CAPITAL MARKETS MID-YEAR REPORT

TORYS EXPLORES THE LATEST DEVELOPMENTS AFFECTING CAPITAL MARKETS

OVERVIEW

As we approach the sixth anniversary of the global financial crisis, our report this year examines the current state of some of the key sectors in North American capital markets.

Public capital markets in North America appear to be rebounding with strength. May saw the announcement of one of the largest public offerings in Canada—Bank of Nova Scotia's sale of C$2.3 billion in shares of CI Financial by way of a bought deal. U.S. public markets have been very active—2013 was one of the strongest U.S. IPO markets in recent memory and positive trends continue into 2014. Despite continued scrutiny of the fairness of the public markets, and claims like those from Michael Lewis that the stock markets are rigged, investor confidence appears to be building, and recent regulatory initiatives, such as the implementation of the JOBS Act in the U.S. and the liberalization of marketing rules in Canada, have proved successful in creating a friendlier regime for companies looking to access North American public markets. Forthcoming changes in the Canadian private placement market are also expected to increase financing options for pre-IPO companies.

For Canadian banks, the preferred share market has finally re-opened over a year after the Basel Committee implemented requirements on non-viable contingent capital (NVCC) designed to reduce systemic risk. In the first five months of 2014, Canadian banks raised C$2.0 billion in preferred share offerings. The first offering of NVCC subordinated debt, however, is yet to surface and we expect the new rules will result in significantly less subordinated debt raised by financial institutions in Canada. While preferred share offerings by Canadian financial institutions have been well received by the market, mining companies have faced constraints raising sufficient traditional equity and debt capital and have increasingly been turning to streaming transactions, attracting investors outside the traditional stream space, such as pension funds and private equity firms.

Alongside encouraging activity in North American capital markets, some sectors continue to face regulatory uncertainty. Reform related to over-the-counter derivatives, often cited as an aggravating factor of the 2008 financial crisis, continues to drag. Similar to the U.S. experience under the Dodd-Frank Act, progress in establishing a comprehensive Canadian regulatory regime has been slower than expected. In the Canadian mortgage market, securitization programs sponsored by the federal government provided critical liquidity during the financial crisis. Current levels of government support are unlikely to go on indefinitely, but before the government can reduce its support, a more robust private market will need to develop. In the U.S., the trend toward inversions—transactions in which a U.S.-based multinational company lowers its overall effective tax rate by expatriating to a low-tax jurisdiction—appears to be accelerating. Some believe this surge may indicate that the window of opportunity for inversions may vanish as U.S. lawmakers apply greater scrutiny to these transactions.

To discuss any of the issues in the report, please contact the authors.

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CROSS-BORDER FINANCING OPPORTUNITIES: IPOS AND ALTERNATIVES

BY MILE KURTA, RIMA RAMCHANDANI
AND RICHARD WILLOUGHBY

Despite lingering concerns about the global economy and another quiet first quarter in 2014, the Canadian IPO market appears to be showing signs of life. While IPO activity in Canada has not reached the levels seen during the peak of the Canadian income trust boom in 2005, activity was relatively strong during 2013, and the pipeline for the remainder of 2014 appears to be building. Since the beginning of 2013, there have been 22 Canadian IPOs raising aggregate proceeds of over C$3 billion[1] in a variety of sectors, including real estate, technology, financial services, energy and consumer products.

The U.S. IPO market has been even stronger, with over 200 IPOs in 2013 yielding aggregate proceeds of over US$50 billion, a significant increase over the previous two years and one of the strongest U.S. IPO markets in recent memory. Companies from the energy, financial and health care sectors were dominant, representing over 50% of the aggregate IPO proceeds in 2013. U.S. IPOs by companies backed by private equity and venture capital firms were also on the rise compared to previous years. These trends have continued into 2014, with approximately 100 U.S. IPOs so far this year, led by the pharmaceutical, biotechnology, financial services, health care and technology services sectors.

Any company considering a Canadian IPO will inevitably face determining how best to tap the U.S. capital markets, whether through a concurrent U.S. public offering or private placement.

Cross-border IPOs

There are benefits for companies going public in Canada to simultaneously go public in the United States and become listed on a U.S. stock exchange. In addition to being a significant source of additional capital, the U.S. capital markets may provide better valuations for certain issuers, especially those whose peer group

[1] Representing completed IPOs in Canada raising over C$25 million in proceeds.

includes U.S. companies—and a dual listing generally results in greater liquidity for shareholders. Cross-border companies also have improved opportunities to use their securities as acquisition currency, since a U.S. listing will be viewed favourably by U.S. target stockholders.

Securities regulatory developments in both Canada and the United States continue to affect the cross-border IPO market. While the heightened corporate governance and auditing requirements imposed by the Sarbanes-Oxley Act (S-Ox) in the United States in the early 2000s were blamed for chilling the U.S. IPO market, more recent U.S. rule-making initiatives are having a positive impact, including the relaxation of regulatory requirements under the 2012 Jumpstart Our Business Startups Act (JOBS Act). Over 80% of U.S. IPOs since the beginning of 2013 involved emerging growth companies (EGCs), which, generally, are companies with less than US$1 billion in annual revenues. Most companies considering a Canadian IPO will qualify as EGCs, making them prime candidates for cross-border IPOs. The JOBS Act has significantly lowered the cost of going and staying public in the United States for these companies—at least for as long as they remain EGCs, which may be for a period of up to five years post-IPO.

One of the benefits afforded to EGCs under the JOBS Act is the ability to test the waters to gauge market interest in an IPO by communicating with certain sophisticated investors before filing a prospectus with the Securities and Exchange Commission (SEC). Testing the waters is also permitted in connection with Canadian IPOs. This regulatory change was implemented in Canada in mid-2013 as part of a larger suite of changes that liberalized the rules governing how public offerings may be marketed to Canadian investors. The changes resulted in the Canadian rules conforming more to the SEC's public offering rules, although there are still some cross-border differences. For example, in Canada there is a 15-day quiet period after testing the waters for an IPO before a preliminary prospectus may be filed. And in the United States, materials other than the IPO prospectus, known as "free-writing prospectuses" (equivalent to "marketing materials" in Canada), cannot be given to investors until a price range is disclosed. These rule differences must be navigated during transaction planning and marketing, but the bigger picture for IPO markets is that securities regulators on both sides of the border now permit issuers and underwriters to gauge investor interest before publicly launching a deal and, during the marketing phase, investors now have access to term sheets and other helpful summary information.

