holders when regulators absorb insolvent issuers aren't yet absolutely clear;
- Bond term lengths defining the European market won't necessarily satisfy U.S. investors;
- Loan underwriting practices in the European covered bond market may prove too conservative for U.S. borrowers;
- No track record to date validates the viability of using commercial mortgages and commercial MBS in cover pools, rather than using residential assets exclusively; and
- Competition from covered bonds could potentially limit participation of life insurance companies and private capital sources in multifamily mortgage funding.

It should be noted that uncertainty over regulatory practices in cases of issuer insolvency – particularly regarding bond holder rights to cover pool assets – is thought to be a primary factor in the limited track record of covered bond issuance in the U.S. That is, while issuance of covered bonds is not prohibited in the U.S., to date only two U.S. financial institutions have issued covered bonds.

Over decades and even centuries, covered bonds have evolved into a key capital markets component in nearly all European countries. These instruments date back two centuries to their origination as a means of agricultural financing. They subsequently evolved into public interest and government operations, followed by residential and commercial real estate financing markets.

Use of covered bonds declined somewhat in the 20th century as European inter-bank finance markets came to prominence. But then issuances increased again rapidly in the 1990s to meet investor demand for highly liquid

financial products. Covered bonds currently play an important role in the European financial system, and thereby contribute to the efficient allocation of capital and ultimately economic development and prosperity.

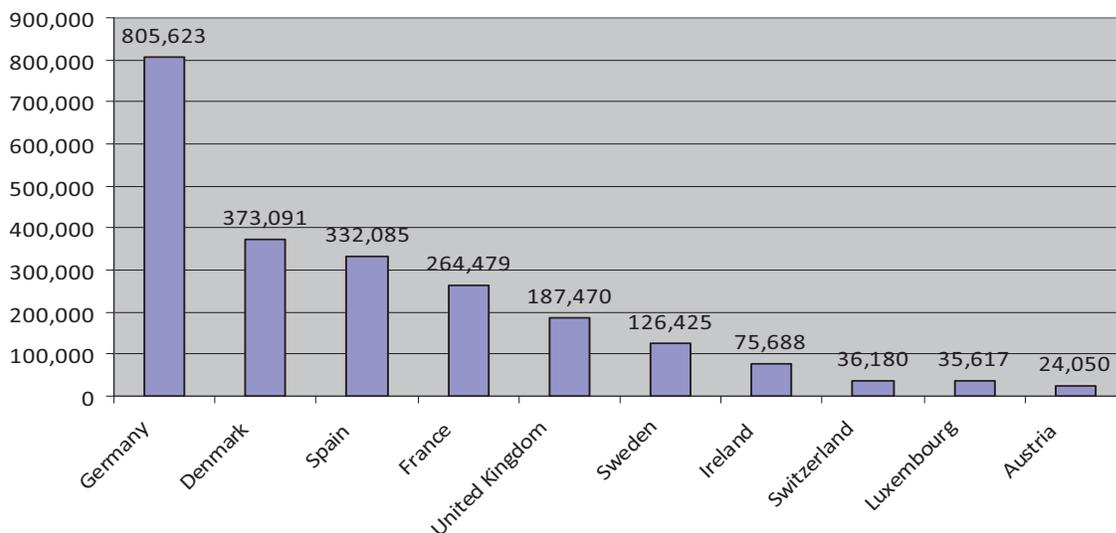
According to the most recent data available, covered bonds now equate to approximately 20% of outstanding residential mortgage debt in the European Union. The total principal outstanding at the end of 2008 amounted to €2.38 trillion (\$2.84 trillion) worth of bonds covered by mortgage loans, public-sector loans and ship loans – up 12% from the year-earlier figure.³

Mortgage covered bonds continue to dominate the market, accounting for 78% of the gross supply and 64% of the outstanding volume of covered bonds at the end of 2008.⁴ The five largest issuing countries in 2008 were Germany, Denmark, United Kingdom, France and Spain – with public-sector loans playing prominent roles in each.

