SEPTEMBER 2018

Debt Market Monitor

Debt Capital Markets Services

Covered bonds issuance could affect mortgage funds supply

Covered bonds are not new; however, they have not been used long in Canada, and they have been used sparingly in the U.S. These bonds are debt securities typically issued by a financial institution and secured with a pool of assets. Unlike securitized instruments, covered bonds are an obligation of the issuer. In addition to the issuer's guarantee, collateral is also provided as security in a setup often called dual recourse. The combination one-two punch of the dual recourse provides an excellent and inexpensive source for funding uninsured mortgages. If the owner of an asset in the covered pool defaults, the issuer must replace it with a performing asset. Although covered bonds are not the primary supplier of mortgage funds, they are a growing and somewhat contentious source – a situation that could present a problem in the near term.

In Canada, the emergence and growth of the covered-bond market goes back to the Great Recession. In 2008, the percentage of mortgage dollar volume backed by covered bonds was a meager 1.1%. By 2016 it had grown to 9.6% – more than 770% – in eight years. Covered bonds in Canada are subject to limited issuance by the Office of the Financial Superintendent of Financial Institutions (OSFI) – a.k.a. the supreme regulator, as the holders of these bonds have rights above those of depositors, something that is considered controversial and why the issuers are restricted to using 4% of their assets. Currently, the six largest banks in Canada have issued between 2.9% and 3.3% of assets in covered bonds, getting close to the maximum allowable. The Bank of Canada estimates that banks have room to issue another $50 billion in covered bonds before hitting the wall. For context, the first quarter of 2018 saw over $26 billion in uninsured mortgage originations at traditional lending institutions in the Greater Toronto Area alone, according to The Bank of Canada.

Regulators are considering whether they should simply increase the allotment for covered-bond issuance or curtail it. Their concern relates to the overall money supply – more specifically, what is referred to as M1 by economists. Loosely defined, M1 is the supply of all physical currency, demand deposits and anything that can be immediately converted to cash. M1 funds much of the float to financial institutions. In turn, the float is used for mortgage lending. The problem is that the M1 supply is quickly slowing and, therefore, putting even more pressure on the issuance of additional covered bonds. If the economy hits a speed bump, the M1 will slow even further and, depending upon the severity of an economic slowdown, defaults in mortgages could occur, creating a snowball effect for financial institutions that issue covered bonds.

Fiscal Snapshot

Bank of Canada

	Bank Rate	Bank Prime Lending Rate
August 2018	1.75	3.70
One month ago	1.75	3.70
One year ago	1.00	2.95

Government of Canada Benchmark Bond Yields

	5-Year	10-Year	Long
August 2018	2.16	2.22	2.35
One month ago	2.22	2.31	2.33
One year ago	1.53	1.85	2.26

Indicative Commercial Mortgage Spreads* Over Government of Canada Bond Yields

Conventional	5-Year	10-Year
August 2018	1.50 - 2.20	1.60 - 2.20
One year ago	1.50 - 2.25	190 - 2.35
Insured	**5-Year**	**10-Year**
August 2018	0.80 - 1.10	0.80 - 1.10
One year ago	0.95 - 1.15	0.95 - 1.25

*Spreads are indicative of high quality real estate in major Canadian markets.

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Highlighted Transaction

Asset Type	Single tenanted office building
Location	Major Canadian city
Facility Details	A $14.5M senior, permanent mortgage charge to assist with the acquisition of the asset. Terms included a 10 year term, amortized over 25 years at a competitive rate of interest.

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Please contact our Debt Capital Markets team for more details related to debt financings or real estate transactions.

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