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THE INSURED MORTGAGE PURCHASE PROGRAM

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CONTENTS

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INTRODUCTION

One of the major consequences of the collapse of the US real estate bubble in 2008 was the triggering of a significant crisis of confidence in global financial markets. In Canada, as elsewhere, the crisis made it harder for major financial institutions to secure short- and long-term financing and for Canadian consumers to obtain mortgage financing for property purchases.

To address these temporary problems in the Canadian mortgage credit market, the federal Department of Finance announced the creation of the Insured Mortgage Purchase Program (IMPP) in October 2008. The stated purpose of the program is to "help Canadian financial institutions raise longer-term funds and make them available to consumers, home buyers and businesses in Canada."(1) The total program envelope, initially $25 billion, was increased to $75 billion in November 2008, then to $125 billion when Budget 2009 was tabled.

This document provides a detailed description of the IMPP's operation, from funding to the mortgage purchase mechanism. In particular, it shows how the government will be able to generate revenue from this operation and the reason why there is virtually no associated risk. Lastly, it examines the possibility that the program may not be able to achieve its stated mandate of promoting access to credit for consumers and businesses.

OVERVIEW OF THE INSURED MORTGAGE PURCHASE PROGRAM

Financial institutions in Canada hold a substantial number of residential mortgages on their balance sheets. These include a large volume of mortgages that are insured against default by the Canada Mortgage and Housing Corporation (CMHC) or by private sector firms backed by the guarantee of the Government of Canada. For mortgage lenders, these mortgages are of very high value because they represent virtually no risk to the quality of their balance sheets.

(1) Department of Finance Canada, *Government of Canada Responds to Global Financial Turmoil with Support for Canadian Credit Markets*, News release 2008-075, http://www.fin.gc.ca/n08/08-075-eng.asp.

Under the IMPP, the government proposes to purchase these mortgages from financial institutions. More specifically, through CMHC, the government intends to buy *National Housing Act* Mortgage-Backed Securities (NHA MBS), a kind of bond for which the underlying asset is a pool of mortgage loans guaranteed by CMHC. In exchange, financial institutions will receive a cash payment that they may use to make new loans to consumers and businesses.

To put IMPP activities into perspective, consider that at the end of November 2008, the estimated value of outstanding residential mortgages in Canada was $900 billion.[(2)] Through the IMPP, the Canadian government proposes to purchase up to $125 billion worth of these mortgages, which would result in its holding nearly 15% of all outstanding mortgages in the country.

IMPP FUNDING

To secure the necessary funding for this purchase program, the government issued new debt instruments in the Canadian market. They are for variable terms, even though available statistics suggest the government has generally preferred to issue short-term instruments (less than one year). When the IMPP was announced, the total value of outstanding Canadian government instruments was $401.2 billion,[(3)] an amount that, during the operation of the IMPP, is expected to increase by approximately 30%.[(4)] Proceeds from the sale of those instruments is transferred to CMHC, which is responsible for purchasing NHA MBS. Note that, by funding the IMPP through the issue of new debt instruments, the government knows the exact interest rate applicable to the newly obtained funds. This information, together with a carefully designed mortgage purchase mechanism, enables the government to ensure that the program will produce revenue.

MORTGAGE SECURITIES AUCTION

CMHC purchases NHA MBS at market value through a reverse auction method. This is a simple process: CMHC first indicates the total envelope, say $8 billion, that it wishes to

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(2) Bank of Canada, *Bank of Canada Banking and Financial Statistics*, February 2009, Table E2.

(3) Ibid., Table G4.

(4) Readers may note, for information purposes, that the total value of outstanding Government of Canada instruments declined by $85 billion between 1996 and 2007.

allocate to the purchase of NHA MBS for a specific auction.(5) Financial institutions wishing to sell such securities(6) to raise cash must then submit to CMHC the total value of NHA MBS they wish to sell as well as the yield they are prepared to pay.(7)

The number of auction offers accepted is determined by distributing available funds, starting with the offer providing the highest yield, based on the amount of that offer, and then distributing the funds to the offers in descending order of yield, based on the amounts of those offers, until the total amount CMHC wishes to spend is reached. To ensure its offer is accepted in accordance with the highest-yield distribution criterion, a financial institution that urgently needs liquidity will be inclined to offer a higher yield than an institution with less pressing needs at the time it submits its auction offer to CMHC.

