# FREQUENTLY ASKED QUESTIONS ABOUT COVERED BONDS

## Background

***What are covered bonds?***

Covered bonds are debt obligations that provide recourse to the issuer, usually a bank. Upon an issuer default, covered bond holders also have recourse to a pool of collateral (known as the "cover pool"), which is maintained separate from the issuer's other assets.

***What type of assets can make up the cover pool?***

The cover pool usually consists of high quality assets, including residential mortgages, public debt, or ship loans. Cash, or cash equivalents, also may serve as cover pool collateral.

***Are covered bonds a new product?***

Although relatively new to the United States, covered bonds are not a new product. Covered bonds have been used to raise capital in Europe since 1769, when the first covered bond was issued in Prussia to finance agriculture. Germany, France, and Spain have large covered bond markets aided by specific legislation that prescribes a framework for the issuance of covered bonds. The United Kingdom's participation in the market has been rapidly expanding with the passage in 2008 of legislation bolstering its popularity. *See* "Covered Bond Structure Outside of the United States." European issuances remained at historic lows in 2014, and issuances of covered bonds into the United States by non-U.S. issuers continued to drop dramatically in 2014 (to approximately $10 billion) as cross currency swap costs made issuing bonds in USD less favorable. There has been some recovery in the issuance of covered bonds into the United States in 2015 as cross currency swap costs have declined.

***How are covered bonds issued?***

Covered bonds can be issued as a single issuance or as a program. Under the Securities Act of 1933 (the "Securities Act"), covered bonds are regulated as securities and each issuance must be registered under the Securities Act or exempt from registration. Covered bond programs issuing in the United States often rely on the Rule 144A exemption; however, on July 30, 2012, the Royal Bank of Canada obtained SEC approval for a registration statement for its covered bond program. The Bank of Nova Scotia and Bank of Montreal followed suit in 2013. Both banks had their registration statements declared effective in the second half of 2013 though Bank of Montreal has yet to issue any covered bonds under its SEC registered program. The Bank of Nova Scotia conducted its inaugural SEC registered covered bond issuance in September 2014.

***What type of bond is issued?***

Covered bonds typically are fixed rate bonds with a maturity of no less than one year and no more than 30 years, but in a few cases up to 50 years. The bonds are low risk, yield-bearing products having long maturities.

***Who invests in covered bonds?***

Central banks, pension funds, insurance companies, asset managers, bank treasuries, and other institutional investors seeking a low risk, yield-bearing product with a long maturity invest in covered bonds.

***What factors are considered when rating agencies rate covered bonds?***

Rating agencies treat covered bonds as a hybrid instrument. The ratings analysis is based in part on the credit and rating of the issuing entity and in part on the collateral (or cover pool).

In evaluating the cover pool in covered bond issuances, rating agencies consider the following factors:

- the effective segregation of the cover pool assets from the claims of other creditors of the issuer;
- the immunity of over-collateralization from the claims of other creditors of the issuer;
- the bankruptcy-remoteness of the collateral posted by swap counterparties;
- provisions against the risk that the cover pool's cash flows could be commingled with other revenues of the insolvent issuer and might not reach the covered bond holders; and
- protection against borrowers' attempts to set off their debt against any claim they have against the issuer.

## Covered Bond Structure in the United States

***How are covered bonds structured?***

There are two ways to structure covered bonds. The depository institution can issue the covered bonds directly, or a special purpose vehicle ("SPV") can be established to act as issuer or as guarantor. The covered bond structure used by U.S. issuers utilizes a SPV as an issuer. *See* "*How are covered bonds structured when the depository institution issues the covered bonds directly?*" and "*How are covered bonds structured when a SPV is established to issue or guarantee the covered bonds?*"

Regardless of structure, there are three general principles of all covered bonds. The covered bonds must be secured by high quality assets; management of the cover pool must be supervised; and investors must be first in priority upon an issuer's insolvency. Whether contractual or statutory, there must be a framework in place that protects the cover pool from the claims of other creditors of the issuer and directs payments to covered bond holders upon a bankruptcy.

***Who holds the collateral and protects the investors under the U.S. covered bond structure?***

Under the U.S. covered bond structure, a U.S. bank issues a secured mortgage bond to a SPV and the SPV issues covered bonds to investors. As a result, there are two trustees under the U.S. covered bond structure. The mortgage bond indenture trustee is an independent trustee designated by the mortgage bond issuer. This trustee represents the interests of the mortgage bond holder (the SPV) and enforces its rights if the mortgage bond issuer defaults. The covered bond indenture trustee is an independent trustee designated by the covered bond issuer who represents the interests of covered bond investors and enforces the investors' rights if the covered bond issuer defaults. *See "How are covered bonds structured when a SPV is established to issue or guarantee the covered bonds?"* for an explanation of the roles of the mortgage bond issuer and the covered bond issuer and their respective obligations.

***How are investors protected under the U.S. covered bond structure?***

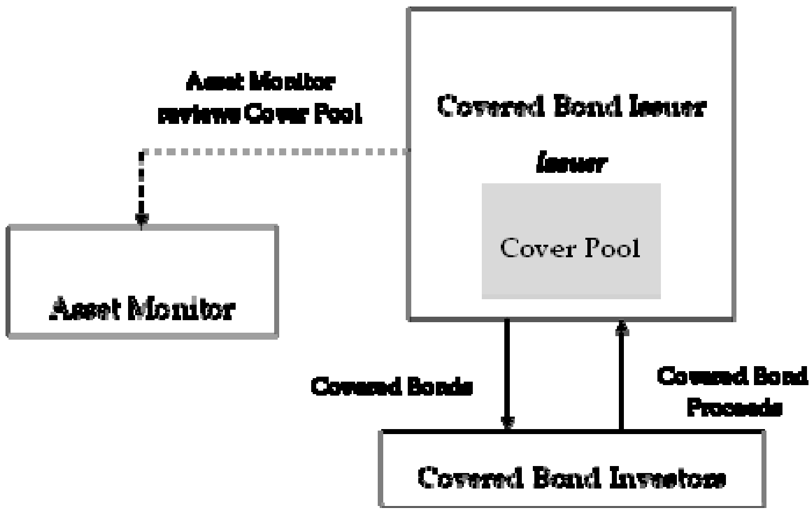
In the event of a mortgage bond issuer default, the covered bond indenture trustee, on behalf of covered bond holders, will deposit all mortgage bond payments and related proceeds into a guaranteed investment contract ("GIC"), or other arrangement whereby the cash is invested with, or by, one or more financially sound counterparties. The purpose of entering into a GIC is to ensure continued timely payments to the covered bond holders and avoid acceleration of payments under the covered bonds. Mortgage bond issuer events of default include failure to make timely payment of interest and principal, failure to satisfy the asset coverage test, and the occurrence of certain insolvency events.

The covered bond indenture trustee performs a monthly proceeds compliance test to ensure there are adequate proceeds available to make timely payments on the covered bonds. *See "What is a proceeds compliance test?"* Failure to satisfy the proceeds compliance test results in an event of default that would trigger acceleration of the covered bonds. Additional SPV events of default include interest and principal payment failures and the occurrence of certain insolvency events. If the covered bonds are accelerated, the covered bond indenture trustee can cause the covered bond issuer to liquidate the collateral to make payments due under the covered bond. *See "What happens to payment flows if there is a mortgage bond acceleration?"* and *"What happens to payment flows if there is a covered bond acceleration?"*

***How are covered bonds structured when the depository institution issues the covered bonds directly?***

Direct issuance is used in most non-U.S. countries with specific covered bond legislation. These transactions are structured so that the depository institution originating the mortgage loans making up the cover pool is also the issuer of the covered bonds and retains the assets in the cover pool at the issuing entity level. Legislation in many European countries provides priority treatment for covered bonds in the event of bankruptcy. Specifically, in the event of an issuer insolvency, covered bond holders have priority rights over the cover pool assets.

