The federal government introduced the Jobs, Growth and Long-term Prosperity Act in April 2012 in order to implement the 2012 federal budget. This statute included amendments to the National Housing Act to introduce a new Part I.1 to the NHA (the “Covered Bond Legislation” or the “Legislation”) that establishes a framework for the issuance of covered bonds by eligible Canadian issuers. The Covered Bond Legislation was proclaimed in force on June 29, 2012, but the ability of issuers to issue covered bonds under the new regime was delayed pending rules that had to be established by Canada Mortgage and Housing Corporation (“CMHC”). On December 17, 2012, CMHC published its Canadian Registered Covered Bond Programs Guide (the “Guide”), which sets out comprehensive rules for the issuance of covered bonds under the Covered Bond Legislation.

History

Canadian banks have been issuing covered bonds since 2007. Without a statutory scheme for covered bonds, issuers used securitization techniques to create covered bond collateral that would not be available to satisfy claims of any other creditors of the issuer or its affiliates. The structure, which has been replicated by every Canadian covered bond issuer since 2007, involves the establishment of a bankruptcy remote special purpose entity (usually either a trust or a limited partnership) to which the issuer would transfer assets comprising the covered bond...
collateral. This special purpose entity (the “Guarantor”) would then guarantee the bonds issued by the issuer and secure its guarantee with a first ranking security interest over the covered bond collateral. The two legal issues that had to be addressed in order to reach a conclusion that the covered bond collateral would be beyond the reach of other creditors of the issuer or its affiliates are (i) that the assets comprising the covered bond collateral were legally sold to the Guarantor (that is, legally isolated from the issuer or its affiliate transferring such assets) and (ii) in the event of the insolvency of the issuer, the assets and liabilities of the Guarantor would not be consolidated with those of the issuer in the course of dealing with the estate of the issuer. These legal issues would be addressed in a legal opinion at the time of closing of each covered bond transaction and are colloquially referred to as “true sale” and “non-consolidation” opinions.

Several countries in Europe have statutory covered bond regimes. In these jurisdictions, the availability of designated covered bond collateral to satisfy the claims of covered bondholders in priority to all other claims is assured by statute without investors having to rely on structural techniques. Over the past few years, Canadian issuers of covered bonds came to learn that some investors were only comfortable with the certainty provided by a statutory covered bond regime and were not willing to rely on structural solutions supported by reasoned legal opinions. As a result, requests were made of the federal government to introduce a statutory covered bond regime for Canadian issuers.

As at April 2012 (the date that the Covered Bond Legislation was introduced), the six largest Canadian banks had issued covered bonds totalling approximately $60.7 billion, many of these to foreign investors. A large portion of the assets backing these covered bonds consisted of mortgages insured by CMHC or other mortgage insurers which insurance was backed by federal government guarantees (“Insured Mortgages”). Because of a general reluctance to allow federally regulated financial institutions (“FRFIs”) to effectively issue secured debt that would rank ahead of depositors, the Office of the Superintendent of Financial Institutions (“OSFI”) limits the amounts of covered bonds that any FRFI can issue to 4 per cent of the FRFIs assets.

### Covered Bond Legislation

The passage of the Covered Bond Legislation established a statutory covered bond regime for eligible Canadian issuers. The Legislation prohibits (and has prohibited since its proclamation) the use of Insured Mortgages as collateral for any bonds registered in accordance with such legislation. Collateral is limited to

(a) “loans made on the security of residential property that is located in Canada and consists of not more than four residential units,”

(b) securities that are issued by the Government of Canada, and

(c) any other prescribed assets.

However, in the case of (a) above, the loans may not include loans insured by CMHC or other mortgage insurance companies or loans where the amount of the loan exceeds 80 per cent of the value of the property at the time of the loan. Also, the value of assets in (b) above must not exceed 10 per cent of the total covered bond collateral. The result is that covered bond collateral may no longer consist primarily of assets of or guaranteed by the federal government.

The Legislation entrenches a requirement that statutory covered bonds be supported by collat-
eral that is owned by a separate Guarantor. A “covered bond” is defined in the Legislation as “a debt obligation in relation to which the principal and interest owing are guaranteed to be paid from the loans or other assets held by a guarantor entity,” and a “guarantor entity” is defined as “an entity that is created and organized for the principal purpose of holding loans or other assets as the covered bond collateral for a registered program with the intention of legally isolating those loans or other assets from the registered issuer.”

