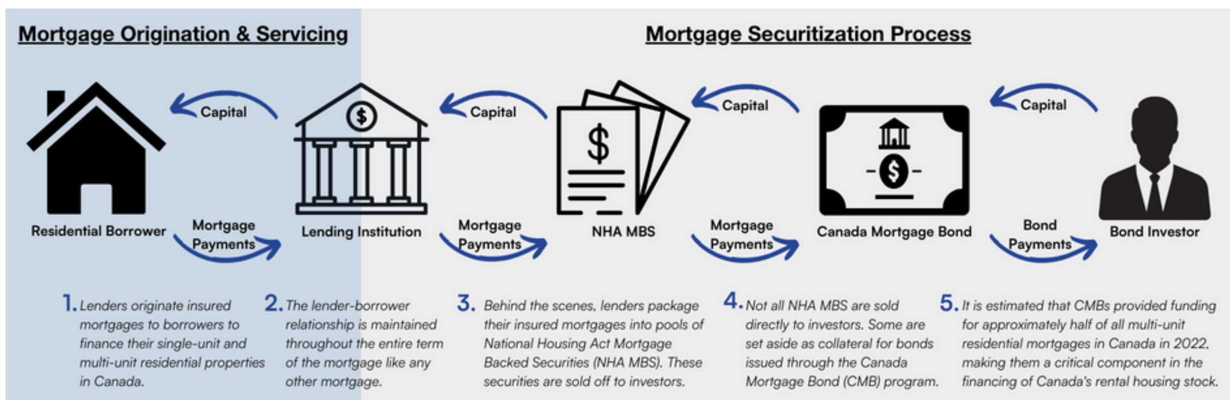
Commercial Mortgage Commentary

Market News

Feds Seek to Consolidate CMB Program

Since its inauguration in 2001, the Canada Mortgage Bond (CMB) program has grown to become a key component of Canadian mortgage markets. By selling CMBs to traditional bond investors and using the proceeds to purchase mortgages that have been securitized by lenders through the National Housing Act Mortgage-Backed Securities (NHA MBS) program, the CMB program provides critical funding to mortgage lenders. Because the program transforms the underlying mortgage cashflows into more uniform coupon payments, CMBs are marketable to a wider array of fixed income investors who may otherwise be unable to invest in the mortgages directly. Additionally, the liquidity provided by securitization gives lenders capital to originate new mortgages to borrowers rather than hold the loans on their balance sheet. The entire process is supported by the fact that all payments of interest and principal on the underlying mortgages are guaranteed by the Canada Mortgage and Housing Corporation (CMHC), a federal crown corporation. In simple terms, the CMB program provides investors with safe investment returns, lenders with access to a stable and predictable source of funding, and residential borrowers with competitive and accessible mortgage financing. The program's success has been evidenced by strong uptake from both domestic and international investors. At the end of June, there were $271 billion of CMB outstanding.

While the majority of CMBs are secured by insured mortgages on single-unit residential real estate (i.e., mortgages held by Canadians on single-family homes, condos and townhomes etc.), insured mortgages on multi-unit residential properties (i.e., rental apartments, seniors housing and student housing etc.) also find their way into the NHA MBS backing these bonds. As it turns out, these securitized multi-unit residential mortgages account for a sizable share of all outstanding multi-unit residential mortgages in Canada. According to Intellifi, a leading mortgage services firm, of the estimated $44 billion in multi-unit residential mortgages originated in Canada in 2022, about 64% ($28.4 billion) were insured by the federal government through CMHC. Of those insured loans, about 82% ($23.3 billion) were securitized through the NHA MBS program. An estimated 90% [Continues on Next Page]



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($21.0 billion) of those NHA MBS were ultimately packaged into CMBs, meaning that the CMB program provided funding for nearly half of all multi-unit residential mortgages originated in 2022. Put another way, funding from the CMB program plays a key part in financing Canada's rental housing stock, which remains under heightened pressure due to a rapidly growing population and persistent supply-side constraints.

Despite its success over the past two decades and its role as a critical conduit of capital to the residential mortgage market, the future of the CMB program is now in question following an announcement by the federal government this past March. The government is considering whether to consolidate the CMB program into its regular Government of Canada (GoC) borrowing program, citing reduced borrowing costs and savings that it intends to direct toward affordable housing initiatives. Because bond markets have typically required higher interest rates on CMBs when compared to GoCs, the government believes it could capture this difference in interest rates as savings by consolidating the two programs. The plan would effectively substitute GoCs for CMBs as a source of funding – proceeds from lower cost GoCs would be used to purchase securitized mortgages from the NHA MBS program rather than CMBs. Since the government already fully guarantees interest and principal payments on the underlying mortgages, consolidation would not change the government's overall exposure to residential mortgage credit risk. Should the consolidation plans move forward, new CMB issuances would cease, and the government would issue GoC bonds as CMBs mature, meaning it would take approximately 10 years until full consolidation.

