The National Housing Act Mortgage-Backed Securities Program in Canada

by Ian Witherspoon

INTRODUCTION

In the 1980s interest rates for mortgages soared to record levels and were continuing to rise, putting the ability of Canadians to purchase homes out of reach. In response to this crisis, the Canadian Mortgage and Housing Corporation (CMHC) began to look at ways to reduce cost of borrowing.

CMHC studied the U.S. mortgage securitization market, reviewing programs such as Ginnie Mae (Government National Mortgage Association), Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). The Ginnie Mae program proved to be the model upon which CMHC based the structure of the Canadian program, occasionally referred to as Cannie Mae.[1]

In 1985 CMHC introduced the National Housing Act Mortgage-Backed Securities program (NHAMBS). Prior to this date the securitization of mortgages in Canada was virtually non-existent. For purposes of NHAMBS, CMHC's role was expanded through an amendment to the National Housing Act (NHA) to include the provision of the unconditional guarantee of timely payment of pools of NHA-insured mortgages.

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HOW NHAMBS WORKS

The guarantee provided by CMHC is in effect a guarantee by the government of Canada. The NHAMBS is the only mortgage-backed security with such a guarantee. CMHC's objectives under this program are to ensure a steady flow of funds for the financing of residential home construction and purchase, as well as to lower mortgage interest rates and encourage longer term loans.

In order to create a more competitive market, CMHC needed to create a system that would provide both large financial institutions and smaller regional lending institutions with the ability to provide financing at comparable rates to one another. For investors, the National Housing Act MBS combines the benefits of investing in insured residential mortgages with an unconditional guarantee to investors of timely monthly payments of principal, interest and any principal prepayments. Both the insurance of principal and interest on the NHA mortgage and the guarantee of monthly payments on the NHAMBS are provided by CMHC.

CMHC is the administrator of the NHAMBS program. It reviews and approves all MBS issues, and is the guarantor of timely payment on behalf of the federal government. Simplification is a key feature of the NHAMBS program. CMHC uses external institutions to carry out various functions to provide cen-

CANADA MORTGAGE AND HOUSING CORPORATION

The Canada Mortgage and Housing Corporation was established in 1945 and is a federal agency which has the mandate to provide affordable housing for Canadians. CMHC's mandate as established through the National Housing Act, is "to promote the construction of new houses, the repair and modernization of existing houses, and the improvement of housing and living conditions."

CMHC provides mortgage loan insurance to protect approved lenders in both urban and rural communities from borrower default, and by doing so has helped support a private housing market that now meets the needs of some 80% of Canadians. The National Housing Act (NHA) is the federal government legislation that was introduced in 1944 with the goal of improving housing and living conditions for Canadians. The NHA authorizes CMHC to provide a system of mortgage loan insurance as a key mechanism in mobilizing funds for housing. CMHC mortgage loan insurance has supported the provision of more than 3 million dwelling units—one out of every three built in Canada over the last 52 years.

tralized service for both issuers and investors.

The two major roles that are carried out by external organizations are that of the Central Payor and Transfer Agent (CPTA) and the role of the Custodian. CMHC contracts with an institution that meets its requirements and has the expertise to perform the role of the CPTA. The main tasks of the CPTA are to collect payments of principal and interest monthly from the issuers and to forward these to the registered NHAMBS investors. The CPTA also maintains ownership records, replaces certificates when sold or lost, maintains information to support secondary market pricing and assists CMHC in monitoring issuer performance.

The Custodian is contracted by those financial institutions which issue the NHAMBS. It operates at arm's length and is approved by the CMHC. The role of the Custodian is to hold the mortgage assignments, which provide the underlying security for the NHAMBS pools, on behalf of the investors and CMHC.

Who Can Participate?

Participants in the NHAMBS program must be a Canadian chartered bank, insurance company, trust company, loan company, caisse populaire, credit union, or other company or corporation authorized by CMHC to issue mortgage-backed securities. The institution must have the experience, management capability and facilities necessary to assure the CMHC of its ability to issue and service mortgage-backed securities.

