

Covered Bonds Consultation Paper

The following consultation paper outlines the major elements of the proposed legislative covered bonds framework and, where indicated, notes that the Government is seeking input on a particular element. General consultation questions can be found on page 3 and more specific questions in the technical annex.

The Department of Finance invites all Canadians to comment on these proposals. Comments should be received by June 10, 2011. They can be sent to:

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Once received by the Department of Finance, all submissions will be kept confidential but will be subject to the *Access to Information Act* and may be disclosed in accordance with its provisions.

Background

One of the lessons of the financial crisis is the importance of financial institutions (FIs) having a variety of funding sources that are robust under stress. Providing funding options that are robust under stress enhances the stability of FIs and the financial sector.

One source of funding that has become increasingly important to Canadian banks in recent years is covered bonds. Covered bonds are debt instruments that are generally issued by a FI and secured by a pool of high quality assets. As with senior debt issuances, the issuer pays interest and principal on the bond. Unlike senior debt, a covered bond is backed by a segregated pool of high quality assets. If the issuer defaults on bond payments, the covered bondholders continue to be paid from the pool of cover assets.

Covered bonds are common internationally. They have been used in Europe since the mid-eighteenth century. Banks in France, Spain, and Italy issue covered bonds under a legislative framework. The UK recently put in place a legislative framework for covered bonds. They are also gaining in popularity outside Europe; New Zealand is in the process of creating a legislative framework, a bill is before the US congress, and Australia recently announced that it will amend its framework to permit the issuance of covered bonds by its banks.

Covered Bonds in Canada Today

In a relatively short period of time, covered bonds have become a significant funding source for Canadian banks. Since the first covered bond issuance by a Canadian FI in 2007, total issuances have increased to over \$30 billion and the pace of issuances is increasing. In 2010, the outstanding stock of Canadian covered bonds doubled. To date, all Canadian covered bonds have been issued by banks. In comparison, the outstanding stock of Canada Mortgage Bonds, another fundraising tool for Canadian lenders, is about \$170 billion.

As there is no legislative framework for covered bonds in Canada, Canadian banks issue covered bonds under a contractual framework. The bank first establishes a covered bonds program, which involves creating a cover pool and selling assets into that pool. The bank then issues covered bonds, with different note features and maturities, backed by the assets in the pool.

In order to ensure the cover assets are segregated from the issuing bank, the pool of assets is owned by a bankruptcy-remote special purpose vehicle (SPV). This SPV guarantees the bonds issued by the FI and the issuer provides assurances to investors that in the event of issuer default, the cover assets will continue to be available for the benefit of covered bondholders. If the cover assets are insufficient, the bondholders have a claim against the estate of the issuer for the residual. The SPV is consolidated into the financial accounts of the issuing bank and thus the bank continues to hold capital against the cover assets.

The Office of the Superintendent of Financial Institutions has placed a limit on covered bonds issuances by deposit-taking federally regulated financial institutions (FRFIs) of 4 per cent of total assets.

A wide range of investors have shown interest in Canadian covered bonds. The bonds have been issued in different jurisdictions, including Canada, the US, Australia and Europe, and in different currencies, such as the Canadian dollar, US dollar, Swiss Franc, Australian Dollar, and Euro. All the assets in the cover pools have been loans made on the security of Canadian residential properties, but within that category they have included insured mortgages, uninsured mortgages, and lines of credit secured by a home.

This non-legislative, contractual approach provides a high level of disclosure to investors on the cover assets and has been successful in developing a covered bonds market for Canadian issuers, but suffers from two drawbacks that make the market less robust and reduce the ability of Canadian FIs to diversify their funding sources. First, the issuer's assurances in the prospectus that the cover assets will be available for the benefit of covered bonds investors are not a substitute for statutory protection. Second, some international investors are restricted from purchasing bonds issued under a non-legislative framework, narrowing the investor base.

Budget Announcement

Recognizing the growing importance of covered bonds, the Government committed in Budget 2010 to setting out a legislative framework under which FRFIs could issue covered bonds. Since Budget 2010, the Government has been working with key stakeholders to better understand the covered bonds market and has examined legislative covered bonds frameworks in other jurisdictions.

A legislative framework for covered bonds will benefit Canadians. The legislation will create a more robust product that will retain investor confidence in periods of market instability by providing legal certainty and setting minimum standards for covered bonds. It will also help FIs diversify their sources of funding by increasing investor interest in Canadian covered bonds.

