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Focus on: Covered Bonds
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OSFI about to adjust Canada's Issuance Limit



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On 19 November, the Canadian banking regulator OSFI published a **statement** outlining plans that are already relatively advanced to amend the issuance limit for Canadian covered bonds. Under the consultation draft, the maximum amount of cover pool assets for the six domestic systemically important banks (D-SIBs) would increase from 5.5% to 7% of assets. Small and medium-sized institutions (SMSBs) would in future be permitted to pledge up to 15% of their domestic assets for covered bonds. Until now, both D-SIBs and SMSBs have been subject to a limit of 5.5% of total balance sheet assets. For SMSBs, both the ratio and the denominator therefore change; foreign-currency assets are deducted. The consultation runs until 18 January 2027, and the final rule is scheduled to take effect in May 2027.

Issuance Freedom Versus Creditor Protection

Very few covered bond regimes impose such limits at all. The basic purpose of these caps is to prevent banks from tying up too large a share of their assets for the benefit of covered bond investors. The larger the cover pool, the fewer unencumbered assets remain available to satisfy other creditors in the event of insolvency or resolution. The cap therefore applies not to the outstanding volume of covered bonds, but to the total assets encumbered, including overcollateralisation.

This initiative forms part of a broader regulatory reorientation aimed at promoting competition in the Canadian banking sector. In particular, smaller institutions are to gain better access to covered bond funding and thereby diversify their sources of financing. At the same time, OSFI is retaining quantitative limits in order to protect the interests of unsecured creditors and depositors.

For covered bonds, this creates an increasingly favourable regulatory environment. Eligible instruments in Canada can already be recognised as Level 2A HQLA with a 15% LCR haircut. In addition, OSFI will reduce the risk weight under the capital framework in 2027 for exposures to Canadian systemically important institutions – including their covered bonds – from 20% to 15%. The issuance limit therefore complements demand-side incentives with a supply-side easing; however, the rules are legally separate.

Issuance Limits Ignore Positive Externalities

We welcome this easing and generally view issuance limits critically, typically as a sign of relatively early-stage covered bond markets – a stage that Canadian covered bonds have long since outgrown. We understand the basic scepticism of supervisory authorities in new covered bond markets regarding asset encumbrance. But we are convinced that the negative externality of covered bonds for unsecured debt also comes with a positive externality that supervisors are often too quick to overlook: while the existence of covered bonds, and especially the associated overcollateralisation, does increase the loss given default (LGD) for unsecured creditors, the mere existence of covered bonds reduces the probability of default (PD) through lower overall funding costs and more efficient access to debt funding sources. On a combined basis (PD × LGD), the introduction of a covered bond program may therefore, despite increasing asset encumbrance, lead to a lower expected loss.

What Would the Change Mean for Individual Issuers?

Before turning to the numbers, we would like to highlight a particular regulatory feature. Canadian covered bond regulation does not take voluntarily or incidentally held overcollateralisation into account when calculating the OSFI limit (Canadian Registered Covered Bond Programs Guide 4.3.8).

In addition, the domestic assets of SMSBs cannot be readily verified from the outside. In our presentation, we assume a maximum value based simply on a 100% domestic-asset assumption.

The overcollateralisation figures (OC) are derived from the recognised cover pool and the outstanding amounts published by CMHC. Because the cover pool data are rounded, these are approximate values rather than the exact OC figures reported in the monthly investor reports. In the case of Fairstone, the figures refer to the period before the Laurentian acquisition. However, since Fairstone has only just issued its first covered bond, the implications of the issuance limits are in any event of limited practical relevance.

Caisse Centrale Desjardins (CCDJ) is not regulated by OSFI, but by the Autorité des marchés financiers (AMF). Accordingly, the OSFI limit adjustment is not actually relevant for CCDJ. Nevertheless, we consider it reasonable to assume that the AMF will make a similar decision, and we base this assumption on the parallel decision by OSFI and AMF to apply a 10% limit during the COVID crisis.

CANADA | Covered Bond Cover Pool Limits

Issuer	Total Assets CAD bn	Limit old CAD bn	Limit new CAD bn	CB outst. CAD bn	Related effective Collateral	OC %	Headroom old CAD bn	Headroom new CAD bn
RBC	2.396,4	131,8	167,7	61,7	66,4	7,6%	65,4	101,3
TD	2.085,5	114,7	146,0	62,9	66,3	5,3%	48,4	79,7
Scotiabank	1.521,8	83,7	106,5	59,4	63,1	6,3%	20,6	43,4
BMO	1.500,0	82,5	105,0	26,2	28,0	6,9%	54,5	77,0
CIBC	1.160,0	63,8	81,2	39,6	42,5	7,2%	21,3	38,7
National Bank	616,4	33,9	43,1	9,4	10,2	8,2%	23,7	32,9
D-SIBs total	**9.280,1**	**510,4**	**649,6**	**259,2**	**276,5**	**6,7%**	**233,9**	**373,1**
Desjardins	523,6	28,8	28,8	18,5	19,5	5,2%	9,3	9,3
Equitable Bank	52,7	2,9	7,9	1,5	1,7	11,5%	1,2	6,2
Laurentian Bank	50,9	2,8		0,3	0,3		2,5	
Fairstone Bank	32,5	1,8		0,8				

Sources: Issuers Websites, OSFI, CMHC, Bloomberg, Helaba Research



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