3.7 CANADA

By Canada Mortgage and Housing Corporation (CMHC)

I. FRAMEWORK

From 2007 until 2012, Canadian covered bonds were issued pursuant to a contractual framework. In June 2012, Canada implemented dedicated covered bond legislation with the amendment of the National Housing Act[1], making Canada Mortgage and Housing Corporation (CMHC) responsible for administering the legal framework for covered bonds. In December 2012, CMHC implemented the legal framework and published the Canadian Registered Covered Bond Program Guide (CMHC Guide) which prescribes detailed requirements for registered issuers and programmes.[2] The NHA and the CMHC Guide together form the legal framework for Canadian registered covered bonds. The legal framework provides statutory protection for covered bond investors, prescribes eligible issuers, programmes and cover pool collateral, and establishes a high standard of disclosure.

Since 2013, new covered bond issuance is restricted to "registered" covered bonds issued under the legal framework. To be able to issue covered bonds, issuers must submit applications to CMHC to obtain registered issuer and registered programme status. Issuers and programmes that meet the minimum requirements and are approved by CMHC are added to the Canadian Covered Bonds Registry maintained by CMHC. CMHC has the power to suspend a registered issuer's right to issue further registered covered bonds.

Contractual or non-registered covered bonds issued between 2007 and 2012 ("Historical Bonds" in the CMHC guide) that are not registered under the legal framework will remain managed in separate programmes and amortise gradually until February 2019. For information on Canadian "contractual" covered bonds (please see ECBC European Covered Bond Fact Book 2012).

Under the new legal framework, eligible collateral consists of Canadian residential mortgage loans that are not insured against borrower default. Mortgages which are insured against borrower default are not permitted to be held as collateral. The Government of Canada and CMHC do not provide any guarantees or backing for covered bond issues.

The covered bond issuance limit of 4% of total assets, which was put in place in June 2007 by the Office of the Superintendent of Financial Institutions (OSFI), is unchanged. OSFI regulates Canadian federally incorporated financial institutions (including all of the current Canadian covered bond issuers except for one provincially regulated issuer which is regulated by the Quebec Autorité des marchés financiers (AMF)). The AMF has similarly imposed a covered bond issuance limit of 4% of total assets on that provincially regulated issuer. Details below are related to Canadian registered covered bonds issued by registered issuers under the legal framework.

II. STRUCTURE OF THE ISSUER

Only banks, trust and loan companies, cooperative credit associations and insurance companies in Canada are eligible to register as issuers under the Canadian covered bonds legislative framework with the approval of CMHC. CMHC's approval is contingent upon fulfilment of minimum legal requirements set out in the CMHC Covered Bonds Guide. The framework requires that at least two rating agencies provide current ratings at all times for at least one series or tranche of covered bonds outstanding, based on their assessment of the issuer and the covered bond transaction. CMHC may suspend the right of issuing "registered" covered bonds in case of a breach of legal requirements that are not remedied. The seven-covered bond "registered" programmes are: Canadian Imperial Bank of Commerce, Royal Bank of Canada, Bank of Nova Scotia, National Bank of Canada, Fédération des Caisses Desjardins du Québec, Bank of Montreal and Toronto Dominion Bank.

