Summary of Market Consultation on the Proposal to Consolidate Canada Mortgage Bonds

The Government announced in Budget 2023 that it would undertake consultations to seek market participants' views on the proposal to consolidate Canada Mortgage Bonds (CMB) into the regular bond program. In June-July 2023, the Department of Finance, in collaboration with the Bank of Canada and the Canada Mortgage and Housing Corporation (CMHC), held around 30 meetings with stakeholders involved in the mortgage market and received 61 written submissions. The Department of Finance, CMHC and the Bank of Canada examined each submission to understand the views of market participants. These perspectives have been used to guide the decision on the future of the CMB program.

Overall Comments

The majority of market participants opposed the proposal to consolidate the CMB program. Instead, consulted participants suggested that the government consider the option of purchasing CMBs to capture the spread and generate revenues to fund its objectives. Participants view the CMB program as an effective mechanism to fund the mortgage market and to foster financial stability and competition in the mortgage market. Market participants also emphasized the important role that CMBs play in attracting foreign investors in the Canadian debt market as approximately 40% of CMBs are held by foreign investors.

Impact on Mortgage Lenders

Market participants emphasized that small and medium-sized mortgage lenders, particularly those in the multi-family sector are likely to be disproportionally affected by a potential consolidation. Given the feedback that these lenders heavily rely on CMBs as their primary source of funding, in combination with the low-profit margin of mortgage lending activities, consulted participants advised that consolidation could increase their costs and suggested that this would eventually be transferred to borrowers or prompt some lenders to exit the market.

Hedging

Market participants, particularly multi-family mortgage originators, also emphasized the crucial role of CMB issuance in managing their operational risk, especially for hedging their exposure to the underlying GoC yield and the CMB spread. Participants stated that in order to provide funding certainty to multi-family developers, lenders commit to funding well in advance, typically ranging 6 to 24 months. The process by which lenders utilize CMB issuance as a hedge against fluctuations in interest rates during this process was also discussed through the consultations. Feedback received during the consultations indicated that the absence of the hedging tool and pursuant risk-mitigation would need to be priced in and passed on to mortgage borrowers through higher mortgage rates.

The feedback noted that the impact on hedging and mortgage costs would disproportionately impact small and medium-sized lenders, especially multi-family lenders. The government was advised that these smaller lenders lacked diversified funding sources and alternate hedging capabilities compared to larger financial institutions, which could lead to the exit of some players.

Impact on the Yield Curve

Market participants found it difficult to assess the impact of the potential consolidation on Canada's yield curve. However, a consensus among most participants emerged, indicating that the consolidation could result in an increase of 5-7 bps in GoC yields.

Miscellaneous

Participants emphasized the importance of CMBs for the development of a transactions-based rate market, especially in the context of the transition from the Canadian dollar offered rate (CDOR) to the Canadian overnight repo rate average (CORRA). The benchmark sized CMB floating-rate note (FRN) has been a leader in the CDOR-CORRA transition as Canada Housing Trust (CHT) is the only consistent CORRA issuer in the market. Consequently, the cessation of CMB issuance would mean the end of the CORRA FRN and would impede progress on the CORRA transition.

Going Forward

Market participants suggested that the government consider a hybrid model where the government would buy a portion of the CMBs issued alongside investors. This would allow the government to generate revenues while preserving the market-driven nature of the CMB and the hedging capabilities that CMBs provide. Participants suggested two options:

1) The government buys a portion of each CMB transaction;

2) The government increases the size of CMB funding above $40B/year and becomes the main buyer of additional CMB issuance.

Participants recommended that should the government decide to move forward with consolidating the CMB program, the government should retain the swap that converts the amortizing structure of National Housing Act mortgage-backed securities (NHA MBS) into the bullet structure of CMBs. Participants highlighted that this feature provides significant liquidity for NHA MBS.

With regards to potential pricing absent CMBs, participants suggested that the government may want to consider pricing NHA MBS at a fixed spread above GoC bonds. This approach would help mitigate the impact on hedging operations. Participants suggested that the government establish the spread well ahead of a transaction to provide complete certainty to mortgage lenders. However, some lenders said parts of their portfolios would remain exposed to spread risk under this approach.

On timing and communication, participants suggested that the government consider a transition period for full consolidation ranging from 12 to 24 months. It was advised that such a horizon would allow mortgage lenders to make necessary system and process adjustments, especially for smaller lenders with limited capacity to fund via alternate means.