Figure 1 shows the total volume of outstanding covered bonds by country for the fourth quarter of 2008 for the top 10 European countries. The U.S. ranked 15th of the 25 countries reportedly issuing covered bonds according to the ECBC, with a total outstanding volume of \$15.4 billion in 2008.

In addition to the United States, other countries identified by ECBC but not depicted in this chart include: Norway, Netherlands, Portugal, Italy, Czech Republic, Hungary, Canada, Finland, Greece, Slovakia, Poland, Iceland, Latvia, and Ukraine. The combined outstanding principal of the top 10 issuing countries at the end of 2008 was €2.26 trillion (\$2.7 trillion). The other 15 countries' combined outstanding volume at the end of 2008 totaled only €119.2 billion (\$142.3 billion).⁵

Figure 1: Total Volume of Outstanding Covered Bonds (Top 10 European Countries)/Million



Source: *European Covered Bond Council Fact Book (2009)*

The major categories of covered bond assets are mortgage loans, public sector loans and ship loans. Regulators in each country specify the array of eligible cover pool assets. All European nations that allow covered bonds have activity in bonds backed by residential and commercial mortgages.

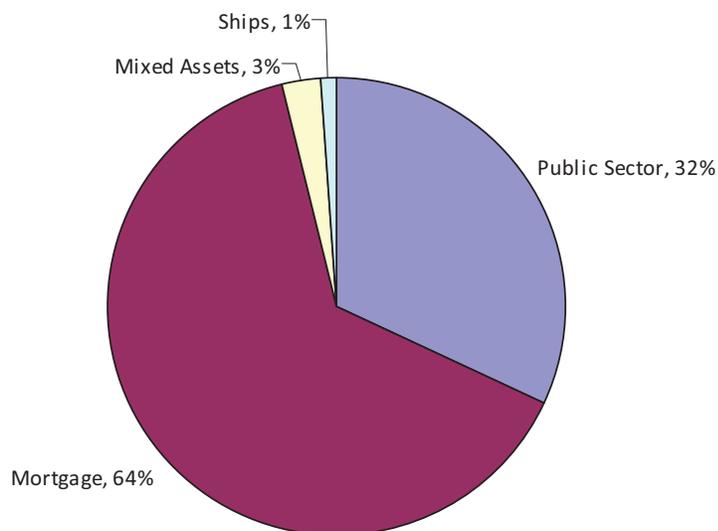
³ European Covered Bond Council Fact Book (2009), p. 92.

⁴ European Covered Bond Council Fact Book (2009), p. 93.

⁵ European Covered Bond Council Fact Book (2009), p. 93.

Covered bonds issued to fund public sector lending play an important role in Germany, France, Ireland, Luxembourg, Austria, Italy and Spain. Covered bonds backed by ship loans are much less common, found mostly in Denmark and Germany.

Figure 2: Total Outstanding Covered Bonds by Asset Classification (European Market)



Source: European Covered Bond Council Fact Book (2009), p. 88.

Mortgages are far and away the most heavily utilized classification among assets used as collateral for covered bonds issued throughout the European Union and the U.S. (see Figure 2). According to ECBC data, among the 25 countries currently issuing covered bonds (including the U.S.), 64% of outstanding issues are backed by mortgage collateral, and 32% are backed by public sector loans.