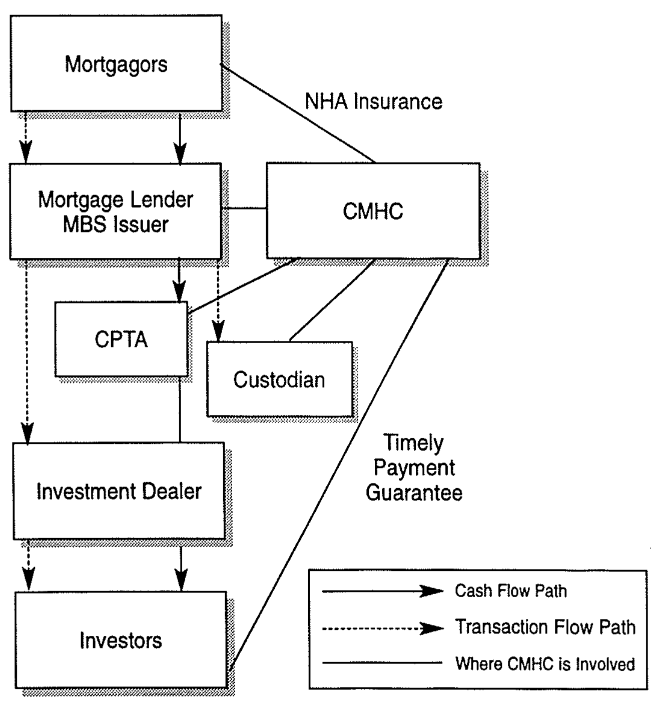
In addition, CMHC requires that the issuer have a net worth of at least $3 million, plus 2% of the aggregate principal amount of NHAMBS issued, plus amounts approved for a proposed issue but not yet issued. The following diagram (see Figure 1) provides an overview of the NHAMBS program, the process and the role of each of the parties involved.

The NHAMBS represents an undivided interest in a pool of NHA-insured residential mortgages. As mortgages, these financial instruments are secured by the value of the underlying real estate. CMHC provides mortgage loan insurance on all pooled mortgages and an unconditional guarantee of timely payment to NHAMBS investors.

These securities, as investments, combine the investment qualities inherent in both real estate mortgages and Canadian government bonds. The fact that NHAMBS are the only mortgage-backed securities fully backed by the government of Canada places them on par in terms of quality to a government of Canada bond, with the advantage of higher yields of NHA-insured mortgages. The benefits of these certificates are further enhanced by the timely payment guarantee from CMHC.

Each NHA Mortgage-Backed Security is created by a CMHC approved issuer, and each pool is a single-issuer pool. The approved issuer brings together a pool of NHA-insured mortgage loans which meet specific eligibility requirements. Issuers pay a non-refundable application fee plus a guarantee premium, with respect to the timely payment guarantee. The guarantee premium is applied to the principal amount of the pool at the date of issue.

Figure 1. How NHAMBS Works



CMHC obtains an assignment of the residual interest in the mortgages. In 1994 the requirement of providing individual assignments of the mortgages was changed to allow for a single global assignment between the issuer and CMHC of all the mortgages listed on the schedule of mortgages.

The issuers must also execute powers of attorney in favor of CMHC which give CMHC the authority to execute assignments and register the pooled mortgage in the name of CMHC. The issuer of the MBS must also provide duplicate registerable mortgage documents. All mortgage papers and supporting documentation are given to the Custodian, which holds the documents until maturity of the pool.

The issuer also establishes a CMHC-approved Principal and Interest Trust Account to receive all monthly payments from the pooled mortgages. The issuer then carries out its plan to sell and deliver the securities to investors.

NHAMBS issues are sold to investors by investment dealers, or they may be sold directly by the issuing institution. As with government bonds and other securities, NHAMBS can either be registered in the name of the owner-investor or in the name of a securities firm. The latter is commonly referred to as being registered in "street name." This is the most commonly utilized registration because, like a bond in bearer form, an NHAMBS certificate in street name is negotiable, thereby allowing it to be readily bought or sold. If issued in "street name," the financial institution maintains records of individual ownership.

Another advantage of the NHAMBS program is that issuers need only prepare prescribed information circulars for each new NHAMBS issue. The circulars contain information of interest to investors and are prepared and available upon request from the institution issuing the MBS. NHAMBS are exempt from normal requirements of an extensive and complex prospectus applicable to other issues of securities. Provincial securities commissions treat NHAMBS in the same manner as government bonds, which are also exempt from prospectus requirements.

Pool Qualifications

Loans that the issuer intends to be placed in their NHAMBS pool must meet all of the requirements in order to receive CMHC's guarantee of timely payment. All mortgages in the pool are based on blended equal payments. The interest rates can range from low to high on individual mortgages in the pool, with a maximum range of 200 basis points between them, and have a term of at least six months.

The minimum size of pools for the NHAMBS is $2 million, although the average pool size issued in 1998 was $42.8 million. Loans are grouped together for pooling based on the remaining amortization periods for all mortgages. They are either placed in short-term range pools of 15 years or less, or the longer term pools of 15 years or more. There can be up to six maturity tranches in a pool, as all loans in a pool must have a maturity date that falls within the last six months of the pool, with at least one loan maturing in the final month of the pool. Loans are further grouped according to the two general types of NHAMBS, either pools that are open to prepayments or pools that are closed to prepayments.

