BMO Canadian MBS Index ETF (ZMBS)

Q&A

BMO Canadian MBS Index ETF
ZMBS
Duration: 2.26
YTM: 0.52% | **M**
Mgmt Fee: 0.15%

ZMBS invests in Canadian National Housing Act Mortgage Backed Securities (NHA MBS 975 Pools) which make it an ideal investment for those looking for defensive income.

- AAA Rated with term to maturity greater than one year
- Minimum amount outstanding of $100 million
- Rebalanced on a monthly basis

Has the housing / mortgage market in Canada been impacted by COVID-19 related slowdowns?

Canada's national housing agency says the number of new homes being built and sold will remain below the levels they were at before COVID-19 until 2022 at least, and prices won't get back to where they were for another two years. The CMHC is now forecasting that prices will fall by between nine and 18 per cent from where they were before the pandemic, before recovering a little in the early part of 2021. But they aren't expected to be fully back to where they were before at least 2022.

The speed of the slowdown will obviously not go at the same pace everywhere. In oil-dependent Alberta, prices are forecast to go down by as much as 25 per cent. Other provinces are expected to see smaller declines. CMHC is forecasting that housing starts could plummet by as much as 75 per cent, while home sales will likely fall by about 29 per cent.

On June 5th 2020 CMHC announced that tougher requirements are being introduced. From July 1st onward new applicants will face higher credit score requirements (scores of 680 or above for at least one borrower), and a requirement to keep the share of their income that is spent on all housing costs (mortgage, tax, energy) at 35% (from current level of 39%) or less of total earned income. These changes are being implemented to protect home buyers, reduce government and tax payer risk and support the stability of the housing market.

We know that in the U.S. home ownership has involved a lot of speculators, particularly during the crisis. What makes ZMBS different?

They key difference is that mortgages in ZMBS are all CMHC backed, guaranteed by the Canadian government.

Additionally, In Canada home owners are penalized heavily for prepayment on mortgages which means there is less speculating in the market, in the US the mortgage can be paid off anytime without penalty. In Canada most mortgages have a 5 year term, with amortization over 25 years where in the States they have fixed 30 year mortgage terms. Mortgage interest in the US is tax deductible which may have led to more speculative buyers.

Canadian issuers are much more closely regulated requiring insurance on mortgages with down payments under 20%. In the US there are different rules in different States and regulation is loose. While they have the 20% rule, they eliminate the insurance after 20% in equity as been reached.

In the U.S. in 2008, defaults peaked at about 5% of all mortgages, and exceeded 20% for those deregulated subprime loans. In Canada, defaults rose in 2008 and after, just as they did in the U.S. But they topped out at about .45% of all mortgages.

What's the deferral risk or prepayment risk with ZMBS?

Prepayment: In Canada, those wishing to prepay their mortgage face heavy penalties which deters this practice. Mortgage-backed securities are a pool of mortgages which ensures that prepayment risk is diversified. ZMBS further diversifies this risk by investing in a portfolio of MBS.

Deferral: NHA MBS are not impacted by mortgage deferrals. The issuer funds the principal and interest payments for any deferred mortgages. Hence, the coupon would not be lower, it would remain the same. At a high level, mortgage originators are seeing anywhere from 15-20% mortgage deferrals for their books, MBS coupons have been paid as expected.

Would ZMBS be considered a HQLA "High Quality Liquid Asset"?

The Basel LCR standard defines assets eligible as Level 1 HQLA to include marketable securities representing claims on or guaranteed by sovereigns, subject to those securities meeting certain conditions. One condition is that the securities are not an obligation of a financial institution - the holder of the security must not have recourse to the financial institution. In Canada, OSFI has incorporated the Basel definition of Level 1 HQLA into its LAR Guideline. The accompanying OSFI Notes state that "Securities issued under the National Housing Act Mortgage Backed Securities (NHA MBS) program may be included as Level 1 assets".

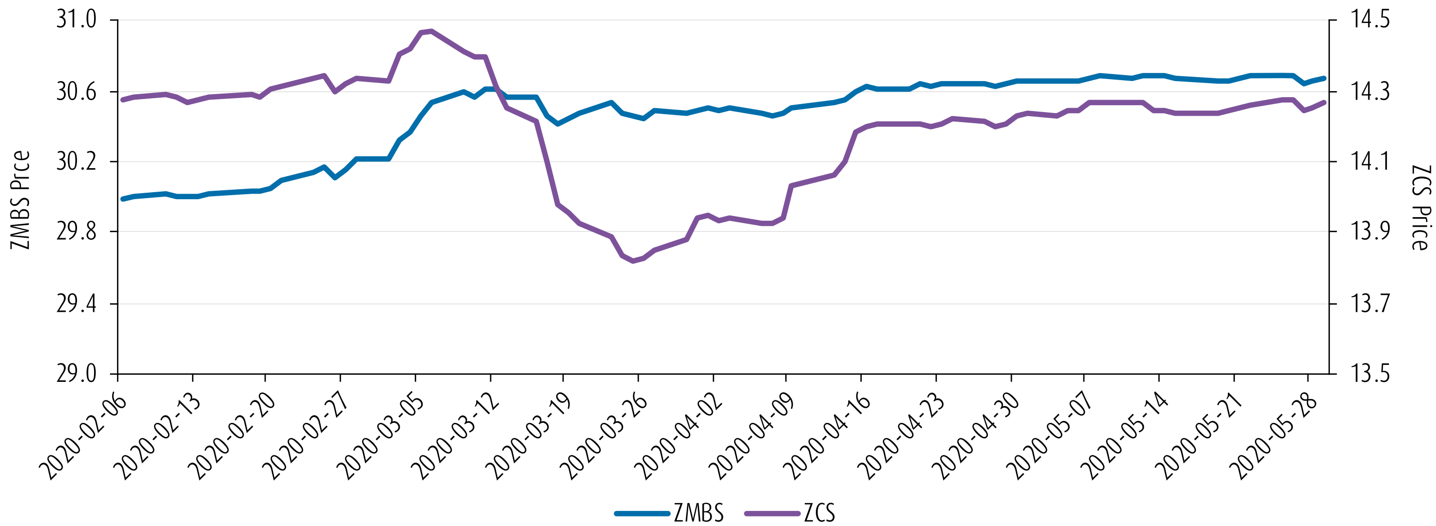
What happens if a mortgage holder defaults?