In addition to permitting testing the waters, the JOBS Act provides several other accommodations to EGCs. These companies may defer compliance with auditor attestations of internal controls (a requirement originally imposed by S-Ox that is often of particular concern given the costs and time associated with compliance). EGCs may make confidential submissions of IPO registration statements with the SEC, which both mitigates the market risk of having a prospectus on the public record during what could be a very lengthy SEC regulatory review process and results in better alignment with the generally shorter Canadian regulatory review

process. EGCs may also provide reduced disclosure in their prospectuses, including fewer years of audited financial statements and selected financial information and less detailed executive compensation information. Canadian EGCs conducting cross-border IPOs are also permitted to present their financial statements under International Financial Reporting Standards without having to provide a U.S. GAAP reconciliation.

An alternative to conducting a cross-border IPO is to go public in Canada first and later conduct a public offering in the United States. A company that is already public in Canada can qualify as an EGC for purposes of a U.S. IPO, and if the company has been public in Canada for at least one year and has a public float of more than US$75 million, it may simultaneously take advantage of the JOBS Act and the multijurisdictional disclosure system (MJDS). The MJDS permits companies with a one-year Canadian reporting history to plan and execute a U.S. IPO with minimal U.S. securities regulatory involvement. This approach accommodates a U.S. IPO but without the usual U.S. regulatory and consequential timing risks.

Barriers to entry for Canadian issuers are diminishing, including because U.S. investment banks are becoming more comfortable using a Canadian company's existing public disclosure for U.S. marketing purposes.

Private Placement Alternatives

There are many companies, however, whose capital needs and business objectives simply do not warrant a cross-border IPO, or for which the benefits are outweighed by the added regulatory burdens and greater litigation and shareholder activism risks associated with becoming a U.S. registrant. For these companies, conducting a Canadian IPO combined with a U.S. private placement is the most common alternative. One of the more popular methods of accessing the U.S. capital markets in connection with a Canadian IPO is through a Rule 144A private placement of securities to sophisticated U.S. institutional investors, known as qualified institutional buyers or QIBs. Given the high threshold that investors must meet to be eligible to participate in Rule 144A offerings, Canadian issuers also often rely on Rule 506 of Regulation D. Rule 506 has historically been one of the most widely used private placement exemptions, in part because it permits offerings not just to QIBs but to a broader group of accredited investors. However, Rule 506 offerings were singled out for stricter treatment under the JOBS Act through the so-called bad actor rules, which prohibit certain individuals from participating in these offerings. In some cases, the effect of the bad actor rules has been to prevent or discourage issuers from relying on Regulation D.

The popularity of Rule 144A is demonstrated by recent cross-border offering

statistics. Virtually every large Canadian IPO in 2013 and 2014 to date has included a U.S. private placement tranche under Rule 144A. A much smaller number of these transactions included a Rule 506 offering. To facilitate concurrent Canadian public/U.S. Rule 144A offerings, there has been a trend to reduce the complexities associated with these transactions. For example, Canadian companies that have little or no trading in the U.S. (which is likely the case for an issuer going public in Canada) can structure the offering so that securities issued in the United States do not have a legend, provided the purchaser is a QIB and covenants to resell the securities to the company or in accordance with the offshore resale exemption provided by Rule 904 of Regulation S. Although not universally accepted, this approach may alleviate some of the concerns that U.S. investors have with purchasing restricted securities, including the potential delays and expenses associated with removing legends on securities.

Another financing option available is the U.S. high-yield debt market. “Rule 144A for life” offerings, which involve privately placing bonds without back-end registration rights, are becoming more common and are losing the stigma historically associated with bonds that are not registered with the SEC. In our experience, barriers to entry for Canadian issuers are diminishing, including because U.S. investment banks are becoming more comfortable using a Canadian company’s existing public disclosure for U.S. marketing purposes.

Canadian Exempt Market Opportunities

Regulatory initiatives in Canada can also be expected to increase capital-raising opportunities, especially for pre-IPO companies. Canadian securities regulators have explicitly adopted the objective of facilitating financings in the exempt market with a focus on small- and medium-sized businesses. Various initiatives are underway in Ontario and other provinces that are expected to permit crowd-funding as well as improve opportunities to market securities using an offering memorandum instead of a prospectus and to sell securities to close friends and family. Predictably, these changes to the exempt market are accompanied by regulatory counter-measures to protect retail investors, including tightening access to the accredited investor and minimum amount exemptions, imposing new filing requirements and requiring investors to sign risk acknowledgment forms. However, we do not expect these measures to significantly undermine the overall objective of liberalizing the exempt market. Most importantly, if the planned regulatory changes are implemented successfully, they should facilitate small- and medium-sized companies becoming IPO candidates in the future.

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THE PREFERRED SHARE MARKET FINALLY RE-OPENS FOR CANADIAN BANKS

BY BLAIR KEEFE, DAVID SEVILLE
AND THOMAS YEO

In the last few years, Canadian banks have been effectively sidelined from the preferred share and subordinated debt markets. The first half of 2014 has finally seen that market open again, with six Canadian banks completing preferred share offerings in the first five months of the year, and we expect to see more follow.

Background

In January 2011, the Basel Committee released new requirements that all non-common capital instruments issued on or after January 1, 2013 contain provisions that require them to be converted into common shares if the relevant regulator determines that the bank is no longer viable (thus the term non-viable contingent capital or NVCC). Capital instruments lacking NVCC features that were outstanding on January 1, 2013 no longer qualify as capital and must be phased out. It is estimated that as of October 31, 2013, the six largest banks in Canada had approximately C$50 billion of non-NVCC subordinated debt and preferred shares outstanding[1], much of that issued in the wake of the financial crisis and now coming up on the five-year rate reset and redemption right of the banks.

What was once a $10 billion-per-year market—one that helped fund the banks' growth and allowed ongoing redemptions from time to time of outstanding subordinated debt and preferred shares—went dry as banks considered how to implement NVCC. There was no strong incentive for banks to rush to market with NVCC instruments as the phase-out rules for the existing non-NVCC instruments were relatively favourable and, under the new Basel III rules, common share equity has become the predominant form of capital in any event. As well, no bank was eager to be the first to release an offering as there was a general assumption that the first issuances of NVCC instruments might require a significantly higher coupon or interest rate to compensate investors for the risk of a triggering event conversion. Additionally, banks were hopeful that the Office of the Superintendent of Financial Institutions (OSFI) might reconsider its requirement that the NVCC conversion features be built into the terms of the instruments and move to a statutory regime utilized by other major

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[1] Based on the financial statements of Toronto-Dominion Bank, Royal Bank of Canada, Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce and National Bank of Canada for the financial year ended October 31, 2013.

jurisdictions, including the United States. In the end, OSFI maintained its position by requiring contractual NVCC.

