

NOTICE RELATING TO THE ISSUANCE OF COVERED BONDS

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1. Scope of Application

This Notice applies to all financial services cooperatives governed by *An Act respecting financial services cooperatives* or *An Act respecting the Mouvement Desjardins*. More specifically, it applies to financial services cooperatives that are members of a federation, to a federation, as well as to financial services cooperatives that act as treasurer of a group (*hereinafter, "financial institution" or "institution"*).

2. Introduction

Covered bonds are debt securities secured by a pool of collateral ("cover pool") – made up of high-grade mortgages (hypothecs) or public sector loans – on which investors have a priority claim. Institutions that issue covered bonds are liable for their payment. The dual nature of protection offered by covered bonds sets them apart from senior unsecured debt¹ and asset-backed securities. In fact, covered bonds offer recourse on the issuing financial institution and on the cover pool; therefore, covered bonds create a preferred class of creditors.

Covered bonds are exposed to the risk of deterioration in the value of the cover pool due to liquidity problems, foreign exchange fluctuations, or interest rate and maturity mismatches. Moreover, in the event of the bankruptcy or winding-up of the issuing financial institution, covered bonds could reduce the residual level of assets available to repay creditors, including the *Autorité des marchés financiers* (the "Authority") where it is subrogated in the rights of a depositor under the *Deposit Insurance Act*.²

The Authority considers that in addition to the benefits that covered bonds may provide, the risks associated with these bonds are considerable. Accordingly, the Authority intends to analyze each covered bond program of the institutions under its supervision. This Notice sets out the Authority's expectations regarding the issuance of covered bonds.

¹ Debt security conferring on the holder a priority claim on the assets and, occasionally, the earnings of the debtor.

² R.S.Q., c. A-26, s.35

3. Guidance of the Authority

Financial institutions cannot issue covered bonds without authorization from the Authority, in accordance with sections 81 and 82 of *An Act respecting financial services cooperatives*.³

The Authority considers each bond issue to be unique based on the quality of the assets in the cover pool, the risk profile of the financial institution, the economic conditions prevailing at the time of issuance, etc. As a result, financial institutions must outline the proposed program, the related risks and planned mitigation measures. Consequently, the Authority will authorize covered bond programs on a case-by-case basis.

In certain cases, the Authority's authorization of a covered bond program may be subject to prudential requirements, including, for example:

- an additional capital requirement under prudential supervision guidance;⁴
- a limit on the aggregate amount of mortgages (hypothecs) to be included in the cover pool;
- a limit on the maturity date of the bonds.

4. Authorization of covered bond programs

The financial institution must submit a request for authorization of its covered bond program to the Authority in writing. Such requests should set out the various components of the proposed program, in particular:

- management of the program;
- program particulars (e.g., volume to be issued, overcollateralization level, risks);
- results of stress tests.

The request must be accompanied by any necessary documents for purposes of analysis as well as a legal opinion obtained by the financial institution.

Once all of the program information is submitted, the Authority will notify the financial institution of the time required for its analysis. The duration of this validation process will be determined by factors such as the scale of the program.

³ R.S.Q., c. C-67.3

⁴ Autorité des marchés financiers, *Ligne directrice sur les normes relatives à la suffisance du capital de base*, December 2008 (in French only).

a. General framework for covered bond programs

Financial institutions should consider the principles of sound management proposed in the Governance Guideline⁵ as they pertain to covered bond programs. Management, monitoring and oversight of the program should be supported by a reliable governance structure. The Authority expects the roles and responsibilities related to the covered bond program to be clearly defined and properly documented.

Financial institutions should ensure that the members of the board of directors are involved and that board members as a whole have the required knowledge to understand the program and the related risks.

They should also implement the appropriate systems, policies and procedures for covered bond issuances. The management of covered bond program risks should be appropriately incorporated in the overall risk management strategy⁶ of the financial institution.

b. Analysis of covered bond programs

During the analysis of a covered bond program, the Authority may focus on the following aspects:

- the volume of bonds to collateralize. Financial institutions should disclose the maximum volume that they are able to issue by taking into account factors that are not under their control, such as a decline in real estate prices or an increase in payment default rates;
- the liquidity of the assets in the cover pool in the event of the insolvency of the issuing financial institution, the timeframe required to sell these assets to cover payment of the bonds, and downgrades as a result of a sell-off of assets;
- the level of overcollateralization to be maintained as a credit enhancement technique;
- the credit quality of the cover pool in terms of probability of issuer default and asset losses using different assumptions for recovery rates, delays and costs;
- interest rate risk related to the issuance.
- currency risk, where covered bonds are issued outside Canada;
- the institution's short-, medium- and long-term financing plan (including the covered bond program);
- risks of a downgrade of the financial institution and its consequences on the quality of the cover pool.

⁵ Autorité des marchés financiers, *Governance Guideline*, April 2009.

⁶ Autorité des marchés financiers, *Integrated Risk Management Guideline*, April 2009.

One of the Authority's concerns with respect to covered bond issuances is the value of the cover pool, which may deteriorate if the pool is exposed to risks related to liquidity, currency, interest rate and maturity mismatch, or issuer insolvency. Therefore, the Authority requires financial institutions to perform stress tests to ascertain the strength of the program's structure. These tests could, for example, assess the adequacy of cash flows generated by the assets to provide timely payments under normal circumstances and in crisis situations, or in the event of issuer insolvency.

c. Legal opinion

The Authority also expects financial institutions to obtain a legal opinion on their covered bond programs. The Authority will specifically examine the validity of the segregation of the cover pool and its immunity against recourse by unsecured creditors.

Where a financial institution plans to issue covered bonds outside Canada, the legal opinion must confirm the legality of the program under the legislation of the country where the bonds will be issued, and address, in particular, the impact of local laws on bankruptcy remoteness of cover pool assets, enforceability in respect of claims and the cover pool, and bankruptcy or receivership procedures.

Further information

Please refer your questions to:

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