Below is a diagram of the direct issuance structure where the depository institution issues the covered bonds.

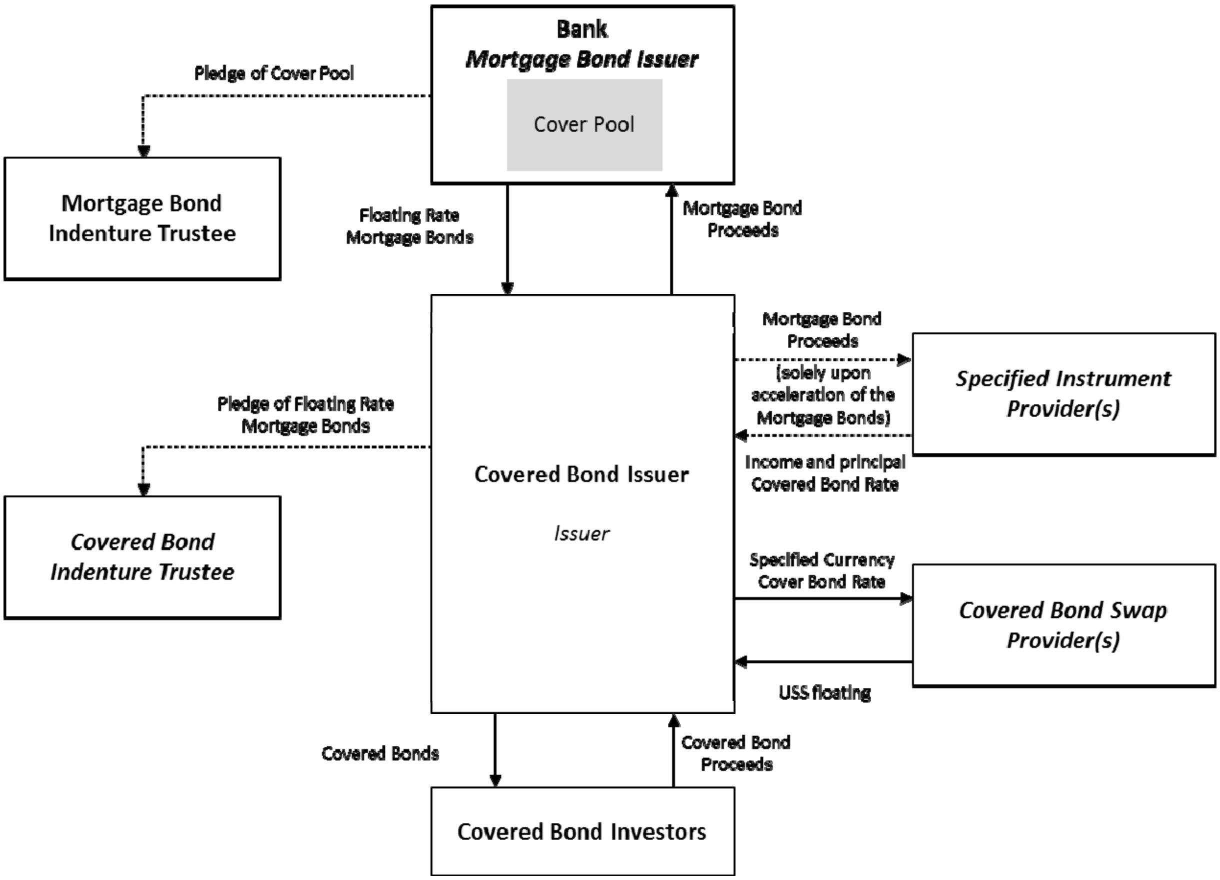



***How are covered bonds structured when a SPV is established to issue or guarantee the covered bonds?***

The two-tier structure used in the United Kingdom and Canada (both of which retained such structure in their covered bond legislation when passed) provide for the depository institution originating the mortgage loans to sell the mortgage loans to a SPV. The depository institution issues the covered bonds and the SPV guarantees the payment of the covered bonds, secured by the mortgage loans. The synthetic two-tier structure used by U.S. bank issuers provides for the depository institution originating the mortgage loans to sell mortgage-backed bonds to a SPV established to act as issuer of the covered bonds. The cover pool assets (the mortgage loans) remain with the depository institution. Both of these structures provide bankruptcy protection similar to that granted by statutes implementing direct issuance structures in the European Union (the "EU").

In the U.S. structure, the proceeds from selling covered bonds are used by the covered bond issuer to purchase the mortgage bonds, which are secured by a separate pool of mortgages on the bank's balance sheet. The mortgage bond indenture trustee, for the benefit of the holder of the mortgage bonds, has a perfected security interest in the mortgage pool.

On the next page is a diagram of the synthetic two-tier structure used by U.S. issuers where a SPV is established to issue covered bonds.




## Covered Bond Structure Outside of the United States

***What is the general non-U.S. regulatory framework for covered bond issuances?***

According to the European Covered Bond Council 2015 European Covered Bond Fact Book, there are 35 countries with covered bond legislation, including France, Germany, Italy, Spain, Portugal, Sweden, Denmark, Norway, Finland, United Kingdom, Australia, Canada and New Zealand and an active covered bond market in close to 40 countries. The typical regulatory framework for a non-U.S. covered bond is a direct issuance single-tier structure; however a number of jurisdictions, including the United Kingdom and Canada, utilize a two-tier framework similar to the synthetic structures that were used in those jurisdictions prior to the passage of covered bond legislation. Although legislation varies in each jurisdiction, there are two key factors that enable a covered bond market to flourish: legislation providing for special treatment for the benefit of covered bond holders under bankruptcy law in the event of an issuer insolvency; and special treatment under the banking capital laws that provide favorable risk weighting for covered bonds in comparison to the issuer's unsecured debt for the benefit of covered bond holders that are banks or are otherwise subject to prudential capital requirements.

***How are covered bonds treated by the ECB as collateral for repo activities?***

The European Central Bank, or ECB, classifies securities for repo purposes. Banks, which comprise a significant portion of the covered bond investor base, tend to hold covered bonds as collateral for their repo activities. For these purposes, the ECB follows the covered bond definition used in the EU's Undertakings for Collective Investment and Transferable Securities ("UCITS") Directive for collective investment vehicles. In order to have an EU-recognized "covered bond" regime, a country must implement the requirements of Article 52(4) of the UCITS Directive, which essentially includes covered bonds issued by an EU Member country under statutes imposing special bankruptcy protection for covered bond holders. For repo purposes, jumbo covered bonds of credit quality step 1 or 2 are discounted at 1%-8% (1%-9% for other covered bonds), depending on maturity; bank debt is discounted at 1%-9%, depending on maturity; and securitizations are discounted at 10%.

Under the ECB's monetary policy, covered bonds issued by non-EU Member country issuers who are G-10 country issuers (such as Canada) also may qualify as collateral for repo purposes, provided that the UCITS Article 52(4) criteria are otherwise met.