1 See National Housing Act R.S.C., 1985, c. N-11.

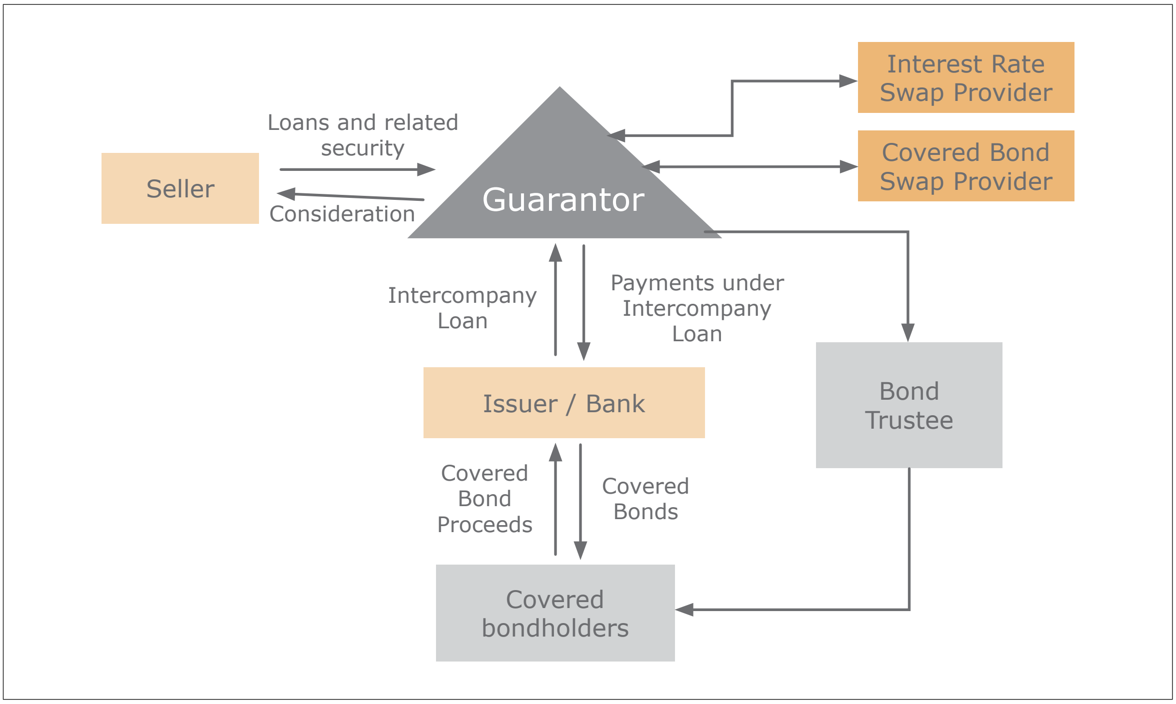
2 See CMHC's Canadian Registered Covered Bond Programs Guide (www.cmhc-schl.gc.ca).

Canadian registered covered bonds are direct obligations of the issuer. In addition, in the event of issuer insolvency or default, investors have a claim over the pool of cover assets. The cover assets are held in a bankruptcy-remote special-purpose entity, the guarantor, which provides an irrevocable guarantee in respect of interest and principal payments due and payable under the covered bonds that would otherwise be unpaid by the respective issuer. In Canada, the guarantor may be set up as a Limited Liability Partnership (LLP) or a trust. To date, all registered programs have used an LLP. A bond trustee (which has to be arm's length and bankruptcy remote from the issuer) must be designated to represent the views and interests (and enforce the rights) of covered bond holders.

Cover assets are segregated from the issuer through a contractual true sale of the mortgage loans to the guarantor entity. However, registered legal title to the mortgage collateral typically remains with the issuer or lender from which they are purchased by the guarantor until the earliest to occur of: (1) material breach or default by the issuer; (2) impending or actual issuer insolvency; (3) material breach or default by the servicer of eligible loans; or (4) any other event as prescribed in the issuer's transaction documents. Each registered issuer must engage an arm's length bankruptcy-remote custodian with appropriate systems and knowledge of handling mortgages. The issuer must provide the custodian with the details of eligible and substitute assets, and quarterly updates thereof.

An intercompany loan is provided by the Issuer to the Guarantor. The Guarantors use the proceeds from the intercompany loan to acquire all rights, title, interests in and certain records related to a specified pool of mortgage loans originated by the Seller. The Intercompany loan, denominated in Canadian dollars, is comprised of a Guarantee Loan and Demand Loan. The Guarantee loan amount must be equal to the sum of the Canadian-dollar amount of all covered bonds outstanding and the overcollateralisation required for the Asset Coverage Test to be met at all times. The Demand loan is a revolving credit facility equal to the difference between the Intercompany loan and the Guarantee loan. The Guarantor enters into swaps or collateral hedges to minimise interest rate and FX mismatches (see section V – Asset-Liability Management).

