July 12, 2023

Funds Management Division
Financial Sector Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa ON K1A 0G5
CMBconsultation-consultationsOHC@fin.gc.ca

Dear Sirs/Madams,

Re: Consultation on the Proposal to Consolidate Canada Mortgage Bonds

We are writing you on behalf of the Investment Industry Association of Canada (IIAC) and its members and appreciate the opportunity to comment on the consultation on the proposal to consolidate Canada Mortgage Bonds (CMBs) into the regular Government of Canada borrowing program.

The IIAC is the national association representing investment firms that provide products and services to Canadian retail and institutional investors. The IIAC represents financial services firms, and registration categories, of every size and type, operating in Canadian and global capital markets. The IIAC represents members that manufacture and distribute a variety of securities including mutual funds and other managed equity and fixed income funds and provide a diverse array of portfolio management, advisory and non-advisory services. IIAC members trade in and equity on all marketplaces, provide carrying broker services and underwrite issuers in public and private markets.

Summary

There is a general consensus among the IIAC and its member firms that there is not nearly enough clarity on the anticipated future state of the Canadian insured mortgage funding market resulting from the recent budget announcement by the Department of Finance (DOF).

Key Concerns

- The DOF needs to clarify and provide additional details on key aspects of the CMB program including governance, stability, predictability, funding capacity, pricing, hedging and liquidity, which are strengths of the current program.
- The likely temporary or permanent re-pricing of the GoC curve from the structural inclusion of approximately C$40bln CMB Issuance annually, will indirectly impact costs paid by Issuers who borrow as a referenced spread to the GoC curve. Some the of largest borrowers include Provincial, Municipals, Pensions and Corporations.
- It has not been articulated at all by the DOF whether a shift in the GoC bond curve, which may result from added bond supply and the potential exit of certain domestic and international investors, would negate potential savings from a consolidated borrowing program.

General Comments

- CMHC ‘s strong governance model and predictable issuance schedule has provided a level of stability to Canada’s mortgage market not experienced by other jurisdictions. Through both the global financial crisis and COVID crisis CMB issuance remained well received by the market and provided lenders with the funding certainty they needed to keep the mortgage market open. This stability has enabled the Canadian mortgage market to grow organically in a manner that ensures a competitive marketplace that ultimately benefits the consumer.

- It is estimated that roughly $100 billion, or 40%, of the $260Bn outstanding CMBs are held by non-residents. A number of these foreign investors are likely to exit the Canadian market and it is unclear what effect this will have market functioning. It is believed that a large number of current foreign CMB investors will not remain invested in the Canadian market because of the presence of higher yielding HQLA in other global markets – including the US treasury market.

- There is real concern around how the Government of Canada (GoC) issuance level and spreads over the GoC bond curve will be determined and administered in a transparent, predictable, and fair way as opposed to currently being a function of competitive open markets forces.

- Assuming there are any program revenue savings, is there going to be assurance and accountability that the savings will be used towards affordable housing programs?

- Assuming the DoF decides not to match the 5yr and 10yr tenors currently issued, there will be resulting large curve exposures on their balance sheet. How does the DOF plan to manage those curve mismatches, measure and take account for any slippage that could reduce potential savings?

- The current bullet CMB program with the involvement of Swap Counterparties contribute approximately 40% of additional liquidity to the Canadian bond market as a function of reinvestment management. Should a new program moved to an amortizing structure, it would have a significant negative impact on liquidity, especially for market NHA MBS, with a higher level of impact to mid/small issuers.

- Current "on-the-run" CMB bonds provide effective and cost-efficient hedging mechanisms for small and large issuers. Pipeline hedging allows issuers to offer rate hold to mortgage borrowers leading to a well functioning and competitive market based, tradeable mortgage market which serves to drive down costs and promote healthy market functioning.

Department of Finance Questions

Potential Impacts on Market Participants

CMB consolidation would represent a notable change in the Canadian fixed income market. The government is interested in the views of all market participants that interact with the CMB program to understand the potential implications of the consolidation of the CMB program, including other bond issuers, government securities distributors, investors, and mortgage lenders and other CMB program participants.

As we assess the benefits and risks of CMB consolidation, we would like to hear all views from market participants, including with respect to the following questions:

Assessing Market Impacts

- What changes might arise from CMB consolidation from your perspective and how you would expect to address them?
- If investors in CMBs are no longer able to purchase newly issued CMBs, what alternative investments would they turn to and what impact would this have on their portfolio?
    - Investors are likely to turn to other government spread or NHAMBS product. Some Institutions will have no equivalent similar CAD yield alternatives without changes to their investment policies. This change will create a scarcity of HQLA eligible spread assets and may create significant distortion in the remaining pool of eligible assets. Investors will look for high quality fixed income investments as alternatives possibly driving riskier investment decisions.
- Would mortgage lenders anticipate making any changes to their regular operations as a result of CMB consolidation? How would this impact mortgage lenders' hedging operations?
    - Lenders as involved in the secondary and primary markets for their risk management and will likely need to test and monitor hedge effectiveness. CMB liquidity has already begun to deteriorate since the budget announcement regarding the possible cessation of the traditional program. Reduced liquidity typically results in wider spreads which are now being passed along to borrowers which will ultimately have the impact of increasing cost of funds.