Questions for Consultation

A legislative framework for covered bonds that creates a robust market and allows FIs to diversify their funding sources should also satisfy three policy objectives. First, the framework should promote financial sector stability and be a source of strength for Canadian financial institutions. Second, the framework should provide for high standards that are consistent with international best-practices. And third, it should outline the role for the covered bonds registrar (the body that would oversee the framework); to as great an extent as possible, issuers should be guided by market discipline, not regulatory constraints.

The technical annex to this paper outlines the details of the proposed Canadian covered bonds framework and describes how they will help meet the objectives above. The Department welcomes comments on this important policy issue, and is specifically seeking input on the following general questions.

- 1) What are the key aspects the legislative framework should cover? Does the proposed framework strike the appropriate balance between the interests of covered bondholders and other creditors of banks, both secured and unsecured?
- 2) How prescriptive should the legislative framework be? What features of covered bonds should be standardized by the framework to create a robust, deep and liquid market?
- 3) What are the necessary characteristics of the covered bonds registrar and what entity should perform this role?

Technical Annex

1.0 Breadth of the Framework

A covered bonds framework can include a range of elements. Some elements are essential structural features of any framework, such as the manner in which assets are segregated, and must be specified in the framework. Others, such as the term and features of the covered bond note, are normally left to market discretion. The benefits of fixing a particular parameter must be weighed against the loss of flexibility.

In some cases, it may be appropriate to initially set out a particular parameter in the legislative framework, but allow regulatory authority to vary the parameter over time.

1.1 Guarantor: Asset Segregation

A basic element of a covered bonds legislative framework is the manner in which the cover assets are segregated from the issuer. In some countries, the cover assets are not sold to another entity at the time of issuance but instead listed on a registry. The actual separation of assets from the issuer occurs after the issuer defaults. This approach lowers the initial costs of creating a cover pool but may increase uncertainty if the issuer defaults.

In other jurisdictions, including the non-legislative framework in Canada as noted above, the cover assets are sold to a bankruptcy-remote SPV (a guarantor), which guarantees the covered bond. The SPV approach is slightly more costly initially, as assets must be sold to the SPV, but provides for a clearer and simpler post-insolvency process, as the cover assets are already segregated in a bankruptcy-remote vehicle.

The Government proposes that the legislative framework require asset segregation through a legal sale to a special-purpose vehicle.

1.2 Guarantor: Protection in insolvency

Investors in covered bonds look for assurances that if the issuer defaults, the assets in the cover pool will be used to prevent any disruption of cash flows to investors. Cash flows could be disrupted if, for example, the liquidator of the issuer seizes the assets held by the guarantor or the assets become subject to a stay.

The current contractual framework provides these assurances to investors. The key benefit of a legislative framework to investors is additional clarity regarding the insolvency process. Legislative changes could impact federal insolvency processes.

In addition, covered bonds service providers look for assurances that they will receive payment for their services if the SPV becomes insolvent. Current Canadian practice provides this assurance through contracts. A legislative framework that sets out the priority of service providers would provide greater legal clarity. Legislative amendments

to the rules governing the insolvency of the SPV could impact the federal insolvency processes.

The Government proposes that the legislative framework clarify that in the event of issuer insolvency, the covered bondholders have priority of claim over the assets held by the SPV. The Government also proposes to protect the priority of service providers in the event of the insolvency of the SPV.

1.3 Guarantor: Permitted SPVs

If the framework sets out priority for service providers in federal legislation, as described above, it is important that it is clear that the SPV benefits from this statutory change.

The current Canadian practice is to have a trust or limited partnership be the SPV, depending on tax and other considerations. Although it is possible for a corporation to be the SPV, no issuer has used this structure. A corporation is clearly subject to federal insolvency statutes. The insolvency framework for LPs may not be as clear as for corporations, but there are examples of courts applying the federal insolvency legislation to insolvent partnerships. The insolvency regime applicable to an insolvent trust is less clear.

With respect to the insolvency process, is there an advantage in requiring one type of SPV vehicle over another?

1.4 Assets: Eligible Assets

To date, Canadian covered bonds have been secured by loans backed by residential real-estate located in Canada. These loans are suitable cover pool assets because they form a significant portion of FRFI assets, are relatively standardized, are more stable than other asset classes, and generally match the term of the covered bonds.

In other countries, residential mortgages are also a significant fraction of cover pool assets. In a few countries, such as Germany, issuers have issued covered bonds backed by other assets, such as public sector loans, ship loans, or aircraft loans.

In Canada, permitting assets other than residential real-estate loans would increase the complexity of the covered bonds framework without significantly increasing its utility.

The Government proposes that the legislative framework permit loans made on the security of a residential property located in Canada to be included in the cover pool.