> Figure 1: General Covered Bond Structure



Source: CMHC

III. COVER ASSETS

Eligible assets for Canadian registered covered bonds are:

> Eligible loans comprised of Canadian residential loans on properties with 1-4 units that:
  - are not insured against borrower default;
  - are first ranking mortgages,
  - have a maximum 80% loan-to-value (LTV);
  - are not in arrears at the time of transfer to the Guarantor and have had at least one payment made (of principal or interest) in accordance with the terms of the loan;
  - are not the subject of any dispute, proceeding, set-off, counterclaim or defence;
  - are not subject to a right of set-off by the borrower; and
  - are originated by the issuer or otherwise comply with its underwriting policies.

> Substitute assets up to the prescribed limit (10%) of total value of cover pool assets. They must be Canadian government bonds or other prescribed assets.

> Cash in an amount not exceeding the amount necessary to satisfy the guarantor entity's payment obligations for the next six months.

Where the mortgage securing an eligible loan also secures other indebtedness, such other indebtedness must (i) be owned by the same lender, (ii) be the subject of a release of security and (iii) have the benefit of a cross default provision with the eligible loan that is enforceable against the borrower. Only eligible loans may be transferred to the guarantor. Any loan that did not meet the eligibility requirements at the time of transfer must be repurchased by the issuer.

The Government of Canada and CMHC do not provide any guarantees or backing for covered bond issues.

IV. VALUATION AND LTV CRITERIA

As noted above, the maximum LTV at the time of transfer of a loan to the guarantor is 80%. In Canada, prudential regulators require property values to be assessed during the underwriting process prior to making a mortgage loan. Property valuation is either performed by an accredited third-party property appraiser or an independently maintained valuation/risking model is used to assess the stated property value based on similar properties recently sold in the same area.

Under the covered bonds legal framework, loans are included in the cover pool coverage calculations up to the 80% LTV cap. Effective July 1, 2014, property values must be indexed at least on a quarterly basis for the purposes of valuing the covered bond collateral. The indexation methodology for a covered bond programme is disclosed to investors in the covered bond programme prospectus and must be in line with any regulatory requirement.

V. ASSET – LIABILITY MANAGEMENT

Overcollateralisation and Coverage Tests

Within covered bond programmes, there is an inherent liquidity mismatch due to the bullet payment nature of the covered bonds and the cash flows generated from the cover assets. Following a default by the issuer, the principal cash flows generated from the cover assets may not be sufficient to ensure timely repayment of the outstanding covered bonds. To mitigate this credit and liquidity risk, the covered bond framework requires issuers to establish a contractual minimum and maximum level of overcollateralisation by adopting a minimum and maximum value for the Asset Percentage (AP) used to discount mortgage loans in the cover pool as part of the Asset Coverage Test (described below). The CMHC Guide also stipulates that cover pool collateral assets shall be at least 103% of the outstanding Canadian dollar equivalent nominal amount of covered bonds secured at all times, with required disclosure effective January 1, 2018. As with market practice in other jurisdictions, issuers tend to maintain an OC level higher than the regulatory minimum OC level required.

Typical of SPV structures, Canadian issuers must meet the following tests:

> Asset Coverage Test (ACT): Conducted on a monthly basis, the ACT ensures that sufficient assets are available to cover the outstanding amount of covered bonds plus a level of OC. An asset monitor also tests the accuracy of the ACT calculation yearly, or more frequently under specific circumstances.

> Valuation Test (VT): Conducted on a monthly basis, the VT ensures a covered bond programme`s exposure to market risk (namely, volatility in interest rates and currency exchange rates) is monitored. The VT measures the present value to the covered bond collateral relative to the Canadian dollar equivalent of the market value of the outstanding covered bonds guaranteed by it.

> Pre-Maturity Test (PMT): Covered bonds may be issued with an Extended Due Date for payment ("soft bullet"), or as ("hard-bullet") covered bonds that are not extendible. In respect to hard-bullet covered bonds, at programme specific ratings triggers, the PMT ensures that the covered bond collateral includes sufficient cash to meet in full all principal payments due under the maturing hard-bullet series covered bonds (together with all other payment obligations ranking in priority) for a period prescribed in the transaction documents of the specific programme.

