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# • CANADIAN COVERED BONDS AND MORTGAGES: A SUGGESTED COMPROMISE •

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## Introduction

Over the past few years, Canadian mortgage lenders have relied heavily on the two securitization programs sponsored by Canada Housing and Mortgage Corporation ("CMHC") that are ultimately guaranteed by the federal government.[1] The federal Department of Finance has signaled a strong desire to see the establishment of funding alternatives that would enable mortgage lenders to fund uninsured mortgages in the capital markets in order to reduce reliance by mortgage lenders on the CMHC sponsored programs. The federal government has taken a number of steps since the 2008 financial crisis to manage the exposure of Canadian taxpayers to losses in the event of a severe decline in house prices. For the past two calendar years (2014 and 2015), the amount of new guarantees for NHA MBS has been limited to $80 billion annually, and new guarantees for CMB have been limited to $40 billion annually, even though the demand by issuers is materially higher.

Should the federal government decide to go further to reduce taxpayer exposure to the Canadian housing market by further limiting the availability of the NHA MBS or CMB programs, or by significantly increasing the fees for these programs in order to build up reserves, mortgage lenders will need to fund more mortgages in other ways. The following are the principal alternatives available:

*(i) Deposits*

This method is only available to deposit-taking mortgage lenders. In fact, for these lenders, any mortgage financing alternative would be measured against the cost of funding though deposits. Although it may appear that shifting mortgage financing from government guaranteed securitization programs to a financial institution's own financial resources would reduce taxpayer exposure, it should be recalled that a significant portion of most deposits with financial institutions benefit from government-backed deposit insurance. True risk transfer occurs only to the extent the mortgage risk is transferred to investors in the financial institution who do not benefit from government support.

*(ii) Whole loan sales*

Mortgage lenders, particularly those who cannot accept deposits, often look to the sale of mortgages on a serviced basis as a means of funding their ongoing lending businesses while continuing to maintain customer relationships. Typically, these sales are to financial institutions who will then either fund these mortgages (if they are insured) through the NHA MBS or CMB programs, or else through deposits. As noted above, both of these methods entail ongoing taxpayer exposure.

*(iii) Securitization of uninsured mortgages using asset backed commercial paper (ABCP)*

Today in Canada, all of the operating ABCP conduits are sponsored by large Canadian banks. Because this financing method uses short-term liabilities (ABCP) to fund longer-term assets, the sponsoring bank must provide a liquidity facility, which adds to the cost of this alternative. Also, because of the credit enhancement that the mortgage lender must provide, the effective advance rate using ABCP is typically less than it would be for a whole loan sale. However, one advantage of this method from a policy perspective is that funding is derived from capital market investors who do not have the benefit of government-backed deposit insurance. Recently released regulations aimed at prohibiting the financing of insured mortgages in any manner other than through one of CMHC's sponsored securitization programs will severely restrict the use of ABCP to finance insured mortgages going forward,[2] so this financing method is expected to be used primarily for uninsured mortgages from now on.

*(iv) Residential Mortgages Backed Securities (RMBS)*

Prior to the 2008 financial crisis, there was a small private label (non-government supported) RMBS market in Canada. The development of a significant Canadian RMBS market for uninsured mortgages would answer all of the policy objectives of reducing taxpayer exposure as ownership of the mortgages passes directly to the RMBS investors, without the benefit of any government or financial institution support. However, in order for this market to develop or to entice

the larger financial institutions to finance their mortgages in this way, the all-in funding costs of RMBS would have to be competitive with the interest rates paid on deposits. For reasons described below, this is not the case today, nor does the author expect it to be the case in the foreseeable future.