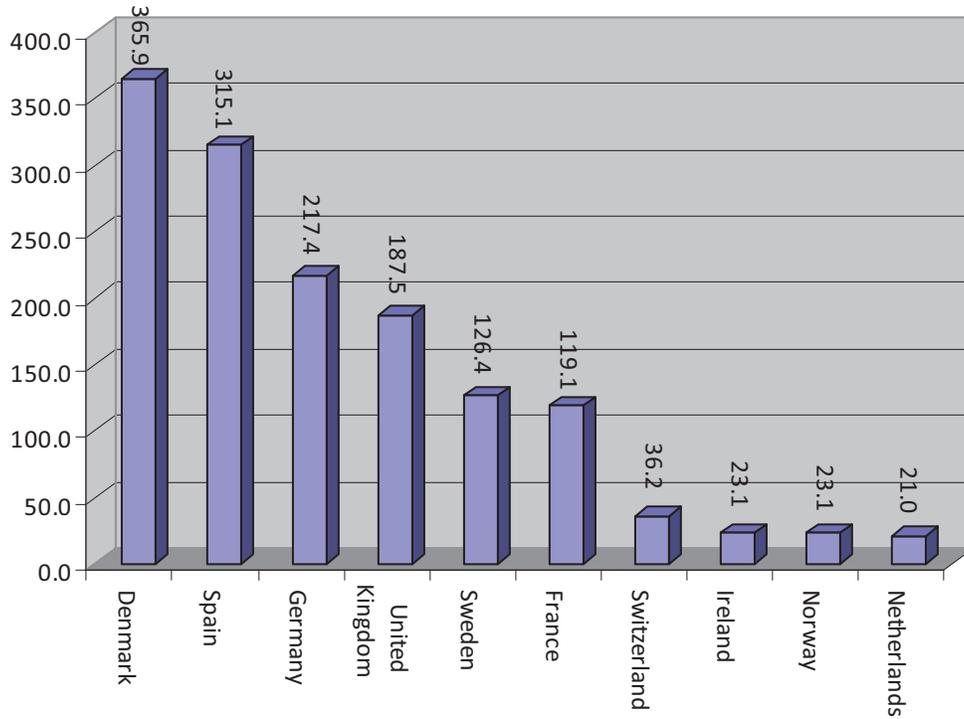
It's also informative to note that Germany alone accounts for €558 billion (\$666 billion) of the approximately €773 billion (\$923 billion) in outstanding covered bonds backed by public sector loans.⁶ This indicates that use of mortgage collateral is even more widespread than the aggregate data alone might suggest.

Figure 3 shows the volume of covered bonds backed by mortgage assets for the top 10 issuing countries in Europe. Additionally the United States had a total of \$15.4 billion in outstanding volume in 2008, all categorized as mortgage asset collateral, according to the ECBC.⁷ Disbursement of covered bonds by category in the European Union outstanding at the end of 2008 is shown in Figure 4.

⁶ European Covered Bond Council Fact Book (2009), p. 92-93.

⁷ European Covered Bond Council Fact Book (2009), p. 92.

Figure 3: Total Volume of Covered Bonds Collateralized by Mortgage Assets (Euros/Billion)



Source: European Covered Bond Council Fact Book (2009), p. 92.

Figure 4: Total Covered Bonds Outstanding by Asset Class in Europe/Billion



Source: European Covered Bond Market Fact Book (2009), p. 88-92.

As for continued market expansion in Europe, the ECBC concludes: “there is a strong expectation that the covered bond market will continue to grow, especially since legislators across Europe have adopted modern covered bond regulations or modernized existing ones”.⁸

U.S. POTENTIAL: REGULATORY FRAMEWORK

But just how well would the regulatory framework and other factors that have driven growth of the European covered bond market translate to U.S. real estate capital markets? It’s a difficult question to answer with any certainty, given that the European market has grown in part because Europe’s borrowers and investors don’t have access to American-style GSEs or Federal Home Loan Banks.

One way to approach that question is to consider key differences between covered bonds and the MBS marketplace that plays such a prominent role in U.S. commercial and multifamily finance. Our analysis identified four particularly significant differences between covered bonds and MBS as sources of long-term funding for mortgage loans:

- In the event the cover pool mortgages don’t pay interest and principal as originally agreed, covered bonds provide investors with a second form of recourse, i.e., to the bond issuer. MBS do not provide this second form of recourse when borrowers are delinquent; bondholders simply face greater exposure to underlying real estate risks.
- European covered bond regulations allow an issuer to substitute collateral if some of the underlying mortgages default, under-perform or are prepaid; this helps maintain the cover pool’s credit quality and in turn the bonds’ ratings and values. U.S. “REMIC” (real estate mortgage investment conduit) rules require static MBS collateral pools rather than allowing for collateral substitution; this means an issue’s repayment risk fluctuates in correlation to the credit quality of the original mortgages.
- Covered bonds minimize the risk of prepayment in the event an issuer defaults prior to maturity, by way of an investment contract guaranteeing payments on the bonds from default through maturity. MBS investors assume prepayment risk potentially resulting from both mortgage defaults and prepayment.
- In a typical MBS transaction, the securities issuer no longer carries the underlying mortgages on its balance sheet – which frees up capital with which to make additional loans. In a covered bond transaction the collateralized mortgages remain as liabilities on the issuer’s balance sheet – hindering the volume of new lending capabilities compared to a U.S.-style securitization.

