3.7 CANADA

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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 (NHA) 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. 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, pre scribes eligible issuers, programmes and cover pool collateral, and establishes a high standard of disclosure.

Since 2013, all new Canadian covered bond issuance has occurred as "registered" covered bonds issued under the legal framework. In order for an issuer to be able to issue registered 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.

All of the current Canadian covered bond issuers, except for one issuer regulated by the Quebec Autorité des marchés financiers (AMF), are regulated by the Office of the Superintendent of Financial Institutions (OSFI) that regulates Canadian federally incorporated financial institutions. Under OSFI and AMF regulatory requirements, total assets pledged for covered bonds must not, at any time, represent more than 5.5% of a deposit-taking institution's total on-balance sheet assets.

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. The framework requires that at least one rating agency provide current ratings at all times for at least one series or tranche of covered bonds outstanding.

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 guarantor entity, 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 as the guarantor entity. 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

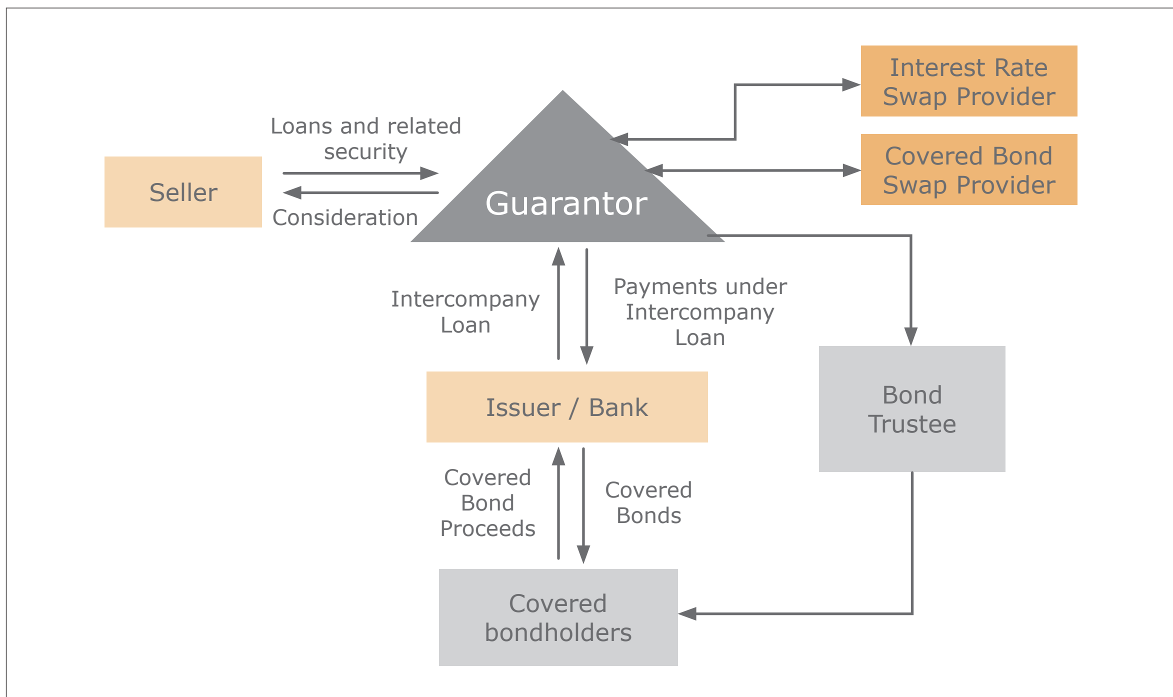
1 See National Housing Act R.S.C., 1985, c. N-11.

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

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 guarantor uses the proceeds from the intercompany loan to acquire all rights, title, interests in and certain records related to a specific 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 since July 2014, must include an express waiver of set-off); 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.

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. Effective July 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. 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 have in place covered bond collateral hedges 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 rating 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 and comprehensive in terms of information disclosure and reporting frequency. All material information and transaction documents 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. 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.

As of April 2022, eight of the ten Canadian covered bond issuers had joined ECBC Covered Bond Label and published its Harmonised Transparency Template (HTT).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

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. Issuers are required to 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 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 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.