***How are covered bonds treated under the EU Capital Requirements Directive?***

The Capital Requirements Regulation (the "CRR") also makes it more attractive for credit institutions to invest in legislative covered bonds. The CRR, which implements the provisions prescribed by the Basel III capital framework, requires European credit institutions to hold a certain amount of eligible capital depending on the risk weighting of their assets. Covered bonds meeting the UCITS Article 52(4) criteria benefit from a 10% risk weighting, which is half of the capital charge allocated to unsecured debt from the sale issuing financial entity or group. By contrast, covered bonds that are not legally based are subject to a 20% risk weighting.

The CRR also implements the new liquidity coverage ratio (the "LCR") which forms part of the Basel III requirements. When fully implemented in 2018, the LCR will require a bank to hold a LCR of at least 100% (*i.e.*, it must hold stocks of liquid assets sufficient to meet all net cash outflows under a 30-day stress scenario). The LCR has been phased in under the CRR from October 2015 and currently applies at 60%. For the purpose of the LCR, covered bonds of extremely high credit quality can be included as Level 1 high quality liquid assets with a cap of 70% of total assets and a minimum haircut of 7%. Covered bonds that do not meet the Level 1 criteria but meet other specified requirements can be included as Level 2A assets with a haircut of at least 15% or in Level 2B with a haircut of at least 30%. Level 2A and Level 2B assets may not in the aggregate exceed 40% of the asset pool with Level 2B capped at 15%.

## U.S. Regulatory Framework for Covered Bonds

***What is the U.S. regulatory framework for covered bond issuances?***

The United States does not have any legislation for covered bonds. Therefore, U.S. issuers have developed a synthetic two-tier structure to replicate the protections afforded by legislation in certain

European countries. *See* "Covered Bond Structure in the United States."

***Why hasn't the covered bond market developed in the United States the way it has in Europe?***

The United States covered bond market has lagged behind the European market due to a lack of legislation. One of the reasons that covered bond legislation has not been lobbied for in the United States is that, until the recent market turmoil, banks had alternative means for obtaining mortgage funding that were not available to their European counterparts.

One example of such funding is government-sponsored enterprises, or GSEs. The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") were chartered as GSEs to correct perceived deficiencies in the U.S. mortgage market. In accordance with their GSE charter, Fannie Mae and Freddie Mac developed a strong secondary market for mortgages by integrating the mortgage markets with the capital markets to make funds more readily available to mortgage borrowers. Fannie Mae and Freddie Mac, with the implicit backing of the U.S. government, could issue debt at lower interest rates than other issuers, and could securitize qualifying mortgages without providing or purchasing credit enhancements. Private companies later used this securitization structure to securitize mortgages, such as jumbo mortgages, that did not qualify under the GSE program.

Another example of alternative funding in the United States is the Federal Home Loan Banks (the "FHLB"). The FHLB are 12 banks set up under a government charter in the early 1930s to provide support to the housing market by advancing funds to over 8,000 member banks that originate mortgage loans. The FHLB system was modernized in 1999 under the Gramm Leach Bliley Act.

Unlike GSEs, which raise capital by selling mortgages in the secondary market, the FHLB system issues debt to raise capital to advance funding to loan originators. Specifically, the FHLB banks sell consolidated obligations to institutional investors. Because the system has a standalone AAA credit rating and enjoys GSE status, it can raise debt at rates only slightly higher than Treasury securities. Additionally, the FHLB banks advance funds to their member financial institutions at interest rates that are lower than those in the commercial market, particularly on longer-term funds. Loans are priced at small spreads over comparable Treasury obligations.

To be eligible to join the FHLB, a financial institution must:

- be duly organized under the laws of any state or of the United States;
- be subject to inspection and regulation under the banking laws, or similar state or federal laws or applicable state insurance laws;
- make long-term mortgage loans;
- be financially stable enough that the FHLB bank can lend to it safely; and
- have a management and a home financing policy consistent with sound and economical home financing.

The general rule that a member must maintain 10 percent of its assets in mortgages is not applied to institutions defined as "community financial institutions," which can post new forms of collateral such as small business loans and farm loans for advances.

***Given the existence of funding by government-sponsored entities and the FHLB, why are U.S. regulators now interested in the covered bond market?***

Due to the credit crisis in the United States, GSEs faced liquidity crises of their own, while the financial markets continued to show the ill effects of turmoil triggered by mortgage losses. Although FHLB members can borrow at lower rates than they can issue covered bonds, the financial institutions seeking such funding must buy equity in the FHLB equal to 5 percent of their borrowings and post 120-130 percent over-collateralization. There is no equity buy-in cost for covered bonds and the recommended over-collateralization is only approximately 105-110 percent. Therefore, FHLB funding could cause greater strain on cash-starved financial institutions.

Post-crisis, the economy was underperforming in terms of growth and job creation, and financial institutions were affected by the generalized pullback in liquidity and deteriorating credit quality. Many financial institutions retreated from certain business lines, limited their participation in markets for some financial products, delevered their balance sheets, and took other actions aimed at balance sheet repair. With the mortgage securitization market closed to financial institutions and other sources of lending either scarce or more expensive, the U.S. government viewed covered bonds as another funding source that could assist in reviving the lending market.

***Have any government agencies issued guidance related to covered bond issuances?***

The FDIC released a Covered Bond Policy Statement on July 15, 2008, and the Treasury Department issued Best Practices for Residential Covered Bonds on July 28, 2008. Two days later, U.S. House Representative Scott Garrett of New Jersey ("Rep. Garrett") proposed the Equal Treatment of Covered Bonds Act ("H.R. 6659") to Congress. The bill did not pass. Two additional attempts were made in 2009 by Rep. Garrett to pass covered bond legislation. Rep. Garrett also introduced a covered bond regulatory framework amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") prior to its adoption. On June 25, 2010, the joint House-Senate Conference Committee was one vote short of the number of votes needed to include the amendment in the final version of the Dodd-Frank Act. Unsuccessful attempts to include covered bond provisions in broader pieces of legislation were made again in 2011 and 2012. Most recently, in July 2013, Rep. Garrett sponsored the Protecting American Taxpayers and Homeowners Act ("PATH Act"), a bill that would create a sustainable housing finance system ("H.R.2767"), which includes a covered bond legislative framework. There were no covered bond legislative developments in 2014 or 2015. *See* "The FDIC Covered Bond Policy Statement," "The Treasury Department Best Practices for Residential Covered Bonds," and "Covered Bond Legislation."

## The FDIC Covered Bond Policy Statement

***What uncertainties in the U.S. covered bond market were addressed by the FDIC Covered Bond Policy Statement?***

Prior to the release of the Policy Statement, market participants were unsure if the FDIC, in a receivership scenario, would seek to repudiate the covered bond transaction documents. Market participants also were concerned about how long it would take to access the collateral due to the 90-day automatic stay provision in the event of a bank insolvency under the Federal Deposit Insurance Act ("FDIA").

***What is the scope of the FDIC Policy Statement?***

The Policy Statement is applicable to depository institutions insured by the FDIC. Although the Policy Statement provides much sought-after guidance, the scope of transactions the guidance covers is limited. The Policy Statement applies only to (i) recourse debt obligations (ii) of an insured depository institution (iii) with a term of greater than one year but not exceeding 30 years (iv) that are secured directly or indirectly by perfected security interests in a pool of mortgage loans or, not exceeding 10% of the collateral, by AAA-rated mortgage bonds.

