

Canadian Structured Finance Newsletter

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ROOM TO GROW IN THE CANADIAN COVERED BOND MARKET

Covered bonds issued by Canadian financial institutions are on-balance-sheet, full-recourse senior unsecured debt obligations, with additional recourse to a portfolio of specific assets that has been transferred to a bankruptcy-remote entity, which provides a secured guarantee in the event of the issuer's default. The assets backing the guarantee usually consist of a portfolio of mortgages, referred to as the Cover Pool. Noteholders' having recourse to the Cover Pool allows the covered bond to be rated higher than the issuer's other senior unsecured debt obligations.

The first Canadian financial institution to issue a covered bond was Royal Bank of Canada (RBC) in November 2007. Bank of Montreal (BMO) and Canadian Imperial Bank of Commerce (CIBC) joined RBC in January 2008 and September 2008, respectively. Each of Canada's five largest banks has now established a covered bond program. Initially, Canadian banks issued exclusively in the well-developed European market for covered bonds, but recent issuances from RBC and CIBC have reached Canadian and U.S. investors. For Canadian financial institutions, issuing covered bonds allows diversification of funding sources and access to foreign capital markets at a favourable funding rate.

Since late 2009, the volume and frequency of issuance has stepped up, with both RBC and CIBC coming to market on three occasions since November 2009. RBC has issued \$1.6 billion of Canadian-dollar-denominated covered bonds and US\$1.5 billion of U.S.-dollar-denominated covered bonds during this period. The mortgages in the RBC Cover Pool are first-lien prime conventional residential mortgages, with a maximum loan-to-value ratio of 80%. CIBC has issued US\$2 billion and CHF 675 million since December 2009. The Cover Pool for the CIBC bonds is also composed of first-lien prime residential mortgages. However, all mortgages in the CIBC Cover Pool are insured by the Canada Mortgage & Housing Corp. (rated AAA).

While DBRS expects the market to continue to grow, the Office of the Superintendent of Financial Institutions (OSFI), the regulator of financial institutions in Canada, has effectively placed a cap on the volume of covered bonds that can be issued by Canadian financial institutions. In a letter dated June 27, 2007, OSFI allowed financial institutions to issue up to 4% of their total assets (as determined by the numerator of the assets-to-capital multiple) in covered bonds. If the 4% limit is exceeded at any time after issuance, the covered bond issuer must immediately notify OSFI. The chart below shows current covered bond issuance by each of Canada's Big Five Banks, their maximum allowable issuance and their remaining potential covered bond issuance.

Big Five Covered Bond Issuance

CAD Millions As at October 31, 2009	RBC	CIBC	BMO	TD	BNS
Assets-to-Capital Multiple	16.25	16.33	14.09	17.07	16.65
Total Capital	\$34,881.3	\$18,826.8	\$24,859.2	\$28,337.6	\$28,588.4
Implied Total Assets	\$566,820.7	\$307,441.8	\$350,265.7	\$483,722.4	\$475,996.7
Maximum Issuance Amount (4% of Total Assets)	\$22,672.8	\$12,297.7	\$14,010.6	\$19,348.9	\$19,039.9
Covered Bonds Outstanding* (CAD Equivalent)	\$7,835.1	\$6,423.6	\$1,499.9	\$0.0	\$0.0
Potential Remaining Issuance	\$14,837.8	\$5,874.1	\$12,510.8	\$19,348.9	\$19,039.9

*As of April 28, 2010.
Source: DBRS and OSFI.

Unlike many European countries, Canada has no explicit legislation for covered bonds that prescribes certain priority rights to holders of covered bonds over the specific assets backing the covered bonds upon an issuer's insolvency. In the absence of a legislative framework, Canadian covered bond transactions contain contractual provisions (such as the segregation of the Cover Pool by transferring it to a bankruptcy-remote entity) intended to provide similar protections to those available in jurisdictions where covered bond legislation is in force. However, in the March 4, 2010, federal budget, the government stated that it would "help federally regulated financial institutions diversify their funding sources by introducing legislation setting out a framework for covered bonds," thereby increasing "legal certainty for investors in these debt instruments." DBRS views this as a positive development that should promote greater market acceptance and further issuance of covered bonds by Canada's financial institutions.

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