Another means of assessing the extent to which covered bonds might play a prominent role in U.S. commercial/multifamily real estate finance is to review significant legal and regulatory issues pertaining to structure and use of covered bonds here. And while a couple of institutions have issued these securities, it’s hard to avoid the conclusion that the regulatory framework today remains insufficient to support a thriving domestic covered bond market.

While legislation including covered bond regulation has been introduced, and relevant regulatory agencies have recommended frameworks, no current federal legislation or regulations clearly and unambiguously protect covered bond investor interests in the event of insolvency of an insured depository institution.

Nevertheless covered bonds generally are subject to some federal laws and regulations, including the Uniform Commercial Code (UCC), Rule 144A under the Securities Act, Regulation S under the Securities Act, and the Federal Deposit Insurance Act (FDIA).⁹

⁸ European Covered Bond Council Fact Book (2009), p. 92-93.

⁹ European Covered Bond Council Fact Book (2009), p. 325-335.

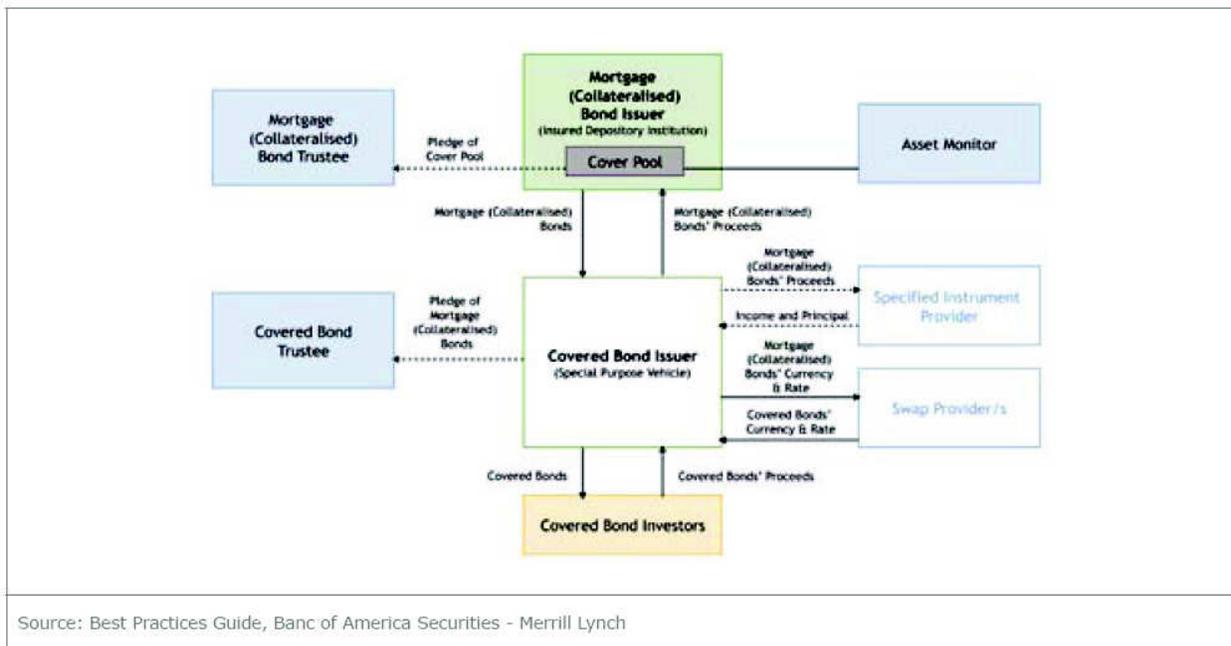
While more dedicated legislation has been under development (see below), covered bond issuance, including issues backed by mortgage collateral, has increased somewhat in recent years.