PROGRAM BENEFITS

The NHAMBS program provides guarantees for loans on single-family owner-occupied homes, rental properties and social housing loans. Homeowner loans are prepayable, subject to penalty, and there is one program that passes through the penalty to investors and another that does not. Non-prepayable multifamily loans are pooled separately. NHA-insured social housing mortgages are issued to finance low-cost housing for senior citizens, the disabled and the economically disadvantaged. Typically, such housing is sponsored by government housing agencies, other social service organizations and private non-profit organizations.

The key feature of social housing pools is the absence of prepayment at the option of the borrower on the underlying mortgages. The fact that the social housing loans do not contain a prepayment option and are sponsored by government agencies makes them more attractive to investors who seek predictable cash flow. The NHAMBS program also guarantees mixed pools which are comprised of a combination of homeowner, multiple or social housing mortgages.

Principal and interest payable by the mortgagors of houses and apartment buildings on which insured mortgages are issued are passed through to the registered NHAMBS investors by the CPTA (Central Payor and Transfer Agent). The principal is distributed based on an expected actual pass-through approach, also called a modified pass-through, while interest payments are calculated and credited at the coupon rate of the securities.

Similarly, any lump sum prepayments are passed through to the investors, including any applicable interest bonus payable by the mortgagors, as is the case with certain pool types. Since each NHAMBS pool may have different prepayment conditions, a review by the investor of the Information Circular relative to each pool should be standard practice.

In situations when mortgagors haven't made their regular payments, as required under the terms of their respective mortgages, the issuer must make these scheduled payments to the CPTA for credit to the NHAMBS investors. Upon the maturity of the loans, the loan is paid out by the mortgagor, and the remaining principal is passed through to the investor as a lump sum.

Default Protection

CMHC mortgage insurance protects the lender/issuer against mortgage default, assuring payment of principal and interest in accordance with the terms of the mortgage insurance policy. CMHC guarantees full and timely payment of principal and interest to the NHAMBS investor in case of issuer default. The investor is fully protected by this guarantee.

If the financial institution which issued the NHAMBS fails to make the scheduled monthly payment, CMHC will make the timely payment to the investors. That the regular monthly payments are made to the NHAMBS investors whether or not payments from mortgagors are actually received by the issuing financial institution is the key innovation in the NHAMBS. While there are other investments based on a pooling of mortgages, NHAMBS issues are the only such investments with a guarantee by CMHC backed by the government of Canada.

The investment certificates are available in multiples of $5,000, and they may be included in any RRSP fund portfolio or as part of a self-directed RRSP. The NHAMBS are also available for RRIFs, deferred profit-sharing plans and revoked plans.

Foreign Participation

Another important advantage of the NHAMBS is that foreign investors and Canadians living outside Canada can also purchase these securities. Similar to government bonds, NHAMBS are exempt from withholding taxes that investors living outside Canada must normally pay on interest earned.

The other advantage of the NHAMBS is that, as with interest-rate-sensitive securities, their return is determined by prevailing market conditions. There are significant differences between NHAMBS issues and Guaranteed Investment Certificates (GICs) issued by banks and trust companies. GICs do not have the government guarantee through CMHC that is standard on an NHAMBS issue. Also, the underlying mortgages in an NHAMBS are fully insured by CMHC.

The timely payment guarantee of all principal and interest regardless of the amount compares with a maximum of $60,000 of federal deposit insurance on GIC investments. In addition, GICs are not tradable on the secondary market, limiting their liquidity in comparison to NHAMBS.

Yields on the NHAMBS are higher than for other government of Canada securities with comparable maturities. In 1998, average yields over comparable government of Canada bonds were approximately 60 basis points for prepayable issues and 30 basis points for non-prepayable issues.

Secondary Market Developed

Through the efforts of CMHC and the Canadian financial industry, a secondary market where NHAMBS can be traded has been established. This liquidity is an important feature that helps make NHAMBS an attractive investment for individuals and institutions. Like government of Canada bonds, NHAMBS prices in this secondary market tend to fluctuate with changing interest rates. To facilitate determination of buying and selling prices, the CPTA provides an eight-decimal place number that shows the proportion of principal still to be repaid for a specific pool. This Remaining Principal Balance (RPB) factor is reported monthly for each NHAMBS mortgage pool.