The primary benefits to investors in purchasing covered bonds issued by a registered issuer pursuant to a registered program under the Legislation are set out in ss. 21.63 and 21.64 of the NHA that provide as follows:

21.63 Nothing in any law of Canada or a province relating to bankruptcy or insolvency, or any order of a court made in relation to a reorganization, arrangement or receivership involving bankruptcy or insolvency, prevents or prohibits the following actions from being taken in accordance with the provisions of contracts relating to covered bonds that are issued under a registered program:

(a) the making of any payments, including a payment to a registered issuer;
(b) the netting or setting off or compensation of obligations;
(c) any dealing with covered bond collateral, including
   (i) the sale or foreclosure or, in Quebec, the surrender of covered bond collateral, and
   (ii) the setting off or compensation of covered bond collateral or the application of the proceeds or value of covered bond collateral; and
(d) the termination of those contracts.

21.64 Despite anything in any law of Canada or a province relating to bankruptcy or insolvency, or any order of a court made in relation to a reorganization, arrangement or receivership involving bankruptcy or insolvency, the transfer of loans or other assets to a guarantor entity - to be held as covered bond collateral - by a registered issuer, any of its affiliates or any prescribed entity

(a) is effective against every person;
(b) is not voidable or, in Quebec, annulable;
(c) is not subject to any other remedies available to creditors of the registered issuer; and
(d) does not constitute a fraudulent conveyance, unjust preference or other reviewable transaction.

All that is required for these benefits is that, at the time of issuance, a covered bond must be issued under a registered program and that, at the time that the covered bond collateral is transferred to the Guarantor, such transfer must be done by a registered issuer or its affiliates.

The Guide

The Guide builds upon the skeletal requirements of the Legislation and provides a comprehensive prescriptive framework for the issuance of covered bonds by eligible Canadian issuers.

CMHC’s Role

CMHC is to maintain a publicly accessible registry of all registered issuers and registered covered bond programs. CMHC is also given the power to grant registration to an issuer and each program and to suspend such registration. It is this power that gives CMHC the authority to dictate the balance of the requirements in the Guide.

CMHC’s statutory ability to suspend the rights of a registered issuer under a registered program appears to be unlimited and can be exercised for any reason, provided that the registered issuer is given 30 days’ notice of and the reasons for the intended suspension. The Guide indicates that CMHC will only exercise this power where there has been a failure of the registered issuer to comply with the requirements of the Guide or the Legislation. However, if a registered issuer is in financial distress it is conceivable that OSFI
would wish to restrict or prohibit the transfer of covered bond collateral from the issuer or its affiliates to the Guarantor. It is likely that CMHC would suspend an issuer or its programs if OSFI issued such a directive to the issuer.

**Requirements for Registered Issuers**

The Guide sets out the material that must be submitted by an issuer wishing to apply for registration, including an application form included as an annex to the Guide and the form of undertakings to be given. If it appears to CMHC that an applicant as a registered issuer does not comply or will be unable to comply with the requirements of the Guide or the Legislation, it will advise the issuer of its concerns. An issuer may supplement or resubmit its application; however, if CMHC ultimately rejects the application there appears to be no right of appeal. The application fee for registration as a covered bond issuer has initially been set at $700,000 per issuer.

**Requirements for Registered Programs**

The Guide sets out all the material that must be provided in order to register a covered bond program, including the application form in an annex. The material also includes a “pro forma Public Offering Document” stipulating areas of mandatory disclosure for each program and requires the filing of all material transaction documents. It appears that the intent of these requirements is to replicate for covered bonds the level of disclosure that would be available on SEDAR for publicly issued debt. Each registered program must also have a custodian for the covered bond collateral, a bond trustee to act on behalf of bondholders, and a qualified cover pool monitor. The initial and annual fee for registration of each covered bond program has been set at $700,000 per program per year, regardless of the size of the program. This is in addition to the registered issuer application fee.

It is also necessary to file legal opinions addressing, among other things, (a) true sale and (b) non-consolidation. The Guide does not set out any restrictions on the factual assumptions or qualifications that can be made in this opinion. At best, these opinions can only be reasoned opinions based on the state of facts in existence not only at the time the opinion is given but also at all relevant times into the future. Since there is a high likelihood that in the event of financial distress of the issuer facts may not transpire exactly as they are supposed to under the transaction documents, it is really not clear what these opinions will add to the statutory protection afforded by the Legislation.