2014: The First NVCC Preferred Shares

There were no NVCC offerings throughout 2013, the first year in which the new requirements were in force; the first Canadian bank did not jump back into the preferred share market until January 2014. Royal Bank of Canada (RBC) announced a C$200-million offering of NVCC rate reset preferred shares on January 21, 2014—a deal that was quickly upsized to C$500 million. RBC's deal paved the way for five more Canadian banks to access the preferred share market, as Toronto-Dominion Bank, Bank of Montreal, National Bank of Canada, Canadian Western Bank and Laurentian Bank raised a total of C$2.0 billion in the first five months of 2014 and RBC completed another C$500 million offering in late May. The offerings were well received by the market, evidenced by the upsizing of some of the deals after announcement, and the pricing of the deals generally, which were estimated to be only 10 to 30 basis points higher than the expected dividend rate on a similar non-NVCC instrument.

The NVCC Market Going Forward

The market is still waiting for the first offering of NVCC subordinated debt. There are a few reasons why the banks have remained hesitant to tap that market. One reason relates to changes in capital ratios mandated by Basel III, which reduce the need for subordinated debt on a bank's balance sheet. Prior to the introduction of Basel III, subordinated debt could account for almost one-third of the total capital of a bank. With the new minimum total capital requirement of 10.5%[2] (including a countercyclical capital buffer of 2.5%) of risk-weighted assets and a 8.5% minimum for tier 1 capital, effectively the most that can be satisfied with subordinated debt is 2% of the bank's risk-weighted assets. As well, under Basel III, most deductions from capital must be made from common share equity, whereas in the past, certain deductions could be made from total capital. Effective January 1, 2015, the leverage or asset-to-capital ratio in Canada will be based on tier 1 capital as opposed to total capital. This requirement is particularly important for smaller deposit-taking institutions because they tend to be limited by their asset-to-capital multiples. As a result, we expect that subordinated debt will be eliminated from the capital structure of many smaller institutions—and will form a significantly smaller portion of the capital structure of larger institutions than it has historically.

Market uncertainty also remains over how the proposed "bail-in" debt regime will interact with NVCC instruments. In October 2011, the Financial Stability Board issued a paper providing that regulators should have the power to convert (or write off) all or

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[2] An additional 1% surcharge will apply to the largest six banks, which were designated as domestic systemically important banks by Office of the Superintendent of Financial Institutions in March 2013. The surcharge will apply by January 1, 2016.

part of the unsecured and uninsured creditor claims of a financial institution under resolution into equity or other ownership instruments. It was proposed that such a conversion would be done in a manner that respects the hierarchy of claims in liquidation. The 2013 Canadian federal government budget includes a proposed plan to implement a "bail-in" regime for systemically important banks[3]; Canadian banks and the market generally are still waiting for details as to how the federal government intends to implement this regime. The institutional investors that make up the vast majority of the market for subordinated debt are particularly concerned with how the bail-in regime will function and the effect of further dilution after NVCC instruments are converted, resulting in a "wait-and-see" approach to investor interest in NVCC subordinated debt offerings.

The precise conversion formula to be adopted by the banks for NVCC subordinated debt is not yet known. Under OSFI's requirements, conversion formulas for both NVCC preferred shares and subordinated debt need to be set to ensure respect for the relative hierarchy of claims between the two types of instruments in the event of a triggering event. In other words, since debt ranks ahead of equity in the traditional capital structure, in the event of a triggering event, holders of subordinated debt

We expect that subordinated debt will be eliminated from the capital structure of many smaller institutions—and that it will play a much smaller role for larger institutions.

should receive more common shares on conversion than holders of preferred shares on a dollar-for-dollar basis. The banks have put substantial effort in the development of a formula used in the preferred share offerings which addresses concerns about potential market manipulation and death spirals in situations where conversion appears to be a possibility. As of the date this article was written, all offerings of NVCC preferred shares have used the same formula based on the issue price of the preferred shares, plus declared and unpaid dividends, divided by the volume- weighted average trading price over the 10 trading days before a triggering event, subject to a $5.00 floor price. It is unlikely that other banks will depart from this formula. The preferred share formula would suggest that the conversion formula for subordinated debt will use some multiple of the principal amount of the debt, together with accrued interest, to achieve the hierarchy of claims desired by OSFI. Issuers of NVCC subordinated debt should consider obtaining an advance income tax ruling from the Canada Revenue Agency confirming the deductibility by the bank of the interest payments, although we anticipate no difficulty in banks obtaining that ruling.

[3] Supra, note 2.

In the early days of NVCC offerings in Canada, Canadian banks have been content to stick to offerings of preferred shares. Although there has been a healthy appetite for the offerings so far, the market for these shares is principally Canadian retail investors. If the Canadian preferred share market is ultimately not large enough to fulfill the banks' capital needs, banks will need to turn to subordinated debt.

Canadian banks are also hopeful that an additional tier 1 capital instrument in which the distributions from the instruments could effectively be deducted for tax purposes by banks will eventually be available for issuance in Canada. Banks in other jurisdictions have access to this type of financing, which involves a hybrid debt instrument. Such instruments require careful structuring to achieve the desired tax, accounting and regulatory capital treatment.

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STREAMING TRANSACTIONS IN THE MINING SECTOR: A FINANCING LINCHPIN

BY MICHAEL AMM AND IAN ARELLANO

As the challenging environment for mining sector financing continues, streaming transactions are playing a prominent role in bridging the "financing gap". Traditional equity, debt and project finance markets have not been available to mining companies to the extent they have been in the past. Mining companies have had to become more creative in financing the development of their projects and their M&A transactions—and they have increasingly turned to streaming transactions as a catalyst to help secure an overall financing package.

Background

A streaming transaction is an agreement whereby a financing party agrees to purchase future deliveries of minerals from an identified property in exchange for a significant up-front advance payment, referred to as a "deposit", which is applied against future deliveries, typically together with additional ongoing fixed payments (which are a portion of the market price) as the minerals are delivered. The transaction is essentially a long-term commodity purchase contract at pre-agreed prices with the delivery obligations contingent on future production over a specified period or for the life of mine. The financing party obtains exposure to mineral prices and the ultimate size and grade of the underlying resource, but not construction or production cost risks. Like a senior lender, the financing party normally takes security over the project assets and related subsidiary companies to secure the performance of the obligations under the streaming agreement. Streaming transactions are typically based on the production of precious metals, whether as the main output or as a by-product of a base metals project; however, the streaming model can also be used with respect to other commodities. Basically a hybrid transaction structure with both secured debt and equity-type participation characteristics, stream financing arrangements are highly customizable to fit the specific needs of a particular mining company, a particular project and the related financing requirements.

Streaming transactions are used by mining companies to finance resource development and the acquisition of new resource assets and to monetize a portion of the value of existing assets. Major streaming transactions in recent years have included Inmet Mining's US$1 billion precious metals streaming agreement with Franco-Nevada for the development of its Cobre Panama mine and Vale's US$1.9 billion precious metals streaming agreement with Silver Wheaton in connection

with its Salobo, Brazil and Sudbury, Canada mines. In addition to these large deals, streaming transactions have been completed in smaller amounts, including some transactions valued in the several millions of dollars. Financing parties have historically been the major streaming companies such as Franco-Nevada, Silver Wheaton, Royal Gold and, more recently, Sandstorm. Increasingly, other players, such as major pension funds and mining-focused private equity firms, are becoming active participants.

