Non-agency MBS alternative?

US covered bond developments debated

Congress is set to debate the Covered Bonds Act next month – a move that has been welcomed by investors looking for an alternative to non-agency RMBS. However, issuers appear to be less convinced about the development of a covered bond market in the US.

According to one RMBS investor, it's premature to expect the buy-side to re-enter the US private label RMBS market because it remains tainted by subprime associations. "Rather, the industry should be focusing on establishing a decent covered bond market. The product requires banks to retain the risk on their books and that's what investors want to see at the moment," he remarks.

Jerry Marlatt, senior of counsel at Morrison & Foerster, agrees that investor appetite for non-agency RMBS is extremely limited at present. In contrast, covered bonds look attractive because they offer dual recourse to the underlying assets and the issuing bank, and the assets are refreshed every month. This is evidenced by the more than US$15bn in covered bonds issued into the US market this year by foreign banks.

"Covered bonds are a more secure investment than RMBS," he notes. "Additionally, prepayment speeds are a significant factor in RMBS pricing, but you don't see this in covered bonds."

Steven Miller, partner and md at Odeon Capital, says he understands why investors would currently prefer covered bonds over structured deals in the US. But he points out that from an issuer's perspective, a traditional RMBS structure both addresses customer needs and generates income via fees. In comparison, covered bonds arguably limit issuers' ability to manage their investible cash.

Additionally, while most RMBS qualify for off-balance sheet treatment, covered bonds are held on-balance sheet. "This dictates how much capital an issuer retains and, therefore, how much they have to charge a consumer to compensate for it," Miller explains. "Ultimately, I believe the lack of a fully-functioning RMBS market will drive up the cost for consumers and so we need to come up with viable alternatives until it returns. Covered bonds go some way towards this, but they aren't a replacement."

From an issuer's perspective, the all-in cost of funds determines whether they opt for a securitisation or a covered bond, Marlatt concurs. Bank of America and Washington Mutual issued covered bonds in 2006, but no other US transactions have been issued since then partly because of the financial crisis and partly because the existing structure is expensive.

Under the existing structure, the entire collateral pool has to be liquidated immediately if a bank becomes insolvent, with the decision about alternative reinvestment made at issuance. Marlatt points out that it's hard to find an entity willing to take up to US$20bn of assets at one time and so the reinvestment collateral has to be low yielding. Consequently, the difference between the low yield and the bond's coupon has to be made up with swaps, which are typically off-market and thus expensive.

Another issue with covered bonds is the uncertainty around what the FDIC will do in an insolvency. It can find another bank to take over the bonds; repudiate the bonds; or take no action and allow a payment default, which means the trustee can foreclose.

Nevertheless, the adoption of a statute is expected to facilitate covered bond issuance in the US. The Covered Bonds Act is likely to be debated by the House in September (see separate News Round-up story). It provides for a more typical European structure, whereby the cover pool is separated from the bank in a bankruptcy and therefore doesn't have to be liquidated or reinvested.

But whether a flood of covered bond issuance occurs as a result is debatable. "Covered bonds in the US to date haven't had strong political backing: the current focus on the bill is more of a technical movement," explains Marlatt. "Many participants believe that covered bonds would be a helpful financing alternative in the US and support is slowly developing among smaller regional banks that need to fund their commercial mortgage portfolios, for example."

Miller adds: "The real issue is that there has been a breach of faith among all constituents in the US RMBS market, with good reason. So, the question is how to restore trust in this market?"

He suggests that this process needs to begin on a macro basis by creating an economic environment where house prices stop sliding. Once the housing market has stabilised, the next step is to introduce accurate, high quality reporting.

"Private label RMBS continue to pay down – either by voluntary prepayments or defaults – meaning that there is dramatically less paper outstanding each year, yet a significant number of investors need to be invested in the sector. It is the only mortgage sector where people are finding value at the moment," Miller observes.

Elton Wells, head of SecondMarket's structured products group, indicates that concerns about a double-dip recession are preventing the private label RMBS market from returning just yet. He believes that activity in the sector could have potentially restarted before the Greek volatility began, however.

"Originators realise that simpler structures, better collateral and underwriting standards, and greater credit enhancement are necessary in the post-crisis non-agency RMBS sector," he concludes. "A couple of deals have been completed privately this year – such as the Kondaur Capital transaction – which have enough credit enhancement and a decent spread. But investors generally remain cautious on the sector and will continue to do so until unemployment figures begin improving."

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