1.5 Assets: Uninsured Collateral

Of the six existing covered bonds programs in Canada, five use residential mortgage loans that have been insured by the Canada Mortgage and Housing Corporation as cover assets. Using uninsured mortgages as collateral can, in the longer term, reduce reliance on government-backed mortgage insurance and also improve the liquidity of uninsured mortgages.

Should the framework encourage the use of uninsured collateral and if so, how should it do so?

1.6 Assets: Asset valuation

Under the current non-legislative framework, a predetermined formula is used to value the assets in the cover pool. The valuation of the assets depends on factors such as insurance and arrears status. In general, a similar formula is used by all Canadian covered bonds programs.

So long as the issuer is not in default, the value of the assets must meet the asset coverage test (ACT), which requires sufficient assets, including overcollateralization, to make all payments on the covered bonds. This ensures that after issuer insolvency the cover assets are sufficient to meet covered bonds obligations and administrative costs, even if some assets become non-performing.

After issuer default, the cover pool assets must be sufficient to meet the asset test (AT) which requires that the cash flows from the assets in the pool are sufficient to service the payments on the covered bonds. Failure of the SPV to meet the AT is an event of guarantor default, and accelerates payment on the covered bonds. Current Canadian practice is for the ACT and AT tests to be conducted monthly.

The Government proposes that the legislative framework standardize the approach used to value the assets in the cover pool and prescribe how often the test must be conducted, reflecting current Canadian practice.

1.7 Assets: Record-keeping

In the event of issuer insolvency, covered bonds investors and regulators need clarity on which assets have been sold to the SPV and which assets remain on the books of the issuer. Confusion on where the assets reside could lower the value of the covered bonds, and at an extreme, result in insufficient assets in the cover pool and disrupt payments on covered bonds.

The potential for confusion would be reduced if issuers were required to maintain records on what assets have been transferred to the SPV and make these records accessible to the SPV.

The Government proposes that the legislative framework require the issuer to keep records on what assets have been transferred to the SPV and to provide the SPV with sufficient information to allow it to perfect its claim on the cover assets.

1.8 Issuers: Eligible Issuers

Budget 2010 committed to creating a covered bonds framework for FRFIs. Institutions that are not FRFIs could benefit from the framework by selling eligible assets to a FRFI aggregator, which can issue the covered bond.

The Government proposes that the legislative framework be available to federally regulated financial institutions. Non-FRFIs would be able to benefit from the framework by selling eligible assets to FRFIs.

1.9 Issuers: Registration of Eligible Issuers and Programs

An effective legislative framework provides investors clarity on what covered bonds it encompasses. Investors should know which covered bonds programs benefit from legislated protection in insolvency and which programs operate under a non-legislative framework, particularly if issuers are permitted to maintain parallel legislative and non-legislative programs.

To provide this clarity, it would be appropriate if eligible issuers were required to register under the covered bonds statute and show they meet the requirements of the framework before registering their covered bonds programs. Information on registered issuers and programs would be publicly available.

A strong framework allows exit as well as entry. Registered issuers should be able to withdraw their programs from the framework, but only if the program has no outstanding covered bonds. Registered issuers should also be able to withdraw if they have no registered programs.

The Government proposes that the legislative framework provide the covered bonds registrar with the authority to set out a process for registration under the Act. Only registered programs of registered issuers would benefit from the legislative framework.

The Government also proposes that the covered bonds registrar make public information on what programs are registered. A registered issuer may apply to the covered bonds registrar to withdraw a program from the legislative framework, so long as the program has no outstanding covered bonds. The registered issuer may also apply to withdraw from the framework if it has no registered programs.

Should the framework permit registered issuers to have unregistered covered bonds programs that operate outside the framework?

1.10 Issuers: Transition

Once the legislative framework is established, some banks may wish to bring their existing non-legislative programs under the statutory framework so that they can benefit from the legal certainty it provides.

The Government proposes that, subject to the approval of the registrar, existing covered bonds programs could become registered programs if the issuer becomes a registered issuer and the program otherwise complies with the legislation.

1.11 Cover Pool: Overcollateralization

Overcollateralization is the amount by which the value of cover pool assets is required to exceed the value of the covered bonds issued. A higher level of overcollateralization serves as a credit-enhancement for the covered bond, but diminishes the amount of assets available to other creditors and depositors of the issuer. Under current Canadian practice, issuers generally set the maximum overcollateralization at 10 percent.

The Government proposes that the legislative framework standardize current Canadian practice and set a maximum level of overcollateralization.