Recent Transactions

In 2014 there have been several examples of streaming transactions forming a key part of a multifaceted financing package for M&A transactions and project development. Stream financing has been filling the gap created by the challenges of raising sufficient traditional equity, debt and project financing.

In February 2014, Klondex Mines completed its US$83 million acquisition of the Midas mine and related ore milling facility from Newmont Mining, which transformed Klondex from an explorer to a producer with fully integrated operations. The acquisition and related expenses and debt repayment were funded through a C$42.6 million equity private placement, mezzanine debt in the form of C$25 million principal amount of 11% secured notes and a US$35 million streaming and royalty arrangement with Franco-Nevada. The Franco-Nevada financing arrangement included a prepaid gold stream requiring the delivery of 38,250 ounces of gold over five years and separate 2.5% net smelter return royalties on Klondex's Midas and Fire Creek properties to take effect following the completion of the fixed gold deliveries.

Stream financing has been filling the gap created by the challenges of raising sufficient traditional equity, debt and project financing.

Stream financing from a non-traditional stream investor played a prominent role in Osisko Mining's proposed partnership with Yamana Gold as an alternative to Goldcorp's original C$2.6 billion unsolicited takeover bid. The proposed transaction with Yamana was supported by C$550 million of new financing from La Caisse de dépôt et placement du Québec (the Caisse) and the Canada Pension Plan Investment Board. The contribution of the Caisse was a C$275 million gold stream to acquire 37,500 ounces of gold per year from Osisko's Canadian Malartic mine. The stream commitment included a repurchase and put clause that would have provided the Caisse with a guaranteed minimum return of 8%. The financing transactions were ultimately not implemented as Osisko entered into a different business combination agreement with Yamana and Agnico Eagle Mines as a response to a subsequent improved unsolicited offer from Goldcorp.

First-of-its-kind stream financing based on diamond production has been proposed as

a significant portion of a C$944 million comprehensive financing package to permit Stornaway Diamond Corporation to complete its Renard diamond project in Quebec. The financing package consists of equity financing, senior and mezzanine debt facilities, separate cost overrun credit facilities and a US$250 million diamond stream financing to be provided by the Orion Mine Finance Group and the Caisse. Under the stream financing, the stream buyers will purchase a 20% undivided interest in the diamonds produced from specified portions of the project.

Key Issues

Certain key issues often encountered in structuring and implementing stream financing agreements are described below.

Deposit

The manner, timing and conditions for the payment of the deposit by the stream financer are key areas of focus. The deposit may be paid in a single lump sum or by way of installments based on the satisfaction of certain conditions or on the contribution of certain other financing. In most cases, the stream financer seeks to ensure that its contribution is "last dollar"—i.e., once the deposit is advanced, the project will have sufficient financing to reasonably assure completion. Stream financers rely on deliveries of commodities based on the production of the mine for its return, so they are particularly focused on the risk of project non-completion.

Remedies

Streaming agreements usually provide for two types of remedies depending on the timing and nature of a breach. In certain circumstances, the remedy may be a refund of the deposit plus interest; in other circumstances, the remedy may be a payment of the greater of that amount and the present value of the remaining mineral deliveries under the stream. These variable remedies reflect the fact that a stream is different from a loan in many respects and allows the financing party to benefit from commodity price and mining project upside potential.

Intercreditor Issues

In many cases, stream financing transactions are implemented in conjunction with existing credit facilities or new credit facilities arranged as part of an overall financing that includes the stream. In either case, intercreditor issues need to be addressed as the stream financing and credit facility will likely share the same security package. The stream financing will most often rank behind the credit facility, but there are situations where it may rank equally. A stream financer relies primarily on the mineral stream for the return on its financing and therefore will usually seek provisions allowing for stream deliveries to continue in all circumstances where the mine is operating (even when there is a default under the senior facility) and for any realization process to ensure that the mining assets are sold as a whole to allow operations to continue and the new owner to acknowledge the obligations under the stream. These and related issues are often fundamental for both the stream

financer and credit facility lender and should be addressed as early as possible in the transaction process.

Joint Ventures

Operators seeking stream financing often have joint venture partners with a minority interest in the underlying asset. In these cases, it is necessary to have the joint venture partner agree to and participate in the stream transaction, or to structure the transaction so that it affects only the majority interest of the operating partner.

Tax Structuring

Stream financing transactions are typically quite sensitive to tax, and pricing is based on specific assumed tax treatment. As a result, careful planning, often on a multijurisdictional basis, is needed when structuring the transaction. Transaction agreements also need to address the issue of how a change in tax treatment will be handled.

Ratings Implications

In 2013, Standard & Poor's announced that it would start taking a closer look at streaming transactions, with the possibility of classifying the transactions as debt for the purposes of ratings analysis depending on specified transaction characteristics. This has focused larger mining companies on the credit rating implications of streaming transactions and certain adjustments to the structure to avoid potential debt characterization.

Conclusion

As financing challenges continue to impact many mining sector participants, we expect that streaming transactions will both continue to have a strong presence in the sector and evolve in tandem with other creative financing solutions.

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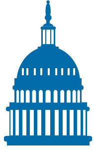
UNITED STATES INVERSION OPPORTUNITIES

BY CORRADO CARDARELLI, PETER KEENAN
AND DAVID MATTINGLY



By some measures, the United States imposes the highest nominal corporate income tax of any OECD country.[1] As a result, a number of U.S.-based multinational corporate groups have recently decided to lower their overall effective tax rate by expatriating to another country. Generally this means combining with a foreign (non-U.S.) partner corporation in an "inversion" transaction. The trend toward inversion appears to be accelerating.

In a typical inversion, a U.S. corporation and a foreign partner effectively become subsidiaries of a new foreign holding company located in a low-tax jurisdiction such as Ireland. Shareholders of the U.S. corporation and its foreign partner transfer their shares to the new foreign parent in exchange for parent stock and possibly other consideration. The key to a successful inversion is that former shareholders of the U.S. corporation must own less than 80% of the stock of the new foreign parent. If the former shareholders own 80% or more of the new foreign parent, then the parent will be taxable as a U.S. corporation under the U.S. anti-inversion laws.

The tax savings of inverting can be dramatic. As reported in *The Wall Street Journal*, a successful inversion combining Pfizer Inc. and AstraZeneca plc could reduce Pfizer's annual tax bill by $1 billion or more, according to one estimate.[2]

Recent Deals

Recent deals reflect the pattern of U.S. and foreign partners combining under a new parent in a low-tax jurisdiction. Earlier this year, for example, Endo Health Solutions Inc. (a U.S. corporation) combined with Paladin Labs Inc. (a Canadian corporation) under a new parent, Endo International plc (an Irish corporation).