> Amortisation Test (AT): Following an issuer event of default, the AT ensures that the notional value of cover assets is at least equal to the outstanding Canadian Dollar equivalent covered bonds principal.

Covered Bond Collateral Hedges and Ratings Triggers

Furthermore, the issuer is required to put in place covered bond collateral hedges (if not there already) for the guarantor at the time of each transfer of covered bond collateral or covered bond issue in order to minimise interest rate or FX mismatches which may include contingent covered bond collateral hedges, which become effective, e.g., in case of an event of default of the registered issuer. The guarantor carries out monthly valuations to assess market risks (see above). Hedging counterparties must meet the counterparty requirements set out in the CMHC Guide, including minimum standards established by rating agencies. The terms of each transaction document must explicitly state that the guarantor may replace a specific counterparty upon rating triggers or in case of an event of default of the registered issuer. CMHC must be informed of counterparty replacement, termination or resignation. Swap counterparties rank pari passu with covered bondholders prior to issuer default.

The framework requires a ratings trigger for the establishment of a cash reserve for the benefit of the guarantor sufficient to meet in full all interest payments due on outstanding covered bonds for a period of time specified by the issuer in its transaction documents together with all payment obligations of the guarantor entity ranking prior to such interest payments. It is retained in a bank account and, following an issuer event of default, the balance of the cash reserve forms part of available revenue receipts to be used by the guarantor to meet its obligations under the covered bond guarantee.

VI. TRANSPARENCY

The Canadian covered bond legal framework is prescriptive in terms of information disclosure and reporting frequency. The requirements are comprehensive and include the following:

> All material information related to a registered issuer and covered bond programme must be accessible on an ongoing basis, mainly through a dedicated website set up by the issuer. All transaction documents must be available on the website.

> A monthly report must be prepared within 15 business days following the end of each month and include detailed information on the covered bond programme (e.g. key parties/counterparties, ratings, event of

default occurrence, credit enhancement and rating triggers, statistics related to cover asset and covered bonds, material issues and deficiencies).

As of April 30, 2018, five of the seven Canadian covered bond issuers joined ECBC Covered Bond Label and published its Harmonised Transparency Template (HTT).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

CMHC is responsible for administering the Canadian covered bonds legal framework. Only eligible federally and provincially regulated financial institutions that meet the requirements of the legal framework can issue registered covered bonds. In Canada, federal financial institutions are prudentially regulated by OSFI. Provincially regulated financial institutions are subject to prudential regulation by the applicable provincial entity, including, in the case of provincially regulated issuers in Quebec, the AMF.

CMHC takes the lead role in assessing and monitoring compliance with the Canadian legal covered bond framework requirements. A registered issuer shall deliver to CMHC a certificate signed by the issuer's executive officer attesting that the Issuer has complied with the requirements of the Canadian covered bonds legal framework. Notification to CMHC of material change to an issuer's registered covered bond program or terms of covered bonds is required. Registered issuers must also provide immediate notice to the CMHC in case of: (1) a failed ACT and/or AT; (2) awareness of a rating downgrade/ withdrawal/trigger; (3) a breach or default under the terms of the covered bond programme; and (4) breach or default under the covered bonds legal framework.

Issuers are required to appoint an independent third party cover pool monitor (CPM) with adequate qualifications. The responsibilities of the CPM consist of ensuring the accuracy of the records regarding the cover pool and of the required tests particularly the Asset Coverage Test. Results should be reported to the CMHC and the bond trustee annually or whenever deemed reasonable. Issuers should make available all information needed by the CPM. Following issuer insolvency, the CPM remains in place for the benefit of the guarantor.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The guarantor is structured as a bankruptcy-remote, special-purpose entity and, as such, following insolvency of the issuer, all the assets of the guarantor are segregated from those of the bankrupt estate of the issuer. Covered bond holders shall retain a claim against the registered issuer for any deficiency in the repayment of all principal, interest and other amounts owing thereunder, and such covered bond holders shall rank pari passu with the ordinary depositors of the registered issuer.