For mortgages to be eligible assets for the cover pool, they must be "eligible mortgages." *See "What are 'eligible mortgages'?"* The protection afforded by the FDIC is only applicable if the covered bonds are issued with the consent of the bank's primary federal regulator and comprise no more than 4% of the bank's total liabilities.

***What are "eligible mortgages"?***

Eligible mortgages are defined as performing first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income, and complying with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination.

***What are the options available to the FDIC when acting as conservator or receiver?***

The FDIC set forth three options when the FDIC is acting as conservator or receiver for a depository institution. The FDIC can:

1. continue to perform on the covered bonds;
2. pay off the covered bonds in cash (compensatory damages) up to the value of the pledged collateral; or
3. allow liquidation of the pledged collateral to pay off the covered bonds.

Under Scenario 1, payments on the covered bonds would be made as scheduled. Scenarios 2 and 3 would be triggered if the FDIC were to repudiate the transaction or if a monetary default were to occur. In both cases, holders of covered bonds would receive the outstanding principal amount plus accrued and unpaid interest on the bonds to the date of the FDIC's appointment as conservator or receiver, up to the value of the cover pool. In Scenario 2, the FDIC would retain all of the collateral. In Scenario 3, if there is excess collateral, the FDIC would retain the excess for distribution under the FDIA and if there is not enough collateral, it would limit the amount of secured claims to the collateral value.

***How long will investors have to wait before exercising rights in an event of monetary default?***

The Policy Statement provides guidance on the availability of expedited access to collateral pledged for qualifying covered bonds in a receivership or conservatorship after a default on a bank's obligation to the covered bond holders. The Policy Statement enables a covered bond holder to exercise its rights to collateral (1) if the bank remains in monetary default for at least 10 business days after the investor delivers a written request to the FDIC to exercise its rights, or (2) if the FDIC as conservator or receiver provides written notice of repudiation of a contract to the investor and does not pay damages within 10 days after the effective date of such notice.

***How does the FDIC Policy Statement promote a U.S. covered bond market?***

The Policy Statement is helpful in promoting a U.S. covered bond market because it provides certainty to holders of covered bonds regarding the amount they may recover and the manner in which they can exercise their rights in the event of a default where the FDIC is appointed conservator or receiver.

***How does the FDIC Policy Statement affect the structure of U.S. covered bonds?***

The FDIC noted that there is nothing in the Policy Statement requiring the use of a SPV to issue covered bonds. *See "How are covered bonds structured when a SPV is established to issue the covered bonds?"* Rather, if a SPV is used, the FDIC will use its "well-defined standards to determine whether to treat such entities as separate from" the depository institution. The determination as to whether a SPV is a separate entity will be based on specific facts and circumstances. This guidance most likely will enable new issuers to consider direct issuance structures for covered bonds in order to benefit from a securities law exemption. *See "How are covered bonds structured when the depository institution issues the covered bonds directly?"*

## The Treasury Department Best Practices for Residential Covered Bonds

***What is the scope of the Treasury Department Best Practices for Residential Covered Bonds?***

The Best Practices for Residential Covered Bonds establish a template for U.S. covered bond issuances and outline additional standards intended to bolster investor confidence in covered bonds. The Best Practices are not enforceable, but are meant to complement the Policy Statement and promote the creation of a high-quality, standardized U.S. covered bond market.

The Treasury Department defines a covered bond as a debt instrument with a maturity of more than one year and less than 30 years secured by a perfected security interest in a specific pool of collateral.

***What guidance do the Best Practices offer relating to assets in the cover pool?***

The cover pool is limited to residential mortgage loans that meet certain quality characteristics. The Best Practices recommend that an issuer maintain an over-collateralization of at least 5% of the outstanding principal amount of the covered bonds at all times and actively manage the assets to maintain the quality required.

In addition, the Best Practices recommend that the loans have a maximum loan-to-value ("LTV") ratio of 80% in order to be eligible for the cover pool, no single metro statistical area should make up more than 20% of the cover pool, and negative amortization mortgages should not be included. Mortgages in the cover pool should be first-lien only. For purposes of calculating the minimum overcollateralization required, only the portion of the loan not exceeding 80% LTV will be credited.

***How do the Best Practices suggest further securing timely payments to covered bond holders?***

The Best Practices recommend that, at the time of issuance, the covered bond issuer enter into one or more swap agreements to: (1) provide scheduled interest payments, in the event that the issuer becomes insolvent, until proceeds are received from the FDIC or liquidation of the collateral; and (2) mitigate timing mismatches between interest payments and interest income, if applicable. This is consistent with the existing U.S. covered bond structure.

If a covered bond is denominated in a currency other than U.S. dollars, the Best Practices recommend the issuer enter into a currency swap at the time of issuance.

The Best Practices also recommend that an issuer enter into a GIC, or other similar arrangement. The GIC should pay ongoing scheduled interest and principal payments after a default or repudiation by the FDIC, so long as the GIC provider receives proceeds from the cover pool at least equal to the par value of the covered bonds.

***How do the Best Practices promote a U.S. covered bond market?***

In addition to providing guidance that complements the Policy Statement, the Best Practices expand on issues affecting the covered bond market in an attempt to standardize industry practices.

The Best Practices set forth cover pool disclosure requirements intended to boost investor confidence in the covered bond market. For example, the Best Practices suggest that the issuer should make available to investors descriptive information about the cover pool at the time of issuance and on a monthly basis thereafter. If more than 10% of the cover pool is substituted within any month, or more than 20% within any quarter, the issuer should provide investors with updated information. Results from asset coverage tests that are required to be performed monthly to ensure compliance with threshold collateral levels also should be made available to investors. In addition, the depository institution and the SPV (if one is used) should disclose any other information that an investor might view as material to an investment decision.

The information that the Best Practices suggest be included in a disclosure document is consistent with the information that would be disclosed for a registered asset-backed securities offering to which the disclosure requirements of Regulation AB (promulgated pursuant to the Securities Act) would be applicable prior to the recent amendments to Regulation AB.

***How do the Best Practices affect the structure of U.S. covered bonds?***

The Best Practices specifically contemplate covered bond issuance—either through a newly created, bankruptcy-remote SPV, or directly by the depository institution and/or a wholly-owned subsidiary. The SPV approach is in line with the current U.S. structure. The direct issuance approach, where the issuing institution designates a pool of residential mortgages that constitute the cover pool, is the structure currently used in Europe. *See* "Covered Bond Structure in the United States" and "Covered Bond Structure Outside of the United States."

By recognizing both structures, the Best Practices provide issuers with flexibility when determining how to structure transactions. This flexibility is important because the Best Practices also specify that covered bonds may be issued either as registered securities or pursuant to an exemption from the registration requirements of the Securities Act. If banks were to use a direct issuance structure, covered bonds might be eligible for the exemption from registration provided by Section 3(a)(2) under the Securities Act for "bank securities."

Although the Best Practices provide additional guidance that will assist in promoting a U.S. covered bond market, the guidance is limited to covered bonds where the collateral in the cover pool consists of residential mortgages. The structure set forth in the Policy Statement and Best Practices can be used to issue covered bonds using various types of receivables as collateral, such as car loans and credit card receivables. Broadening the scope of assets that could be used in the cover pool would make this guidance applicable to a greater number of financings.

## Covered Bonds Under the Dodd-Frank Act

***What rules promulgated under the Dodd-Frank Act, if any, affect covered bonds issued in the United States or to U.S. investors?***

The Dodd-Frank Act, required, among other things, that the SEC adopt a number of rules relating to asset-backed securities. Such rules include risk retention requirements, asset-level disclosure requirements (including enhanced disclosure under Regulation AB), and the prohibition of conflict of interests and heightened disclosures in connection with credit ratings.

