Funds Management Division
Financial Sector Policy Branch
Department of Finance Canada
James Michael Flaherty Building
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Ottawa ON, K1A 0G5

Sent to: CMBconsultation-consultationsOHC@fin.gc.ca

Dear Department of Finance,

We are writing this letter on behalf of the members of the Mortgage-Backed Securities Issuer Association[1] ("MBSIA") as a response to the Department of Finance request for consultation related to CMB consolidation. The MBSIA has been serving the mortgage-backed securities industry since the 1980s and to this day continues to represent industry participants who access the wholesale funding market through the NHA MBS and CMB programs. Our membership comprises diverse number of issuers, from small non-bank lenders, trust companies, credit unions to large Schedule 1 Banks.

The CMHC securitization programs are a critical source of mortgage funding for our members. In addition, the programs have been a source of significant fee revenues through the timely payment guarantee fees. These fees provide an income stream for CMHC that can be returned to the federal government in dividends from CMHC.

In this response we are sharing a summary of these diverse perspectives in relation to CMB consolidation proposal. Our response to the Department of Finance questions will focus on the government's outlined overarching objectives:

1. More efficiently fund NHA-MBS purchases and redirect savings to priority affordable housing programs
2. Ensure continued stability of the Canadian mortgage market
    - Minimize impact on price and quantity of NHA-MBS purchases
    - Consistent support to small and medium sized lenders, which promotes competition in the Canadian mortgage market
3. Maintain the sustainable and flexible GoC borrowing program

The MBSIA website includes a complete list of active members.

Overall Comments

We thank the Department of Finance for seeking the industry's feedback on the proposed consolidation of the CMB program into the government's regular borrowings. The CMB has become a critical component of the Canadian mortgage market. The NHA MBS and CMB programs have been tailored to provide a larger benefit and anchor funding base to small and medium sized lenders with fewer alternative funding sources, which has been a vital component of facilitating strong competition in the mortgage market.

Any material changes in these programs will thus have a disproportionate impact on these small and medium sized lenders. The Department of Finance has done a good job of recognizing some of those concerns which is noted in the questions being asked in the consultation.

Unfortunately, the consultation has left out critical details of whether or how the CMB program itself may change. The lack of clarity as to how the consolidation would be implemented has presented challenges in tailoring the response. As part of our response, we are seeking clarification on key aspects regarding the future state of the CMB program so that we can assess the impact of the consolidation on the stability, predictability, capacity, hedging, and liquidity related to the program.

There are a range of views within the industry regarding the merits of the proposal, and individual members have been encouraged to submit their comments. If the government decides to proceed with the proposal, the fundamental ask from our membership is to keep the existing CMB infrastructure in place for the most orderly transition. The most critical infrastructure features to maintain are (1) the bullet funding structure in 5- and 10-year terms that uses the existing seller swap mechanism and (2) the availability of a market hedging instrument that preserves the predictable funding rates.

Consolidation of the CMB program as proposed could impact and potentially disturb a well-established program. The existing program has provided numerous advantages to the Canadian market, from stable and reliable source of funding to attracting international investors and supporting growing liquidity in the Canadian capital markets. As a predictable source of low-cost funds, the existing program supports competition among mortgage lenders.

While the membership of the MBSIA generally support the government's overall outlined objectives, the members suggest that it may be difficult to satisfy all three objectives simultaneously. The following outlines two options that could facilitate a more effective way for the Department of Finance to meet their stated objectives:

1) Instead of consolidation of the CMB program into the government's debt management strategy, the Department of Finance could approve an increase in the CMB and NHA-MBS funding programs that would generate additional guarantee fees revenue that can be directed to affordable housing programs. This objective could be further supported by directing the majority of the additional CMB funding to 10-year term that largely supports multi-unit residential lending.

The Department of Finance could become a dominant buyer of each of these respective issuances. This would allow the government to capture any realizable spread savings as well as the additional CMB and NHA MBS guarantee fees without disturbing a well-functioning market and continuing to support the Canadian capital market depth and liquidity.

2) Alternatively, the Department of Finance may also consider investing in the current CMB program, progressively increasing their purchase capacity until they are buying a substantial portion of a tranche or the entire tranche in due course. This would allow maintenance of existing pricing dynamics but support governments objectives of capturing any potential economic benefit via CMB spread. A moderate transitional approach would allow for observation of pricing and liquidity impact on the Government debt program, CMBs, mortgage market and other Canadian credit products together with continuation of market-based hedging instrument availability.