*(v) Covered Bonds*

Covered bonds are a hybrid of uninsured deposit notes and RMBS. They represent direct liabilities of the issuer and are secured by an underlying pool of uninsured mortgages (the "cover pool"). They do not benefit from deposit insurance; therefore, they do constitute a private sector response in transferring all of the mortgage risk away from government-backed securitization or deposit insurance. Covered bonds issued since the introduction by the federal government of legislation establishing a statutory covered bond framework have become an important component of the Canadian financial sector and of housing finance in particular—a Canadian success story.[3] However, because of a general reluctance to allow federally regulated financial institutions ("FRFIs") to effectively issue secured debt that would rank ahead of their depositors, the Office of the Superintendent of Financial Institutions ("OSFI") limits the amount of covered bonds that any FRFI can issue to 4 per cent of the FRFI's assets (the "4% Limitation").[4]

To date, covered bonds issued by the largest Canadian financial institutions have proven to be, by far, the most viable and robust alternative to the CMHC-sponsored government-backed securitization programs; however, the 4% Limitation will soon limit the viability of covered bonds as an ongoing method to replace the CMHC sponsored programs.

The main criticism of the Covered Bond Legislation is that this method of financing is, for practical purposes, available only to the largest Canadian financial institutions. Smaller deposit-taking FRFIs as well as non-deposit-taking lenders do not have access to this method of mortgage financing. The Department of Finance has indicated on several occasions that it does wish to ensure that there is competition in the Canadian mortgage market. By allowing covered bond issuers to increase the amount of covered bonds that they may issue, the government or federal regulators could well tilt the playing field too much in favour of the larger institutions unless corresponding assistance could be provided to smaller financial institutions or other mortgage lenders. At the present time, the only practical assistance that could be given to smaller mortgage lenders would be to facilitate greater reliance by them on the CMHC-sponsored securitization programs, which would likely entail further restrictions on the availability of these programs to larger Canadian financial institutions.

This article proposes a compromise solution. The government may continue to limit the availability of NHA MBS and CMB and increase the fees for these programs, particularly for the largest users, but the slack should be taken up by increasing the 4% Limitation on covered bond issuance. However, to ensure that this financing alternative is not limited to the largest Canadian banks and to ensure competition in the mortgage market as the NHA MBS and CMB programs are scaled back, any increase in the 4% Limitation should be conditional on issuers of covered bonds providing a portion of the additional funds raised to mortgage originators that do not have their own covered bond programs ("Third-Party Originators"). As an illustrative example, for each $1 of funding of

Canadian residential mortgages that a covered bond issuer provides to Third-Party Originators after the effective date of the increase in the 4% Limitation, a covered bond issuer could be entitled to have an additional $2 of covered bonds outstanding, up to a new limit (the "New Limitation") of perhaps 8 per cent of that issuer's assets.

Not only would this proposal provide efficient funding for uninsured Canadian residential mortgages for covered bond issuers and Third-Party Originators, but the New Limitation could increase the likelihood of additional Canadian financial institutions becoming successful covered bond issuers.

Also, requiring the benefits of the New Limitation to be shared with Third-Party Originators would provide liquidity to this segment of the mortgage lending market, much of which consists of smaller FRFIs, and the additional liquidity would be expected to reduce the overall risk profile of these mortgage lenders to Canada Deposit Insurance Corporation ("CDIC") as deposit insurer, thereby at least partially offsetting CDIC's additional risk to covered bond issuers by virtue of the New Limitation.

## Covered Bonds

Canadian banks have been issuing covered bonds since 2007. Without a statutory scheme for covered bonds, issuers used securitization techniques to create covered bond collateral that would not be available to satisfy claims of any other creditors of the issuer or its affiliates. The structure, which has been replicated by every Canadian covered bond issuer since 2007, involves the establishment of a bankruptcy remote special purpose entity (usually either a trust or a limited partnership) to which the issuer would transfer assets comprising the covered bond collateral. This special purpose entity would then guarantee the bonds issued by the issuer and secure its guarantee with a first ranking security interest over the covered bond collateral. The stream of interest and principle payments on the collateral funds the principle and interest payments for the covered bonds, and these bonds also constitute direct obligations of the issuers. Should the issuer fail, the collateral of the guarantor entity constitutes security for the direct obligations of the issuer under the covered bonds.

As at April 2012 (the date that the Covered Bond Legislation was introduced), the six largest Canadian banks had issued covered bonds totaling approximately $60.7 billion,[5] many of these to foreign investors. A large portion of the assets backing these covered bonds consisted of mortgages insured by CMHC or other mortgage insurers which insurance was backed by federal government guarantees.