The monthly payments are collected by the CPTA from the issuers on the 14th of the month and passed through to the registered owners on the 15th of each month. Issuers of the NHAMBS have the opportunity to reinvest the funds from the 1st of the month to the 14th of the month, when the funds are due to be collected by the CPTA.

The first payment is sent to investors approximately 45 days from the date of the NHAMBS issue. This payment consists of principal, together with any unscheduled principal repayment, received during the preceding month and one month's interest at the coupon rate of the certificate. Monthly payments will be similar each month since NHAMBS schedules blend principal and interest repayment in the same way as NHA-insured first mortgages.

However, increased payments might be received by investors in an NHAMBS prepayable issue. This occurs when unscheduled payments are made by the borrower; these are automatically passed through to the investors. Unscheduled payments that might be made before maturity of an NHAMBS include advance payments of principal on a mortgage or bonuses or penalties, depending on the applicable pool type outlined in the information circular.

Investors may receive the full payment of principal of a mortgage loan before the scheduled maturity date, should the mortgaged property become damaged beyond repair, or should the mortgage loan go into default, thereby warranting legal action resulting in the liquidation of the loan from the NHAMBS pool.

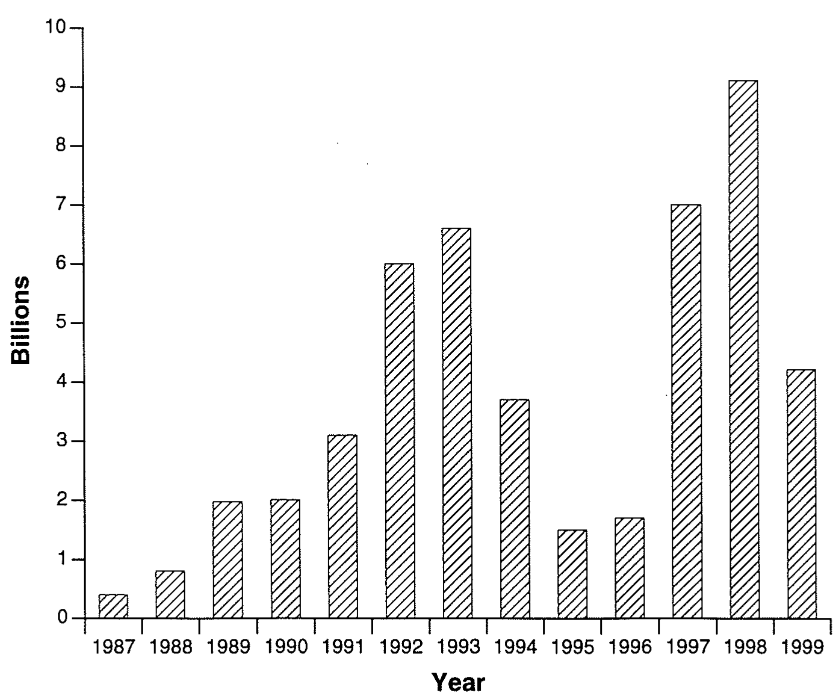
PROGRAM SIZE

Since the inception of the program in January 1987 there have been 2,647 pools issued totaling over $44 billion. In 1998 there was a record volume of NHAMBS issued to-

Table 1. NHA Mortgage-Backed Securities, Volumes by Lender Type Issued Between January 1, 1987, and September 6, 1999

Lender Type	*No. of Pools*	*Issued Amount*	*Market Share*
Trust Companies	896	9,885,581,665.51	20.45
Chartered Banks	795	19,622,359,395.05	40.60
Loan Companies	669	14,011,735,717.24	28.99
Life Insurance Companies	209	2,254,159,279.05	4.66
Credit Unions/CPs	149	2,562,092,132.65	5.30
Grand Total	2,718	48,335,928,189.50	100.00

Figure 2. Growth of NHAMBS Program



taling $9 billion, representing 212 pools. The size of each pool issued has increased over the past few years, with the average pool size in 1998 at $42 million.

Currently there are 52 approved NHAMBS issuers, including banks, trust companies, life insurance companies, loan companies, caisse populaires, credit unions and investment dealers (see Table 1). The Canadian mortgage market as of March 1999 was $401 billion, of which the NHAMBS accounts for $21 billion or approximately 5.3%.

The following chart (see Figure 2) demonstrates the growth in the market since the inception of the program. In 1994 volumes began to decline due to the economic conditions and a rise in interest rates which affected the supply of mortgage product for securitization. CMHC reviewed the program with a view to revitalizing its market performance and in 1997 introduced a new pool type, in which the investor receives an indemnity against any mortgage prepayments that are outside of the allowable prepayment provisions outlined in the information circular. The indemnity is only paid to the investor if the current market price of the pool is trading above par, at a premium; if the pool is trading at par or below then no indemnity is due to the investor. This pool also benefits the issuer, as any penalty or bonus paid by the mortgagor is retained by the issuer.