- What impacts could CMB consolidation have on the Canadian fixed income market investor base, including international investor participation?
    - Risk that international investors abroad doesn't reinvest into either lower yield Canada bonds or higher yielding bonds with different credit characteristics. International Investor participation is one of the great successes of the current CMB program and, in fact, the Canadian bond market. The professionalism and maturity of the program has brought a very large and active International Bank Treasury and Central Banking community into the Canadian bond market that, previously, would not have participated.
    - With decreased international participation as well as a higher overall funding load, it would fall on the Canadian Investor base (to absorb the majority of additional GOC supply. This would have the likely impact of increasing yields across the entire Interest rate curve affecting not only Government issuers but also Provincial and Corporate spreads.
- Should the government decide to move forward with CMB consolidation, what considerations should be taken into account with regard to the timing of implementation?
    - How long the program has existed, and the number of investors impacted and how well the program has operated. The time it would take for international investors policy statements to be modified and alternative mortgage hedging tools effectiveness to be measured.

Adjustments to the Government's Debt Management Strategy (DMS)

- Please provide views on the best way for the government to incorporate this additional issuance into its DMS.
    - It would be important for the Government to increase the frequency of DMS announcements, to provide longer term clarity of schedule and ensure that any new program has 5- and 10-year terms regularly available.
- Is it preferable for the government to mirror existing CMB issuance or distribute issuance across sectors?
    - If the consolidated issuance program was not mirrored, how can it be properly measured and quantified? The existing structure allows for the CHT to purchase amortizing MBS and issue bullet bonds by way of a swap allowing for immunization of interest rate risk.
- If the government were to spread $40 billion of issuance across the range of issuance sectors, how would it be best distributed?
    - Between 1-5 year and 10 years.
- What are the implications of using a mirrored structure without FRNs?
- Please provide views on the impacts of increased borrowings on liquidity and market functioning for GoC debt.
    - Increased borrowing may result in increased liquidity, but market functioning may deteriorate with reduced international participation and increased reliance on domestic participants.
- Should the government open new benchmarks in existing sectors in order to accommodate this increase in issuance? In which sectors?
    - Yes, the 3-year term should be considered.
- Should the government reorganize maturity dates in the context of opening new benchmarks?

Funding Cost for Mortgage Lenders

Currently, the funding cost provided to mortgage lenders through the CMB program is linked to the yield on CMB issuance, which is a transparent, market-driven rate. In the absence of CMBs, a new methodology will be needed to determine the funding cost provided to mortgage lenders. How to determine the new funding cost will be a crucial element in ensuring the program continues to function effectively and continues to meet the government's objectives with respect to the NHA MBS program, including the provision of stable financing for mortgage lenders in line with market rates, and the promotion of competition in the Canadian mortgage market by ensuring small and medium sized lenders maintain similar levels of participation in the sale of NHA MBS.

- Is the government considering the correct objectives referenced above with respect to the funding cost for mortgage lenders?
    - We would encourage a significant level and quality of analysis prior to making any changes. The transparency and the predictability of the spread over GoC will be a crucial metric to achieve this objective. Pursuing this objective comes with a high risk of unintended consequences. The current CMB provides a stable environment for lenders and borrowers to make commitments to each other with minimal uncertainty and without taking on undue market risk.
- What are your views on the three objectives' potential interconnectedness?
  The objectives ARE interconnected and changes to one will impact the entire ecosystem. The overall impact to both the healthy functioning of the aggregate Canadian Bond market as well as the cost and transparency around the mortgage market will has the potential to create significant and possibly detrimental impacts to the overall Canadian mortgage market.

With respect to determining the new funding cost, the government is considering conducting regular NHA MBS purchases with pricing set as a spread to the GoC yield curve, with the opportunity to reset the spread at regular intervals to ensure the price remains roughly in line with market rates. This would seem to provide pricing stability or predictability for mortgage lenders. However, as market conditions change, the spread may need to be reset at regular intervals to help ensure that the program reflects current market conditions.

- Please assess the pros and cons of this model and how it would align with the government's objectives.
    - Currently the CMB spread to Governments (the lending fee) is set in a transparent transactions-based manor in keeping with IOSCO principals. How does DOF plan to replicate the transparent transaction-based lending rate upon consolidation.
    - There a risk this variable becomes 'politized' and becomes a hidden tax on first time and lower income homebuyer.
- Are there any other pricing models that should be considered?

Should the government decide to proceed with CMB consolidation using a set spread to the GoC curve, the spread could be calibrated with reference to a basket of liquid securities (e.g., GoC, provincial bonds, etc.) that are closely correlated with CMBs. This basket would be designed to reflect a 'theoretical CMB' and would aim to maintain current funding costs for mortgage lenders and support predictable price movements. Using a basket to reflect the broader market in calibrating the spread could reduce the need for more frequent spread adjustments than pricing based solely on the GoC yield curve.

- What data points should be included in the construction of a basket for the all-in pricing of a theoretical CMB?
    - Existing CMB spreads, NHAMBS spreads, Ontario Spreads, GoC Rates, swap spreads
- What steps can the government take to ensure transparency in the rate offered by the theoretical CMB approach?

In closing, we would like to reiterate that CMHC's strong governance model and predictable issuance schedule has provided a high level of stability and confidence in the Canadian mortgage market and has allowed it to function in a manner that ultimately benefits the wider Canadian borrower. The IIAC and its members believe that the proposal consolidate CMBs into the regular Government of Canada borrowing program is rife with unknowns and risks.

Thank you for considering our comments. If you have any questions, please do not hesitate to contact me.

Yours sincerely,

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