CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

February 21, 2012

H.R. 940
United States Covered Bond Act of 2011

As ordered reported by the House Committee on Financial Services on June 22, 2011

SUMMARY

H.R. 940 would establish a framework for regulating financial instruments known as covered bonds. Covered bonds are full-recourse debt obligations, secured by a pool of performing assets. Under the bill, investors in covered bonds would receive greater compensation in some cases if the issuer were placed into the receivership or conservatorship of the Federal Deposit Insurance Corporation (FDIC). CBO expects that implementing the bill would lead to an increase in the use of covered bonds in the United States. CBO estimates that this increase would add to the cost of financial resolution programs, although any gross additional costs to the FDIC over the next 10 years would be offset by amounts assessed on depository institutions and other large financial institutions over many years.

CBO reviewed the nontax provisions of H.R. 940. Enacting those provisions of the legislation would increase net direct spending by $50 million, and would increase net revenues by $15 million over the 2012-2022 period, resulting in a net increase in the deficit of $35 million over the next 10 years, CBO estimates. The Joint Committee on Taxation (JCT) reviewed the tax provisions of H.R. 940 and expects that enacting those provisions would probably decrease revenues to the federal government; however, the legislative language requires further specification before the revenue effect can be estimated. Pay-as-you-go procedures apply because enacting the legislation would affect direct spending and revenues.

In addition, CBO estimates that implementing the bill would cost $10 million over the 2012-2017 period for activities of the Securities and Exchange Commission (SEC), assuming appropriation of the necessary amounts.

H.R. 940 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

H.R. 940 contains a private-sector mandate, as defined in UMRA, on financial institutions because they would be required to pay additional fees or deposit insurance premiums to offset the costs to the FDIC associated with the covered bond program under the bill. Based on the expected use of covered bonds under the bill, CBO estimates that the cost of the mandate would fall well below the annual threshold for private-sector mandates ($146 million in 2012, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 940 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By Fiscal Year, in Millions of Dollars												
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2012-2017	2012-2022
CHANGES IN DIRECT SPENDING													
Estimated Budget Authority	0	*	1	3	4	6	6	7	7	8	8	14	50
Estimated Outlays	0	*	1	3	4	6	6	7	7	8	8	14	50
CHANGES IN REVENUES[a]													
Estimated Revenues	0	0	0	*	1	2	2	2	2	3	3	3	15
NET INCREASE IN THE DEFICIT FROM CHANGES IN DIRECT SPENDING AND RECEIPTS													
Impact on Deficit	0	*	1	3	3	4	4	5	5	5	5	11	35
CHANGES IN SPENDING SUBJECT TO APPROPRIATION													
Estimated Authorization Level	*	2	2	2	2	2	2	2	2	2	2	10	20
Estimated Outlays	*	2	2	2	2	2	2	2	2	2	2	10	20

Note: * = between $0 and $500,000.

a. Amounts included under this heading only include changes in revenues associated with the nontax provisions of H.R. 940. The staff of the Joint Committee on Taxation expects that the tax provisions of H.R. 940 would probably decrease revenues; however, the legislative language requires further specification before the revenue effect can be estimated.

BASIS OF ESTIMATE

CBO estimates that enacting H.R. 940 would increase federal deficits by $35 million over the 2012-2022 period. Most of those estimated net costs would result from the legislation's effect on the Orderly Liquidation Fund (OLF) of the FDIC, which was established by the Congress in 2010 to liquidate certain large financial institutions. CBO also estimates that the SEC would spend an additional $10 million over the 2012-2017 period and $20 million over the 2012-2022 period, assuming appropriation of the necessary amounts.

For this estimate, CBO assumes that H.R. 940 will be enacted during fiscal year 2012, that fees will be levied on issuers of covered bonds to cover the administrative expenses of federal regulatory agencies and to pay for establishing a covered bond registry (as authorized by the bill), and that amounts estimated to be necessary for discretionary expenses of the SEC will be provided for each year.

Background

Covered bonds share some similarities with other means of financing, such as unsecured debt and asset-backed securities. Each allow the issuer to raise funds for lending or other purposes and to repay investors from general cash flows. However, covered bonds have some unique features:

- The securing collateral (that is, the asset pool) must be continually refreshed if an asset becomes delinquent or does not otherwise meet qualifying criteria (unlike other asset-backed securities that are secured by a fixed group of assets that does not change); and,

- If the issuer of a covered bond were to default, investors would have dual recourse against both a fixed pool of assets that would be unavailable to other creditors and other assets of the issuer. (This is unlike unsecured debt and asset-backed securities where investors have recourse against the general assets of the issuer or a fixed pool of assets, respectively, but not both.)

Effect of H.R. 940 on the Issuance of Covered Bonds

CBO expects that enacting H.R. 940 would lead to an increase in the issuance of covered bonds because the bill would mitigate investor uncertainty in the case of default. Under current law, if a covered bond issuer is placed into receivership or conservatorship of the FDIC, the agency has the option to terminate future payments and instead pay investors up to the par value of the bond plus accrued interest. This option is available even if cash flows of the underlying collateral are sufficient to sustain continued payments to investors. Even in cases where full par value plus accrued interest is paid, this treatment increases the risk to investors that future returns may not be as great as if bond payments were continued. H.R. 940 would mitigate this reinvestment risk by requiring that the entire collateral pool of a covered bond be transferred to a separate estate in the event that an issuer is placed into receivership or conservatorship. This would prevent the FDIC from terminating bond payments early, thus making covered bonds more attractive to investors.