SOME TECHNICAL ASPECTS OF THE TRANSACTION

Two technical conditions included in the design of the reverse auction mechanism will enable the government to obtain a yield on NHA MBS greater than the borrowing cost incurred to obtain the necessary funds for the transaction. The first is the inclusion of a *minimum yield* that financial institutions must meet if they want CMHC to consider their offers. Offers below that rate are automatically rejected. Because the Canadian government knows its exact borrowing rate, it will seek a minimum yield that is greater than that rate. The acceptable minimum yield is made public on the CMHC website on the day of the NHA MBS auction through an *NHA MBS Auction Operation Call for Auction Offers* (see the sample call for offers for the 14 January 2009 auction in the appendix).

To be considered by CMHC, an offer made by a financial institution must also name an *interest rate swap counterparty*. An interest rate swap is simply a financial contract entered into by the two parties under which one of the parties exchanges a stream of variable interest payments with the other party (the “counterparty”) in return for a stream of constant interest payments.(8)

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(5) In view of the size of the IMPP’s total envelope, the government cannot buy all NHA MBS at one time. It would be difficult for the financial markets to absorb a sudden $125 billion increase in federal government loans. In addition, gradual purchasing enables the government to periodically assess the impact of its intervention on credit availability in Canada.

(6) Only those financial institutions authorized by CMHC to issue NHA MBS may take part in these auctions.

(7) The yield is calculated on an annual basis for the term of the securities and payable in 12 equal monthly instalments per year.

(8) An interest rate swap is usually used by financial institutions as an interest rate risk management instrument.

In this case, CMHC purchases NHA MBS comprising fixed rate and variable rate mortgages. The interest payment received on the aggregate of NHA MBS purchased at auction is therefore variable. To offset this interest rate risk, CMHC requires that the financial institution taking part in the auction find a swap counterparty that will agree to receive variable interest payments from CMHC in exchange for fixed payments corresponding to the yield offered in the financial institution's offer. For example, if a financial institution offers a yield of 3%, then the swap counterparty agrees to make a fixed 3% payment(9) to CMHC in return for variable rate payments from CMHC.

Thus, through the inclusion of a minimum yield and an interest rate swap guaranteeing the government a fixed interest payment equal to or greater than its borrowing cost, the government is assured of earning a return on the transaction.

IMPP-RELATED RISKS

Considering the amounts involved in the IMPP, it is legitimate to ask what the resulting risks are for Canadian taxpayers. The simple answer is that the risks are minimal, for the following reasons.

First of all, the NHA MBS purchased by CMHC consist of pools of mortgages already guaranteed by CMHC against default. As a result, the risk of default by a mortgage holder is already borne by CMHC, whether the mortgage appears on the balance sheet of a financial institution or that of the Government of Canada. From that standpoint, the IMPP generates no additional risk for Canadian taxpayers.

The only source of risk is the credit risk associated with the swap counterparty. If the counterparty becomes insolvent, CMHC loses its fixed interest rate, although it continues to receive variable-rate payments from the various mortgages it has purchased. However, it no longer has any assurance that the yield it receives will be greater than the Canadian government's borrowing cost, which could result in losses to the Treasury.(10) In actual fact, this risk is minimal, since only swap counterparties with very high credit ratings(11) are eligible to participate in the auction process. The insolvency risk is therefore low.

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(9) The rate is calculated on an annualized basis.

(10) In practice, with the Canadian government's borrowing cost at an historical low, this possibility is unlikely, even in the event of bankruptcy by the swap counterparty.

(11) In particular, the swap counterparties must have a minimum of two long-term credit ratings of A- (as defined by Standard & Poor's) or equivalent, one of which must be from Standard & Poor's or Moody's.

IS THE IMPP A GIFT TO FINANCIAL INSTITUTIONS?