The opinion that an investor should be seeking is that, even if under case law the transfer of assets could be recharacterized as merely granting security over the assets or the Guarantor could be consolidated with the issuer upon the issuer’s insolvency, the covered bond collateral will nevertheless be available to covered bondholders in priority to all other claimants as a result of the Legislation. This is the only reason that the entire statutory regime is necessary.

**Ratings and Rating Triggers**

If covered bonds are outstanding under a registered covered bond program, at least two rating agencies must at all times have current ratings attached to at least one series or tranche of covered bonds outstanding under the program. There appears to be no requirement as to what these ratings must be.

The transaction documents must prescribe that certain things happen upon the downgrade of the credit rating of the issuer below a level
prescribed in the documents (a “ratings trigger”), including

(a) the establishment of a cash reserve sufficient to satisfy in full the Canadian dollar equivalent of all interest payments due under all series or tranches of covered bonds outstanding for a period prescribed in the transaction documents,

(b) the application of pre-maturity tests designed to ensure that the covered bond collateral includes sufficient cash to satisfy in full the Canadian dollar equivalent of all principal payments due under all series or tranches of hard bullet covered bonds outstanding for a period prescribed in the transaction documents, and

(c) a curtailment of cash comingling of the Guarantor’s cash with that of the issuer.

**Covered Bond Collateral**

In addition to the restrictions on covered bond collateral set out in the Legislation, the Guide stipulates additional criteria in order for mortgage loans to constitute “Eligible Loans.” These additional requirements, which are tested as at the time of the transfer to the Guarantor, include

(a) no payments of principal or interest may be in arrears,

(b) at least one payment of principal or interest (or blended payment) must have been made in accordance with the terms of the loan,

(c) the loan must constitute a first mortgage,

(d) the loan must not be secured by a mortgage that also secures an insured mortgage loan, and

(e) the loan must have been originated in accordance with the issuer’s or its affiliate’s approved underwriting policies in effect at the time that the loan was originated.

Each registered covered bond program must also establish a minimum and maximum level of over-collateralization. For this purpose, each program must have an “Asset Percentage” that is the ratio (expressed as a percentage) of the Canadian dollar equivalent of the principal amount of all covered bonds outstanding under the program to the value of the covered bond collateral established in accordance with the Guide. Minimum Asset Percentages are to be determined by the registered issuer with regard to limits, if any, imposed by regulatory or supervisory authorities. The maximum Asset Percentage for a registered covered bond program can be up to 100 per cent and must be disclosed in any public offering document and be the subject of a contractual covenant in the transaction documents in favour of bondholders.

**Mandatory Disclosure**

Each registered issuer is required to establish a website for its registered covered bond programs. Covered bond investors must have access to this program website on a continuous basis, and the website may, but need not be, password protected. The program website must be set up so that it can be accessed by following a link from the CMHC registry website. The Guide also sets out a number of other requirements for each program website.

Except in the case of private placements (discussed below), a registered issuer is required to provide investors with full, true, and plain disclosure of all material facts concerning its covered bond program and the bonds. This is the level of disclosure required for public offerings under Canadian securities laws, and the Guide intentionally incorporates the concepts of “full,
true and plain”, “material fact,” and “material change” into its disclosure requirements. An annex to the Guide sets out the minimum level of disclosure that must be included in public offering documents.

There is a confusing exception to the public offering document requirement for covered bonds issued on a “private placement basis.” The term “private placement basis” is not defined in the Guide, but, from the context, it appears that “private placement” is to be determined based on each jurisdiction where the covered bonds are offered. In a distribution in a jurisdiction where a prospectus, a registration statement, or a similar disclosure document is required by applicable securities legislation, the distribution will not qualify as a “private placement.” However, an “offering memorandum” requirement is not sufficient to designate an offering as not being a private placement. Unfortunately, the term “offering memorandum” is also not defined. Canadian lawyers should generally be able to determine what a private placement will be in the context of a distribution in Canada. However, in other jurisdictions it may be much more difficult to determine whether or not a public offering document is required under the Guide.