The U.S. Department of Treasury advocates establishing a definitive legislative and regulatory framework that would promote investor confidence and sound market integration. Treasury already provides a “Best Practices for Covered Bonds” guide encouraging domestic market development (see Appendix A).

The FDIC approved a final Covered Bond Policy Statement (Appendix B) clarifying the agency’s position on qualifying covered bond transactions in July of 2008. The statement provides a common template to promote the development of a standardized covered bond market in the U.S.

Two large domestic financial institutions, Bank of America and the former Washington Mutual Bank (subsequently absorbed by JPMorgan Chase), have helped pioneer early U.S. covered bond issuances. These private-label issues aimed to comply with state laws of New York and Delaware. The general covered bond structure utilized by U.S. banks is depicted in Figure 5.

Figure 5: Simplified (SPV) Covered Bond Structure Currently Used by US Banks

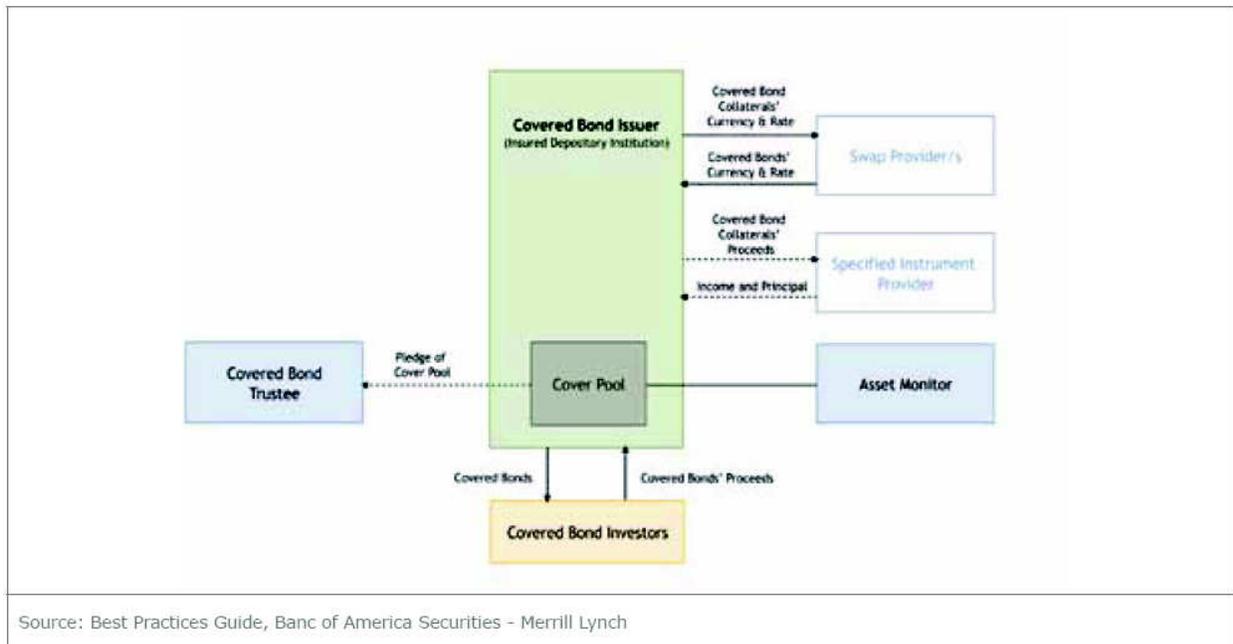


Source: *European Covered Bond Market Fact Book (2009)*, p. 327.

Bank of America, Citigroup, JPMorgan Chase and Wells Fargo have announced their support for the two key statements addressing important U.S. policies regarding covered bonds. These institutions have also shown interest in setting up programs using the guidelines, or aligning existing covered bond programs to the standards under the final FDIC Covered Bond Policy Statement and the Treasury Department Best Practices Guide.