We believe that either of those options would continue to support lending market stability, predictability, efficiency and continue to foster competition within the Canadian mortgage market while providing much needed additional revenues to redirect to affordable housing programs. However, if the government proceeds with a partial or full consolidation, the government should make its holdings of CMBs available for borrowing. This would support mortgage lenders' need to borrow CMBs to establish short positions and allow for a smooth continuation of established hedging activities.

Below please see direct responses to the three Parts of the consultation.

Assessing Market Impact

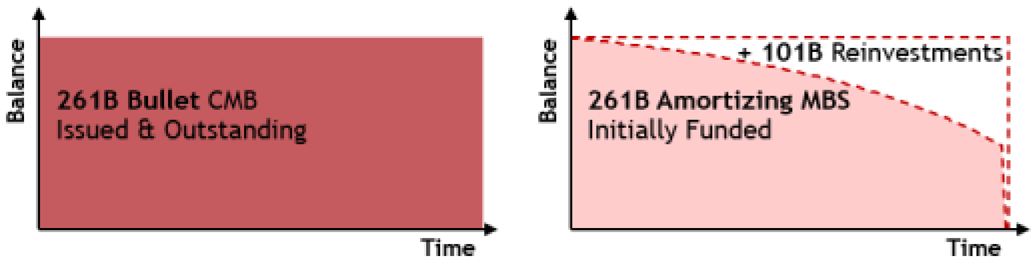
Given the entrenched and predictable CMB process, any changes to the program would impact all its participants. Below we address key potential impacts, subject to the implementation, and reach of those changes:

a. Liquidity and Funding Capacity

As a bullet funding program, the CMB requires reinvestment of amortized NHA MBS principal through the swap mechanism, which impacts both the liquidity aspect of the NHA MBS market as well as the market's funding capacity. The amount of funding that is generated by the CMB program is larger than $40 billion per annum due to the reinvestment feature. The reinvestment portion of the program acts as a large and stable buyer of NHA MBS and provides ongoing liquidity to the NHA MBS market. Reinvestment comprises ~39% of total NHA MBS sold to CMB over the course of the program.

If the structure is changed to become amortizing (similar to IMPP introduced in March 2020) we believe this may have significant impact on liquidity in general, and especially for lenders with less diversified funding models. To support the Government's objective of ensuring continued stability of the Canadian mortgage market by minimizing the impact on price and quantity of NHA MBS purchased and to provide consistent support to small and medium-sized lenders, maintaining reinvestment and bullet funding features of the CMB program are paramount. The bullet structure and swap mechanism also simplify the pricing process for the NHA MBS sold to CHT.

Graph 1: Demonstration of how the current structure behaves through time.



b. Pricing Predictability and Transparency

Current "on the run" CMB bonds provide an effective and cost-efficient hedging mechanism for certain issuers allowing them to hedge both the interest rate risk and credit spread risk. This hedging approach provides a competitive advantage for smaller and medium sized lenders by providing a low risk, cost effective hedging option for a long-term mortgage pipeline. Pipeline hedging allows mortgage lenders to offer rate holds to mortgage borrowers leading to well a functioning and competitive market. The absence of an observable market-based instrument for hedging both the interest rate risk and credit spread risk will introduce uncertainty to those lenders, which is likely to result in more expensive/imperfect hedging outcomes that will likely trickle down via mortgage pricing to the consumer, potentially negatively impacting affordability considerations. This is especially relevant to multi-family and affordability sector where long mortgage commitment periods are common to accommodate complex underwriting processes and funding solutions that dovetail with construction phases.

The predictability of the current CMB program enhances the ability to hedge the cost of funds with existing CMBs allowing mortgage lender to commit to longer-term pricing for insured single family, multi-family, and affordable housing lending solutions. These may become more expensive if CMB hedging is no longer available, which runs counter to the government's objective of supporting affordable housing.

A more complicated hedging (e.g., against a basket of fixed income securities) will not offer a perfect hedge for credit spread risk that the current program offers and may both increase the cost and decrease the effectiveness of commitment hedging for small and medium sized lenders.

c. Investors and capital markets

Elimination of $40 billion of distinct product could decrease Canadian market depth as international investors could pivot to other markets if unable to find appropriate substitute in CAD. Deposit taking mortgage lenders manage portfolios of HQLA, which typically include holdings of CMBs. The removal of $40 billion of eligible annual HQLA assets is likely to drive investors to other assets such as NHA MBS, provincial bonds, covered bonds, ABCP/ABS or other instruments that might need to be further developed to fill the gap. It is difficult to estimate how much demand will transition to GoC bonds, given that their return profile is less desirable.