While the idea of cost savings and increased funding for affordable housing initiatives is welcome, the lending community has expressed concerns about possible oversights from the proposal. For starters, merging $271 billion of CMBs into the federal government's liabilities would increase current total GoCs outstanding by approximately 20%. Furthermore, replacing the roughly $40 billion in annual CMB issuances with GoCs would increase the government's current total annual debt issuances by approximately 10%. This increase in the government's debt burden would likely result in a structural increase in GoC bond yields. Research by National Bank estimated that CMB consolidation could push-up GoC yields as much as 2-4 basis points (bps), which would increase the cost of all government debt and erode the government's expected savings. Higher yields would have the added effect of increasing borrowing costs for provincial and municipal governments, corporations, and ultimately households, since most borrowing rates are directly or indirectly calculated as a spread over the government's cost of borrowing. Taken in aggregate, this could more than offset the potential savings from consolidation of the CMB program.

Additionally, there remains a lack of clarity around what the new funding structure would look like. One of the primary reasons the CMB program has been so successful is that it provides a highly predictable funding cost and funding schedule, allowing lenders to confidently price and fund loans for the eventual purpose of securitization. The well-defined schedule of eight CMB issuances per annum spreads available funding throughout the calendar year and limits the length of time between a lender's funding of a loan and subsequent securitization. This has benefited the lending community in providing a more consistent product to its borrower clients.

Lastly, given that the federal government will not be providing any updates on its potential consolidation plans until its Fall Economic Statement, lenders only have certainty around future CMB issuances until August and September of this year for 5yr and 10yr bonds, respectively. The lending process of quoting, underwriting, obtaining a certificate of insurance, and funding a CMHC-insured loan typically takes a minimum of three months, and can take much longer when CMHC has a backlog of applications. This means that lenders and their capital sources are nearing, or have already reached, the point at which they can no longer confidently quote on new term insured multi-unit loans. This uncertainty could result in a reduction in funding volumes at a time when demand for insured mortgages is exceptionally high.

As mentioned, the CMB program has had much success since it commenced in 2001. It is a critical and stable source of funding for residential mortgage lenders and provides essential capital for the growth and maintenance of Canada's rental housing stock, as evidenced by the fact that it provided funding for approximately half of all multi-unit residential mortgage origination in 2022. The lending community welcomes further clarity on the future of this successful program – namely, guidance on the intended structure of funding and loan pricing mechanics should the government elect to consolidate the two programs.

Base Rates

The Bank of Canada (BoC) surprised markets with a 25bps hike at its June rate decision and bond yields climbed throughout Q2 to near the decade highs that were previously reached in October 2022. The sizable rise in bond yields was more than enough to offset the declines that came in the wake of the U.S. banking crisis in March, putting upward pressure on mortgage rates.

Bank of Canada Rate

As of the time of writing, the BoC is preparing for its July 12th interest decision where markets currently expect another 25bps hike to its key policy rate. The conditions driving expectations of a hike are largely the same as those present in June when the bank ended a five month pause in interest rate increases to bring the policy rate to 4.75% – its highest level since 2001. At that time, tight labour market conditions, stubbornly elevated inflation, stronger than expected GDP growth, and accelerating housing market activity were all factors. The labour market remains historically tight with the latest data from Statistics Canada showing that the economy added 60,000 jobs in June, which was well above expectations. A slight increase [Continues on Next Page]

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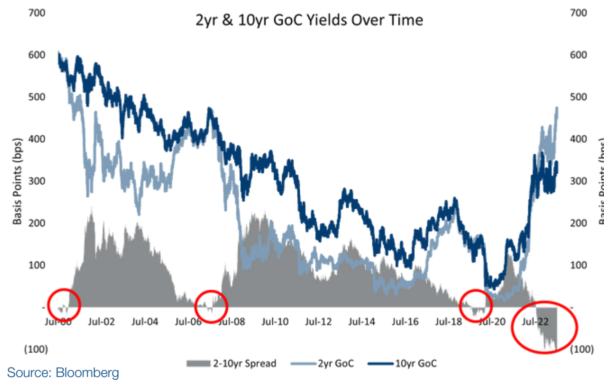
in the unemployment rate to 5.4%, and a slight decline in wage growth to 4.2% YoY provided some signs of easing, but likely not enough to hold back the BoC from another hike. On the inflation front, the most recent reading saw the consumer price index (CPI) decline to 3.4% YoY in May. While promising at first glance, a deeper look at the numbers is less encouraging. Much of the decline amounted to base year effects whereby elevated prices in the year prior exaggerated year-over-year declines in inflation. This was particularly evident in gasoline prices, which were down 18.3% relative to May 2022 when Russia's invasion of Ukraine led to a spike in energy prices. Removing gasoline prices would have actually resulted in a CPI reading of 4.4% in May.