The expatriating U.S. corporation often seeks a foreign partner already located in an appropriate low-tax jurisdiction, simplifying tax structuring. For example, the

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[1] OECD, "Taxation of Corporate and Capital Income," Table II.1. Corporate Income Tax Rate (2013), available at http://www.oecd.org/tax/tax-policy/Table%20II.1_May%202013.xlsx.

[2] Liz Hoffman, "Pfizer Sees Tax Savings from AstraZeneca Deal," *The Wall Street Journal* (April 28, 2014).

combination of Actavis, Inc. (United States) with Warner Chilcott plc (Ireland) under Actavis plc (Ireland) reflects this approach. The same could be said of the proposed combination of Pfizer Inc. (United States) and AstraZeneca plc (United Kingdom) under a new United Kingdom holding company.

One aspect of the Endo and Actavis transactions described above is the necessity for the expatriating U.S. company to identify a smaller but still substantial foreign partner. A foreign partner that is too small triggers the 80% rule described above. If, for example, the foreign partner is worth 20% or less of the combined company, then in an all-stock deal, the U.S. corporation's former shareholders would presumably receive 80% or more of the shares of the new foreign parent. As a result, the new foreign parent would be taxable as a U.S. corporation.

A surge in inversions may indicate that some U.S.-based multinational groups believe the window of opportunity for inverting under the current rules could vanish.

On the other hand, if the U.S. corporation's former shareholders receive between 60% and 80% of the new foreign parent stock, then a different anti-inversion rule applies. Under this rule, U.S. tax applies to certain "inversion gain" of the former U.S. parent over a limited period of time. Public filings by Actavis Inc. indicate that this tax on "inversion gain" may be triggered by its combination with Warner Chilcott plc.[3]

Based on the rules described above, a U.S.-based multinational group that seeks to invert must carefully select its foreign partner.

A Window of Opportunity?

The surge in inversions may indicate that some U.S.-based multinational groups believe the window of opportunity for inverting under the current rules could vanish. The current rules clearly have ceased to have the desired effect. As noted recently by John Koskinen, the U.S. Commissioner of Internal Revenue, "We've done, I think, probably all we can within the statute. We try to make sure people are within the bounds, but if they're within the bounds, if they play according to the rules, then they have a right to do that [i.e., to invert]."[4]

If the groundswell of indignation over inversions fails to subside, then the U.S. Congress may feel compelled to act. One possible outcome would be for Congress

[3] Actavis Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (filed August 1, 2013).

[4] Quoted in Richard Rubin, "Treasury Said to Seek U.S. Crackdown on Corporations Making Offshore Tax Deals," Bloomberg BNA Daily Tax Report (April 30, 2014).

to overhaul the U.S. tax regime and lower the corporate tax rates. At least as likely, however, is that Congress will enact severe new anti-inversion laws.

On May 20, 2014, U.S. Senator Carl Levin introduced legislation that would dramatically limit the ability of a U.S. corporation to expatriate. The legislation would replace the 80% threshold and the 60% to 80% rule described above with a single 50% threshold. In other words, ownership of more than 50% of the new foreign parent by former shareholders of the U.S. expatriating entity would cause the foreign parent to be taxable as if it were a U.S. corporation, thereby eliminating the U.S. tax benefit of inverting. The benefit would also be eliminated if the foreign parent's expanded affiliated group is primarily managed and controlled in the United States and has significant business activities in the United States, whether or not the 50% test is satisfied.

If enacted as proposed, Senator Levin's new rules would be effective for transactions completed after May 8, 2014, and before May 9, 2016. Thus the proposed legislation directly targets today's typical inversions, including transactions not yet consummated, such as the proposed combination of Pfizer and AstraZeneca. Unlike the proposed legislation, similar anti-inversion rules proposed by the Obama Administration would affect only transactions completed after December 31, 2014.

How and when the U.S. Congress will act to stem inversions remains uncertain.

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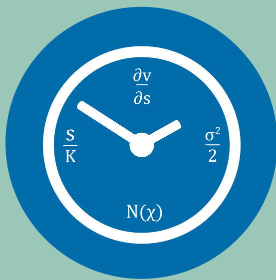
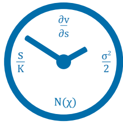


OTC DERIVATIVES REGULATION: END USERS MARK TIME

BY CHRISTOPHER FOWLES



Canadian initiatives to regulate over-the-counter (OTC) derivatives—customized contracts whose values or obligations are based on the performance of an underlying asset, index, rate or other variable—gathered momentum in the past year, but progress has been slow and uncertain.

Financial institutions and sophisticated buy-side market participants that invest globally, such as Canada's major pension funds, have been tracking the more advanced American and European OTC derivatives regulatory developments and are preparing for regulation in Canada. Many commercial (non-financial) end users whose operations are primarily Canadian and who use derivatives mainly to hedge interest rate, currency and commodity risks, have felt the effects of U.S. OTC derivatives legislation and are standing by for Canadian regulation to be implemented. But so far, they have little incentive to commit significant management time and financial resources to getting up to speed on legislative initiatives and preparing for compliance.

Derivatives and their Role in the Financial Crisis

Derivatives are unquestionably a useful and efficient way for commercial entities and financial institutions to hedge or mitigate interest rate, currency, credit and other risks. However, derivatives can also be used to engage in excessive speculation, particularly since they allow investors to make highly leveraged bets on existing risks or to gain exposure to risks created solely for speculative purposes. While governments, regulatory agencies and market participants still debate the reasons for the 2008 financial crisis, the use of OTC derivatives, if not a cause, was at least an aggravating factor. Among OTC derivatives, the credit default swap—an insurance-like contract that allows parties to isolate the risk of certain credit events (such as a company defaulting on a loan obligation or becoming bankrupt) and to buy or sell protection against those events occurring—is singled out for its role in some of the worst excesses of the financial crisis. Complex financial instruments linked through credit default swaps to the performance of risky subprime mortgages contributed to the collapse, fire sale or bailout of several large financial institutions.

Canada, which weathered the global financial crisis relatively well, was forced to deal with its own homegrown crisis when investors, spooked by rising subprime defaults, balked at investing in highly rated non-bank-sponsored asset-backed commercial paper (ABCP). Issuers of non-bank ABCP, who were relying on investment in new

paper to repay paper coming due, were unable to retire outstanding ABCP. The use of credit default swaps added to these woes. Non-bank ABCP issuers entered into credit default swaps to sell long-term credit protection to international banks on portfolios of debt, asset-backed securities and other derivatives in order to generate a significant part of the yield on non-bank ABCP. When credit spreads (a measure of relative credit risk) increased and the credit protection became more valuable to the banks, the terms of the credit default swaps required ABCP issuers to provide more collateral to support their obligations, collateral they didn't have. For more than a year, the $32-billion non-bank ABCP market in Canada remained in a holding pattern while issuers, large investors, dealers and their advisers mapped out and implemented a plan to restructure the frozen paper.