> Upon an issuer event of default, the guarantor is required to meet the covered bond obligations using the cash flows generated from the cover assets. In case of insufficient cash, the guarantor is permitted to sell the cover assets, find alternative funding or enter repos. The entire pool of cover assets is available as security for all the outstanding covered bonds issued under the programme, so there is no direct link between particular assets and a specific series of covered bonds.

> Upon a guarantor event of default, covered bonds accelerate. Preferential rights are limited to the guarantor's assets. Payments are made in accordance with the applicable order of priority.

An issuer or guarantor event of default include at a minimum (other events maybe prescribed in the documentation) the following: (1) impending or actual insolvency; (2) failure to pay principal, interest or any other amount due under the covered bond programme when due; (3) failure to comply with the remedial action following a rating trigger; and (4) failure to meet the AT by a guarantor on a calculation date. An issuer's transaction documents can provide a remedy period of up to 10 business days for a failure to pay principal, and up to 30 days for failure to pay interest or other payment under the covered bonds.

On 18 April 2018, the Government of Canada published the final version of the Bank Recapitalisation (Bail-in) Conversion Regulations, SOR/2018-57, under the Bank Act and CDIC Act (Bail-in Regulations). The Bail-in

Regulations specify the prescribed shares and liabilities that are eligible for bail-in conversion and their conversion terms. Covered bonds are specifically excluded from prescribed liabilities under the bail-in regulations.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Canadian covered bonds may be eligible to be used as liquid assets (Level 2A) under the European Union's Liquidity Coverage Requirement Delegated Act (EU LCR), the EU's implementation of the Basel liquidity coverage ratio requirements, provided they comply with the requirements set out in the EU LCR. Canadian covered bonds may be eligible for the same risk weighting as unsecured bank debt for purposes of calculating regulatory capital ratios under Article 120 of the European Union's Capital Requirements Regulation (CRR). If denominated in euro, Canadian covered bonds may be eligible for European Central Bank repo operations as a haircut category III asset pursuant to European Central Bank Guidelines 2015/510 and 2016/65 on the implementation of the Eurosystem monetary policy framework. Valuation haircuts are generally based on credit quality, residual maturity and coupon structure of the covered bond. Canadian covered bonds are subject to the same spread risk factors and concentration thresholds as unsecured debt pursuant to Articles 176 and 185 of delegated regulation (EU) 2015/35 implementing the EU's Solvency II directive 2009/138/EC (Solvency II).

Canadian covered bonds are not UCITS 52(4)-compliant because Canadian issuers do not have their registered head office in an EU state. Therefore, they do not benefit from the more preferential risk weighting under Article 129(4) and (5) of CRR, and are not eligible for the preferential risk factors and concentration thresholds in Articles 180(1) and 187(1) of Solvency II.

X. ADDITIONAL INFORMATION

X.1. Eligible for Level 2A assets under Canada's implementation of Basel's Liquidity Coverage Ratio (LCR)

Covered bonds meeting certain structural requirements (including that they are issued and owned by a bank or mortgage institution, and are subject by law to special public supervision designed to protect bond holders) are included as Level 2A assets for the LCR, provided they satisfy the following conditions:

> Not issued by the institution itself or any of its affiliated entities;

> Either (i) have a long-term credit rating from a recognised external credit assessment institution (ECAI) of at least AA- or in the absence of a long-term rating, a short-term rating equivalent in quality to the long-term rating; or (ii) do not have a credit assessment by a recognised ECAI but are internally rated as having a probability of default (PD) corresponding to a credit rating of at least AA-;

> Traded in large, deep and active repo or cash markets characterised by a low level of concentration; and

> Have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%.

Covered bonds issued by Canadian institutions prior to the Canadian covered bond legislation coming into force on 6 July 2012 may be included as Level 2A assets if they meet the above conditions.