CMHC's NHAMBS have stimulated the diversification of the Canadian securitization market. Single-seller conduits entered the market in 1990, initially securitizing small portfolios of short-term trade receivables, typically commercial paper financing.[2] Bombardier Credit established the first dealer receivables program, followed by Chrysler, IBM and Citibank Canada. The Asset-Backed Securities (ABS) market began to broaden with the introduction of the Multi-Seller conduits, which now eclipse those of the single seller. The use of private conduits to securitize residential mortgages grew from $11 million outstanding in 1995 to $16.5 billion by March 1999.

Traditionally banks have not had the need nor desire to use securitization for their mortgage funding purposes, due to their heavy reliance on an extensive network of branches and their ability to utilize funds from term deposits and GICs to fund their mortgages. Many financial institutions have seen their usual source of funds decrease due to the increasing trend of investors to invest in mutual funds and the stock market. Subsequently, in the mid-1990s, banks began to shift their focus from the return on assets to the return on equity, leading to greater use of securitization. The asset class composition of the ABS market is comprised mainly of Credit Cards (49%), Auto Loans (21%), Equipment Leases (16%) and Auto/Equipment Leases (7%). Recent issuance volume is shown in Table 2. The Asset-Backed Commercial Paper now makes up the largest issue of the Canadian securitization market. Given its early role in the growth of securitization and its success in the market, the NHAMBS product remains the benchmark of the industry.

Financial institutions have begun using and developing other securitization conduits to meet their needs and to manage their capital and liquidity requirements. In response to the demands of the current market situation, CMHC has begun to review the current program to ensure that it continues to meet the needs of both the issuers and the investors, while continuing to fulfill its mandate.

Table 2. Canadian Asset-Backed Securities Issuance

($) Billions	*1996*	*1997*	*1998**
NHAMBS	1.8	7.1	7.7
Term ABS	0.8	2.9	2.7
ABCP	8.5	22.3	29.4
Total	11.1	32.3	39.8

*Figures as of September 1998.

CMHC has been examining ways to improve the current product's accessibility and flexibility to meet the needs of institutions that issue NHAMBS. In addition, CMHC has undertaken to find ways to streamline the issuing process to make it more cost effective and less time-consuming to issue NHAMBS. CMHC continues to actively promote the evolution of the secondary market to increase the liquidity of the NHAMBS, through changes that would make the product less complex for investors.

CONCLUSION

CMHC has been able to achieve its objectives of helping Canadians purchase homes through the NHAMBS program, while also benefiting the Canadian mortgage market. Financial institutions issuing NHAMBS have benefited from this program through a reduction of specific costs associated with traditional mortgage funding, such as liquidity costs and capital taxes.

In addition, they have achieved a new source of off-balance sheet financing, which reduces capital requirements and improves both the return on equity and return on capital ratios. The issuers also continue to profit from the securitized mortgages from the servicing of the loans. CMHC, with the assistance of the investment community, has been able to establish an efficient secondary market for NHAMBS. As with government of Canada bonds, there is an active secondary over-the-counter market for the buying and selling of already-issued NHAMBS among financial organizations, thereby providing investors with liquidity.

For Canadians seeking financing for the purchase of homes, the NHAMBS has provided new sources of funds for residential mortgage financing that have demonstrated lower interest rates. Home buyers have more mortgage financing available to them with a wider range of options on mortgages.

In addition, the NHAMBS add greater stability to the mortgage market by providing longer term mortgages and flexible prepayment privileges. Also, the securitization of social housing mortgages under the NHA Mortgage-Backed Securities Program has been instrumental in reducing the associated financing costs of these projects, which ultimately results in a savings for Canadian taxpayers.

The continued success of the NHAMBS program and the commitment of CMHC to innovation and improvements reflect the tremendous potential for growth in the NHAMBS sector as the conduit of choice for mortgage securitization in Canada.

NOTES

[1] *Editor's note:* Ginnie Mae provides guarantees of timely payment of principal and interest on securities issued by mortgage companies in the United States. The securities are backed by pools of FHA (Federal Housing Administration) and VA (Veterans Administration) insured mortgage loans. All three organizations are agencies of the U.S. government, and the Ginnie Mae securities provide a full faith and credit guarantee of the government.

[2] *Editor's note:* Conduits are entities that purchase loans and issue pass-through securities.