Asset-backed securities are defined under the Dodd-Frank Act to mean (A) a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

(i) A collateralized mortgage obligation;

(ii) A collateralized debt obligation;

(iii) A collateralized bond obligation;

(iv) A collateralized debt obligation of asset-backed securities;

(v) A collateralized debt obligation of collateralized debt obligations; and

(vi) A security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

Since covered bonds are primarily senior debt obligations of the issuing bank payable from the bank's general funds and the cash flows from the cover pool assets are used to pay on the bonds only upon an issuer event of default, covered bonds do not meet the definition of asset-backed securities under the Dodd-Frank Act.

***If covered bonds do not meet the definition of asset-backed securities, why are these rules relevant to covered bonds?***

In most cases, these rules relating to asset-backed securities are not applicable or relevant to covered bonds because absent an unusual structure, covered bonds are not asset-backed securities. Other rules, such as risk retention, would not affect covered bond deals even if covered bonds were deemed to be asset-backed securities because the structure of covered bonds is such that the cover pool assets remain on the issuer balance sheet so the issuer retains 100% of the risk. SEC Exchange Act Rule 17g-5 was amended to further clarify rules relating to certain conflicts of interest between arrangers and the rating agencies hired to rate their products and to require the posting of all communications between the parties in connection with the rating process on a secured website for other rating agencies to access. Arrangers also would have to maintain such information over the life of the rating and provide signed representations to such effect. Rule 17g-5 is broader than other rules discussed in that it relates to all structured finance products, not just asset-backed securities and its purpose was to discourage ratings shopping. Despite the broader definition, however, generally covered bonds are not subject to the rule.

That said, some of the heightened disclosure requirements, including asset-level disclosure under revised Regulation AB, may be applicable to Canadian issuers who issue registered covered bonds after the effective date of the Regulation AB amendments pursuant to registration statements filed with the SEC that were filed in reliance on no-action letters granted by the SEC.

Since RBC, BNS and BMO were eligible to register securities on Form F-3 but their related covered bond guarantors were not, these Canadian banks sought no-action relief from the SEC that would allow them to register the covered bonds and the guarantor's guarantee on Form F-3. The no-action relief was granted subject to certain conditions being met, including meeting certain disclosure requirements under Regulation AB despite the fact that covered bonds do not meet the definition of asset-backed securities (and therefore would not otherwise be subject to Regulation AB). The heightened asset-level disclosure required under Regulation AB must be provided for all issuances that occur on or after November 25, 2015. Item 1125 sets forth the data requirements, which for residential mortgages include 272 data points relating to the borrower, the loan, and the property. Item 1111 sets forth the filing requirements and the format for such filings. The type and amount of data required has raised consumer and data privacy concerns and is further complicated for non-U.S. issuers who are subject to different consumer and data privacy laws or whose home country's mortgage lending market is different than that in the United States resulting in some of the information being inapplicable or unavailable.

***Are there any other rules promulgated under the Dodd-Frank Act that do apply to covered bonds?***

The Volcker Rule, which was adopted pursuant to Section 619 of the Dodd-Frank Act, could have implications for some covered bond issuers or investors. The Volcker Rule was designed to prevent or limit bank investments in hedge funds or private equity funds. By its terms, the Volcker Rule prohibits or limits a bank from holding an ownership interest in a covered fund. A covered fund is defined under the Volcker Rule as any entity that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act for an exemption from the requirement to register as an investment company under the Investment Company Act because those are exemptions commonly used by hedge funds and private equity funds. Unfortunately, those exemptions are also used by many other types of entities, including some covered bond issuers and many asset-backed issuers.

Therefore, in technical terms, the question is whether an investment in a covered bond constitutes an "ownership interest" in a non-exempt "covered fund" as such terms are defined in the Volcker Rule. If an issuer of covered bonds is deemed to be a covered fund because Sections 3(c)(1) or 3(c)(7) is the only exemption available to it, then investment in the covered bonds by a U.S. bank would be prohibited or limited under the Volcker Rule unless (a) the covered fund fell within one of the Volcker Rule covered fund exclusions, or (b) the investment in the covered bonds did not represent an "ownership interest" in the covered fund as defined in the Volcker Rule.

If the covered bonds were issued in a U.S. public offering, then the Volcker Rule would not be applicable since entities cannot rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act if they have made a public offering of securities. The same is true if the issuing bank makes a private offering of covered bonds but has other publicly offered securities outstanding. If the covered bonds were not issued in a U.S. public offering (*i.e.*, issued in a private offering or non-U.S. offering), sometimes the prospectus will specify what Section of the Investment Company Act the issuer relied upon for an exemption. If a Section other than Sections 3(c)(1) or 3(c)(7) is specified, no further analysis is required as the covered bonds will be outside of the scope of the Volcker Rule and investment in the covered bonds will not be subject to restriction under the Volcker Rule.

If there is no specific reference to the Section of the Investment Company Act relied upon by the issuer, it may be possible to determine whether Section 3(c)(5) of the Investment Company Act may be available in order to rule out the need to rely on Sections 3(c)(1) or 3(c)(7). If the offering documents for the covered bonds list the assets held by the issuer, you may be able to determine if Section 3(c)(5) is an available exemption. As described above, Section 3(c)(5) provides an exemption from registration requirements of the Investment Company Act for an issuer that is not engaged in the business of issuing redeemable securities and that is primarily engaged in the business of purchasing or making various types of specified loans. Section 3(c)(5)(C) is most often the exemption available to covered bond issuers because it provides an exemption for an issuer who has at least 55% of its assets consisting of interests in real estate, including residential or commercial mortgage loans. At least 25% of the remaining assets must consist of real estate related assets. Note that securitized mortgage loans would not be qualifying interests in real estate for Section 3(c)(5)(C) but could be, under certain circumstances, a real estate related asset. An investor report from the issuer may also be helpful in determining the issuer's assets. If the issuer's assets satisfy the Section 3(c)(5)(C) requirement, the issuer would not be a covered fund under the Volcker Rule and an investment in its covered bonds would not be subject to restriction under the Volcker Rule.

Rule 3a-6 provides that a foreign bank or foreign insurance company is not an investment company if they are regulated as such in their home jurisdiction and are engaged substantially in commercial banking activity or writing insurance agreements or reinsurance of such agreements. An issuer that is qualified to rely on Rule 3a-6 would not be a covered fund under the Volcker Rule and its covered bonds would not be subject to restriction under the Volcker Rule. In a two-tier structure, such as Canadian covered bonds, this exemption would be available for the issuing bank but another exemption would be required for the non-bank guarantor.

The Volcker Rule also excludes from the definition of covered fund an issuer and a guarantor of covered bonds if one of the entities is a "foreign banking organization" (as defined in the Volcker Rule) and the cover pool consists solely of assets that qualify under the loan securitization exclusion. This exclusion expressly requires a two-tier structure. If the qualifying covered bond exclusion applies, neither of the issuer nor the guarantor would be a covered fund under the Volcker Rule even if one of them expressly relied on Section 3(c)(1) or 3(c)(7) and the covered bonds of such an issuer would not be restricted under the Volcker Rule.

Canadian covered bond issuers now include Volcker Rule representations in their offering documents to notify investors of the Volcker Rule exemptions they are relying on and confirm that the covered bonds are exempt from the Volcker Rule. This has become best practices for these issuers whether they are issuing in the United States or abroad.

