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News Bulletin

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Bright Outlook for Covered Bonds

This year has proven to be an interesting one for the covered bond market, and we anticipate that 2013 will bring many important new developments. During 2012, the covered bond market continued to provide attractive financing opportunities for European banks. However, many of the most noteworthy developments in 2012 occurred outside the Eurozone. Various new jurisdictions approved covered bond legislation, including Canada, Mexico, Morocco, New Zealand, Singapore, and South Korea. We saw various covered bond issuances from Australia and also from Latin America. Quite a number of foreign banks accessed the U.S. dollar market with issuances into the United States conducted on an exempt (Rule 144A) basis and sold to institutional investors. This year also saw the first U.S. SEC-registered covered bond offering. These dollar-denominated issuances proved that there is a significant investor base for covered bonds in the United States. A number of key regulatory developments, including CRD IV in Europe, Basel implementation in the United States, and limitations on concentrations and risk weightings, will have a significant influence on the shape of things to come. As we head into 2013, our crystal ball tells us that non-European covered bond issuances are likely to remain significant. We also remain hopeful that, with a recovery in the housing market and the elections behind us, 2013 will prove the magic year for covered bond legislation in the United States. Below we provide a brief update on Canadian and U.S. developments.

I. CMHC Announces Details of the New Canadian Covered Bond Framework

On December 17, 2012, the Canada Mortgage and Housing Corporation ("CMHC") announced the details of the new legislative framework for Canadian covered bonds.[1] Details of the new framework were published in the Canadian Registered Covered Bond Programs Guide (the "Guide"), which provides the conditions and restrictions applicable to registered covered bond issuers and registered covered bond programs.[2] Only Canadian issuers that meet all of the requirements specified in the Guide can issue registered covered bonds.

Key provisions and requirements of the Guide are set forth below:

- Primary covered bond collateral must now consist of uninsured one to four unit Canadian residential mortgage loans;

- Substitute assets, which may include Government of Canada securities, can make up ten percent of the value of the cover pool;

[1] The announcement is available on CMHC's website at http://www.cmhc.ca/en/corp/nero/nere/2012/2012-12-17-1600a.cfm.
[2] The Canadian Registered Covered Bond Programs Guide is available on CMHC's website at http://www.cmhc.ca/en/hoficlincl/cacobo/upload/Canadian-Registered-Covered-Bond-Programs-Guide.pdf.

- Insured mortgages cannot be held as covered bond collateral;
- Eighty percent is the maximum loan-to-value limit;
- Establishment of a minimum and maximum level of overcollateralization for each registered covered bond program;
- Requirements for registered issuers to index housing values, which will affect asset coverage test calculations;
- Heightened disclosure requirements included in a pro forma public offering document;
- Requirements to engage a bond trustee, custodian and cover pool monitor and their respective roles;
- Monthly and annual reporting requirements to investors and CMHC; and
- Establishment of a website for each issuer's registered covered bond program that investors and CMHC can access.

CMHC has suspension powers and discretionary authority as to whether it will register a particular issuer or program. In addition, CMHC will administer the new framework and establish and maintain a publicly accessible registry containing information about registered issuers, registered programs, suspended issuers, and any other information the CMHC deems necessary.

II. Joint Committee on Taxation Releases Legislative Text for U.S. Covered Bond Act

On December 17, 2012, Representative Dave Camp (R-MI), Chairman of the House Committee on Ways and Means, issued a letter to Representatives Spencer Bachus (R-AL) and Barney Frank (D-MA), Chairman and Ranking Member, respectively, of the House Committee on Financial Services regarding the U.S. Covered Bond Act of 2011 ("H.R. 940"). Enclosed with the letter was a draft of legislative text amending the tax provisions in H.R. 940 and a preliminary revenue estimate from the Joint Committee on Taxation ("JCT").

Representative Camp's staff has been working with the JCT and industry representatives on modifying the tax provisions in H.R. 940 so that they would have minimal or no effect on revenue. The House Committee on Ways and Means will continue to evaluate the tax provisions in H.R. 940, which could result in further changes.

This represents a positive development in that H.R. 940 had been assigned jointly to the House Committee on Ways and Means and to the House Financial Services Committee upon introduction of the bill in 2011. Although the House Financial Services Committee approved the bill in June 2011 by a 44-7 vote, the bill was unable to move to the floor of the House for a vote so long as it was before the House Committee on Ways and Means. While the House Committee on Ways and Means has not finished its consideration of the bill, this development indicates that considerable thought has been given to the bill and the House Committee has suggested specific changes to the bill, which do not appear to be inconsistent with traditional covered bonds. Hopefully this means that the House Committee on Ways and Means is close to the end of its deliberations.

The beginning of 2013 will see the convening of a new Congress. All unfinished legislation from the old Congress must be reintroduced in the new Congress. This means that H.R. 940 will need to be reconsidered by the House Committee on Financial Services and the House Committee on Ways and Means. Similarly, a new covered bond bill will need to be introduced in the Senate. Once again, the prospects for eventual adoption of covered bond legislation are good, despite the uncertainty about the timing. The best prospects occur if the bill is attached to other legislation. On its own, the bill will be subject to being crowded off the legislative agenda by more urgent bills. While, in the past, Bank of America has supported covered bond legislation, none of the major money center banks to date has pressed for adoption of covered bond legislation. Their attention has been focused on the many provisions of the Dodd-Frank Act affecting banks. Also, with the expansive funding limits for Fannie Mae and Freddie Mac, the FDIC insurance coverage for deposit accounts of any size and a depressed real estate market, there has been no funding pressure for banks in connection with their mortgage loan production. Each of these factors is changing favorably for covered bonds and this movement is expected to continue into 2013, thus improving the prospects for passage of legislation.

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