CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

October 1, 2010

H.R. 5823
United States Covered Bond Act of 2010

As ordered reported by the House Committee on Financial Services on July 28, 2010

SUMMARY

H.R. 5823 would establish a framework for regulating financial instruments known as "covered bonds." Under this legislation, holders of those bonds would be eligible for a new federal program to resolve claims in the event of a default or the insolvency of the issuer, including cases where the issuer is put into receivership or conservatorship by the Federal Deposit Insurance Corporation (FDIC). Federal banking agencies or the Securities and Exchange Commission (SEC) would regulate covered bonds issued by firms under their supervision and would serve as trustee in the event of default. H.R. 5823 also would authorize the agencies to charge fees to cover related administrative expenses.

CBO estimates that, over the 2011-2020 period, enacting H.R. 5823 would increase net direct spending by $50 million and net revenues by $18 million, thereby increasing deficits by $32 million over that period. In addition, CBO estimates that implementing the bill would increase discretionary spending by $9 million over the 2011-2015 period for activities at the SEC, assuming appropriation of the necessary amounts. Pay-as-you-go procedures apply because enacting the legislation would affect direct spending and revenues.

H.R. 5823 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.

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. 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 $141 million in 2010, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 5823 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											
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2011-2015	2011-2020
CHANGES IN DIRECT SPENDING												
Estimated Budget Authority	0	3	4	5	5	5	6	6	8	8	17	50
Estimated Outlays	0	3	4	5	5	5	6	6	8	8	17	50
CHANGES IN REVENUES												
Estimated Revenues	0	0	0	1	1	2	3	3	4	4	2	18
NET INCREASE OR DECREASE (-) IN DEFICITS FROM DIRECT SPENDING AND RECEIPTS												
Net Changes in Deficits	0	3	4	4	4	3	3	3	4	4	15	32
CHANGES IN SPENDING SUBJECT TO APPROPRIATION												
Estimated Authorization Level	1	2	2	2	2	2	2	2	2	2	9	20
Estimated Outlays	1	2	2	2	2	2	2	2	2	2	9	20

BASIS OF ESTIMATE

CBO estimates that enacting this bill would increase deficits by $32 million over the 2011-2020 period. Most of those estimated costs would result from the impact of the legislation on the FDIC's deposit insurance and financial resolution programs. In addition, we estimate that the SEC would spend an additional $9 million over the 2011-2015 period, assuming the appropriation of the necessary amounts. For this estimate, CBO assumes that H.R. 5823 will be enacted in 2010 and that spending will follow historical patterns for similar activities.

Use of Covered Bonds

Covered bonds share some similarities with asset-backed securities, but the risk-sharing provisions are very different. Asset-backed securities typically are backed by the cash flows of a fixed portfolio of loans without recourse to other collateral. Covered bonds are general obligations of the issuer and are backed by a flexible pool of assets valued at more than the par value of the bonds. While used extensively in Europe to finance mortgages and other investments, covered bonds have rarely been used in the United States: in 2009, the volume of covered bonds accounted for a negligible share—less than a tenth of one percent—of the liabilities of federally insured institutions.

Several factors have limited the use of covered bonds, including the higher level of risk retained by issuers (which affects the amount of equity capital a bank must maintain); the availability of less costly sources of financing (such as federally guaranteed debt, purchases by government-sponsored entities, advances from Federal Home Loan Banks, and federal tax-exempt bonds or tax credits); and uncertainty about the status of some covered bonds in the event of insolvency. The FDIC issued guidance in 2008 on the disposition of covered bonds held by insured depository institutions that had failed, but those polices only applied to bonds issued for residential mortgages.

H.R. 5823 would expand investor protections for certain covered bonds. It would establish special deadlines and procedures for claims involving FDIC-insured institutions and, in some instances, allow investors to receive a higher level of compensation than under existing FDIC polices. The new program would apply to bonds issued to finance residential and commercial mortgages, public-sector assets, small business loans, and other asset classes authorized by regulators. Such bonds could be issued by financial as well as certain nonfinancial firms and would not be subject to limits on the amounts issued.

Direct Spending and Revenues

Implementing this legislation would affect the cash flows of the FDIC by increasing potential losses when the agency closes or liquidates failed financial firms through either the Deposit Insurance Fund (DIF) or the Orderly Liquidation Fund (OLF). Increasing the use of secured liabilities, such as covered bonds, would increase the FDIC's losses because fewer assets would be available to cover payments to depositors. FDIC spending to resolve failed institutions would be higher under the legislation because it would result in higher compensation for covered bondholders relative to current law. Such costs would largely be offset over time, however, by additional offsetting receipts from higher deposit insurance premiums (in the case of the DIF) or net revenues from special assessments on certain large firms (in the case of the OLF).

Estimates of the impact of this legislation on the use of covered bonds are uncertain. Firms base their investment decisions on many economic, legal, and strategic considerations, including but not limited to the issues addressed by this bill. On balance, CBO expects that the additional volume of covered bonds issued under the bill would probably be small because of the continued advantages of other forms of financing. Based on historical data on the funding sources used by banks, CBO estimates that, under this bill, covered bonds would be equivalent to about 1 percent of the projected assets of federally insured institutions by 2020—around $200 billion and that most of those bonds would replace other unsecured sources of funding. We estimate that increasing the secured sources of funding for banks would increase the FDIC's losses by a few basis points relative to current law.

Relative to CBO's baseline projections of FDIC resolution activities under current law, CBO estimates that enacting H.R. 5823 would increase deficits by $32 million over the 2011-2020 period. That estimate represents the difference between the expected value of FDIC spending to resolve insolvent firms and the amounts collected to offset any additional losses. Most of the net budgetary impact over the 10-year period reflects the timing of the cash flows associated with such liquidation activities; it may take several years, for example, to recoup additional losses through deposit insurance premiums or special assessments. In addition, the assessments levied to offset losses incurred by the OLF would become an additional business expense for companies required to pay them. Those additional expenses would result in decreases in taxable income somewhere else in the economy, which would produce a loss of government revenue from income and payroll taxes (estimated to total about 25 percent) that would partially offset the revenues collected from the assessment itself.

CBO estimates 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. 5823 would increase discretionary spending by about $9 million over the 2011-2015 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. 5823, the United States Covered Bond Act of 2010, as ordered reported by the House Committee on Financial Services on July 28, 2010

	By Fiscal Year, in Millions of Dollars												
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2010-2015	2010-2020
	NET INCREASE OR DECREASE (-) IN THE DEFICIT												
Statutory Pay-As-You-Go Impact	0	0	3	4	4	4	3	3	3	4	4	15	32

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 5823 contains no intergovernmental mandates as defined in 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 ($141 million in 2010, adjusted annually for inflation).

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