

Introduction

Can Covered Bonds Compete with Fannie and Freddie?

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Now that it has become indisputably clear that Fannie Mae and Freddie Mac are backed by the federal government, some change in our system of housing finance is essential. We cannot continue to pursue a structure in which the profits go to the shareholders and managements of these two enterprises, but the taxpayers pick up the losses. There will be many proposals for reform, but the likelihood is that Congress will want to retain Fannie and Freddie as they are, and their supporters will argue that the new regulatory structure will prevent any problems in the future. This is the same argument that was used when the original regulatory structure was adopted in 1992, and unfortunately, once again it is likely to be a winner. This outcome moves from a likelihood to a certainty if there is no other system of housing finance to replace the government-backed securitization regime.

We are already hearing from Capitol Hill that Fannie and Freddie are the only vehicles for creating the traditional U.S. 30-year fixed rate mortgage, and suggestions that anyone who would close them down must make clear how the mortgage market could possibly operate without them. Covered bonds are one of the alternative financing methods that could in the future replace GSE securitization as the principal mechanism for financing residential mortgages.

This is actually the second conference on alternatives to Fannie and Freddie. In March 2004—as part of AEI’s long inquiry into the policy implications of the GSEs—we held a conference on the residential financing systems that are employed in Europe, focusing particularly on the interesting Danish system. In your folders you will find a paper on the Danish mortgage system. The Danish system has similarities to both securitization and covered bonds, and deserves serious consideration, particularly because it operates successfully without any government support.

In Denmark, every time a mortgage loan is made, the lending bank issues a bond to fund it. Mortgage banks in Denmark finance and take the credit risk of mortgages but do not take deposits. The terms of the bond issued by the Danish mortgage bank match the interest rate and maturity of the mortgage loan, so the mortgage bank does not take any interest rate risk. The bonds are collateralized by a pool of identical mortgages and are callable, so the borrowers pay a premium on issuance for the right to prepay.

Neither the mortgages nor the bonds are due on sale of the home, so a low-rate mortgage becomes a valuable element of the home’s selling price. Credit losses are very low in Denmark, largely because an 80 percent loan-to-value ratio is required and mortgage loans are made with recourse.

The most interesting part of the Danish system is that borrowers have the right to buy back the mortgage bond when interest rates rise. Higher rates cause the bond to decline in value, and by

repurchasing it homeowners in effect create equity in their homes by reducing their mortgage obligation; in effect, they are paying a slightly higher interest rate on a lower principal amount. I won't go into all of the details. The point is that the Danish system allows the creation of the fixed-rate, 30-year mortgage that is said to be the hallmark of the U.S. GSE system, but does this without any government involvement or liability.

We should explore other systems for residential mortgage finance, including changes in the laws and regulations that will reduce the risk of holding mortgages and the costs of refinancing when interest rates decline. The important point is that the subprime meltdown is proof that we have been using a system of residential mortgage finance that has large elements of instability and risk built into it, and we should be looking for alternatives before Fannie and Freddie come back to life and resume their svengali-like control of Congress.

In the conference today, we will look at covered bonds as one means of financing residential mortgages. One of the key issues in the covered bond proposal is the need to address the FDIC's concern that insured banks could place some of their best assets in the cover pool and thus expose the FDIC to greater losses in resolving a failed bank. Issues like this turn out to be difficult and have compelled the FDIC to place significant limitations on the use of covered bonds by insured banks.

But the Danish system reminds us that covered bonds can be issued by institutions that do not also take deposits. In other words, there is no obvious reason why—once the way is opened for alternatives—a covered bond system for financing mortgages could not be constructed outside the regular banking system, thus avoiding conflicts with the priorities of the FDIC and the insured deposit system.

An entirely separate group of financial institutions could offer mortgages that are financed by covered bonds. There is no inherent reason why, in the efficient capital markets we have today, we should still be financing long-term assets like mortgages with short-term liabilities like deposits. As everyone knows by now—and was demonstrated clearly in the collapse of the S&Ls—this is a prescription for instability, moral hazard, and taxpayer risk. Covered bonds, as they are used in the Danish system, offer the possibility of a more stable system of mortgage finance by more closely matching long-term mortgages with long-term financing. They also have other advantages that will be outlined in today's conference.

The collapse of the S&Ls, and now Fannie and Freddie, should be convincing evidence that we have to find another way to provide the American people with a system of financing home ownership. Going back again to the old way, by resuscitating Fannie and Freddie, is not the right answer.