The CMB market supports international investor participation in Canadian capital markets that took many years to establish. Current syndication processes have aided in international outreach and broad market support and has been helpful to deepen Canadian capital markets. The current CMB syndication process is highly consistent with similar mechanisms used by the Global SSA community, and as such has a strong level of comfort from the international investing community which attracts them to Canada. If the result is decreased international participation, the higher overall funding load would fall on the Canadian investor base (including banks and dealers) to absorb the majority of additional GoC supply. This may have the potential impact of increasing yields across the entire interest rate curve affecting not only Government issuers but also Provincial and Corporate yields. In addition, the risk profile of Canadian primary dealer's balance sheets, who are charged with market making additional supply, could increase bid ask spread on bonds compounding the effect, especially during periods of market volatility.

d. Operational Changes and timing

Given potential impact to funding sources, markets, operations, systems and other considerations to market participants and the government, ample timing should be provided for market participants to adapt to the new process (12-24 months). This time frame could be reduced if government chose to make limited changes to current process.

We also note that certain small and medium lenders rely solely or considerably on CMB funding to support asset origination. Any disruption to this process is likely to generate change to their general operations, at least at the beginning. Mortgage originations could decrease while they reassess their ability to access reliable funding. If changes to the program are limited in nature (i.e., only the buyer of the CMB bonds changes but other aspects of the program remain), that can assuage concerns and be significantly less disruptive.

Adjustment to Government's Debt Management Strategy

The MBSIA members do not have strong views in how the Government manages its borrowing program, however, the members do have a strong preference to maintain the same 5- and 10-year bullet funding. Issuing government debt in the same sectors would limit government's interest rate risk exposure but may have unintended consequences on the government's curve if too much supply is issued in one specific sector. Lack of FRN issuance may impact continued development of the CORRA market where CMBs are playing instrumental role at this time. The government could consider retaining the FRN issuance by using T-bills as the funding and pricing benchmark.

It is not clear what the impact to all credit instruments would be due to extra $40 billion issuance in GoC bonds and some market participants have indicated it may increase the cost of all government debt, which would also make all credit products more expensive. It is likely that this would impact mortgage pricing to consumers making mortgage payments less affordable. Opening other sectors such as 7-year may alleviate some of these considerations, however, the absolute increase in supply of GoC bonds still needs to be considered as they may not be a direct CMB substitute.

Funding Cost for Mortgage Lenders

As noted above, the current CMB market provides a competitive advantage for small and medium lenders to make commitments with minimal uncertainty and without pricing risk. If the existing program attributes are not maintained, the hedging costs and/or pricing risk may increase the funding cost for small and medium sized lenders and the mortgage market may see an increase to the cost of financing for borrowers and/or decrease in profitability for small and medium sized lenders.

While the government is considering the correct objectives, they may not be efficiently achievable in the proposed process. Any small increase in the pricing of government debt could decrease or even eliminate any potential spread capture via investment in the CMB. Uncertainty is further likely to disturb efficient market dynamics and impact affordability. Leaving the program in its current form but expanding total annual CMB issuance where the government is the dominant investor may be a more appropriate pathway for the government to achieve the objectives outlined with limited market impact.

Pricing Considerations

Moving away from market-based pricing will decrease efficiency. It is difficult to determine what pricing criteria would satisfy competitive, efficient, and reliable pricing similar to what has been available from the CMB program. A fixed spread over GoCs is not subject to market moves as CMB is and would introduce pricing distortions between insured mortgages and conventional mortgages, which are subject to the market pricing for credit and liquidity purposes. Certain lenders may not be able to hedge efficiently any pricing mechanism that is derived by hedging a basket of securities. This approach is more complex and may be difficult to implement for a smaller entity. It is also uncertain how the securities in the basket would be impacted (i.e., Provincial bonds) if they become a dominant hedge instrument.

Concluding Summary

We thank the Department of Finance for the opportunity to provide our members views on the proposed consolidation of the CMB program. We agree that the government is considering the right objectives but are not sure that they are all achievable simultaneously. The membership of the MBSIA recommends an increase in the size of the CMB program with the government buying a portion of the CMB issuances. This option could simultaneously satisfy all three of the government's objectives.

We request further clarity on any changes on key features of the CMB program and would like another opportunity to comment once the Department of Finance has determined the proposed approach. Our members look forward to continuing to participate in the vital CMHC securitization programs.

We can be contacted at info@mbsia.ca if you have any questions or would like to discuss any aspect of our responses.

Signed by:

Mortgage-Backed Securities Issuer Association