The passage of the Covered Bond Legislation established a statutory covered bond regime for eligible Canadian issuers.[6] The Legislation prohibits (and has prohibited since its proclamation) the use of insured mortgages as collateral for any bonds registered in accordance with such legislation. Collateral is limited to

a) loans made on the security of residential property that is located in Canada and consists of not more than four residential units;

b) securities that are issued by the Government of Canada; and

c) any other prescribed assets.

However, in the case of (a) above, the loans may not include loans insured by CMHC or other mortgage insurance companies or loans where the amount of the loan exceeds 80 per cent of the

value of the property at the time of the loan. Also, the value of assets in (b) above must not exceed 10 per cent of the total covered bond collateral. The result is that covered bond collateral may no longer consist primarily of assets of or guaranteed by the federal government.

The primary benefits to investors in covered bonds issued under the Covered Bond Legislation are (1) the ability of the bondholders to realize on their security cannot be prevented or prohibited by any court order made in relation to the reorganization, arrangement, or receivership involving the bankruptcy or insolvency of the issuer, and (2) despite the bankruptcy or insolvency of the issuer, assets isolated in the guarantor entity to be held as covered bond collateral cannot be avoided or set aside.[7]

According to Poschmann,[8] as at August 2015, Canadian issuers have about $102 billion in covered bonds outstanding, and about $70 billion of those have been issued under the Covered Bond Legislation. This represents approximately 10 per cent of the issuers' aggregate residential mortgage loan assets.[9]

Covered bonds have proven to be an efficient way to finance uninsured residential mortgages in the capital markets. However, the 4% Limitation will begin to restrain the growth of this investment vehicle, particularly if the federal government continues to scale back the size of government-sponsored securitization programs for insured mortgages. The following table (taken from Poschmann) illustrates the remaining capacity under the 4% Limitation for existing covered bond issuers.[10]

Table 1: Covered Bonds Issued and Permitted; Millions of Canadian Dollar Equivalent

| As of June 2015 | CIBC | RBC | BMO | BNS | NBC | DESJARDINS | TD | Total |
|---|---|---|---|---|---|---|---|---|
| Issued prior to Registration under the Legacy Covered Bond Program | 5,274 | – | 3,506 | 8,974 | 2,019 | 2,481 | 8,021 | 30,274 |
| Issued under the Legislative Covered Bond Program | 5,862 | 27,602 | 4,199 | 10,385 | 5,329 | 2,969 | 14,995 | 71,341 |
| Total | 11,136 | 27,602 | 7,705 | 19,359 | 7,348 | 5,450 | 23,016 | 101,615 |
| OSFI Limit* | 17,470 | 42,397 | 24,711 | 33,629 | 8,149 | 6,963 | 39,756 | 173,075 |
| Current Unused Issuance Capacity | 6,334 | 14,795 | 17,007 | 14,271 | 800 | 1,514 | 16,739 | 71,459 |
| Issuance Capacity with a 6% limit | 15,069 | 35,993 | 29,362 | 31,085 | 4,874 | 4,996 | 36,617 | 157,997 |
| Issuance Capacity with an 8% limit | 23,804 | 57,192 | 41,718 | 47,900 | 8,949 | 8,477 | 56,495 | 244,534 |

Note: The regulatory cap on Desjardins issuance is set by the Autorité des marchés financiers at five billion euros.
*AMF cap for Desjardins.
Source: Issuer statements.

It would be reasonable to ask why the 4% Limitation needs to be increased if most issuers are not near their limits. The answer is that so long as the government is willing to continue to provide enough government guarantees at competitive fees to permit everyone to acquire portfolio insurance where required and fund through NHA MBS and CMB, it would not be necessary to increase the 4% Limitation. But as matters now stand, a further significant tightening of the government-sponsored programs without increasing the 4% Limitation according to this article's proposal would (1) drive deposit-taking lenders to rely more on government-insured deposits, as RMBS is not a viable alternative, and (2) drive non-deposit-taking mortgage lenders first to whole loan sales and ABCP and ultimately (because their cost of funding would be so much higher than government-guaranteed deposits) out of business.