## Covered Bond Legislation

***What would U.S. covered bond legislation accomplish?***

U.S. covered bond legislation would codify the treatment of covered bonds, providing a statutory framework for their issuance. Based on the covered bond bills considered to date, legislation would achieve a number of goals necessary to foster a vibrant covered bond market in the United States.

First, legislation would codify how covered bonds are to be treated if the issuer defaults or in the event that the FDIC becomes a receiver or conservator of the issuer's estate. In either case, the estate of the issuer would be split into two estates with the cover pool being set aside for the benefit of the covered bond holders. This framework would provide certainty to investors as to their rights to payment, and timing of such payments, if the issuer becomes insolvent or is in danger of becoming insolvent.

Second, legislation would permit the separated cover pool to borrow on a secured or unsecured basis from the private markets in order to obtain liquidity to make required payments on the covered bonds. This authority is important for investor protection and to maintain the value of the cover pool because it enables the covered bond regulator to avoid having to sell off assets from the cover pool in a fire sale transaction, which could drive down asset value. By utilizing the private markets to obtain much-needed cash for immediate needs, the value of the cover pool is protected.

Third, legislation would increase the types of assets eligible for use in the cover pool by expanding the definition of covered bond. Asset classes would include: residential mortgage loans, home equity loans, commercial mortgage loans, student loans, auto loans, credit card receivables, municipal and state obligations, small business loans and any other asset class designated by the covered bond regulator. Only a single asset class could be used in a covered bond program. Although the proposed definitions of covered bond in the various bills that have been introduced to date have differed, all definitions required that the covered bond be a recourse debt obligation of the issuer, with a term of at least one year, which is secured by specifically identified assets on the balance sheet of the issuing bank which are performing in accordance with the terms of the contracts which created the assets, and for which there is a perfected security interest in such assets for the benefit of the covered bond holders.

Fourth, legislation would establish a program for registering existing and future covered bond programs and would exempt covered bonds from SEC regulation, except for Securities Act anti-fraud provisions.

***What effects might U.S. covered bond legislation have on the U.S. covered bond market?***

With a statutory framework for covered bonds, U.S. covered bond issuers could abandon the synthetic two-tier structure for a direct issuance structure. Thereafter, U.S. issuers could benefit from such advantages as preferential risk weighting for their covered bonds and greater investor protection in the event of issuer insolvency. In addition, a broad statutory definition of covered bond could open the door for more diverse cover pool assets, including credit card receivables, commercial mortgage loans, home equity lines of credit, and public sector loans.

***Is there a U.S. investor base for covered bonds?***

Although there is still no U.S. statutory framework for covered bonds, U.S. investors are eager to invest in covered bonds. With only two U.S. financial institutions with covered bond programs and no new issuances by U.S. issuers in years, U.S. investors are turning to U.S. dollar denominated covered bonds issued by foreign financial institutions. Recognizing the U.S. investor demand and lack of U.S. issuers, Canadian financial institutions have been issuing U.S. dollar denominated covered bonds in Rule 144A private placements in record numbers. In recent years, CIBC, Bank of Montreal, Bank of Nova Scotia, National Bank of Canada, Royal Bank of Canada and

Toronto Dominion all have issued billions of dollars in covered bonds. On July 30, 2012, the Royal Bank of Canada obtained SEC approval for a registration statement for its covered bond program. In 2013, the Bank of Nova Scotia and Bank of Montreal followed suit. In September 2012, Royal Bank of Canada issued $2.5 billion of the first-ever SEC registered covered bonds and has since issued an additional $11.25 billion of such bonds to U.S. investors. The Bank of Nova Scotia has issued $2.9 billion of such bonds. Bank of Montreal has not yet issued any SEC registered covered bonds.

## Covered Bonds and Securitization

***How do covered bonds differ from securitizations?***

Covered bonds in the United States use a synthetic structure derived from securitization techniques in order to replicate the bankruptcy protection provided by statute in Europe. Securitization structures have been a popular method of financing mortgage lending in the United States since the establishment of government sponsored entities. By comparing covered bonds to the well-known securitization structure, it is easy for prospective market participants to see the similarities and differences between the two funding alternatives.

Below is a chart comparing certain aspects of covered bonds to securitizations.

| | Covered Bonds | Securitization |
|---|---|---|
| **Accounting** | On-balance sheet | On/Off-balance sheet |
| **Recourse** | Direct recourse to the originator | Recourse limited to collateral |
| | Upon default of originator, collateral used to repay bonds | Originator insolvency only affects representation and warranty repurchase obligations |
| | Direct payments by issuing bank pay the bonds | Cash flows from collateral pay the bonds |
| | Exposure to management risks of parent company | Servicer risk |
| **Liquidity** | High degree of homogeneity, liquid trading market | Heterogeneous structures, more illiquid secondary market |
| | Limited spread volatility | Limited spread volatility |
| | Bankruptcy segregated from issuer, preferential claim for bond holders | Bankruptcy remote from issuer |
| **Ratings** | Greater linking of bond ratings to issuing bank (may be viewed by investors as a "hybrid") | No linking of bond ratings to parent company |
| **Assets** | Open-ended collateral pool can evolve over time with strict collateral qualifying criteria | Open or closed-ended pools with strict collateral qualifying criteria |
| **Investors** | Large number of eligible investors | Large investor base that typically invests in asset-backed securities |
| | Taps non-securitization investors (liquidity investors) | |
| | Limited overlay with senior unsecured investor base | |

***From an issuer's perspective, what are the advantages of covered bonds over securitization?***

The greatest advantage to U.S. issuers of covered bonds is that the Federal Reserve will accept high-quality, highly rated covered bonds as collateral at its discount window. Private lenders also are likely to find such bonds attractive as collateral for credit extensions.

Covered bonds are not limited to mortgage funding. Similar to securitization, covered bonds are a way to fund originations of receivables, such as auto loans and credit card receivables. It is a way to diversify funding sources and to compete with European depository institutions that regularly access the covered bond market.

From a cost perspective, it is less expensive to structure a covered bond program than a securitization. Also, the issuer is able to offer a lower rate of return to investors because all assets in the cover pool are high quality assets and the investors have dual recourse to both the cover pool and the issuer, which reduces investment risk for investors. In the United States, the issuer does not hold the cover pool assets directly. Instead, the issuer uses proceeds from the covered bond offering to purchase mortgage bonds from the affiliate depository institution. The mortgage bonds are direct obligations of the depository institution.

Another advantage for issuers, in the current economic market, is the ability to attract investors who are wary of securitization. By offering a product that is dual recourse to both the issuing bank and the cover pool, collateralized by high quality assets, providing transparency to investors, and demonstrating an alignment of the interests of the issuer and investors by keeping the mortgage loans on the balance sheet of the mortgage bond issuer, investors may be more confident about investing in covered bonds than they would in a securitization.

The characterization of covered bonds as dual recourse instruments whose ratings are linked to the issuer's parent company also expands the investor base.

***From an investor's perspective, what are the advantages of covered bonds over securitization?***

Covered bonds provide investors with many benefits. The assets in the cover pool are high quality assets, rather than a mix of assets of varying qualities. Since all covered bond series of an issuer are backed by the same high quality assets, there is a larger trading market for covered bonds, which provides greater liquidity for investors.

