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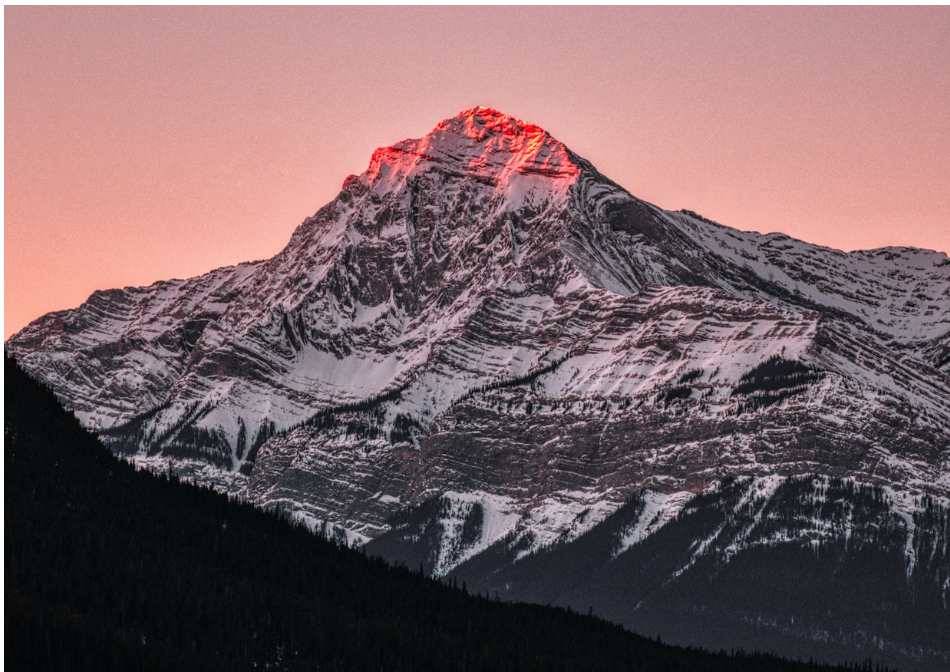
Improving Efficiency in the NHA MBS Market – Lessons from the US



The March 27th Housing Affordability Watch outlined various initiatives CMHC could undertake to enhance the efficiency of the housing finance system to improve affordability in Canada. This is the first in a series of installments where we'll explore each of these options in detail.

CMHC plays an important role in the financing of residential mortgages. It provides mortgage default insurance, and it supports the securitization of insured mortgages through the National Housing Act Mortgage-Backed Securities (NHA-MBS) and Canada Mortgage Bonds (CMB) programs.

The policy rationale for CMHC's role is to improve the efficiency of the housing finance market. Although the NHA MBS program is modeled after the Government National Mortgage Association (GNMA) MBS program in the US, it lacks specific features of the US mortgage securitization program that improve liquidity in the agency MBS market (MBS issued by GNMA, Fannie Mae and Freddie Mac). A closer examination of these features offers valuable insights into opportunities for CMHC to improve efficiency and liquidity in Canada's MBS market.

LINK TO ARTICLE

THE US MBS MARKET

Lenders in the US have two main avenues for securitizing and selling mortgages. First, they can contribute new mortgage originations to a multi-seller MBS established by the housing finance agencies in exchange for cash or a share of the multi-lender MBS. This option is typically favoured by smaller lenders, although larger lenders often sell a portion of their mortgages in this channel. Second, lenders can independently create pools from loans that they originate or buy from smaller lenders and "swap" these mortgage pools for agency MBS. This enables lenders to directly sell these MBS. The mortgage pool operates within a trust structure.

THE TO-BE-ANNOUNCED (TBA) MARKET

The US agency MBS market has a liquid forward market for trading agency MBS, typically extending several months into the future. More than 90% of agency MBS trading volume takes place within this forward market, commonly referred to as the TBA (to-be-announced) market. In the TBA market, only a few basic characteristics of the security are agreed upon: the coupon rate, issuer, and face value of the securities to be delivered. While a sale price is agreed upon upfront, the specific securities comprising the portfolio are finalized just before the settlement date.

On the settlement date, the pools delivered by the seller must meet the Good Delivery Guidelines set by the Bond Market Association. These guidelines outline the requirements for confirming and settling MBS transactions. They include criteria such as the maximum number of pools per lot and the maximum allowable variation between the face value of the pools delivered and the agreed-upon face amount.

TBA prices serve as the basis for pricing and hedging various other MBS, some of which may not even be eligible for TBA delivery. According to estimates by the Federal Reserve of New York, the liquidity benefits of TBA eligibility were as much as 10 to 15 basis points on average in 2009 and 2010, and potentially greater during periods of higher market stress.

DOLLAR ROLLS

Dollar rolls are the primary channel for borrowing and lending mortgage securities within the MBS TBA market. A dollar roll is a form of securities lending similar to a repurchase transaction (repo). In a repo transaction, a lender sells securities to a buyer for cash and agrees to repurchase them at a later date for a predetermined price plus interest. In a dollar roll, the borrower has the option of returning "substantially similar" securities. Unlike a repo, the borrower in a dollar roll owns the principal and interest payments during the roll period.

Dollar rolls play a vital role in financing MBS and enhancing liquidity in the TBA market. They are used to obtain collateral for TBA transactions; avoid operational issues associated with taking delivery of mortgage pools; hedge specified mortgage pools; and express views on prepayment speeds. Dollar rolls constitute a large portion of TBA transactions.

LESSONS FOR CANADA

In Canada, lenders typically rely on their internal treasury or, if they're smaller, warehouse lines from a bank. Any hedging is accomplished through repos of Government of Canada bonds, where the lender takes on the basis risk between their mortgage/MBS portfolio and the government bonds. Small lenders have the option to sell mortgages to CMB aggregators. However, these hedging and funding tools are less efficient than what we see in the U.S. and do not foster an active market that would attract investors such as money managers, insurance companies or large domestic or institutional investors.

CMHC is currently undergoing a mandate review, during which it should assess measures to improve the efficiency of the MBS market. A 5-10 basis point improvement in funding costs would be hugely beneficial to Canadian borrowers. The creation of the CMB program stemmed from CMHC's observation of inefficiencies in MBS securities pricing. The next step should focus on further improving liquidity in the mortgage financing market. CMHC should collaborate with MBS issuers, investment dealers, and investors to establish a TBA market and dollar roll market.

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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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