Aside from the 4% Limitation, the major impediment to growth of the Canadian covered bond market is its practical unavailability to all but the largest Canadian financial institutions. Since covered bonds are first and foremost direct obligations of the issuer, the interest rate that investors will require will be largely dictated by the creditworthiness of the issuer. As a practical matter, this would require any covered bond issuer to have its own high investment grade ratings for unsecured indebtedness.

Also, since the vast majority of issuances are made in international capital markets, international investors are unlikely to be willing to cover prospective issuers that, due to size constraints and the 4% Limitation, do not have the capacity to sustain a sizeable covered bond program with a reasonably steady schedule of new issuances. As can be seen from the table above, Desjardins is the covered bond issuer with the lowest issuance capacity under the 4% Limitation at just under $7 billion. The author believes that it is unlikely that an issuer could sustain a robust covered bond program with a capacity of less than $5 billion.

Finally, it is expensive to establish covered bond programs. Under the Covered Bond Legislation, CMHC was designated as the registrar for all covered bond programs. In that capacity, CMHC is given the responsibility for approving each statutory covered bond program. In December 2012, CMHC published its Canadian Registered Covered Bond Program Guide (as last updated on December 19, 2014, the "Guide")[11] that sets out comprehensive rules for the issuance of covered bonds. It is beyond the scope of this article to describe in detail the requirements under the Guide, but they are onerous and include a requirement for a comprehensive disclosure document. The Guide also establishes initial and annual registration fees (currently set at $700,000 per program for the initial year and $350,000 for each subsequent year). In addition to the registration fees, an issuer would be responsible for accounting, legal and rating agency fees that would push the costs of establishing a new program to several millions of dollars. In addition, there would be ongoing reporting and compliance costs as well as the need for issuers to devote a substantial amount of internal resources to developing a program.

## Federal Government Actions to Limit Taxpayer Exposure

During the 2008 financial crisis and for a few years following, the federal government provided liquidity to mortgage lenders by increasing the limit on the amount of mortgage insurance that mortgage insurers could have outstanding

as well as the amount of new guarantees for NHA MBS and CMB. The amount of insurance that private insurers can have outstanding at any time is set at one-half of the cap for CMHC. The cap on CMHC insurance was raised from $350 billion to $450 billion in March 2008 and was raised to $600 billion in March 2009. Beginning in 2010, the federal government began to take steps to improve the credit quality of insured mortgages. In December 2011, when CMHC had approximately $567 billion of outstanding insurance, many market participants expected that the government would increase the CMHC cap yet again. Instead, the government announced that it had no plans to increase the CMHC insurance limit above $600 billion.[12]

Between 2010 and 2012, the federal government announced the following changes to the eligibility requirements for government-backed mortgage insurance:

- A debt service coverage ratio based on the 5-year interest rate was introduced in 2010, and the required ratios tightened in 2012.
- The minimum amortization period was reduced from 35 years to 25 years.
- The maximum refinancing on insured mortgages was reduced from 95 per cent of home value to 80 per cent.
- Government insurance for home equity lines of credit was withdrawn in 2011.
- Government insurance on mortgages on homes with a purchase price greater than $1 million was withdrawn in 2012.

The federal government has also taken measures to limit the ways in which holders of insured mortgages can finance these mortgages. As noted above, the Covered Bond Legislation prohibited the use of insured mortgages as collateral for covered bonds. Recently released regulations are aimed at prohibiting the financing of insured mortgages in any manner other than through one of the CMHC sponsored securitization programs.[13] The federal government controls the amount of new guarantees that may be provided each year for NHA MBS and CMB. Finally, the federal government may dictate to CMHC the guarantee fees that it can charge for guaranteeing NHA MBS and CMB. The last guarantee fee increases were substantial.