In April 2018, the Government of Canada published 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. Similarly, the AMF has excluded covered bonds from the prescribed debts eligible for conversion as part of the recapitalization of a Quebec-regulated domestic systemically important financial institution in its Regulation Respecting. The Classes Of Negotiable And Transferable Unsecured Debts And The Issuance Of Such Debts And Of Shares published on March 29, 2019 and effective March 31, 2019 pursuant to section 40.50 of the Quebec Deposit Institutions and Deposit Protection Act (chapter A-26).

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Canadian regulated covered bonds may be eligible to be used as liquid assets (Level 2A) under the European Union's implementation of the Basel liquidity coverage ratio requirements provided for in Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR), as supplemented by Commission Delegated Regulation (EU) 2015/61 (LCR Delegated Regulation), provided that they are assigned a credit assessment by an external credit assessment institution (ECAI) which is at least credit quality step 1 or have otherwise been assigned a 10% risk weight under Article 129 of the CRR and provided that they also comply with the other requirements set out in the LCR Delegated Regulation. As of July 8, 2022, those other requirements include that covered bonds issued by credit institutions in third countries comply with the transparency requirements laid down in Article 14 of Directive (EU) 2019/2162. In the case of Canadian registered covered bonds programs, compliance with the disclosure requirements in the Canadian legal framework will result in the requirements in Article 14 of Directive (EU) 2019/2162 being met, provided issuers voluntarily provide additional disclosure, at least quarterly, of loans

where a default is considered to have occurred based on the indications in Article 178(3)(a) of Regulation (EU) No 575/2013[3]. Canadian regulated covered bonds may be eligible for the same risk-weighting as unsecured bank debt for purposes of calculating regulatory capital ratios under Article 120 or 121 of the CRR.

If denominated in euro and admitted to trading on certain markets, Canadian covered bonds may be eligible as collateral for Eurosystem credit operations as a haircut category III asset pursuant to Guidelines 2015/510 and 2016/65 of the European Central Bank (ECB) 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 bonds or loans pursuant to Articles 176 and 185 of Commission Delegated Regulation (EU) 2015/35 that supplements Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). Canadian covered bonds are not covered by Article 52 (4) of Directive 2009/65/EC on undertakings for collective investment in transferable securities (UCITS) because Canadian issuers do not have their registered head office in an EU member state and Canadian covered bonds are not issued in accordance with the provisions of a national law implementing Directive (EU) 2019/2162 (Covered Bonds Directive – CBD). Therefore, they do not benefit from the more preferential risk weighting under Article 129 (4) and (5) of the CRR, and are not eligible for the preferential risk factors and concentration thresholds in Articles 180 (1) and 187 (1) of Commission Delegated Regulation (EU) 2015/35. Third country covered bonds, including Canadian covered bonds, do not benefit from the preferential risk weighting under the CBD.

X. ADDITIONAL INFORMATION

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

Covered bonds that are issued and owned by a bank or mortgage institution, and are subject by law to special public supervision designed to protect bond holders (i.e. the dedicated covered bond legislation under the National Housing Act administered by CMHC, which came into force on 6 July 2012) may be 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- (and, in the event of split ratings, the applicable rating should be determined according to the method used in Basel II's Standardised Approach for credit risk, and local rating scales (rather than international ratings) of a supervisor-approved ECAI that meet the eligibility criteria outlined in paragraph 21.2 of the Basel Consolidated Framework [CRE 21.2] can be recognised if covered bonds are held by an institution for local currency liquidity needs arising from its operations in that local jurisdiction);
- 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%.

Eligible covered bonds may be used as collateral under the Bank of Canada's (BoC) Standing Liquidity Facility, and the Standing Term Liquidity Facility. Eligible covered bonds are those that are compliant with the fed-

3 Disclosure of loans that are more than 90 days past due is already required by the Canadian legal framework.

eral legislative framework for covered bonds, and of sufficiently high quality as determined by BoC (which is considered to be broadly equivalent to a rating of AAA). The combined amount of covered bonds, term ABS and ABCP originated or sponsored by a single institution pledged by a Large Value Transfer System (LVTS) participant cannot be more than 5% of the total value of all the collateral pledged by that participant (but this condition does not apply for borrowings of less than $10 million). BoC announced temporary expansion for its Term Repo Operations eligible securities by including covered bonds (including own-name covered bonds) from March to October 2020. Effective July 2021, certain USD-denominated securities were added to Bank of Canada's eligible collateral including registered covered bonds.