1.12 Cover Pool: Demand Loan

As a matter of practice, Canadian issuers transfer more assets to the SPV than is required to satisfy the ACT. The transfer of these excess assets allows the issuer to easily replace non-performing assets backing a particular covered bonds issuance with assets that have already been reviewed by credit ratings agencies. Issuers are also able to go to market with new covered bond issuances more quickly because they have a stock of assets already in the SPV.

While these excess assets lower transactions costs for issuers, they could increase risk to depositors and other creditors of the issuer if there is a reduction in the amount of assets available upon issuer default. To protect depositors and other creditors, current Canadian practice is to allow the issuer to demand repayment of the excess assets at any time, called a demand loan, although the time period allowed for repayment continues to present some risk to depositors and creditors of the issuer. The demand loan is a valuable feature of the Canadian market that should be carried over to the legislative framework.

The Government proposes that the legislative framework set the value of the demand loan as the amount by which the assets in the cover pool are in excess of what is required under the ACT. To ensure these assets are available to the issuer or its estate, the issuer may call the demand loan at any time, and will be required to call the demand loan based on defined triggers.

When the demand loan is called, assets in excess of what is required under the ACT are returned to the estate of the issuer. The SPV should be given a reasonable period to repay

the loan, such as 60 days, and the value of the demand loan should not decline during the repayment period.

The Government proposes that the legislative framework state that the demand loan is deemed to be called when the issuer defaults. The amount to be repaid will be the larger of the value of the demand loan as calculated on the day the issuer becomes insolvent and as calculated on the day the loan is repaid.

1.13 Cover Pool: Substitute Assets

An important feature of a covered bond program, called “dynamic asset replacement”, is the ability of the issuer to periodically inject additional assets into the special-purpose vehicle in order to ensure that the value of the assets securing the covered bond meets the ACT irrespective of the underlying loan performance.

Occasionally, the issuer may not have a sufficient stock of the same type of assets on its books and may not be able to purchase assets at an acceptable price. To help ensure that this does not result in the SPV failing the ACT, current Canadian practice is to allow the SPV to hold high-quality substitute assets, such as government securities. Substitute assets must be of sufficiently high quality so as to retain market confidence in the strength of the guarantor, but not so high as to make it uneconomic for the issuer.

The Government proposes that the legislative framework set out minimum standards for substitute assets and set a maximum percentage of substitute assets.

1.14 Other: Note Features

Covered bonds have been issued under the non-legislative framework with a variety of note features, e.g., different currencies, terms, and rates. Covered bonds that appeal to a wide range of investors strengthen the financial institution and the legislative framework should not unnecessarily limit innovation.

The Government proposes that the legislative framework impose no limits on the note features of covered bonds.

1.15 Other: Insurable Deposits

Under the Canada Deposit Insurance Corporation Act (CDICA), up to \$100,000 of an eligible deposit is insured by the Canada Deposit Insurance Corporation. In the event a bank becomes insolvent, this additional recourse is unnecessary for covered bondholders as they rely on the assets in the cover pool to satisfy their claims.

The Government proposes that covered bonds be excluded from being eligible deposits under the CDICA.

2.0 Covered Bonds Registrar and Resolution

This section outlines the range of roles for the covered bonds registrar, the body that would oversee the covered bonds framework. It also sets out other key policy elements to reduce the risk of cash flow disruption for covered bondholders if the issuer defaults.

2.1 Role of the Registrar

There are a number of ways for a registrar to help create a robust covered bonds market. One approach, common in parts of Europe, is for the registrar to be involved in all aspects of the market. The registrar would examine proposed issuances and certify they comply with the legislation, supervise the SPV and the issuer, and in the event of issuer insolvency, act as the administrator of the SPV to ensure that cash flow to bondholders is not interrupted.

Under this approach, the investors' confidence in the registrar is the key factor supporting the market. If difficulties with a particular issuance or issuer cause investors to lose confidence in the registrar, this may impact all covered bonds in the market as investors lack the information to make their own judgements between different issuances or programs.

An alternative approach is for the framework as a whole to create a robust market with a high-level of transparency through a strong disclosure regime. Under this approach, the legislation and the terms of the issuance would ensure continuity of payment in the event of issuer default and issuer disclosure would provide investors the information they need to make a judgement on a particular issuance. The role of the registrar would be to certify the covered bond meets the requirements of the legislation and the issuers are providing appropriate disclosure to the market.

This approach matches well with existing Canadian practice, which has high levels of disclosure, reduces government involvement, and allows investors to make their own decisions on the merits of different issuers and issuances.