While CBO expects that enacting H.R. 940 would increase the use of covered bonds by financial institutions, the additional volume over the next 10 years would probably be small for several reasons. First, increases in deposits, slow economic growth, and low demand for lending have reduced the need for bank borrowing in the near term. Second, given the higher level of risk retained by issuers of covered bonds compared to other forms of financing (for example, securitization), additional regulatory capital would need to be maintained. Third, alternative sources of secured financing (most notably, advances from Federal Home Loan Banks) would continue to have advantages over covered bonds, particularly for small banks. Fourth, banks and investors in the United States would likely take a cautious approach until they have become more familiar with the product. Finally, H.R. 940 would allow the federal regulatory agencies to place a cap on outstanding issuances (which CBO assumes would be at or near 4 percent of an institution's liabilities based on current policy).

Considering those factors as well as historical data on the funding sources used by banks, CBO estimates that issuances of covered bonds would increase to between 1 percent to 2 percent of the projected liabilities of insured depository institutions. However, given the variety of factors that influence the financing decisions of institutions, the precise impact of this legislation on the use of covered bonds is uncertain.

Direct Spending and Revenues

H.R. 940 would lead to an increase in the net costs of the FDIC by reducing the value of assets the agency could sell as receiver or conservator of a financial institution. Under current law, the FDIC may sell or transfer the assets of a failed or insolvent institution to offset agency costs (including payments made to insured depositors if necessary). In some cases, the asset pool securing a covered bond would carry a higher value than the par value of the bond plus accrued interest. By requiring that the entire collateral pool of a covered bond (including its excess value) be transferred to a separate estate in the event of a receivership or conservatorship, the legislation would prevent the FDIC from exercising the option of terminating future bond payments (and paying investors par value plus accrued interest) and retaining the excess value. The loss of this excess value would represent an additional cost to the FDIC (mostly in the OLF—although the Deposit Insurance Fund or DIF would also suffer additional losses). CBO estimates that loss at about $50 million over the 2012-2022 period. By comparison, CBO estimates that spending from the OLF, net of recoveries, will total roughly $30 billion over the same period under current law.

Under current law, the FDIC has the authority to recoup losses by increasing premiums on insured depository institutions and levying assessments on large financial institutions. In the case of the DIF, once empirical data became available, the FDIC would probably adjust premiums paid by insured institutions to offset any additional losses attributable to covered bonds, similar to current policy for brokered deposits. Thus, by the end of the

10-year period, the net effect of this legislation on the DIF would probably be minimal or zero on an annualized basis. In the case of the OLF, however, assessments would occur for multiple years beyond any additional spending and, in some cases, would not be collected until well outside of the 10-year period covered by this estimate. Because of this timing lag, CBO estimates that enacting H.R. 940 would increase federal deficits over the next 10 years.

In addition to timing effects, assessments that would be levied to offset additional losses to the OLF under the bill would become an additional business expense for companies required to pay them. Those additional expenses would result in decreases in taxable income elsewhere in the economy, which would produce a loss of government revenue from payroll and income taxes (estimated to be about 25 percent) that would partially offset the revenues collected from the assessment itself.

Relative to CBO's baseline projections for the FDIC, H.R. 940 would increase federal deficits by $35 million over the 2012-2022 period. This estimate of additional outlays and revenues stemming from the bill was done on a probabilistic basis. Following the default of some covered bonds, additional outlays and revenues probably would be much higher under the bill (particularly, if the issuer was a systemically important financial institution); however, in other periods where such an event does not occur, the effect on the federal deficit would be zero. We estimate that provisions affecting other banking agencies, such as the Office of the Comptroller of the Currency and the Federal Reserve, would have a negligible effect on net direct spending and revenues.

Spending Subject to Appropriation

Based on information from the SEC, CBO estimates that implementing this legislation would increase SEC costs by about $2 million a year, adjusted annually for inflation. Thus, we estimate that implementing H.R. 940 would increase discretionary spending by about $10 million over the 2012-2017 period, assuming appropriation of the necessary amounts.

PAY-AS-YOU-GO CONSIDERATIONS

The Statutory Pay-As-You-Go Act of 2010 establishes budget-reporting and enforcement procedures for legislation affecting direct spending or revenues. The net changes in outlays and revenues that are subject to those pay-as-you-go procedures are shown in the following table.

CBO Estimate of Pay-As-You-Go Effects for H.R. 940 as ordered reported by the House Committee on Financial Services on June 22, 2011

	By Fiscal Year, in Millions of Dollars												
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2012-2017	2012-2022
NET INCREASE IN THE DEFICIT													
Statutory Pay-As-You-Go Impact	0	0	1	3	3	4	4	5	5	5	5	11	35

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 940 contains no intergovernmental mandates as defined UMRA and would not affect the budgets of state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

The bill contains a private-sector mandate, as defined in UMRA, on financial institutions because they would be required to pay additional fees or deposit insurance premiums to offset the costs to the FDIC associated with the covered bond program under the bill. The incremental increase in fees or insurance premiums would depend on the number and value of covered bonds issued. CBO estimates that, under this bill, the use of covered bonds would cause the FDIC to increase fees or insurance premiums by a total of about $5 million over the first five years that the mandate would be in effect. Thus, the cost of the mandate would fall well below the annual threshold for private-sector mandates ($146 million in 2012, adjusted annually for inflation).

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