Effective April 1, 2015, CMHC increased its guarantee fee for NHA MBS not sold into the CMB program by, generally, 50 per cent for all terms of NHA MBS. For example, the guarantee fee for NHA MBS having a term of five years increased from 0.20 per cent to 0.30 per cent. However, for any NHA MBS issuer that issues more than $6 billion of market NHA MBS in any calendar year, its guarantee fee for such excess amount was increased by 200 per cent. For example, the guarantee fee for NHA MBS having a term of five years where the issuer (including related parties) has already issued $6 billion of market NHA MBS in the calendar year increases from 0.20 per cent to 0.60 per cent.[14]

Also effective as of April 1, 2015, CMHC announced that it was doubling its guarantee fee for CMB of all terms. For example, the guarantee fee for five-year CMB increased from 0.20 per cent to 0.40 per cent.[15]

## Prospects for a Canadian Private Label RMBS Market

If the federal government policies result in the NHA MBS and CMB securitization programs becoming less attractive to issuers, it would logically follow that other financing alternatives should become relatively more attractive. As noted above, the development of a liquid RMBS

market would be the preferred alternative. Prior to the 2008 financial crisis, Xceed Mortgage Corporation and GMAC Residential Funding of Canada sponsored RMBS programs whereby special purpose entities sponsored by them issued RMBS to investors, without any government support. As far as the author is aware, since the financial crisis, there has only been a single private label RMBS transaction in Canada, and it raised less than $300 million.

One possible objection to permitting the expansion of Canadian covered bonds is that this could delay the development of a Canadian private label RMBS market. However, the reality is that the Canadian private label RMBS market never became more than a niche market, and there is no evidence that a revived private RMBS market would ever grow to a size that would have a meaningful impact on the overall Canadian mortgage market.[16] There are a number of reasons for doubting that the RMBS market could provide a meaningful substitute for NHA MBS and CMB. The most important reason is that RMBS funding has always been more expensive than deposit funding. Those FRFIs with the largest portfolios of uninsured residential mortgages are unlikely to ever find cost advantages to RMBS as compared to simply raising more deposits. Even though the largest tranche of RMBS transactions (typically 85 per cent to 90 per cent) would be structured to have AAA ratings, investors still demand a premium for investing in these tranches as compared to AA or lower-rated bank deposits. The size of the Canadian RMBS market makes this investment relatively illiquid. There is also a significant amount of analysis required for investors to assess the risk/reward profiles of RMBS as compared to plain vanilla bank deposits. Investors want to be rewarded for doing this work by receiving increased yield. Given the size of the Canadian residential mortgage market, it is likely that if a RMBS market is re-established in Canada, it likely will never be more than a niche market.

## Mortgage Aggregation

CMHC's User Guide to the CMB Program makes a brief reference to a category of sellers of NHA MBS to Canada Housing Trust called "Aggregators". Aggregators are defined as sellers (to Canada Housing Trust) whose ordinary course of business does not include operating as lenders that carry on the business of underwriting mortgage loans and lending money to borrowers on the security of residential property.[17] There are a number of investment dealer subsidiaries of banks who have played the role of residential mortgage Aggregators—purchasing residential mortgages from Third-Party Originators (who must be Approved Lenders under CMHC's mortgage insurance programs) and creating NHA MBS that are then sold to Canada Housing Trust as collateral for CMB.

Because the authorized annual limit of guarantees of new CMB tends to be less than the demand by sellers authorized to make use of the CMB program, CMHC developed an allocation methodology for allocating CMB availability to those sellers who want an allocation.[18] Aggregators do not have to use their own CMB allocations but instead make use of allocations passed through to them by Third-Party Originators.

Since Third-Party Originators wish to retain the client relationship with their borrowers, they will sell mortgages to Aggregators on a servicing-retained basis and will be entitled to receive an ongoing servicing fee for the mortgages they continue to service. The Third-Party Originators

will represent that all mortgages they sell are eligible for the CMB program when sold and will covenant to service the mortgages and remit all collections in accordance with CMHC's requirements. They will be required to buy back any mortgages that are discovered to have been ineligible at the time they were sold.

Largely due to the ability of Aggregators to access mortgages from Third-Party Originators and use the CMB allocations of Third-Party Originators in funding through the CMB programs, Third-Party Originators have been able to obtain access to the attractive funding costs of the CMB program. The Aggregators play an important role in ensuring that the benefits of the CMB program are shared among a broad spectrum of mortgage lenders thereby facilitating a competitive Canadian mortgage market. As the federal government tightens the eligibility requirements for insured mortgages, controls the availability of NHA MBS and CMB government guarantees, and increases the guarantee fees, there should be a similar role for mortgage aggregators for uninsured mortgages to make available to Third-Party Originators the benefits of covered bonds. The legal and accounting infrastructure from insured mortgage aggregation is already in place to facilitate that activity.

