Intelligence MEMOS

From: Jeremy M. Kronick and Nikki Hui

To: Jeremy Rudin, Superintendent of OSFI

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Re: **Covered bonds: elsewhere, the sky's the limit, why just 4 percent in Canada?**

Startling house-price increases in some markets and unprecedented levels of mortgage debt have fuelled concerns that taxpayer-backed mortgage insurance may be encouraging excessive borrowing – and putting taxpayers on the hook if loans go bad. One way to mitigate these concerns would be to relax restrictions on a less problematic vehicle for mortgage financing: covered bonds.

Covered bonds are a private funding source not guaranteed by the government. They are high-quality debt instruments issued and fully-backed by banks, and are covered by uninsured mortgage loans (i.e. loan-to-value ratios below 80 percent). The structure of these bonds guarantees that the banks are responsible for the loans they underwrite. Bond investors are attracted to the certainty of knowing that the underlying assets are out of reach of other creditors and the Canada Deposit Insurance Corporation in the event of a bank failure.

This vehicle for financing would help develop Canada's private-label residential mortgage-backed securities market. Canada's dominant *National Housing Act* Mortgage-Backed Securities program involves investments backed by insured mortgages, the bulk of insurance coming from CMHC, which is fully-guaranteed by the Canadian government. This means taxpayers are completely on the hook. Covered bonds present an attractive alternative private funding source.

According to a CMHC report, since 2007, Canadian banks have continually increased their use of covered bonds as a source of funding. Ten percent of Canada's residential mortgages are now funded by covered bonds. Currently, however, covered bonds cannot exceed 4 percent of a financial institution's total assets. In contrast, most major covered bond issuing jurisdictions have no limits on their covered bond issuances.

To be fair, banks have not yet been constrained by the limit. However, the new OSFI stress test requiring all buyers to prove they can afford a 2 percent increase in interest rates is likely to change that. We are already seeing a cooling of our large housing markets, and a decline in mortgage loans reduces banks' asset size, which translates into a reduction in the amount of outstanding covered bonds a bank can have.

The primary argument against not raising the limit is that the CDIC would have fewer bank assets to access in a bank failure since they could not touch the underlying covered mortgage assets. It would, therefore, increase the deposit insurance premium it charges lenders, with consumers eventually picking up the tab. However, there are ways to offset this cost, including changing the assessment base to focus more on consolidated assets and less on deposits, as is now done in the US (Poschmann 2015).

There are many reasons to want to cool the Toronto and Vancouver housing markets, but as this occurs, more banks will come up against the regulatory limit on covered bonds. These bonds present an opportunity to develop a private market for securitization, thus reducing taxpayers' exposure in the housing market. This is both achievable and desirable.

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