Notice relating to the issuance of covered bonds pursuant to the legal framework established by the *National Housing Act*

Reference: AMF Bulletin: 2014-03-20, Vol. 11, No. 11

1. Purpose and scope of application

In its Bulletin dated April 2, 2010, the *Autorité des marchés financiers* (the "AMF") published the *Notice relating to the issuance of covered bonds* (AMF Bulletin Vol. 7, No. 13), which pertains to the prudential oversight of financial institutions under its jurisdiction that issue covered bonds pursuant to contractual arrangements.

Since then, the federal government has adopted a legal framework for the issuance of covered bonds. This legal framework, which is set out in Part I.1 of the *National Housing Act*, R.S.C. 1985, c. N-11 (the "NHA"), came into force on July 6, 2012 (the "NHA Legal Framework"). The purpose of this Notice is to adapt the prudential oversight of covered bond issuances to the NHA Legal Framework.

This Notice applies to all financial services cooperatives governed by *An Act respecting financial services cooperatives* or *An Act respecting the Mouvement Desjardins* that wish to issue covered bonds pursuant to the NHA Legal Framework. More specifically, it applies to a federation, to financial services cooperatives that are members of a federation, as well as to financial services cooperatives that act as treasurer of a group (hereinafter individually referred to as a "financial institution" or an "institution").

However, the *Notice relating to the issuance of covered bonds* published by the AMF on April 2, 2010 continues to apply to a financial institution that issues covered bonds pursuant to contractual arrangements, outside the new framework established by the NHA.

2. Characteristics of covered bonds

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.

Covered bonds provide certain advantages, including dual protection to investors, who have a recourse against the issuing financial institution as well as against the cover pool. However, covered bonds also involve significant risks, and their issuance requires that certain regulatory matters be addressed.

The principal risks to be monitored in connection with the issuance of covered bonds are:

- market risk (interest rate risk and currency exchange rate risk);
- housing market risk;
- risk of a downgrade of the issuer; and
- liquidity risk.

The following are the main problems targeted by prudential oversight:

- in the event of issuer default or insolvency, the covered bonds could reduce the residual level of assets available to repay unsecured creditors;
- overcollateralization; and
- the volume of the covered bond issuance.

The terms "default" and "insolvency," as used above, have the meaning attributed thereto in section 6.2 of the guide published by the Canada Mortgage and Housing Corporation (the "CMHC").

3. Oversight of covered bonds under the NHA Legal Framework

The CMHC has been given the responsibility of administering the legal framework for Canadian registered covered bond programs established under the NHA. As such, it has discretionary authority to establish conditions and restrictions applicable to registered issuers and registered covered bond programs and to oversee and enforce compliance with those conditions and terms. To this end, the CMHC has prepared the *Canadian Registered Covered Bond Programs Guide* (the "CMHC Guide"), which is available on the website of the CMHC. It provides an interpretation of sorts of the NHA provisions governing the issuance of covered bonds and addresses the risks and regulatory matters of concern.

On the whole, the CMHC requires relatively exhaustive information related to risk management. More specifically, the CMHC Guide addresses the credit quality of cover pools, market risks (currency exchange rates and interest rates), consolidated capitalization and indebtedness related to the covered bond market.

4. Authorization of a registered covered bond program

Although the CMHC is the registrar for registered covered bond programs, the AMF is still the regulator of the financial institutions under its jurisdiction. Consequently, financial institutions cannot issue covered bonds in Québec under the NHA Legal Framework unless they have obtained the prior authorization of the AMF, in accordance with sections 81 and 82 of *An Act respecting financial services cooperatives*.

a) General framework for covered bond programs

Financial institutions should take into account the principles of sound and prudent management proposed in the *Governance Guideline* published by the AMF in April of 2009, as they pertain to covered bond programs. Management, monitoring and control of the program should be supported by a reliable governance structure. The AMF 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.

Financial institutions 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 strategy of the financial institution. In this regard, see the *Integrated Risk Management Guideline* published by the AMF in April 2009.

b) Analysis of covered bond programs

In order to acquire an overview and complete its analysis of an institution's application, the AMF will request all of the documents submitted for purposes of registration of a program with the CMHC.

As part of its analysis of a covered bond program under the NHA Legal Framework, the AMF 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 AMF must analyze the critical volume based on the harm that could result to unsecured creditors and based on the structure of the institution's liabilities if it were to default;

- liquidity risk: This analysis should have two components: (i) consider 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, and; (ii) take into account the volume of assets that has already been used as security, since this could impact refinancing operations;

- the maximum overcollateralization limit for each new issuance within the scope of a hypothetical repayment to depositors in the event of default: While excessive overcollateralization may be to the advantage of the issuing institution and holders of covered bonds, it could reduce the assets available to unsecured creditors in the event of a default or insolvency;

- results of stress tests: The AMF must monitor how tests are structured. These tests could address macroeconomic shocks (such as interest rates, economic growth and the real estate market), the financial soundness of the institution and the characteristics of the covered bonds in light of the economic context;

- the risk of a downgrade of the institution or a default by the institution: The AMF must consider the degree of correlation between the covered bond issuer's downgrade or default and a decline in the market value of the cover pool.

The other risks mentioned in the *Notice relating to the issuance of covered bonds* dated April 2, 2010 (interest rate risk, currency exchange rate risk, the institution's overall financing plan) and not elaborated upon herein are largely covered by the information required by the CMHC.

c) Legal opinion

The AMF also expects financial institutions to obtain a legal opinion on their covered bond programs. The AMF 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

For additional information, please contact:

Alain Angora
Prudential Oversight of Financial Institutions
Autorité des marchés financiers
Québec City: 418-525-0337, extension 4678
Toll-free: 1-877-525-0337
E-mail: alain.angora@lautorite.qc.ca

March 27, 2014