

## SECTOR COMMENT

# Covered-Bond Impact Would Be Positive for Banks, Negative for FHLBanks

Extracted from "[Moody's Weekly Credit Outlook](#)", dated March 14, 2011

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On 8 March, Representative Scott Garrett (R-NJ) and Representative Carolyn Maloney (D-NY) introduced a new covered-bond bill into the US House of Representatives.<sup>1</sup> If enacted, the proposed legislation will be credit positive for US banks and credit negative for the Federal Home Loan Banks (FHLBanks). However, the US housing finance market may not function as well during periods of stress if greater reliance is placed on the covered-bond market versus the FHLBanks.

The development of a covered-bond market in the US would be positive for the funding profile of US banks by providing an additional funding source for a wide range of assets; at the same time, a robust covered-bond market would compete with FHLBanks advance lending programs.

Currently, FHLBanks' advance lending programs and repurchase facilities are the primary secured funding facilities utilized by US banks. Covered bonds have proven to be very successful funding mechanisms for banks in countries that have legislative (or statutory) frameworks for them. The global covered-bond market has approximately \$3 trillion outstanding.

The FHLB system was established by the Federal Home Loan Bank Act of 1932 to provide a reserve banking system to support US thrift institutions' residential mortgage lending activities. Currently, US banks, large and small, finance a portion of their mortgage portfolio with FHLBank funding. The Administration's proposed housing finance plan focuses the FHLBanks on small- and medium-sized financial institutions, and covered bonds would offer an alternate funding source.<sup>2</sup> The combination of these two factors are credit negative for the FHLBanks because they would reduce the overall footprint and profitability of FHLBanks.

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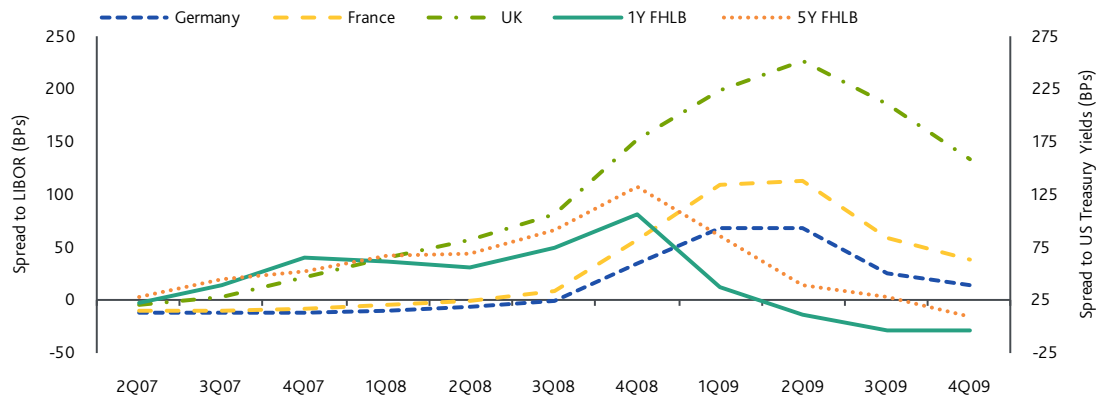
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<sup>1</sup> H.R. 940, the "United States Covered Bond Act of 2011." Also see, "[Proposed US Covered-Bond Legislation Would Provide Strong Investor Protections](#)" in the Securitization section of the March 14, 2011 WCO.

<sup>2</sup> Reforming America's Housing Finance Market: A Report to Congress, February 2011

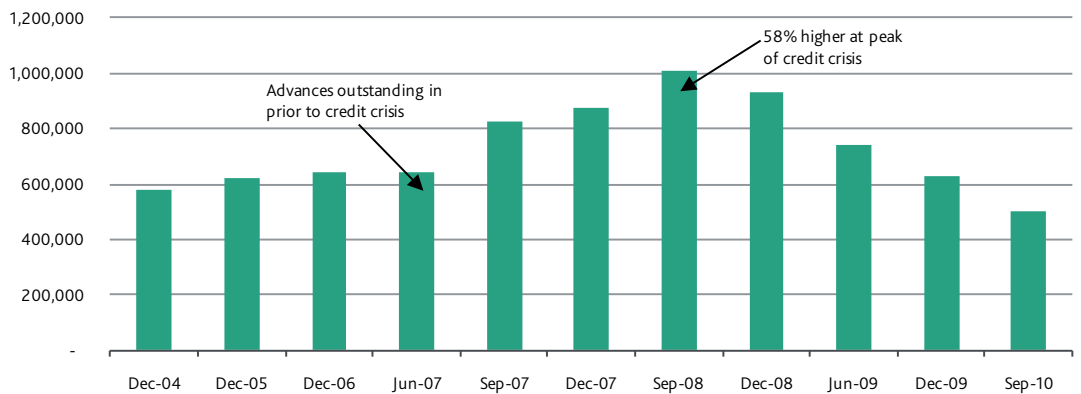
The US housing finance market may not function as well during periods of stress if greater reliance is placed on the covered-bond market versus the FHLBanks. During the recent economic credit crisis, spreads on both FHLBank debt as well as covered-bond debt widened significantly during the crisis (see exhibit 1). However, FHLBank advances were a very reliable source of additional funding for US banks. Total FHLBank advances increased by almost \$400 billion from the beginning of the crisis to peak (see exhibit 2), whereas, European covered-bond issuance without European Central Bank support declined. The increase in funding by the FHLBanks was precisely at the same time during which the capital markets were withdrawing funding for banks owing to asset quality concerns and reinforced the FHLBanks' critical role as liquidity providers to US banks.

EXHIBIT 1  
**FHLB Bonds and EU Covered Bond Spreads (Quarterly Average)**



Source: Bloomberg, Market, Moody's

EXHIBIT 2  
**Aggregate Outstanding FHLB Advances to Member Banks (\$ millions)**



Source: Federal Home Loan Banks

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