In view of the rapid decline in savings among Canadian households following the collapse of the stock markets, it is natural to wonder whether the IMPP is not a gift the Canadian government is making to financial institutions using taxpayers' money. To answer this question, it is helpful to compare the measures taken by the Canadian government with those introduced by American authorities.

In the United States, the federal authority began by injecting taxpayer funds directly into the capital of technically insolvent banks. It then purchased the financial institutions' high-risk assets of uncertain value to enable those institutions to clean up their balance sheets. Taxpayers' money was therefore used to buy assets that no one wanted.

The situation is completely different in Canada, where, to access the liquidity made available to them by the government, financial institutions must dispose of assets that they consider have the highest value: mortgages guaranteed against default. These mortgages present no risk to financial institutions because the institutions are guaranteed to receive the amounts owed them, regardless of the source of those funds. In the current financial crisis, one could ask for no more. In fact, these mortgages are so safe they carry a risk weight of 0% under the rules of the Bank for International Settlements, which means that financial institutions are not required to increase capital when they acquire this type of asset, as they are when acquiring other, riskier assets. Holding these guaranteed mortgages, or even NHA MBS directly, is therefore less restrictive than holding other assets. All of these considerations underlie the value of these assets to financial institutions, and make it clear that the Government of Canada's intervention does not constitute a gift to those institutions.

A simple way to prove this is to assess the financial institutions' involvement in the program. The following table shows the total envelope that CMHC was prepared to spend and the amount of the offers it has received from financial institutions for the nine auctions conducted since the IMPP was announced.

Table 1 – Amounts Offered and Accepted at Auction

1. Date	2. CMHC Call for Offers		3. Auction Result	
	Total Amount Offered ($ billions)	Minimum Rate Offered	Amount Accepted ($ billions)	Average Yield
16 October 2008	5.000	3.925%	5.000	4.241%
23 October 2008	7.000	3.664%	7.000	4.095%
12 November 2008	7.000	3.433%	7.000	3.782%
21 November 2008	6.000	CDOR[a]+75 bp[b]	6.000	CDOR+110.1 bp
14 January 2009	8.000	2.262%	8.000	2.619%
23 January 2009	8.000	CDOR+75 bp	8.000	CDOR+112.7 bp
9 February 2009	8.000	2.590%	7.945	2.700%
20 February 2009	7.000	CDOR+75 bp	2.338	CDOR+76.3 bp
11 March 2009	4.000	2.460%	2.103	2.466%

(a) "CDOR" means "Canadian Dealer Offered Rate," the interest rate that best reflects the banks' cost of funds and the yield on their loans (a variable rate).
(b) The abbreviation "bp" means "basis point," which is one one-hundredth of a percentage point (0.01%).

Source: Table prepared by the author using data obtained from Canada Mortgage and Housing Corportation, *NHA MBS Auction Operations*, http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/auop/index.cfm.

A number of interesting observations may be made based on this table. First, the amount accepted in the last three auctions, and particularly in the last two, was less than what CMHC was prepared to spend: $4.6 billion less at the 20 February 2009 auction and $1.9 billion less at the 11 March auction. At all auctions to date, the total value of offers from financial institutions has been $53.4 billion, whereas CMHC's total envelope was $60 billion. This appears to indicate that the financial institutions' interest in the IMPP is beginning to decline.

Second, the gap between the average yield obtained by CMHC and the minimum yield it demanded fell in the last two auctions shown, an indication that Canadian financial institutions are now dealing with less serious liquidity constraints than at the start of the program and that, consequently, they prefer to retain their guaranteed mortgages rather than sell them to CMHC. It is obviously too soon to draw any final conclusions, but recent data suggest that the financial markets are gradually returning to a normal mode of operation and that there is now a possibility that the total envelope dedicated to the IMPP may not be completely used by financial institutions.

CAN THE IMPP ACHIEVE ITS OBJECTIVES?

As noted in the introduction, the purpose of the IMPP is to assist the financial institutions in obtaining cash that they can then make available to Canadian consumers and businesses. It is true that there is no mechanism compelling the financial institutions to make the newly acquired cash available to households and businesses; they can use it for other purposes, such as improving their balance sheets. However, the data on available credit seem to indicate that the measure has helped financial institutions provide credit to households and businesses.