The assets being used as collateral for the payment of covered bonds remain on the depository institution's balance sheet, so there is an incentive for the depository institution to ensure that it originates performing mortgage loans. If any assets in the cover pool are underperforming, the open-ended pool allows the issuer to substitute performing assets, cash, or cash equivalents. Additions also can be made to the cover pool to replace pre-paying assets, thus avoiding pre-payment risk. In contrast, securitization vehicles are structured to move mortgage loans off the issuer's balance sheet and transfer risk to investors. Collateral pools in securitizations often are closed-ended pools that are subject to pre-payment risk.

Covered bond holders also have dual recourse in the event of default. Investors have a first priority perfected interest in the cover pool. The value of the assets in the cover pool is monitored monthly and results are reported to investors. If assets are not performing, higher quality assets or cash, or cash equivalents, must be substituted into the cover pool. If, for any reason, the collateral in the cover pool is not sufficient to satisfy investors' claims, investors have recourse against the issuer as an unsecured creditor *pari passu* with other unsecured creditors.

Furthermore, pursuant to the FDIC's Covered Bond Policy Statement, holders of covered bonds that meet certain criteria (qualifying covered bonds) will receive additional protections. In the event of an issuer default, investors will receive actual, direct compensatory damages (up to the value of the collateral) from the FDIC if the FDIC is appointed as conservator or receiver of the issuer.

In addition, if the asset coverage test is breached, the issuer has one month to correct the breach. If not corrected, the trustee may terminate the covered bond program and accelerate the mortgage bonds, paying principal and accrued interest to the SPV.

Covered bond holders also are protected from acceleration of covered bond payments upon an issuing bank default. In the event of an issuing bank default, proceeds from the mortgage bonds held by the issuer SPV are invested in guaranteed investment contracts; proceeds from those contracts are paid to a swap provider in exchange for interest and principal due in accordance with the covered bond terms.

## Documentation Generally

***What operative documents are needed for a covered bond transaction?***

In the United States, under the synthetic two-tier structure, two sets of documents are needed. *See "How are covered bonds structured when a SPV is established to issue or guarantee the covered bonds?"* for an explanation of such structure. There is a set of documents relating to the covered bond issuance and a set of documents relating to the mortgage bond issuance. The operative agreements in a covered bond transaction are the mortgage bond indenture, the covered bond indenture, the asset monitor agreement, and the swap agreements.

## The Indentures

***What is the purpose of the mortgage bond and covered bond indentures?***

The mortgage bond indenture creates the mortgage bond held by the issuer SPV. Each program has a base indenture with a supplement for each series. The parties to the mortgage bond indenture are the issuing bank as the mortgage bond issuer and the mortgage bond trustee. The mortgage bond indenture trustee is granted a first priority security interest in the mortgage loans securing the mortgage bond. The mortgage bond indenture trustee's role is to protect the issuer SPV and enforce its rights in the event of a mortgage bond issuer default.

Similarly, the covered bond indenture creates the covered bonds held by the covered bond holders. Each program has a base indenture with a supplement for each series. The parties to the covered bond indenture are the issuer SPV as the covered bond issuer and the covered bond trustee. The covered bond indenture trustee's role is to protect the covered bond holders and enforce their rights in the event of a covered bond issuer default.

## The Asset Monitor Agreement

***What is the purpose of the asset monitor agreement?***

The asset monitor agreement is entered into by the mortgage bond issuer, the mortgage bond indenture trustee, the covered bond indenture trustee, and the asset monitor. The mortgage bond issuer performs an asset coverage test of the collateral in the cover pool on a monthly basis to ensure that threshold requirements set by the rating agencies are maintained. The asset monitor performs such a test for accuracy at the time of issuance and annually by confirming calculations performed by the mortgage bond issuer. If there is a downgrade of the mortgage bond issuer or the mortgage bond issuer makes a significant error in its calculations, the asset monitor will perform the asset coverage test monthly and notify all parties to the agreement, including the rating agencies, of the test results.

***How is the asset coverage test calculated?***

The monthly asset coverage test protects covered bond holders by ensuring that the cover pool assets are performing and that their investment is secured by collateral at least equal to the principal and interest owed. Calculations are performed to ensure that the adjusted aggregate loan amount is equal to or greater than the amount owed on the outstanding mortgage bonds.

The adjusted aggregate loan amount is equal to the value of the mortgage loans, adjusted for current valuation, second lien loan adjustments, delinquencies, and material breaches of bank covenants plus principal collected on the mortgage loans following a mortgage bond issuer ratings downgrade plus any substitution assets (not to exceed 10% of the cover pool).

Failure to meet the asset coverage test is a mortgage bond default and no new series of mortgage bonds may be issued. In addition, no mortgage loans may be removed from the cover pool unless the asset coverage test is met.

## The Swap Agreements

***What is the purpose of the swap agreements?***

There are two types of swap agreements that the issuer SPV may enter into with the swap provider: interest rate swap agreements and currency swap agreements.

Mortgage bonds have floating interest rates and covered bonds generally have fixed interest rates. The issuer SPV will enter into an interest rate swap to ensure that there is adequate cash flow to make interest payments to covered bond holders. An interest rate swap also can be used to mitigate timing mismatches between interest payments and interest income, if applicable.

The other swap agreement that the issuer SPV may enter into with the swap provider is a currency swap. The mortgage bonds are issued in U.S. dollars;

covered bonds, even in the case of U.S. issuers, often are denominated in euros. If the mortgage bonds and the covered bonds are issued in two different currencies, the issuer SPV enters into a currency swap to ensure that there is adequate cash flow to make interest and principal payments to covered bond holders.

Pursuant to the terms of the swap agreement, the swap provider must pay interest payments even if the mortgage bond issuer cannot make its scheduled interest payment (these become deferred payments to the swap provider). These amounts are repaid to the swap provider by the SPV using payments received from the mortgage bond issuer as soon as possible, provided that following a covered bond acceleration, they are paid only after the covered bonds are repaid in full.

After a mortgage bond event of default, the covered bond indenture trustee will transfer all amounts received from the mortgage bonds (proceeds or compensatory damage payments) to the GIC provider. Payment received under the guaranteed investment contract are paid to the swap provider in exchange for the swap provider making all payments in relevant currency for interest and principal to the covered bond holders.

***What happens if there is a rating downgrade of the swap provider?***

Transaction documents typically provide that, in the event of a swap provider downgrade, the swap provider must obtain a third party guarantee, find a replacement swap provider, post collateral, or take action to maintain/restore ratings of covered bonds.

## Ancillary Documents

***What ancillary documents are needed in a covered bond transaction?***

The ancillary documents needed for a covered bond transaction are the securities account control agreement, the reimbursement agreement, and the GIC or similar type of deposit agreement. Generally, auditor "comfort" letters and law firm opinions may also be required.

The securities account control agreement governs the control of securities in the event that qualified securities are substituted for under-performing mortgage loans in the cover pool. The agreement is entered into between the mortgage bond issuer, the mortgage bond indenture trustee, and the securities intermediary (which often is the same party as the mortgage bond indenture trustee).

Under a reimbursement agreement, the mortgage bond issuer's corporate parent agrees to reimburse certain costs and fees related to issuances under the covered bond program. The reimbursement agreement is entered into between the mortgage bond issuer, its parent company, and the covered bond issuer.

