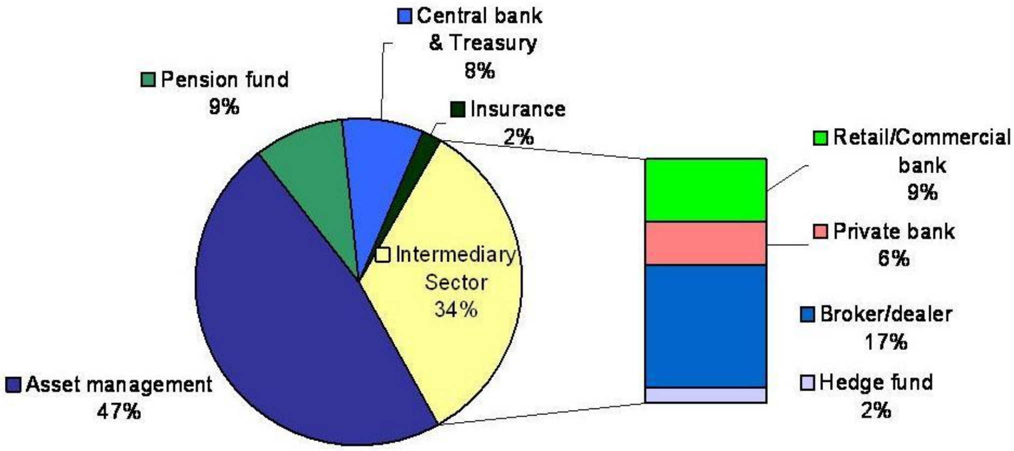
Figure 11
Investors in covered bonds



Source: SIFMA (2009)

the added feature that household mortgage borrowers can redeem their debt by purchasing the relevant issue of the mortgage bonds at the prevailing market price (see Boyce (2008)). By being able to extinguish debt obligations at market prices, household borrowers participate as purchasers in the market for mortgage debt, and prevent the type of collapse in mortgage-backed securities seen in the United States in the financial crisis of 2007 and 2008.

The legislation required to underpin the operation of a covered bond system is more developed in some regions than others. Europe leads the world in this respect. In the European Union, covered bonds are defined by the Capital Requirements Directive (CRD), which limits the range of accepted collateral maximum loan-to-value ratios. While the CRD only recognizes securities issued under special legislation as covered bonds, market participants tend to work with a more general definition that also includes bonds issued under private contractual arrangements using elements from structured finance. There have been a number of such "structured covered bonds", primarily in countries without covered bond legislation (eg the United Kingdom, the Netherlands and the United States) (see Packer et al (2007)).

Indeed, one of the main hurdles against the widespread introduction of a covered bond system has been the legal hurdle of introducing a class of claimholders for the cover pool that are senior to the deposit insurance agency, and hence the general depositors of the bank. The larger is the cover pool for covered bonds, the smaller is the general pool of assets that are accessible to the deposit insurance agency. In the United States, the FDIC has issued a statement on the treatment of covered bonds, limiting the size of covered bonds to 4% of total liabilities after issuance.[6] Given the benefits associated with the shortening of the intermediation chain, there are legitimate questions on how much political will can be mustered in order to amend the relavant laws to allow the operation of the covered bond system.

A possible alternative legal approach would be to permit specialist "narrow" banks whose liabilities are restricted to covered bonds only, and hence whose liabilities are not insured by the deposit insurance agency. Such narrow banks would be akin to Danish mortgage banks whose liabilities match the duration of the assets perfectly and whose equity provides a cushion for bond holders.

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6 The FDIC's statement on covered bonds is at http://www.fdic.gov/news/news/financial/2008/fil08073.html