Residential mortgage-backed securities
April 24, 2018
Introduction

- At the last CFIF meeting, members expressed interest in discussing the development of a Canadian residential mortgage-backed securities (RMBS) market

- Recent developments suggest that RMBS is attracting renewed interest (for example, MCAP’s 2018 deal)

- This deck covers the following:
  - The current landscape
  - Potential avenues to explore in the development of a RMBS market
  - Proposal for a workshop
What is RMBS?

- RMBS transform uninsured illiquid mortgages into a tradeable security (1)

- Rather than keeping mortgage loans on their books, lenders pool their mortgages and sell parts of this pool to investors

- Each part of this RMBS pool is a claim to the cash flows that the lender receives when borrowers make payments on their mortgages

(1) For additional discussion, see Mordel and Stephens (2015) "Residential Mortgage Securitization in Canada: A Review"
Federally regulated financial institutions’ share of low-ratio originations for home purchases has grown rapidly:
- From 2/3 in 2014 to 3/4 in 2017
- Now 90% in Toronto and Vancouver

Potential drivers for this trend include:
- Tighter mortgage insurance criteria
- Rising house prices: more properties over $1M cap for mortgage insurance
- Reduced access to portfolio insurance, notably since fall 2016
- Higher premiums

Tighter access to mortgage insurance has led to a larger share of low-ratio originations (by count, mortgages for purchase only)

Source: Regulatory filings of Canadian banks and Bank of Canada calculations
...limiting funding scope for some originators

- Funding uninsured mortgages may be constrained for:
  - Mortgage finance companies (MFCs) or small and medium size banks (SMSBs) that rely heavily on public securitization (NHA MBS and CMB programs)
  - Lenders with less sticky deposit bases
  - Those close to the covered bond issuance cap

Mortgage Funding Sources

Source: Banks’ regulatory returns, Statistics Canada, company websites
Last observation: 2017Q3

(1) Public securitization funding refers to NHA-MBS and CMB
There are potential opportunities for the development of a private RMBS market

- There is $891B of unencumbered uninsured mortgages on bank balance sheets
  - Monoline SMSBs hold approximately $24B of that total

Monoline SMSBs hold more unencumbered uninsured mortgages as a percent of total assets
There are a number of impediments to the development of a private RMBS market

- Some examples of impediments to the development of a private RMBS market include:

  **Supply Side**
  - D-SIBs have access to cheaper funding sources (deposits, deposit notes, GICs, covered bonds)
  - Non-D-SIBs may not be able to securitize their mortgages
    - Smaller size
    - Potentially riskier mortgages

  **Demand Side**
  - Valuation challenges due to lack of granular-level historical data
  - Yield relative to other fixed income assets
  - Limited appetite for monthly amortizing assets
  - Limited market liquidity and issuance size
Potential avenues to explore for the development of a private RMBS market

- Establishing standards for:
  - collateral
  - deal structure
  - disclosure requirements

- Establishing the appropriate vehicle for RMBS issuance
Potential standards for collateral could include:

- Mortgage size
- Term
- Payment type & frequency
- Property type
- Value
- LTV
- TDS/GDS
- Borrower credit score
Standards which could be established for pools and deal structure could include:

<table>
<thead>
<tr>
<th>Pool</th>
<th>Deal</th>
</tr>
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<tbody>
<tr>
<td>Size</td>
<td>Pass through vs. senior/subordinated structure</td>
</tr>
<tr>
<td>Geographic distribution</td>
<td>Number of tranches</td>
</tr>
<tr>
<td>Servicer quality</td>
<td>Ratings</td>
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<tr>
<td></td>
<td>Risk retention</td>
</tr>
<tr>
<td></td>
<td>Addressing balloon risk</td>
</tr>
</tbody>
</table>
Establishing disclosure requirements

- Access to granular loan-level data, both historical and ongoing, could promote investor interest
  - This supports investor protection, improves market efficiency, and reduces systemic risk\(^{(1)}\)

- Data on insured mortgages could serve as a basis of comparison for the quality of the underlying uninsured mortgages

- In general, disclosure requirements could help establish an appropriate benchmark to determine RMBS spread

Establishing the appropriate vehicle for RMBS issuance

- **Benefits of a single-seller:**
  - Pricing could potentially reflect more acutely the quality of the mortgage pool

- **Benefits of a multi-seller:**
  - Standardization of security and pool structures (consistent with items 1 and 2, i.e. setting collateral and deal standards)
  - Backed by common mortgage eligibility requirements
  - Larger issue sizes, promoting liquidity
Potential workshop to further investigate these topics

Proposal:

- A half-day workshop on the issues related to establishing a private RMBS market
  - Participation: could be broader than CFIF membership to include all types of relevant stakeholders (sell-side, buy-side, issuers, and rating agencies)
  - Timing: June / September

- Areas for discussion could include:
  - Current landscape for an RMBS market
  - Supply and demand side impediments to the creation of an RMBS market
  - Measures to support market development
Appendix
### Amounts outstanding for covered bonds and RMBS in Europe

<table>
<thead>
<tr>
<th></th>
<th>Covered Bonds</th>
<th>RMBS</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Outstanding, € Billions</td>
<td>% of mortgage debt</td>
</tr>
<tr>
<td>UK</td>
<td>97</td>
<td>6%</td>
</tr>
<tr>
<td>Germany</td>
<td>207</td>
<td>18%</td>
</tr>
<tr>
<td>France</td>
<td>178</td>
<td>18%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>68</td>
<td>10%</td>
</tr>
<tr>
<td>Spain</td>
<td>232</td>
<td>44%</td>
</tr>
<tr>
<td>Italy</td>
<td>139</td>
<td>37%</td>
</tr>
<tr>
<td>Ireland</td>
<td>17</td>
<td>17%</td>
</tr>
<tr>
<td>Portugal</td>
<td>33</td>
<td>35%</td>
</tr>
<tr>
<td>Europe</td>
<td>1,639</td>
<td>21%</td>
</tr>
</tbody>
</table>

Source: Deutsche Bank  
Last observation: February 2018
RMBS securitization in the U.S.

Securitization in the United States

USD Billions

% USD Billions

0

500

1,000

1,500

2,000

2,500

3,000


Notes: Non-agency MBS only
Source: Federal Reserve

Last observation: December 2017