## OSFI Guideline B-20

In June 2012, OSFI released guideline B-20: Residential Mortgage Underwriting Practices and Procedures ("Guideline B-20"). Guideline B-20 sets out OSFI's expectations for prudent residential mortgage underwriting and is applicable to all FRFIs that are engaged in residential mortgage underwriting or the acquisition of residential mortgages in Canada. Guideline B-20 is generally not prescriptive in that it does not impose additional requirements for residential mortgage eligibility for FRFIs.[19] Guideline B-20 is primarily about procedures. Among other requirements, Guideline B-20 requires FRFIs to develop and review their individual "residential mortgage underwriting polices" ("RMUPs"). RMUPs are effectively an internal guideline for the FRFI's residential mortgage underwriting eligibility requirements and approval procedures.

One aspect of Guideline B-20 that has proven important to mortgage lenders that are not themselves FRFIs is a requirement that FRFIs that acquire residential mortgage loans from Third-Party Originators ensure that the underwriting standards of those third parties are consistent with the FRFI's own RMUP. As a result, processes have been developed between FRFIs (including but not limited to the mortgage Aggregator subsidiaries of FRFIs) and mortgage lenders who rely on FRFIs for liquidity to ensure that mortgages originated by Third-Party Originators conform to the FRFI's RMUP. Because of Guideline B-20, Third-Party Originators generally are required by Aggregators for the CMB program to provide only mortgage loans that satisfy the relevant FRFI's RMUP. Insured mortgages that do not comply with an Aggregator's applicable RMUP but still satisfy CMHC's eligibility requirements are typically packaged into NHA MBS mortgage pools directly by the Third-Party Originator. Uninsured mortgages sold by Third-Party Originators to FRFIs under the covered bond proposal in this article would have to ensure that all these mortgages complied with the FRFI's RMUP. Any uninsured mortgages that did not satisfy a FRFI's RMUP would have to be financed in another way, such as ABCP or a niche RMBS market.

## Proposal

The conflicting objectives of various stakeholders in the Canadian residential mortgage market can be summarized as follows:

- The federal government would like to reduce taxpayers' exposure to risks of a downturn in the Canadian housing market and, to that end, have (1) tightened the eligibility criteria for government-backed mortgage insurance, (2) imposed requirements that effectively limit the financing of insured mortgages to deposits and CMHC-sponsored securitization programs, (3) imposed annual limits on the issuance of NHA MBS and CMB, which are reset annually, and (4) significantly increased the guarantee fees for NHA MBS and CMB.
- The federal government (as a proxy for consumers) wishes to ensure competition in the Canadian residential mortgage market.
- The federal government would like to see the development of a Canadian private label RMBS market to provide a viable financing alternative for uninsured mortgages, but its primary leverage for encouraging this to happen is to further reduce the availability and increase the cost of CMHC's securitization programs.
- All mortgage lenders wish to ensure that they can finance their ongoing mortgage-lending activities so as to maintain adequate profitability.
- OSFI wishes to ensure the financial stability of FRFIs, and one aspect of this is the ability of FRFIs to demonstrate that they have alternative funding sources beyond deposits.
- CDIC wishes to (1) minimize the probability that any deposit-taking FRFI becomes insolvent, and (2) ensure that CDIC's losses in the event of an insolvency are minimized.
- Existing covered bond issuers would like the 4% Limitation increased in order to build out this successful financing alternative.
- Financial institutions that have previously rejected the covered bond financing option because it is too expensive may reconsider if they can spread the costs over a larger program than what the 4% Limitation would permit them.
- Third-Party Originators wish to ensure access to funding that would enable them to be competitive with the large banks, and this likely means continued preferential access to allocations under the NHA MBS and CMB programs.

The author believes that working with an increased New Limitation for covered bonds provides the best alternative to CMHC sponsored programs. Provided that suitable conditions related to establishing the New Limitation are adopted, an acceptable compromise that would at least partially satisfy all stakeholders should be achievable. The proposal involves increasing the 4% Limitation to a New Limitation determined by OSFI and CDIC with stakeholder input, but imposing a condition that at least some portion of the additional funding in excess of the 4% Limitation be used to purchase uninsured mortgages from Third-Party Originators on a serviced basis.