In October, November and December 2008, the value of credit extended to households rose by $30 billion, including a $24 billion increase in mortgage credit.(12) The figures on non-residential mortgages are less impressive: they show a rise of some $2.2 billion over the same period. Business credit as a whole rose $20.6 billion. In the fourth quarter of 2008, the combined increase was thus slightly more than $50 billion, twice as much as the value of the mortgages that CMHC purchased in its auctions in late December 2008.

However, the rise in household and business credit in the last quarter of 2008 probably did not benefit all economic agents,(13) a fact reflected in media reports detailing the difficulty certain groups of individuals and businesses still have in gaining access to credit. The media have given particular attention to manufacturing businesses of all sizes. Since the Canadian manufacturing sector as a whole was already in a precarious position before the current financial crisis started,(14) it is not surprising that the financial institutions' increased prudence in granting loans, as they reassess the risks underlying their assets, has tightened credit for businesses in that sector. Given the specific economic circumstances of the Canadian manufacturing sector, there is reason to believe that the IMPP is not the best program to assist businesses in the manufacturing sector. This would explain why, in Budget 2009, the Government of Canada made more resources available to financial Crown corporations such as the Business Development Bank of Canada and Export Development Canada – these resources were meant to assist the corporations in providing additional financing to Canadian businesses.

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(12) Bank of Canada (February 2009), Table E2.

(13) "Economic agents" are all the individuals in a society viewed as participants in economic life (e.g., consumers, producers, government players responsible for meeting needs, etc.).

(14) As was the US manufacturing sector.

CONCLUSION

The purpose of this document was to provide a detailed description of one of the important economic measures taken by the Government of Canada to address the current economic crisis, the Insured Mortgage Purchase Program. This program, funded through the lending of considerable sums of money, though at no major risk to the Canadian Treasury, is making needed liquidity available to financial institutions quickly. In return, those institutions must dispose of assets to which they attach considerable value – mortgages guaranteed through government-backed mortgage insurance – leading to the conclusion that the IMPP does not constitute a gift to Canada’s financial sector.

Although it is still too soon to say for certain, the results of the latest auctions conducted by CMHC suggest that the financial institutions’ interest in the IMPP is declining, hence the possibility that the financial markets are gradually returning to a normal mode of operation and that the program’s $125 billion budget will not be completely used.

APPENDIX

NHA MBS AUCTION OPERATION
CALL FOR AUCTION OFFERS

Auction Date:	January 14, 2009
Settlement Date:	January 21, 2009
Term:	5 years
Rate Type:	Fixed
Maturity Date:	January 15, 2014
Total Amount:	Up to $8 billion
Maximum Total Amount per Issuer:	$2.0 billion
NHA MBS Eligibility:	All NHA MBS maturing on or before the maturity date.
Participation Rules:	Standard Terms for NHA MBS Auction Operation (http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/auop/auop_008.cfm) Standard Terms for NHA MBS Auction Operation Swap Transactions (http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/auop/auop_009.cfm).
Minimum Offer Rate:	**2.262%** N.B.: The minimum offer rate will be set by CMHC and posted in the NHA MBS Auction Operation Call for Auction Offers on CMHC's website (http://www.cmhc.ca/en) at 9: 40 a.m. (Ottawa time) on the day of the auction.

All offers must be submitted no later than 10: 00 a.m. (Ottawa time) on the day of the reverse auction. Offers must be sent **only** to the email address specified below. If signatures are not included in the email, please follow up with a signed copy to the following fax number: 613-748-5147.

Contact Information

For submission of offers:
CMHC Treasury
Email: MBS_Auction@cmhc.ca
Email subject line should read: "NHA MBS Auction Offer"
Telephone: 613-748-1450

Other Inquiries
Mark Chamie
Treasurer
Email: mchamie@cmhc.ca
Telephone: 613-748-2191
Fax: 613-748-5147

Source: Canada Mortgage and Housing Corporation, *NHA MBS Purchase Operation Results*, http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/auop/auop_013.cfm.