Intelligence MEMOS

From: Ed Devlin and Anders Forssell

To: Finance Minister Chrystia Freeland

Date: June 26, 2023

Re: **Federal Mortgage-Bond Consolidation Should be a Non-Starter**

The federal government intends to engage in market consultations on the potential consolidation of Canada Mortgage Bonds (CMB) within the Government of Canada borrowing program, it said in its last budget. A decision is expected in the Fall Economic Update.

We would prefer they stay separate, but at a minimum the government should take an incremental approach that will not disrupt markets and it should quantify any benefits before a full-scale roll-out.

Through the Canada Mortgage and Housing Corporation (CMHC), the government aims to make housing affordable and ensure a stable housing finance system. As part of this effort, it sponsors securitization (pooling of assets that are then sold as interest-bearing securities) of insured mortgages through the issuance of CMBs, which it then uses to purchase National Housing Act Mortgage-Backed Securities (NHA MBS) from lenders. Both programs charge a fee in return for a government guarantee of timely payment of interest and principal, which makes the securities more attractive to investors. There is currently about $490 billion of NHA MBS and $260 billion in CMBs outstanding.

The government does not pay the CMB investors and CMBs are not government borrowing. Instead, cash paid to CMB investors comes from homeowner mortgage payments. Ottawa guarantees the payments, but because CMBs are not direct federal borrowing, investors demand a higher yield than Government of Canada bonds. The yield difference has averaged about 0.3 percentage points over the past five years. The government believes it may be able to profit by capturing this yield difference for itself by issuing regular government bonds to purchase those same mortgages.

The one potential benefit of the reform scheme: It can generate additional revenue because it is paying for the NHA MBS with lower cost Government of Canada bonds. Some **estimates** put this benefit as high as $1 billion a year. The Insured Mortgage Purchase Program (IMPP), initiated during 2008-2009, where the Bank of Canada purchased CMHC-guaranteed mortgage-backed securities, was hugely successful at providing liquidity to Canadian banks during the financial crisis while generating government revenue. The current proposal seems to be based on a similar analysis, but we do not believe it is that simple.

This proposed reform will definitely reduce foreign investment into Canada. International investors own approximately $100 billion of CMBs. If they must accept the lower yield of a five-year government bond, some will prefer to invest in the US or other markets. This is especially true since some foreign investors, such as central banks and sovereign wealth funds, are restricted to sovereign and quasi-sovereign bonds, and cannot easily switch into provincial or corporate bonds like most domestic investors. By discontinuing the CMB program, the government risks losing credibility with these investors.

Not all Canadian dollar denominated bonds trade at a spread to CMBs, but all Canadian dollar denominated debt trades at a spread to Government of Canada bonds. So how much would shifting $40 billion a year from the CMB to federal debt cause government bond yields to rise? That is unknowable today (e.g. how much do foreign investors flee Canada?). From our experience in Canadian bond markets, we think federal debt yields rising three to five basis points is conservative. This will increase federal annual borrowing costs by $300-500 million. In addition, there is approximately $7 trillion in debt in Canada that trades at a spread to federal debt. Increasing the yield on this debt by three to five basis points will increase annual borrowing costs by approximately $2 billion to $3.5 billion.

Announcing this potential change was a mistake. Along with creating market participant uncertainty about future reforms, there is a current cost to the economy. Foreign investors shunned the most recent, post-budget, CMB issuance with their share slipping to 15 percent from its historical 30-percent average. CMB daily trading volumes dropped from $3 billion to $2 billion, denying investors precious liquidity. This means mortgage originators have fewer hedging options and therefore offer borrowers less guaranteed interest rates.

And, all this alongside a housing market where mortgage rates have increased significantly as the Bank's tightening has boosted its policy rate 450 basis points to 4.75 percent in a little over a year.

In addition to these practical considerations, there is a more fundamental philosophical question: Who sets borrowing rates for mortgages in Canada? Should it be market driven or set by the government? While there is a strong role for government supervision and regulation in the mortgage market, capital is better allocated by private market participants. Currently, the CMHC manages the CMB program according to its mandate. Consolidating it into the government of Canada borrowing program may lead to more direct government control. As a result, the Canadian mortgage market may become politicized – imagine the election promises! This will not be good for financial stability.

This debt consolidation is not ready for prime time.

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