Shadow banking reform a work in progress

Congress is finally working on a bill on covered bonds, hoping to boost investor demand and give banks another route to fund some of their loans. But if passed in its current form, the bill will have some flaws, including insufficient overcollateralization and inconsistent regulatory regimes for different types of issuers.

The House of Representative Financial Services Committee sent the United States Covered Bond Act of 2010 to the floor of the House last week.

Covered bonds are similar to asset-backed securities in that they are securities typically issued by a bank and backed by a group of loans, usually mortgages. But unlike with ABS or mortgage-backed securities, where the loans are sold to a special-purpose entity and removed from the balance sheet, the loans underlying covered bonds remain on the issuer's balance sheet, which makes it easier for investors to benefit from them in case of insolvency.

Even with a new rule requiring that securitization issuer retain 5 percent of assets on their balance sheet, covered bonds present more protection to investors. That makes them less advantageous for banks, of course. But with securitization still recovering from the financial crisis, issuers may have an easier time attracting investors with covered bonds to fund mortgages.

In particular, investors in covered bonds will have more protection than with securitization as they will be able to benefit from investor-friendly procedures following an issuer default.

Under the bill, for example, the Federal Deposit Insurance Corporation will appoint a receiver for a failed bank issuer of a covered bond. The FDIC has up to 180 days to sell the covered bond to a solvent issuer, while continuing to make scheduled payments of interest and principal. That provides more time to liquidate an asset than under the current regime for covered bonds, which is an interim regime set up by the FDIC. This is also different from securitization. With securitization, if an issuer defaults, investors most often don't have a claim on the assets underlying the bonds since they are off-balance sheet.

The new regime may make regulators unwilling to declare banks insolvent because there will now be an established process for liquidating asset-backed loans and it will be more costly for the FDIC too. But the idea is to help prevent the sort of downward spiral in asset values that resulted from fire sales and that deepened the financial crisis.

But there are still some flaws in the new bill, as Moody's Investors Service noted in a research report. For one, the bill requires covered bond regulators to set minimum overcollateralization levels, but specifically directs them not to take into account liquidity risk, which may lead to losses if an asset can't be traded quickly enough.

The other flaw is that the bill appoints an issuer's primary regulator as the covered bond regulator, which could lead to inconsistencies between programs since different issuers have different regulators depending on their charters. Such inconsistencies would also hinder transparency.

Lawmakers have time to fix the bill, though, considering it hasn't yet been scheduled for a vote in the House and the Senate hasn't picked it up yet. Here's hoping they don't squander that time.