Government Bond Yields

GoC bond yields were once again volatile in Q2, reversing all of the declines seen in Q1 as a result of the U.S. banking crisis. Two-year, 5yr and 10yr GoC yields climbed roughly 80bps, 70bps and 40bps over the quarter to a close of ~4.50%, ~3.65% and ~3.25%, respectively. With shorter-term yields rising further than longer-term yields, the spread between 2yr and 10yr GoCs inverted to levels unseen since 1990 and averaged minus ~125bps during the final week of June. The yield curve has now been in an inverted state for a full year, an event that has historically preceded an economic recession.

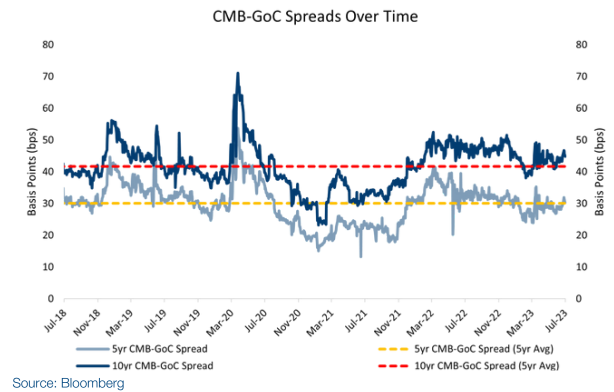


Source: Bloomberg

At the short end of the yield curve, the 1yr GoC hovered around the 5.00% mark through the final week of June, implying that the market now sees the BoC hiking its key policy rate another 25bps over the next year. In contrast, at the end of March, the 1yr GoC was implying 25bps in cuts by the BoC. As for the 5yr GoC, which is the base rate for the majority of fixed-rate conventional mortgages in Canada, yields neared new 15-year highs in Q2. The 5yr GoC climbed as high as 3.80% in mid-June before easing through the final weeks of the quarter to a close of ~3.65%.

Canada Mortgage Bond Yields

The federal government's proposal to consolidate the CMB program at the end of March resulted in a large drop in CMB liquidity as markets grappled with uncertainty surrounding pricing, rate locks and hedging of interest rate risk. Insured activity largely returned to normal in the weeks following and even accelerated by some accounts as borrowers sought to lock-in financing ahead of the increase to CMHC insurance premiums on June 19th. In tandem with government bond yields, 2yr, 5yr and 10yr CMB yields climbed significantly over the course of Q2 to a close of ~4.70%, ~3.95% and ~3.70%, respectively. Large movements in both CMB and GoC yields led to some fluctuation in CMB-GoC spreads over the quarter, but for the most part spreads remained in and around their 5yr moving averages at ~30bps for the 5yr and ~45bps for the 10yr.



Source: Bloomberg

Commercial Mortgages

Conventional

Despite heightened caution among lenders through March and April as the U.S. banking crisis unfolded, anticipated upward pressure on conventional mortgage spreads never materialized. Considering one key proxy for the behaviour of mortgage spreads, credit spreads on corporate BBB rated bonds ended Q2 around levels seen prior to the failure of Silicon Valley Bank. Data from Intellifi shows mortgage spreads for the [Continues on Next Page]

Base Rate Changes Over Time (Delta in bps)							
Base Rates	2023-06-30	QoQ	YoY	2 Years	5 Years	10 Years
Bank of Canada Rate	**4.75%**	▲ 25	▲ 325	▲ 450	▲ 350	▲ 375
Canada Government 5yr	**3.63%**	▲ 62	▲ 51	▲ 262	▲ 155	▲ 180
Canada Government 10yr	**3.26%**	▲ 35	▲ 4	▲ 182	▲ 110	▲ 86
Canada Mortgage Bond 5yr	**3.94%**	▲ 64	▲ 49	▲ 270	▲ 154	▲ 176
Canada Mortgage Bond 10yr	**3.71%**	▲ 37	▲ 1	▲ 194	▲ 115	▲ 76
RBC Prime Rate	**6.95%**	▲ 25	▲ 325	▲ 450	▲ 350	▲ 395

Source: Bloomberg

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highest quality conventional assets hovered around the 180bps mark, with evidence that some lenders are willing to bid even lower into the 160-170bps range for select assets. Capital for these higher quality assets appears to be plentiful, which has led to downward pressure on spreads due to especially competitive bidding.

