



Issue Fact Sheet

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COVERED BONDS

Background

The U.S. housing finance system relies heavily on mortgage-backed securities (MBS). In this system, banks move mortgage loans off their balance sheets by selling the assets to the secondary market, currently dominated by Fannie Mae and Freddie Mac.

European debt markets rely instead on covered bonds as a source of mortgage finance, and they have been proposed as an additional source of liquidity for the U.S. housing market. Covered bonds are similar to MBS with one important exception: covered bond loans remain on the bank's balance sheet. The bank retains control of the assets and makes bond payments from their general revenue. Because they are secured bonds that are also backed by the bank, they are considered safe investments. The structure also requires banks to replace non-performing loans in the pool with ones that are performing.

One obstacle to the development of a strong covered bond market in the U.S. is the lack of a regulatory structure for it. Congress is currently seeking to enact legislation that would create such a framework.

NMHC/NAA Position

NMHC/NAA support Congressional efforts to create a regulatory framework for a covered bond market in the U.S. While covered bonds may provide some additional liquidity to the multifamily mortgage marketplace, efforts to comprehensively replace prevailing multifamily mortgage financing mechanisms with a covered bond system would provide limited benefits at best.

While covered bonds can, under the right circumstance create additional liquidity for the housing finance system, they are unlikely to 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.

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 no institutional investment. There is little existing data or analysis determining to what degree European covered bonds actually finance commercially developed rental housing.

Current Status

On March 8, Rep. Scott Garrett (R-NJ), Chairman of the House Subcommittee on Capital Markets and Government Sponsored Enterprises, introduced a bill ([H.R. 940](#)) that would create a covered bond market in the United States. On June 22, the House Financial Services Committee passed H.R. 940 by a wide, bipartisan margin. The bill limits issuer lending volumes by requiring them to hold loans on their balance sheets, retain capital reserves in case of losses and re-

quires issuers to be responsible for losses. The legislation also directs the regulator to establish limits on the amount of covered bonds an institution can issue based on the amount of total assets in their portfolio.

On November 9, a bipartisan covered bonds bill (S. 1835) was introduced in the Senate. The measure is nearly identical to H.R. 940.

Relevant Committees

House Financial Services Committee
Senate Banking Committee

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Last Updated: November 2011