The Road to Regulation

After several high-profile failures linked to the use of OTC derivatives, governments identified four main areas of risk associated with their unregulated use:

- systemic risk: the risk that the failure of one or more important counterparties could have knock-on effects on a larger number of interconnected financial markets participants, thereby putting global financial markets in jeopardy
- counterparty (credit) risk: the risk of a counterparty being unable to fulfill its obligations, which contributes to systemic risk if the counterparty has substantial positions in derivatives
- lack of transparency: lack of information about the OTC derivatives activities and financial position of banks, dealers and other large financial markets participants
- conflicts of interest: the skewing, often through misaligned incentives, of interests of institutions such as mortgage lenders, brokers and credit rating agencies in favour of certain stakeholders to the detriment of others

To address these risks, G-20 governments committed to principles requiring OTC derivatives to be:

- traded on exchanges or electronic trading platforms where appropriate;
- cleared through central counterparties (CCPs), which would require derivatives users to provide collateral to support their obligations;
- reported to trade repositories (TRs)—centralized storehouses of OTC derivatives data; and
- subject to higher capital and minimum margining requirements if not centrally cleared.

In the United States, the main vehicle for regulatory reform of OTC derivatives is the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). This voluminous piece of legislation, checking in at over 800 pages, comprehensively

overhauls U.S. financial regulation, including the regulation of OTC derivatives activities. Implementing Dodd-Frank is a massive undertaking requiring the passage of almost 400 rules. Not surprisingly, it has not proceeded as quickly or as smoothly as initially intended. However, although not all rules are final (and some are not even available in draft form), many important provisions are operative, so Canadian companies that do business with U.S. counterparties are already feeling Dodd-Frank's effects.

Canadian commercial end users are only beginning to consider how new legislation will apply to and affect their derivatives activities.

In Canada, the pace of regulation has been slow. Quebec was first out of the gate when its *Derivatives Act* came into force in 2009. Late in 2010, Ontario amended its *Securities Act* to put in place a framework for the Ontario Securities Commission (OSC) to regulate derivatives trading activities, derivatives trade repositories and clearing agencies, derivatives-related insider trading and tipping, and derivatives dealers and advisers. Most of the operative provisions are not yet in effect. Several other provinces have passed similar amendments to their securities legislation.

Of the rules intended to give substance to Ontario's regulatory framework, only two have been approved to date, both relating to derivatives reporting. One rule determines which derivatives transactions must be reported. The other rule provides for the regulation of TRs and mandates the reporting of derivatives data to TRs for transactions entered into by local counterparties organized or based in Ontario (or affiliates whose liabilities they are responsible for or derivatives dealers and other registrants under Ontario's *Securities Act*).

Under the reporting rule, reporting responsibility falls to counterparties that are either clearing agencies or derivatives dealers or, if neither counterparty is a clearing agency or derivatives dealer (if, for example, the trade is between two commercial end users), each local counterparty. Data to be reported include unique counterparty, transaction and product identifiers, detailed information about the terms of the transaction, any subsequent changes to previously reported data, and industry-standard valuation data.

Originally, derivatives dealers were to report new derivatives transactions beginning on July 2, 2014. In April 2014, citing the unreadiness of any TR to be designated to accept trade reporting, the OSC delayed the effective dates for reporting new transactions until October 31, 2014 for clearing agencies and derivatives dealers, and until June 30, 2015 for other parties (transactions in effect before those dates have later reporting dates). Since derivatives data that are not accepted by a designated TR must be reported to the OSC, the OSC's decision to wait for TRs to come online is understandable.

Canadian securities regulators have also published draft model rules covering mandatory clearing of derivatives through CCPs (with exemptions for derivatives used by non-financial entities to hedge or mitigate commercial risk and for certain intra-group transactions) and the treatment and transfer of customer collateral and positions. Some provinces may adopt final clearing rules by the end of 2014.

But much remains to be done. After trade reporting rules are fully in effect and clearing rules are finalized and implemented, regulators must still publish and finalize rules to deal with the registration of derivatives dealers, advisers and other market participants, exchange trading and collateral requirements.

Effect of Regulation on Commercial End Users

Canadian commercial end users are only beginning to consider how new legislation will apply to and affect their derivatives activities. Although experience in the U.S. may be instructive, many important consequences of OTC derivatives legislation will only be apparent once a fully constructed legislative regime is in place. Canadian OTC derivatives regulation for commercial end users will likely result in:

- more monitoring, oversight and board involvement in derivatives activities as end users implement derivatives trading policies to ensure regulatory compliance and to take advantage of any applicable exemptions from derivatives regulations
- increased costs of legal and operational compliance, including any additional capital and compliance costs passed on by dealers to their end user clients and any direct costs incurred by end users for record-keeping, reporting and clearing as well as for obtaining legal and accounting advice
- increased collateral requirements since both cleared and uncleared derivatives will require counterparties to post margin or collateral. The effects of collateral requirements may be felt more acutely by large creditworthy end users that so far may have provided little or no credit support to derivatives counterparties
- more basis risk (mismatch between the risk being hedged and the protection provided by derivatives) as end users trade the more precise hedge of a tailor-made, uncleared derivative that requires more collateral for the imperfect hedge of a ready-made cleared derivative requiring less collateral. Eventually, a sufficiently broad suite of exchange-traded and cleared products may be available to allow end users to cover common commercial risks through one or more exchange-traded derivatives without assuming excessive basis risk
- reduced use of derivatives by end users who consider compliance with derivatives rules to be too onerous, complicated or costly and therefore seek alternative hedging solutions or even choose to self-insure risks they might otherwise have hedged

- required compliance with the rules of more than one jurisdiction. OTC derivatives legislation from province to province should be fairly uniform but may not be identical. So even purely domestic contracts will require counterparties to be alert to possible differences. Additional compliance burdens may be imposed on Canadian end users who have, or whose counterparties have, a connection to a jurisdiction outside Canada. Canadian end users have received requests from U.S. dealer counterparties to sign up to protocols drafted by the International Swaps and Derivatives Association to assist U.S. derivatives dealers and other large market participants in complying with their Dodd-Frank obligations. End users must therefore understand and assess the obligations imposed on them by these protocols or similar protocols designed for other jurisdictions. The application of highly technical foreign rules to cross-border derivatives transactions and the different approaches taken by different jurisdictions will add to the complexity.

Financial institutions and other sophisticated market participants and their advisers will continue to prepare for Canadian OTC derivatives regulation by taking stock of their derivatives activities, participating in industry groups, and commenting on draft legislation published by securities regulators. However, the slow pace of regulatory reform has not inspired commercial end users to prepare for regulation that—for now—seems distant.