X.2. Market Overview

Canadian banks remain key participants in international covered bond markets, issuing opportunistically in the CAD, EUR, USD, GBP, CHF, and AUD markets upon favourable basis swaps and strong market technicals.

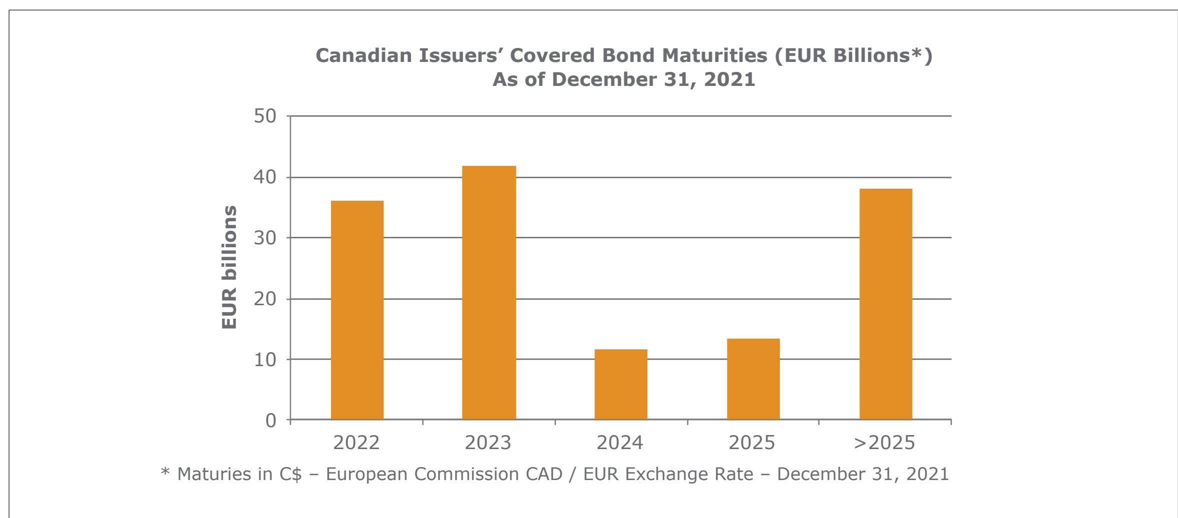
Figure 2: Canadian Banks' Covered Bond Issuance

At 31 December 2021 (C$ bn)	BMO	BNS	EQB	FCDQ	CIBC	HSBC	LBC	NBC	RBC	TD	Total
OSFI 5.5% covered bond encumbrance limit	54.3	65.1	1.9	18.2	46.0	6.6	2.4	19.5	93.8	94.3	402.7
Outstanding covered bonds	26.1	50.0	0.5	9.2	28.6	3.8	0.2	12.1	47.1	25.1	203.2
OSFI Covered Bond Ratio Limit	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	
**Covered Bond Ratio (%)	2.8%	4.5%	1.6%	2.9%	3.6%	3.4%	0.6%	3.7%	2.9%	1.5%	
Remaining encumbrance capacity	**2.6%**	**1.0%**	**3.0%**	**2.5%**	**1.8%**	**2.0%**	**4.8%**	**1.7%**	**2.5%**	**3.9%**	

Source: CMHC

** Covered Bond Ratio refers to total assets pledged for covered bonds relative to total on-balance sheet assets.

> Figure 3: Canadian Issuers' Covered Bond Redemptions (as of 31 December 2021, EUR bn)



Source: CMHC

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), HSBC Bank Canada, Laurentian Bank (LBC), Equitable Bank (EQB).

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), Canadian Imperial Bank of Commerce (1 pool), Bank of Montreal (1 pool), HSBC Bank Canada (1 pool).

For the most up-to-date information, please consult the new ECBC Covered Bond Comparative Database webpage on the Covered Bond Label website www.coveredbondlabel.com.

In the context of the transposition of the Covered Bond Directive (the final deadline for which was 8 July 2022), the ECBC has undertaken a full review and update of the Covered Bond Comparative Database to take account of the latest regulatory developments. This unique reference tool can be accessed via the link hosted on the Covered Bond Label website (www.coveredbondlabel.com/legislation/comparative_database).

For further national information on the Canadian market, please see compare.coveredbondlabel.com/frameworks. To access the "Country Comparison" feature of the database, please see compare.coveredbondlabel.com/compare/select/frameworks.