APRIL 10, 2024

LENDING GROUP INC.

Developing Infrastructure to Support Insured Mortgage Repo

The March 27th Housing Affordability Watch outlined several initiatives CMHC could undertake to improve efficiency in the housing finance system and address affordability issues in Canada's housing market. This is the second instalment in a series that explores these options in detail.

The Federal Government has emphasized the importance of investing in infrastructure to support housing. Similarly, there's a need to invest in infrastructure that enhances the efficiency of the mortgage market overall. As CMHC undergoes its framework review, it should prioritize efficiency initiatives in its commercial operations that would reduce mortgage funding costs.

In an earlier post, we discussed the benefit of establishing a TBA (to-be-announced) and a dollar roll (repo) market facility for National Housing Act Mortgage-Backed Securities (NHA MBS). Given the unique characteristics of insured mortgages in Canada, there is a further opportunity to create a repo facility for insured mortgages. This initiative would play a significant role in enhancing the liquidity of the Canadian mortgage market and fostering greater efficiency overall.

LINK TO ARTICLE

A national electronic registry for mortgages would need to be created to support an insured mortgage repo market. A large portion of Canada's mortgage market, valued at $2.14 trillion, consists of mortgages backed by insurance from CMHC and two private insurers, Genworth and Canada Guaranty. As a federal Crown corporation, CMHC's obligations are ultimately government obligations. Similarly, mortgages insured by Genworth and Canada Guaranty are 90% guaranteed by the federal government. What makes insured mortgages unique is they are essentially an illiquid government-backed asset.

By establishing a national electronic mortgage registry, we can develop a platform for trading and funding insured mortgages. This registry would track a pool of uniquely identified insured mortgages, enabling them to be transformed into securities and used as collateral in repo transactions. The Canadian Depository for Securities (CDS), or a similar entity, could manage these transactions.

When the registry serves as the mortgagee of record, registry participation eliminates the necessity for mortgage assignments. This streamlines the process, reduces the cost of transferring and tracking mortgage ownership rights, and enhances the efficiency of lien release procedures.

A national electronic mortgage registry would primarily function to:

- Track ownership and changes in ownership of mortgage loan servicing contract rights
- Track ownership and changes in ownership of beneficial interests
- Track security interests in beneficial and/or servicing rights

STRUCTURING ISSUES

While the concept of a registry for trading insured mortgages may not appear overly complex, there are significant structural considerations that must be addressed. This facility must be structured to comply with both income tax and securities law requirements. Specifically, the repo arrangements must satisfy the criteria outlined in subsection 260(1) of the Income Tax Act, which defines "securities lending arrangements."

A thorough legal analysis would be necessary to ensure that the mortgage repo falls squarely within this subsection. An important point of contention is likely to revolve around the definition of a "qualified security." The Income Tax Act defines a qualified security as "a bond, debenture, note or similar obligation of or guaranteed by the government of any country, province, state municipality or other political subdivision, or a corporation, commission agency or association controlled by such person."

An NHA insured mortgage is considered to be guaranteed by the Government of Canada, as clarified in CRA Interpretation Bulletin IT-155R3 (paragraph 3, June 16, 1989). Additionally, a separate ruling obtained by a private mortgage insurer affirmed that NHA insured mortgages include those insured by private insurers with a 90% government guarantee. Therefore, the only major issue to confirm is whether each mortgage constitutes a "similar obligation."

Given that the security interest in these mortgages will not be possessory (physically held, used or controlled), the key issues revolve around whether the security interest can be perfected under the applicable personal property securities (PPSA) legislation and what rights, if any, a bankruptcy trustee would have under the repo transaction.

The repo transactions should be exempt from registration and prospectus requirements under section 2.3 of National Instrument 45-106, where the Buyer qualifies as an "accredited investor." However, if the Buyer (or Seller, in repurchase scenarios) is not a Canadian financial institution, a report of the trade on Form 45-106 F1 must be filed within 10 days of the transaction date.
Additionally, an exemption is also available under section 2.36 of National Instrument 45-106, where no filing is required if the Seller is registered or licensed, or exempt from registration or licensing, under provincial mortgage brokerage or mortgage dealer legislation.

While this would need to be confirmed with IIROC, we see no reason why Regulation 2200.2 cannot apply to transactions conducted under a master repo agreement. Although Regulation 2200.2 is not explicitly clear, it seems that no margin is required, except in cases of collateral deficiency.

According to Regulation 2200.3, failure to satisfy the requirements of Regulation 2200.2 will result in a 100% margin requirement, except "where the counterparty is an acceptable institution," in which case no margin is required. Based on the definition of acceptable institution, it seems that the potential counterparties would likely meet the criteria.

Since mortgages are not classified as securities, there would need to be a mechanism to easily pool them. CDS offers structures for establishing a general security pool that could be used for this purpose.

IMPLICATIONS FOR CMHC

Establishing a repo facility for insured mortgages is another step CMHC should take to improve the functioning of Canada's mortgage market. This will require CMHC to conduct a comprehensive review of the necessary structuring requirements from both legal and operational perspectives. Given CMHC's pivotal role in the housing finance market, it is among a select few organizations capable of bringing together all necessary parties for this endeavor. Similar to the Canada Mortgage Bonds (CMB) program, CMHC should explore opportunities for involving other groups in managing this activity.

For example, there are domestic firms that have established platforms for tracking and managing mortgages and their associated cash flows. Implementing a registry for insured mortgage repos would be a feasible next step. Integrating with the CDS (Canadian Depository for Securities) trading platform would then become a viable option, as the focus would shift from managing the insured mortgages to utilizing the securities trading platform.

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Kevin has had a long career in capital markets, housing finance, and public policy. He has worked as an economist for Alberta Treasury, Saskatchewan Policy Secretariat, the Bank of Canada, and the Department of Finance Canada. His work has included tax policy, economic forecasting, as well as monetary policy and debt management. While at the Bank of Canada, he authored two Bank of Canada Review articles on monetary policy tactics. Kevin has worked on a variety of debt programs from treasury bills to domestic and foreign bond issues, and interest rate swaps. He worked on building and managing the federal real return bond program, the Canada Savings Bond program, and built out the bond buyback program and a synthetic foreign funding program – two programs which are still in use today by the federal government. While at CMHC, Kevin managed the market funding program for social housing, built and managed the Canada Mortgage Bonds program, and expanded the products offered under the NHA MBS program. He has worked for several mortgage insurers including CMHC, Canada Guaranty, Triad Guaranty and Genworth. This work encompassed product development and risk management across housing markets in North America, Europe, Asia, Australia, and New Zealand. More recently he has had senior management roles with residential lenders managing underwriting, risk, product development, capital markets, and strategic planning.