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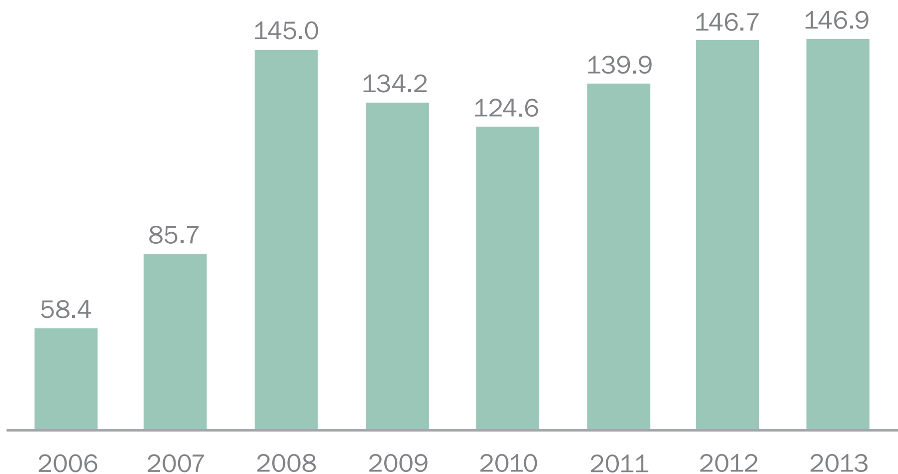
CMHC INSURANCE AND COVERED BONDS—WHAT WILL HAPPEN WHEN THE TRAINING WHEELS COME OFF?: REVISITED

BY MICHAEL FELDMAN AND JIM HONG

In Torys' *Capital Markets 2012 Mid-Year Report*, our article "CMHC Insurance and Covered Bonds—What Will Happen When the Training Wheels Come Off?"[1] was written in response to actions taken by the federal government to significantly reduce its direct exposure to the Canadian residential mortgage market. During the financial crisis, Canadian banks and other mortgage lenders relied heavily on securitization programs sponsored by Canada Mortgage and Housing Corporation (CMHC) to provide liquidity during challenging times. In the two years since that article was published, the training wheels have not yet been removed, although the government has tested a number of tools it can use to remove them if and when it decides to do that.

Figure 1. Mortgage-Backed Securities (MBS) Issued Under the *National Housing Act* (NHA)[2] (in billions)



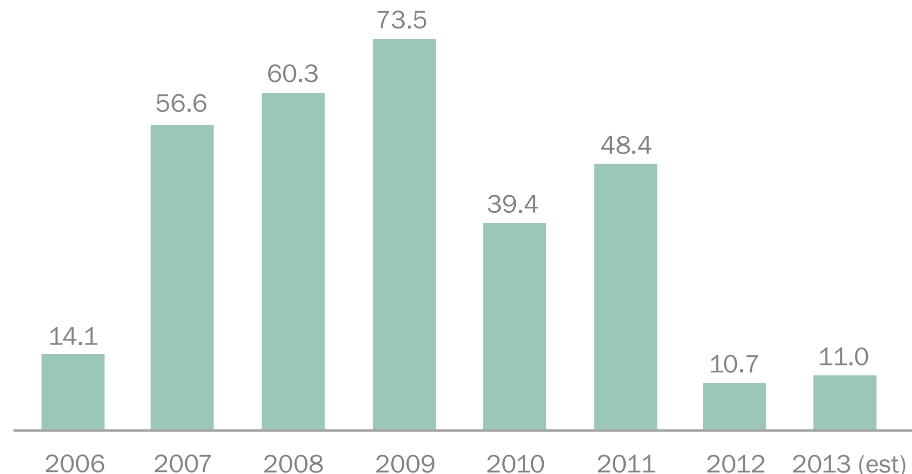
[1] Torys *Capital Markets 2012 Mid-Year Report*, p.21

[2] www.cmhc-schl.gc.ca/en/hofic/incl/mobase/upload/R303a_eng.pdf

Figure 1. shows the reliance of Canadian mortgage lenders on the NHA MBS program since the start of the financial crisis. CMHC has announced that in 2014 it would scale back, guaranteeing only C$120 billion of NHA MBS (of which C$40 billion would be used to back Canada Mortgage Bond issuance).[3]

CMHC provides transactional insurance for mortgages in which the loan-to-value (LTV) ratio is greater than 80%. It also permits its approved lenders to bulk insure their low-ratio (LTV less than 80%) mortgages using portfolio insurance. During the financial crisis, CMHC-written portfolio insurance increased dramatically as mortgage lenders depended on it to give low-ratio mortgages access to CMHC's securitization programs. Only in 2012 did the federal government require CMHC to drastically scale back the amount of portfolio insurance it wrote. Figure 2. shows the changes in portfolio insurance written by CMHC from 2006-2013.[4]

Figure 2. Portfolio Insurance Written by CMHC (in billions)



According to its 2013 Annual Report, CMHC expects to further reduce its annual limit of portfolio insurance from C$11 billion to C$9 billion in 2014.

Between 2011 and 2012, the federal government took a number of steps pointing to its intent to reduce NHA MBS issuance to pre-crisis levels. These steps included:

a. maintaining the statutory limit on the aggregate amount of insurance that CMHC could have outstanding at C$600 billion (a limit set in March 2009) as CMHC approached that limit in 2011;

[3] www.cmhc-schl.gc.ca/en/hofic/incl/mobase/mobase_007.cfm

[4] CMHC, 2014-2018 Summary of the Corporate Plan, p. 14

b. 2011: reducing the maximum amortization period for insured mortgages from 35 years to 30 years and stopping the practice of insuring home equity lines of credit;

c. 2012: reducing the maximum amortization period from 30 to 25 years, imposing caps on debt service coverage ratios needed to qualify for an insured mortgage and eliminating insurance on homes worth more than C$1 million; and

d. 2012: prohibiting federally regulated financial institutions (FRFIs) from using insured mortgages as collateral for covered bonds and substantially reducing the amount of portfolio insurance that CMHC could write.

But as Figure 1. shows, these steps had little effect on the issuance of NHA MBS, with a significant amount of liquidity removed only this year.

We believe that the federal government would like to reduce taxpayer exposure to the Canadian mortgage market and see private investors assume more of this risk. While there was a small market for uninsured residential-mortgage backed securities (RMBS) or asset-backed-commercial paper (ABCP) backed by uninsured mortgages prior to the financial crisis, it was too small to have a meaningful impact on the overall funding needs of the Canadian mortgage market. That small market disappeared in 2008, and only recently have bank-sponsored ABCP conduits renewed their acceptance of uninsured mortgages as collateral.