The structure proposed under this policy statement, and under consideration by those institutions, is depicted in Figure 6.

Figure 6: Potential US Covered Bond Issuance Structure



Source: *European Covered Bond Market Fact Book (2009)*, p. 327.

Although some U.S. regulatory authorities have shown reluctance to establish dedicated covered bond regulations, the Treasury Secretary in early 2009 suggested such legislation should be considered in the context of broader housing finance reform efforts. Again, Treasury maintains that dedicated legislation clearly addressing investor interests in the event of issuer insolvency could help instill investor confidence in covered bonds.

Multiple legislative proposals have been introduced in an attempt to regulate the U.S. covered bond market. The most recent proposed legislation, The U.S. Covered Bond Act (H.R. 4884) aims to facilitate a covered bond market and provide a more comprehensive legislative framework than preceding bills.

The Act would establish regulatory oversight of covered bond markets, including broad provisions for default and insolvency of covered bond issuers, and would subject covered bonds to oversight by federal securities regulators. The legislation also directs the U.S. Securities and Exchange Commission to develop a registration process for covered bonds that are not exempt from SEC oversight.

Eligible asset classes under the proposed legislation include: residential mortgages, home equity loans, commercial mortgages, public agency debt, auto loans, student loans, credit card debt, small business loans, and other asset classes not yet identified by the regulator.¹⁰

Opponents of the legislation question whether a covered bond market would improve liquidity in the U.S. mortgage market. They also cite the additional bank failure risks to which covered bonds would subject the FDIC, along with the related hikes in FDIC deposit insurance rates. Proponents counter that H.R. 4884 is not intended to facilitate a U.S. covered bond market that would replace existing sources of finance, but instead aims to provide additional liquidity complementing other forms of mortgage funding.

Though long considered a reliable and durable source of mortgage capital, the European covered bond market nevertheless suffered its share of distress during the latest global financial meltdown. It remained liquid longer

¹⁰ Treasury Department Best Practices Guide for Covered Bonds, p. 9.
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than many other wholesale funding markets, but was ultimately rendered dormant for several months during the last quarter of 2008.

In the wake of Lehman Brothers' collapse in September 2008, the European covered bond market went without a public issuance until early 2009. Nevertheless, the market did record some positive growth over the course of 2008. While some European jurisdictions haven't seen new issues since then, the European Central Bank reports that the number of issuers has doubled since 2008 (from approximately 75 to 150 issuers).¹¹ Of course it helped that the European Central Bank (ECB) sponsored bond purchase programs to facilitate liquidity.

Despite some €60 billion in ECB-sponsored purchase commitments, however, the return of liquidity appears to be limited. Covered bonds over the past few calendar quarters have traded at historically low volumes and at historically wide yield spreads over their relevant benchmarks.

And now, in 2010, as the perplexing European debt crisis continues to unfold, the expectation is that efforts to resolve state fiscal issues will deflect interest in the covered bond market somewhat. Despite these challenges, new players continue entering the market, and existing issuers are able to expand programs, offer multiple products and diversify funding sources.

CONCLUSION

Based on NMHC's analysis, we conclude covered bonds would appeal to U.S. investors due to the generally strong credit quality of the underlying mortgages and real estate and the attractive yields they might generate without altering risk profiles of conservative portfolios. Covered bonds can also help diversify portfolios while protecting investors through the additional recourse they provide in the event of default.

Accordingly, it appears an active, unambiguously regulated covered bond marketplace would provide some degree of additional liquidity to the domestic multifamily finance arena.

However, based on the performance of the fully regulated and long-established covered bond market in Europe during the financial crisis of 2008, it is clear that this investment category has limitations. Likewise U.S. regulatory authorities have expressed concerns about a covered bond market's potential for increasing the risks that the FDIC or other agency might have to bear.

Therefore NMHC also concludes that a prospective U.S. covered bond market should not be considered an alternative or a replacement for, but rather a supplement to, the current secondary multifamily mortgage system and the GSEs.

¹¹ European Central Bank Annual Report, p. 19.
Analysis: Credit Capacity of Covered Bonds



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