A number of observations follow:

a) In order to ensure that Third-Party Originators can access this funding source in a way that permits them to be competitive, it may be necessary to create a concept of "Qualifying TPO Funding" (that is, funding that would qualify towards the Third-Party Originator funding condition), which would include a maximum spread between an issuer's covered bond funding costs and the yield at which mortgages are purchased from Third-Party Originators. This may not be necessary if

demand for product from Third-Party Originators is sufficient in itself to result in competitive pricing.

b) Facilitating significantly greater covered bond issuance and making this financing alternative less expensive for potential new covered bond issuers should make it easier to fund uninsured mortgages and reduce the market's reliance on NHA MBS and CMB, allowing the federal government to further reduce issuance limits.

c) By reducing the supply of NHA MBS and CMB and by allowing covered bond issuers to be less reliant on deposit funding, Canadian institutional investors may be more willing to consider investing funds in private label RMBS instead. Most covered bonds are issued outside Canada.[20]

d) The methods for purchasing residential mortgages on a fully serviced basis are already widely used for insured mortgages through the work of mortgage Aggregators.

e) While it would not be necessary for mortgages purchased from Third-Party Originators to be included in cover pools, there ought to be no reason they could not be included so long as they are underwritten in accordance with the issuer's RMUP.

f) Increasing the 4% Limitation according to the proposal would increase CDIC's risk profile in respect of the existing covered bond issuers. Most of these issuers are currently perceived as lower risk FRFIs and pay CDIC insurance premiums based on a smaller percentage of insured deposits than other FRFIs.[21] On the other hand, many of the Third-Party Originators selling mortgages to covered bond issuers would be smaller FRFIs that are perceived as higher risk by CDIC and who pay CDIC insurance premiums based on a larger percentage of insured deposits. Ensuring a material additional source of liquidity to smaller FRFIs should mitigate the systemic impact of the increased risk profile for covered bond issuers. To the extent that CDIC perceives that it would still need to be compensated for an increased systemic risk arising from the New Limitation, CDIC could increase its premiums.[22]

g) Current covered bond issuers would welcome the ability to grow their existing programs. While being required to support the funding of competitors is not ideal for them, this would not be the first instance of such support,[23] and they would be able to earn fees for doing so. In addition, many of them already have mortgage aggregation programs for insured mortgages that could readily be expanded to cover uninsured mortgages.

## Conclusion

The nature of a compromise is that no stakeholder gets everything that it wants. If the federal government is to successfully ease the reliance of mortgage lenders on government guarantees, without choking off liquidity in the residential mortgage market (which could precipitate the housing meltdown the government wishes to avoid), the only viable alternative in the near term appears to be covered bonds. By ensuring that the benefits of increased covered bond capacity is shared between covered bond issuers and Third-Party Originators, (a) competition can be preserved in the residential mortgage market, and (b) the increased risk to CDIC resulting from large FRFIs diverting more of their assets to covered bond pools would be at least partially offset by increasing liquidity for smaller FRFIs. While existing covered bond issuers would not appreciate the condition of having to fund

Third-Party Originators, this condition is similar to other situations where large FRFIs provide funding options to smaller ones.

The proposal is not expected to be anyone's first choice. But if it can be a viable second choice for everyone, then it is worth further consideration. As with any compromise, the devil would be in the details, and there would be a number of important details to settle.

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[1] These programs are (1) mortgaged backed securities issued under the *National Housing Act*, R.S.C. 1985, c. N-11 [*NHA*] ("NHA MBS") and (2) Canada Mortgage Bonds ("CMB") issued by Canada Housing Trust. Both programs are operated by CMHC. The NHA MBS Guide can be found at <www.cmhc-schl.gc.ca/en/hoficlincl/mobase/mobase_002.cfm>. The Canada Mortgage Bond User Guide has been made available to CMB program participants but, as at the time of writing, has not been made publicly available by CMHC. According to Thorsten V. Koeppl and James MacGee, "Mortgage Insurance as a Macroprudential Tool: Dealing with the Risk of a Housing Market Crash in Canada" C.D. Howe Institute, July 2015 ("Koeppl and MacGee") at p. 4, the size of the NHA MBS program has doubled since the 2008 financial crisis, leading to the total outstanding amount of NHA MBS (including NHA MBS that is used as collateral for CMB) currently standing at approximately $370 billion.