Further up the risk curve, liquidity appears to be more constrained. Lenders are bidding less aggressively and deal flow remains suppressed. As a result, pricing for the standard conventional deal is more widely dispersed with spreads falling anywhere in the 200-250bps range or higher depending on asset type, borrower quality and location. Certain segments of the market continue to warrant elevated caution, such as office assets, which appear to have fallen further out of favour among lenders in Q2. Lender and borrower preferences continue to skew toward shorter-term deals, although some lenders report that they are increasingly willing to bid on 10yr deals, with term premiums minimal for high quality assets and widening farther along the risk spectrum.

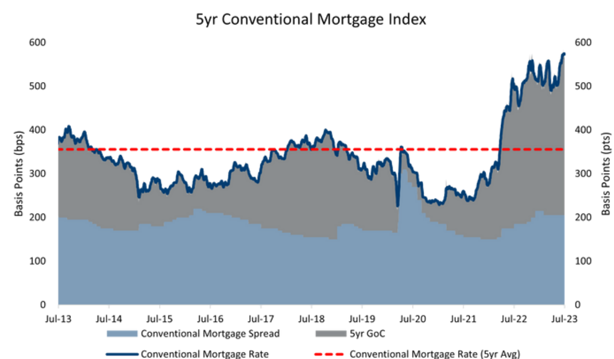
Despite flat spreads, conventional mortgage rates rose considerably through Q2 as a result of rising GoC bond yields. The 5yr Conventional Mortgage Index, a proxy for mortgage rates on the standard conventional deal, averaged ~5.70% through the final month of Q2. At current rates, the index is well above its 5yr moving average of ~3.55% and is at its highest level since October of 2009.

Insured

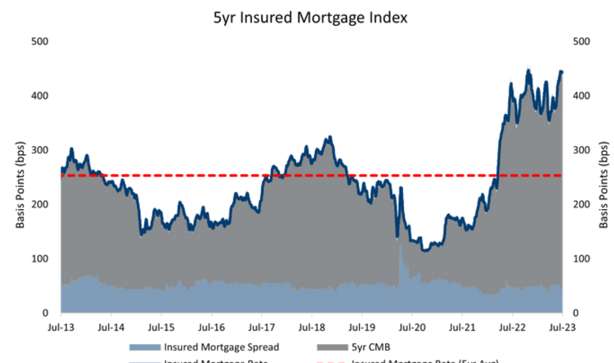
The insured market remained resilient through Q2 as borrowers rushed to get certificates of insurance ahead of the June 19th hike to CMHC's insurance premiums. Premiums increased 75-85bps for standard rental housing depending on effective gross income achievements at the property, and 155bps for MLI Select deals.

Mortgage spreads remained stable with sharpest pricing in the low-to-mid 40s over CMB for both 5yr and 10yr deals. Given 5yr CMB-GoC spreads of ~30bps and 10yr CMB-GoC spreads of ~45bps, this roughly equated to GoC equivalent pricing in the low-to-mid 70s for 5yr deals and the mid-to-high 80s for 10yr deals. That said, a survey of some of the largest insured lenders in Canada showed that nearly 60% of respondents expect insured spreads to move higher in the coming quarter, which is in sharp contrast to the conventional space where most lenders see spreads stabilizing or moving lower.

Like the conventional space, a significant rise in CMB yields in Q2 put upward pressure on insured mortgage rates. The 5yr Insured Mortgage Index averaged ~4.40% in the final month of Q2, its highest level in the past decade and well above its 5yr moving average of ~2.50%. Given inversion in the CMB yield curve and the fact that 5yr and 10yr mortgage spreads are relatively in line, the 10yr Insured Mortgage Index was actually lower at an average of 4.20% in June.



Source: Bloomberg, Intellifi



Source: Bloomberg, Intellifi

ABOUT CMLS FINANCIAL

CMLS Financial is one of Canada's largest independently owned mortgage services companies. Founded in 1974, we are proud to be Canada's Mortgage Company for over 45 years. With offices across the country, we provide a wide range of commercial lending services, residential real estate mortgages and institutional services.

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