In addition to issuing NHA MBS, the largest Canadian banks have also issued covered bonds (essentially full recourse bonds secured by pools of mortgages), chiefly to foreign investors. Prior to 2012, the vast majority of the assets backing these covered bonds consisted of insured mortgages, but as of June 2012, only conventional mortgages could be used to back covered bonds. While covered bonds have the potential to provide funding for a significant amount of conventional mortgages, the Office of the Superintendent of Financial Institutions (OSFI) limits the amount of covered bonds that any FRFI can issue to 4% of the FRFI's assets[5] because of a general reluctance of OSFI to allow FRFIs to issue secured debt that would rank ahead of depositors.

Covered bonds are only available to large issuers because (i) they are primarily credit obligations of the issuer, so pricing is affected by the ratings of the issuer as much as, if not more than, the quality of the collateral, and (ii) they are expensive to implement in terms of fees that must be paid to CMHC in its capacity as Registrar of covered bonds in Canada, and legal and accounting fees. If OSFI could be persuaded to increase the limit on issuance of covered bonds to limits permitted in other countries (such as Australia, which permits up to 8% of assets), this could materially lessen the

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[5] Letter from Office of the Superintendent of Financial Institutions Canada to All Deposit Taking Institutions (June 27, 2007) regarding Limited Issuance of "Covered Bonds" by Canadian Institutions, online: Office of the Superintendent of Financial Institutions Canada.

reliance of covered bond issuers on government-backed insurance. However, banks have been lobbying for an increase to this limit for many years and so far OSFI has not been persuaded.

Investors may be willing to invest in RMBS backed by high-quality conventional mortgages, but in today's environment, these mortgages generally do not yield enough to stimulate private investment.

Creating an Uninsured Canadian RMBS Market

We believe that in order to permit the federal government to further reduce its exposure to the Canadian mortgage market, it would like to see a private RMBS market develop before it drastically reduces the ability of the Canadian mortgage market to rely on its NHA MBS guarantee. Increasing the limit on covered bonds would obviate the need for such a market, but in the absence of an increase in this limit, the withdrawal of so much liquidity in the mortgage market could have a material adverse impact on the Canadian housing market. We believe that a robust uninsured RMBS market in Canada can only evolve once several developments have occurred. The balance of this article discusses these needed developments.

Risk and Quality of Assets

Many investors around the world suffered losses on investments in subprime RMBS. To re-engage in an RMBS market, we believe investors would need assurances on the quality of the underlying mortgages. In June 2012, OSFI released its final version of Guideline B-20, now currently implemented by all FRFIs. The thrust of Guideline B-20 is to establish prudent residential mortgage underwriting practices to manage risks in this market. If investors could be satisfied that the mortgages backing their private RMBS were compliant with Guideline B-20, their appetite for investment may grow.

Higher Mortgage Rates

Investors may be willing to invest in RMBS backed by high-quality conventional mortgages, but in today's environment, these mortgages generally do not yield enough to stimulate private investment. The challenge will be for the government to entice mortgage rates to rise (for example, by significantly increasing insurance premiums for insured mortgages or further restricting the availability of mortgage insurance) while at the same time not causing an alarming decrease in housing prices. We do not expect the government to take any exceptional measures in this regard before the next federal election.

Liquidity

Investors in RMBS want to know that they will always be able to determine a mark-to-

market value, and that there will always be a bid for their RMBS before committing to the effort of analyzing uninsured RMBS as an investment. Much-needed liquidity for private RMBS could be provided if the Bank of Canada would agree to accept highly rated RMBS backed by Guideline-B-20-compliant mortgages as collateral for overdraft loans to Canadian banks.[6] The Bank of Canada may have very good reasons for not expanding the list of acceptable collateral for overdraft loans at this time. However, if the Bank of Canada can see its way to provide the liquidity that the uninsured RMBS market will require, there may be more willingness to invest in these securities.

Structural Factors

Residential mortgages are amortizing assets; consequently, RMBS are typically structured as monthly pay pass-through certificates. The Canadian market has never been able to absorb large amounts of monthly pay pass-through ABS or MBS that are not government guaranteed. Because mortgage interest is not subject to Canadian withholding tax it might be possible to issue monthly pay pass-through MBS to foreign investors, but this may require currency hedging with additional costs. The demand by Canadian institutional investors for semi-annual pay bullet bonds is what led CMHC to establish Canada Housing Trust (CHT) and its Canada Mortgage Bonds (CMB) Program. The CMB issued by CHT are backed by monthly pay pass-through NHA MBS and are effectively packaged with swaps to support notes with bullet maturities that pay interest semi-annually like more traditional bonds. Given the resulting increased demand, the cost of funding using CMB is significantly less than the cost of funding on the underlying NHA MBS if such NHA MBS were to be issued in the market.

There are two potential structures to create semi-annual pay securities with bullet “maturity” dates for residential mortgages. These are (i) using a variable funding certificate (VFC) to absorb monthly payments that can then be drawn on to pay other classes of certificates on their expected maturity dates, and (ii) creating a revolving pool of mortgages that can be used to support notes having bullet “maturity dates”.[7]

VFCs were used in a few transactions prior to the financial crisis but were issued on an uncommitted basis; that is, in the event that the holder of the VFC elected not to allow itself to be drawn on to fund the repayment of another class of certificates backed by the same mortgage pool, the other classes of certificates would turn into monthly pay pass-through certificates. Investors have made it clear that they would

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[6] Through its Standing Liquidity Facility, the Bank of Canada provides overdraft loans to certain financial institutions on a secured basis. The list of acceptable collateral was expanded during the financial crisis to include ABCP that met specified criteria but it has not been expanded to include any other types of asset-backed securities or mortgage-backed securities, other than NHA MBS or securities backed by NHA MBS. See www.bankofcanada.ca/wp-content/uploads/2014/03/SLF-Policy.pdf.

[7] Maturity dates in this sense refers only to expected maturity dates: failure to pay on maturity would lead to accelerated amortization, not default.

not be willing to treat any certificate with a bullet maturity date as a true bullet maturity unless the VFC certificate constituted a committed facility. It would be very difficult for banks, or entities consolidated with banks, such as ABCP conduits, to provide committed VFC facilities because of the capital treatment they would carry. So far, no highly rated entity that is not subject to capital requirements (such as pension funds or government entities) has indicated any willingness to provide committed VFC facilities.

Toronto-Dominion Bank sponsors a program through Genesis Trust II that issues semi-annual pay bullet notes backed by a revolving pool of home equity lines of credit. It would be possible to create a revolving pool of amortizing conventional mortgages, but it is not clear whether investors would accept the notes as having true bullet maturities if they could commence early amortization in the event that the seller were unable to continue to sell new mortgages into the structure.

Conclusion

Although there are strong signs that the federal government would like to accelerate the removal of its support for and exposure to the Canadian mortgage market, there are still several important obstacles to overcome before private investors will be willing to take on this exposure in a meaningful way. Unless the government is willing to risk destabilizing the Canadian housing market, we are likely to continue to see government support of the Canadian residential mortgage market at levels far in excess of pre-2008 levels for several more years.

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