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Improving Efficiency in the NHA MBS Market - Transparent Pricing is Paramount

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 third instalment in a series that explores these options in detail.

The Canada Mortgage Bonds Program (CMB) was established in large part because of perceived structural issues in the government-backed National Housing Act Mortgage-Backed Securities (NHA MBS) program: payments were monthly and included both principal and interest, and the market premium for prepayment was too high.

Initially, there were concerns that the CMB program would replace the NHA MBS program. However, both programs have coexisted. The NHA MBS program has been a valuable source of assets for regulated financial institutions in meeting their liquidity requirements. Under Basel III regulations, a bank must maintain an adequate stock of liquid assets to meet liquidity needs in a 30-day stress scenario. Provincial regulators have followed the federal approach and require a similar framework for credit unions.

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(Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks.)

The liquidity coverage ratio calculation is complex. For our purposes, what's important is that the financial institution holds high-quality liquid assets (HQLA) that can be easily converted into cash with little to no loss of value.

Within the definition of HQLA, assets are categorized into different levels. Importantly, there is no "haircut" (reduction) attached to the value of Level 1 assets, which include marketable securities issued or guaranteed by sovereigns. NHA MBS are also included in the definition of Level 1 assets. This classification allows financial institutions to convert insured mortgages from their residential lending operations into NHA MBS, which earn a spread over Government of Canada bonds of similar duration.

NHA MBS have a timely payment guarantee, so there is effectively no credit risk. However, the question arises: are NHA MBS sufficiently liquid to qualify as a Level 1 asset? During periods of financial distress, we've seen the spreads on these securities widen significantly. Although similar spread widening has been seen with provincial bonds, which also qualify as Level 1 assets, financial institutions cannot create provincial bonds.

The Bank of Canada's backstop facility for these securities has helped dampen spread volatility, but it doesn't address the root issue: liquidity. The key question remains: How liquid is the NHA MBS market?

In the U.S. agency market, there's a transparent pricing framework where mortgage-backed securities are actively traded. In contrast, the Canadian market relies on dealers to provide notational pricing - a method used to estimate the value of a financial instrument, like a bond - for relatively small trade amounts.

CMHC has never established a framework to ensure an active secondary market for mortgage-backed securities (MBS). While adopting some features of the U.S. agency market is a key first step, achieving transparent pricing is paramount. Transparent pricing would encourage money market funds and other liquidity pools to trade in NHA MBS, laying the groundwork for a liquid MBS market. Without this, we risk discovering that the MBS platform cannot meet the liquidity demands we anticipate during a crisis.

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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.

Independent Opinion

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