**Ranking of Covered Bonds on Insolvency of the Issuer**

In addition to bondholders having a claim against the covered bond collateral, the terms of any covered bonds issued under a registered program must provide bondholders with a claim against the registered issuer for any deficiency in the payment of all principal, interest, and other amounts owing. Unless the governing legislation of the issuer provides otherwise, the covered bonds are to rank *pari passu* with ordinary depositors of the issuer and at least *pari passu* with the unsecured unsubordinated creditors of the issuer (other than creditors with legislated priority).

It should be noted that, although OSFI currently limits the amount of covered bonds that a FRFI can issue to 4 per cent of its total assets, there is no regulatory limitation on the ability of a registered issuer to continuously transfer assets to the Guarantor to top up the covered bond collateral. It is possible that, at some point, OSFI may establish limits on the amount of overcollateralization for covered bonds. However, this limitation would not likely preclude issuers from transferring additional covered bond collateral if existing covered bond collateral were written down. In this case, OSFI could issue a specific directive to the issuer to stop these transfers.

**Cover Pool Monitors**

The Guide stipulates that every registered issuer is required to engage a qualified cover pool monitor that must be an accounting firm qualified to be an auditor of the issuer under the issuer’s governing legislation and Canadian auditing standards, or such other class of firm or company approved by CMHC. The cover pool monitor is to undertake certain prescribed procedures in relation to a registered program and issue an annual report to the issuer, CMHC, and the bond trustee as to the results of applying specified auditing procedures. Details regarding the procedures are set out in an annex to the Guide.

**Reporting and Notifications**

Each registered issuer is to provide an annual compliance certificate in the form set out in an annex to the Guide. In addition, registered users must provide notice to CMHC of any material
change made to the terms of its registered covered bond programs no later than the earlier of (i) the date that such notice is provided to rating agencies or investors and (ii) five business days following the effective date of such material change. In addition, there are certain specified actions (such as the occurrence of a ratings trigger or failure to perform any remedial action required upon a ratings trigger) that must be notified to CMHC.

**Conclusion**

The focus of the Guide is on investor protection. Building upon the statutory protection provided to covered bond investors in the Covered Bond Legislation, the Guide’s requirements regarding eligibility of loans as collateral, terms that must be included in each registered program, and disclosure by each registered issuer appear intended to compensate for the fact that Insured Mortgages may no longer be used as covered bond collateral. I expect that Canadian covered bond issuers will willingly embrace the requirements in the Guide in the hope of developing a covered bond market that is no longer dependent on government guaranteed Insured Mortgages as collateral.

[Editor’s note: Michael Feldman is a partner of Torys LLP. His practice focuses on corporate and commercial law with an emphasis on structured asset-backed financing, securitization, infrastructure finance, capital markets, secured lending, aircraft financing, and derivatives.]

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2. With the exception of para. 21.52(1)(b) extending the Legislation to provincially regulated cooperative credit societies, which has not been proclaimed in force as at the time of writing.
5. Until such time as para. 21.52(1)(b) of the Legislation is proclaimed in force (supra note 2), only federal institutions as defined in s. 2 of the Bank Act (Canada), S.C. 1991, c. 46, may apply to become registered issuers.
7. In addition to regulating FRFIs, OSFI now also regulates CMHC.
8. OSFI would have the power to do this if it felt that such transfers constituted an “unsafe or unsound practice.” See Bank Act, s. 645 (supra note 5).
9. The System for Electronic Document Analysis and Retrieval (“SEDAR”) is an electronic filing system developed by the Canadian Securities Administrators for the filing of documents required by provincial securities laws.
10. At the time of writing, no such limits have been published.
11. Supra note 4.
12. Supra note 8.

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**JOBS AND GROWTH ACT AND AMENDMENTS TO FINANCIAL SERVICES LEGISLATION AND GUIDANCE IN 2012**

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On December 14, 2012, the Parliament of Canada passed the *Jobs and Growth Act, 2012*,\(^1\) the second omnibus legislation in 2012 implementing the provisions of the federal Budget tabled on March 29, 2012. Earlier in 2012, the *Jobs, Growth and Long-term Prosperity Act*\(^2\) implemented certain other measures of the federal Budget. Both Acts introduce a number of amendments to the federal statutes affecting Canada’s financial institutions.