In the NHA MBS market all MBS are fully insured by CMHC, both principal and interest with no limit to coverage. If a mortgage holder defaults the issuer will make the payment to the MBS holder and then claim insurance through CMHC. There would not be a disruption in payment to the MBS holder.

With today's volatile markets, what makes this portfolio of MBS a safer investment than corporate bonds?

MBS are AAA rated bonds and are fully guaranteed by CMHC both principal and interest. Corporate Bonds are subject to credit spreads as an additional risk factor where MBS are not.

ZMBS vs ZCS (Price Mar - May 2020)



Are Canada MBS packaged or bundled into derivatives similar to what happened in the US in the mid-2000s?

MBS were a central factor in the US subprime mortgage crisis. With the rapid increase in home prices, lower interest rates, the rise of speculative buyers and growing demand for MBS, the banks lowered their lending standards. MBS credit ratings did not drop as the quality of mortgages declined so investors did not know the quality of the underlying, rating agencies were still giving high ratings. In 2006 housing prices peaked and subprime borrowers began to default. Further amplifying the problem was synthetic CDOs which were betting on the performance of these mortgages. MBS and CDOs (based on pools of these mortgages) were vastly overvalued making it difficult for investors to offload them and in time causing the Government to step in.

In the Canadian MBS market there are no CDOs. In the Canadian NHA MBS market all MBS are backed by distinct pools of mortgages and are fully insured by CMHC, both principal and interest with no limit to coverage. From the credit crisis, Canadian mortgage standards were generally more stringent than in the US with sub-prime mortgages, meaning that the quality of mortgage pools has been higher.

What occurs to the MBS after five years? Do they remain in the index?

Because the typical mortgage term in Canada is 5 years the proceeds from a maturing mortgage will roll into a new 5 year maturity pool. On the roll over the new interest rate will reflect current market conditions. The amount of issuance year to year, while generally laddered, will depend on current interest rates. When rates are low holders are more likely to lock into fixed term while if conditions are reversed are more likely to look for variable.

ZMBS Maturity Weights

Maturity	Weight
1 Year	10%
2 Year	21%
3 Year	20%
4 Year	28%
5 Year	20%

Source: BMO Global Asset Management, as of September 30 2020.

What would be the impact if an issue were to fall below the inclusion threshold set by the Index? Would there be a price impact on the issue?

The size of the NHA MBS market is approximately $500B with the market cap of the index is $150B. Even if our ETF was to get to a 2-3 billion it wouldn't have a material impact on pricing of issues.

What is the relationship between NHA MBS and Federal Bonds?

ZMBS offers short duration, AAA investment grade exposure, with a yield-pick up (around 30bps) over short duration Federal Bonds.

Exposure	ETF Name	Ticker	Current Price	AUM ($MM)	Coupon	Current Yield	YTM	TTM	Duration	Average Credit Rating
Canadian Aggregate	BMO Aggregate Bond Index ETF	ZAG	16.67	5067.20	3.10	2.60	1.26	11.10	8.39	AA
Short Federal	BMO Short Federal Bond Index ETF	ZFS	14.61	595.77	1.77	1.70	0.32	2.94	2.86	AAA
Short Provincial	BMO Short Provincial Bond Index ETF	ZPS	13.51	402.52	2.73	2.55	0.52	3.21	3.06	AA
Short Corporate	BMO Short Corporate Bond Index ETF	ZCS	14.54	1124.57	3.03	2.87	1.23	3.12	2.95	A
Cash Alternative	BMO Ultra Short-Term Bond ETF	ZST	50.63	1285.32	2.62	2.59	0.58	0.44	0.42	A
Canadian MBS	BMO Canadian MBS Index ETF	ZMBS	30.72	116.07	1.71	1.66	0.51	2.82	2.23	AAA

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Let's connect

Call us at 1-800-668-7327 bmo.com/gam/ca/advisor

Source: BMO Global Asset Management, September 30 2020.

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