What are the necessary functions of a covered bonds registrar?
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2.2 Designation of registrar

There are a range of options in selecting the body that would act as the covered bonds registrar. In many countries, including the UK and Spain, a financial sector regulatory body such as the prudential regulator, which is sometimes the central bank, acts as the covered bonds registrar. These bodies can leverage their understanding of the financial sector and relationships with financial institutions, but have to consider how to coordinate the role of the registrar with other responsibilities.

Another approach is to assign the registrar function to a government body that is familiar with financial markets operations but has no financial sector regulatory or oversight responsibilities. Such a body may have the necessary technical expertise but may not have the regulatory perspective that markets would expect the registrar to have.

And finally, the registrar function could be assigned to a private sector entity or a new self-regulatory organization. This approach avoids any perception of a government guarantee of covered bonds, but may not be perceived as sufficiently independent by the markets.

What type of expertise should the covered bonds registrar have? What are the key characteristics of an effective registrar? Can the role be combined with other regulatory responsibilities? Can a private sector or self-regulatory organization carry out the role?

2.3 Penalties

The registrar will need to be able to apply penalties in order to ensure the appropriate functioning of the framework. At minimum, the registrar should be able to suspend an eligible issuer from issuing additional covered bonds. Additional sanctioning powers may also be necessary.

The Government proposes that the legislative framework empower the covered bonds registrar to suspend an issuer from issuing additional covered bonds under the framework. The Government also proposes that consideration be given to lesser penalties as alternatives to suspension. Outstanding covered bonds will continue to benefit from the legislative framework.

2.4 Back-up Swap and Service Providers

A covered bonds program will include a number of service providers to manage the administrative functions. These include:

- Swap provider;
- Cash manager;
- Mortgage servicer;
- Account bank;
- Asset monitor; and,
- Bond trustee.

In many cases the issuer itself will be the service provider, which reduces administrative costs. The risk is that an issuer default will result in key administrative services not being provided for a period of time until arrangements a new service provider is put in place.

One way to address this continuity risk is to prohibit the issuer from acting as a service provider. While this greatly reduces continuity risk arising from issuer default, it would pose administrative challenges and increase costs. Another approach would be to require issuers to put in place back-up service providers at the time of issuance. This would be somewhat less costly than the first option, but would still place additional costs on issuances, even for highly-rated issuers that are unlikely to fail.

A third option may be to require the issuer to put in place back-up administrative service providers only when the credit ratings of the issuer fall below a certain level. This

approach is currently used by Canadian issuers with respect to swap providers. Standardizing this practice so that it applies to all service providers would ensure that covered bondholders are not exposed to continuity risk, while at the same time allowing strong issuers to lower costs by acting as their own service providers.

One concern with this approach is that it increases reliance on credit ratings agencies, an issue that has raised concern in international fora.

The Government proposes that the legislative framework allow issuers to act as swap counterparties and service providers. The issuer will be required to put in place back-up swap providers and back-up service providers (where the issuer is also the service provider) at a particular trigger, such as a credit ratings downgrade that requires the issuer to post collateral for the swap.

Is there an alternative trigger for the establishment of back-up swap and service providers that does not rely on credit ratings?

The Government also proposes that the covered bonds registrar have the authority to set minimum standards for the types of assets that can be used as collateral for swaps.

3.0 Disclosure

The final set of issues addressed in this paper concern the level and nature of disclosure to covered bonds investors and the general public.

3.1 Reporting and Disclosure

To increase investor confidence in the legislative framework, minimum standards for reporting and disclosure are required. These minimum standards will provide for market discipline on issuers by allowing investors to assess the relative values of different covered bond programs. To a great extent, any legislative standards would formalize the high level of disclosure already provided by Canadian issuers of covered bonds.

Key areas for disclosure to the public include:

- Issuer and program ratings;
- Events of default;
- Results of the ACT and AT;
- Summary information on the assets in the cover pool (e.g., arrears rate, loan-to-value ratio, term, etc); and
- The administrative service providers and the back-up providers.

To the extent it is reasonable, this information could be disclosed to the public and the manner of disclosure could be standardized (e.g., on the registrar's website).

The Government proposes that the legislative framework set minimum disclosure requirements based on current Canadian practice, and standardize the manner of disclosure.

3.2 Cover Pool Audit

Under the existing non-legislative framework, issuers ensure that an asset monitor conducts an audit of the assets in the cover pool annually. This audit, among other things,

- compares the mortgage data file with the underlying mortgage documents to ensure completeness; and,
- inspects the mortgage records for details on the borrower.

Under a legislative framework this audit should be required periodically and any deficiencies should be made public to allow investors to make informed decisions. Current Canadian practice is for the audit to be conducted annually.

The Government proposes that the legislative framework standardize the frequency and content of the cover pool audit, based on current Canadian practice.