***What is the purpose of the guaranteed investment contract?***

The GIC or similar guaranteed contract, such as a deposit agreement, is entered into between the covered bond indenture trustee and the GIC provider. The reason for entering into a GIC, pursuant to which the proceeds of the cover pool are invested with (or by) one or more financially sound counterparties, is to ensure ongoing scheduled interest and principal payments after a mortgage bond default or repudiation of the mortgage bond by the FDIC. Upon a mortgage bond issuer event of default, compensatory damage payments from the FDIC or proceeds from the liquidation of mortgage loans are transferred directly to the GIC provider and invested for the benefit of the covered bond holders, so long as the GIC provider receives proceeds from the cover pool at least equal to the par value of the covered bonds. Provided the proceeds compliance test (set forth below) is not breached, the GIC is used to keep the covered bonds from being accelerated. Investments are made with maturities immediately prior to payment dates (interest and maturity).

***What is a proceeds compliance test?***

Upon a mortgage bond event of default, the covered bond indenture trustee performs a proceeds compliance test to ensure that there are adequate proceeds to avoid a covered bond acceleration event. Thereafter, the valuation tests are performed monthly.

The proceeds compliance test is performed by adding the amounts deposited into the GIC account and prior to receipt of compensatory damages or proceeds on the mortgage bonds, the aggregate unpaid principal of each series of mortgage bonds. The sum must be greater than the aggregate principal amount of all series of covered bonds on the acceleration date (taking into consideration repayments of principal). Failure to meet this test is an event of default under the covered bonds.

***What issuance documents are needed for a covered bond transaction?***

The issuance documents needed for a covered bond transaction are the mortgage bond purchase agreement, and the offering agreement, which could be a general program agreement, a Rule 144A program agreement, or a Regulation S program agreement, and often times also a supplemental subscription agreement.

The mortgage bond purchase agreement governs the sale of the mortgage bonds to the covered bond issuer. The agreement is entered into between the mortgage bond issuer and the covered bond issuer.

The Rule 144A program agreement governs the sale of the covered bonds to investors that meet the requirements to purchase unregistered securities under Rule 144A. The Regulation S program agreement governs the sale of covered bonds in transactions that meet the requirements under Regulation S of the Securities Act. The program agreements can be executed for each transaction or can be executed at program establishment.

The subscription agreement also governs the sale of the covered bonds and is used on an issuance basis to supplement a program agreement that is executed at program establishment. The subscription agreement incorporates by reference the program agreement. The subscription agreement is entered into between the covered bond issuer, securities dealers participating in the specified issuance, and the mortgage bond issuer.

***What additional documents, if any, are needed for a SEC registered covered bond transaction?***

For a SEC registered covered bond issuance, the issuer must have an effective registration statement on file with the SEC. In addition, the issuer must file the offering documents provided to investors, such as the base prospectus and any related pricing supplement. Pursuant to no-action letters granted to Royal Bank of Canada, the Bank of Nova Scotia, and Bank of Montreal, these issuers also must include certain cover pool data in their offering documents and file monthly investor reports on Form 10-D containing additional cover pool and program data on an ongoing basis.

When conducting a SEC registered offering, underwriters will expect to execute a U.S. style underwriting agreement and will require the issuer's accounting firm to deliver comfort letters on financial information and cover pool data, and law firms to deliver customary legal opinions with respect to the issuance and U.S. securities law matters.

## Payment Flows

***What is the payment flow for covered bonds?***

Interest on the mortgage bonds is paid monthly, with principal paid on the maturity or redemption date. The covered bond indenture trustee uses the monthly income from the mortgage bond to make payments to the swap provider. On an interest payment date, the swap provider deposits interest payment date payments with the covered bond indenture trustee and if owed, the covered bond indenture trustee makes a termination payment to the swap provider, but only after the payment of all outstanding covered bonds is made in full. On each interest payment date, the covered bond indenture trustee pays interest to the covered bond holders or, if there are currency differences, to the currency swap provider who will deposit the appropriate currency with the covered bond indenture trustee.

On the maturity date, the swap provider deposits maturity date payments with the covered bond indenture trustee and the covered bond indenture trustee pays principal to the covered bond holders.

***What happens to payment flows if the mortgage bond issuer experiences a rating downgrade?***

If the long-term rating of the mortgage bond issuer is reduced to Baa1 or below, or the short-term rating of the mortgage bond issuer is reduced to A-2 / F2 or below, then the mortgage bond issuer must make daily deposits of principal and interest payments received on the mortgage loans into a mortgage bond account at the trustee bank within 28 days from such ratings downgrade. The excess interest is returned to the mortgage bond issuer if interest is paid in full to the covered bond issuer on each interest payment date. The excess principal is returned to the mortgage bond issuer if the monthly asset coverage test is satisfied. *See "How is the asset coverage test calculated?"*

If the long-term rating of the mortgage bond issuer is reduced to BBB- / Baa3 / BBB- or below, then the mortgage bond issuer must make daily deposits of principal and interest on the mortgage loans into a mortgage bond account at the trustee bank within 60 days from such ratings downgrade. The excess interest is returned to the mortgage bond issuer if interest is paid in full to the covered bond issuer on each interest payment date. The excess principal is returned to the mortgage bond issuer if the monthly asset coverage test is satisfied.

Also within the 60-day time period, the mortgage bond issuer must transfer all mortgage loan files as directed by the mortgage loan indenture trustee, with notice to the rating agencies. Within five days of the addition or substitution of a mortgage loan into the cover pool, loan files for all such loans must be delivered to the mortgage loan indenture trustee.

***What happens to payment flows if there is a mortgage bond acceleration?***

On the maturity date, the swap provider deposits maturity date payments with the covered bond indenture trustee. On the maturity date, the covered bond indenture trustee pays principal to the covered bond holders.

If there is a mortgage bond acceleration but no covered bond acceleration, the covered bond indenture trustee, upon receipt of notice of a mortgage bond acceleration, or, if earlier, receipt of money in respect of such mortgage bond (the "mortgage bond proceeds") deposits the mortgage bond proceeds into an account specified for the relevant series of covered bonds. The covered bond indenture trustee uses such proceeds to pay the fees of various trustees and agents and swap provider under the indenture. The trustee also invests proceeds in a GIC and proceeds from the GIC are paid to a swap provider in exchange for interest and principal due on each series of covered bonds.

On an interest payment date, the swap provider deposits interest payment date payments with the covered bond indenture trustee and if owed, the covered bond indenture trustee makes a termination payment to the swap provider, but only after payment of all outstanding covered bonds is made in full. On each interest payment date, the covered bond indenture trustee pays interest to the covered bond holders.

***What happens to payment flows if there is a covered bond acceleration?***

Upon receipt of payments, the covered bond indenture trustee deposits into the applicable receipts account at the trustee (1) all payments of interest and principal on the mortgage bonds and (2) mortgage bond proceeds. On the next interest payment date, the covered bond indenture trustee will pay fees and expenses owed to the indenture trustee, the administrative trustee, and the paying agents. Then, *pari passu*, the covered bond indenture trustee will pay to each swap provider all applicable termination payments (other than excluded payments), the balance of remaining funds for exchange under the swap agreement (for payments of interest and principal), and any excluded termination payments and deferred amounts. Next, the covered bond indenture trustee will pay any unpaid trustee fees, and repay the beneficial owner of the SPV trust its contribution. Lastly, from the amounts received from the exchange with the swap provider above that are deposited into the distribution account for the benefit of the holders, the covered bond indenture trustee will pay interest and principal due to the covered bond holders.

By Anna T. Pinedo, Partner, and

Jerry R. Marlatt, Senior Of Counsel,

Morrison & Foerster LLP