X.2. Market Overview

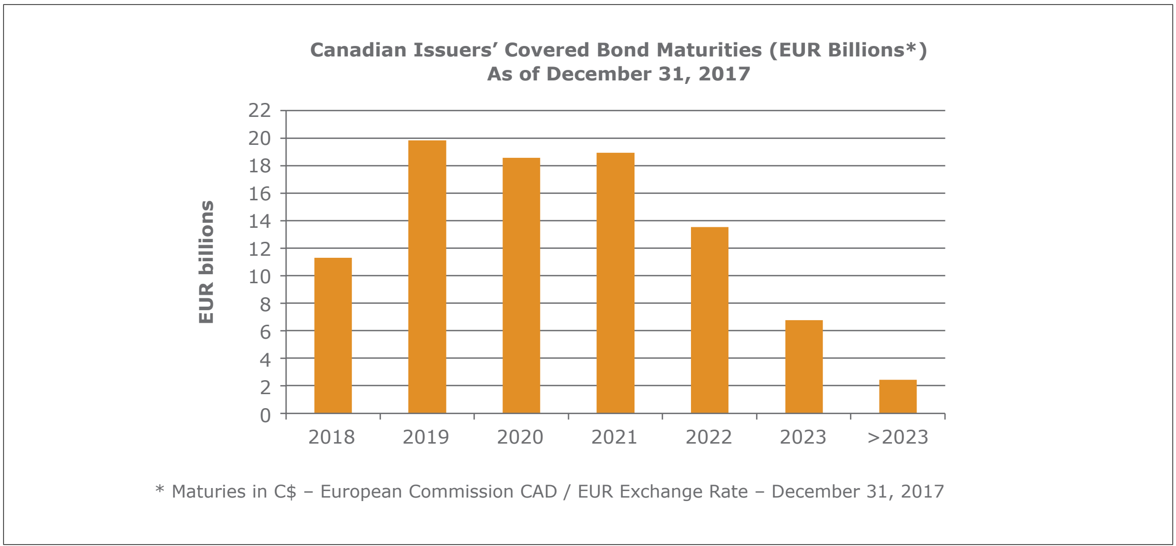
Outstanding covered bonds by Canadian banks continue its upward trend in recent years. Covered Bond issuances by Canadian banks in 2015 and 2016 totalled 29.3 and 28.1 billion euros respectively (see Figure 4 and 5 below) but 2017 was a muted year with issuances of 12.4 billion euros. Canadian banks remain key participants in international covered bond markets, issuing in the CAN$, €, US$, GBP£, CHF, and AU$ markets due to favourable basis swaps and strong market technicals. Canadian banks' constraint in terms of future issuance is the covered bond issuance limits equal to 4% limit of total assets. Maturities of covered bonds, which are spread over the next few years, should also support new issuance (see Figure 3 below). Notable in 2018 is the publication of the final regulations of the Canadian bail-in regime, which will come into force on 23 September 2018. Covered bonds are not eligible for conversion under bail-in and specifically excluded from the bail-in regime. As of April 30, 2018, 5 of the 7 Canadian banks joined the ECBC Label.

FIGURE 2: CANADIAN BANKS' COVERED BOND ISSUANCE

At 31 December 2017 (C$ bn)	BMO	BNS	FCDQ	CIBC	NBC	RBC	TD	Total
OSFI covered bond issuance limit	28.1	37.1	9.1	22.2	9.5	46.1	50.0	202.0
Outstanding covered bonds	22.9	22.5	4.4	16.9	6.8	36.7	27.1	137.3
- non-registered	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.2
- registered	22.9	22.5	4.4	16.7	6.8	36.7	27.1	137.1
Remaining issuance capacity	**5.2**	**14.6**	**4.7**	**5.3**	**2.7**	**9.3**	**22.9**	**64.7**