[2] The draft regulations are *Proposed Regulations Amending the Eligible Mortgage Loan Regulations, Canada Gazette*, Part I, Vol. 149, No. 23, 1132, <http://www.gazette.gc.ca/rp-pr/p1/2015/2015-06-06/pdf/g1-14923.pdf> and *Proposed Regulations Amending the Insurable Housing Loan Regulations, Canada Gazette*, Part I, Vol. 149, No. 23, 1138, <http://www.gazette.gc.ca/rp-pr/p1/2015/2015-06-06/pdf/g1-14923.pdf>. As at the time of writing, these regulations have not been finalized.

[3] The *Jobs, Growth and Long-term Prosperity Act*, S.C. 2012, c. 19, introduced in April 2012, included amendments to the *NHA* to introduce a new Part I.1 to the *NHA* (the "Covered Bond Legislation") that establishes a framework for the issuance of covered bonds by eligible Canadian issuers. The Covered Bond Legislation was proclaimed in force on June 29, 2012.

[4] Letter from Office of the Superintendent of Financial Institutions Canada to All Deposit-Taking Institutions (June 27, 2007) regarding Limited Issuance of "Covered Bonds" by Canadian Institutions, online: Office of the Superintendent of Financial Institutions Canada, <http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/cvbnds.aspx>.

[5] DBRS, Monthly Canadian Covered Bond Report, April 2012 at p. 6.

[6] Comprising (1) federal institutions as defined in s. 2 of the *Bank Act (Canada),* S.C. 1991, c. 46, and (2) provincial co-operative credit societies (*NHA*, s. 21.52).

[7] *NHA*, ss. 21.63 and 21.64.

[8] Finn Poschmann, "How to Make the World Safe for (and from) Covered Bonds", August 20, 2015, C.D. Howe Institute E-Brief. The author is greatly indebted to Mr. Poschmann and relies heavily on his recent research.

[9] *Ibid*., p. 3, fn. 5.

[10] *Ibid*., p. 4.

[11] <www.cmhc-schl.gc.ca/en/hoficlincl/cacobo/cacobo_010.cfm>.

[12] CMHC's balance of insured mortgages has been slowly declining and stood at approximately $566 billion at the end of 2012, $557 billion at the end of 2013, and $546 billion at the end of 2014.

[13] *Supra* note 2.

[14] The complete revised fee schedule can be found in CMHC Advice No. 10 dated December 1, 2014 (www.cmhc-schl.gc.ca/en/hoficlincl/mobase/mobase_003.cfm).

[15] The compete revised fee schedule was sent by CHT to CMB participants in a notice dated December 1, 2014.

[16] According to Koeppl and MacGee, *supra* note 1, p. 5, the value of outstanding private label MBS peaked at approximately $24 billion in 2008. This compares to current outstanding Canadian residential mortgage loans of approximately $1.2 trillion.

[17] Canada Mortgage Bond User Guide, p. 6-1.

[18] This allocation methodology does not appear to be available to the public on CMHC's website but is provided to authorized sellers under the CMB program.

[19] The most notable exception is a requirement that FRFIs be expected to limit the non-amortizing component of a home equity line of credit to a maximum loan to value ratio of 65 per cent or less.

[20] Poschmann, *supra* note 8, p. 2, fn. 1.

[21] *Ibid*., p. 7.

[22] *Ibid*., pp. 7–9, argues that because CDIC insurance premiums would likely have to be increased by virtue of a New Limitation, the method by which CDIC deposit insurance premiums are calculated should be revised to be based on a FRFI's assets rather than its uninsured deposits. While I have no objection to examining alternatives for calculating the premiums on CDIC deposit insurance, it should not be necessary to delay examination or implementation of this article's proposal pending resolution of that issue.

[23] For example, banks offer deposits of their competitors through their investment dealer subsidiaries. Also current Aggregators provide funding to Third-Party Originators, albeit using the CMB allocations of their clients in doing so.