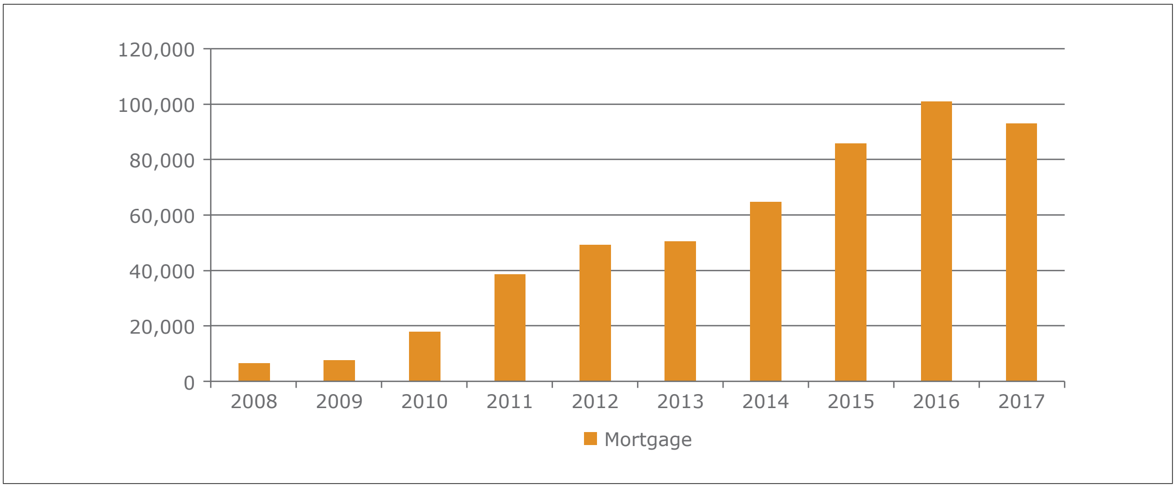
Source: CMHC

> FIGURE 3: CANADIAN ISSUERS' COVERED BOND REDEMPTIONS (AS OF 31 DECEMBER 2017, EUR BN)



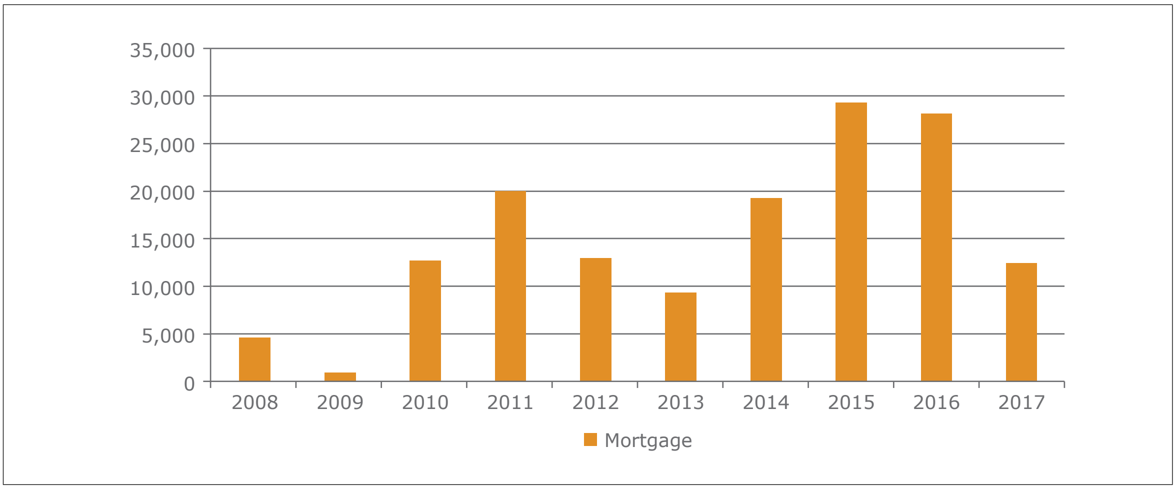
Source: CMHC

> Figure 4: Covered Bonds Outstanding from Canadian Issuers, 2008-2017, EUR m



Source: EMF-ECBC

> Figure 5: Covered Bond Issuances from Canadian Issuers, 2008-2017, EUR m



Source: EMF-ECBC

Issuers: Royal Bank of Canada (RBC), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), Fédération des Caisses Desjardins du Québec(FCDQ), National Bank of Canada (NBC), Toronto Dominion Bank (TD).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/12/Canadian_Covered_Bond.

Covered Bond · Label · : Royal Bank of Canada (1 pool), The Toronto-Dominion Bank (1 pool), The Bank of Nova Scotia (1 pool), Fédération des caisses Desjardins du Québec (1 pool), National Bank of Canada (1 pool).