BMO NESBITT BURNS

Investing in NHA Mortgage-Backed Securities

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INVESTING IN NHA MORTGAGE-BACKED SECURITIES

NHA Mortgage-Backed Securities present a unique opportunity to invest in government-guaranteed residential mortgages.

The National Housing Act Mortgage-Backed Security (NHA MBS) Program provides investors with a high quality monthly-pay investment and, at the same time, facilitates the financing of Canadian residential mortgage loans.

NHA MORTGAGE-BACKED SECURITIES

NHA Mortgage-Backed Securities represent an undivided interest in a pool of Canadian residential first mortgages. In order to qualify for pooling, each mortgage must be insured by Canada Mortgage and Housing Corporation (CMHC), a federal government Crown Corporation.

The mortgage pool is securitized, meaning that the mortgages are packaged into a credit-enhanced investment and sold to investors through investment dealers and banks. The mortgage lender continues to service the mortgages, collecting principal and interest payments. Principal is passed through to investors, while interest payments are made at the pool's coupon rate.

A select list of Canadian banks, trust companies, insurance companies, caisses populaires and credit unions qualify as CMHC-approved NHA MBS issuers.

NHA MBS are available in $5,000 denominations for terms of up to 10 years. NHA MBS are exempt from non-resident withholding tax.

HIGHEST CREDIT QUALITY

NHA MBS are fully guaranteed by CMHC on behalf of the Government of Canada, making them equal in quality to conventional Canada bonds. Due to the CMHC guarantees, all NHA MBS have the same high credit rating regardless of the issuer.

Unlike savings account balances and GICs, which are guaranteed by the Canada Deposit Insurance Corporation for amounts up to $60,000, there is no limit to how much the CMHC guarantee of NHA MBS covers.

THE ROLE OF CMHC

One of CMHC's principal functions is to provide insurance on residential mortgages. With the introduction of the NHA MBS Program in 1987, CMHC's role was expanded to permit it to provide a guarantee of timely payment of principal and interest to NHA MBS investors.

PASS-THROUGH SECURITIES

NHA MBS are known as pass-through securities because the cash flow generated by the underlying mortgage pool (less the issuer's servicing fee) is passed on to investors. Each month, investors receive their coupon interest payment and a pro rata share of the principal payments.

The amount of principal remaining in the pool declines each month, reflecting all principal payments made over time. The amount of principal remaining in the mortgage pool at any point in time is defined by the pool factor.

For example, an NHA MBS pool, on which 2.5 per cent of the original principal has been repaid, will have a pool factor of .9750 – meaning that 97.5 per cent of the original principal remains outstanding. In this case, for an original principal amount of $100,000, the remaining principal would be $97,500 ($100,000 x .9750).

Since a portion of the outstanding principal is paid each month, the amount of principal returned to investors at maturity will be less than the original principal amount.

MONTHLY INCOME

Interest accrues at the coupon rate from the first day of each month on the amount of principal remaining in the pool. Combined interest and principal payments are made to investors on the 15th day of the following month.

When a pool is formed, mortgage maturity dates may vary by as much as six months. Consequently, principal payments made during the final six months prior to maturity may appear larger than anticipated. The final principal and interest payments are made 15 days after the maturity date.

Investors can arrange for payment directly to their BMO Nesbitt Burns account, their bank account or by cheque.

COMPETITIVE RETURN

NHA MBS carry the same backing as conventional Canada bonds, but offer a higher yield. Typically, rates on NHA MBS exceed those offered on GICs.

INVESTMENT CHOICES

There are several types of NHA MBS, each with distinct characteristics that reflect the features of the mortgages in the pool. For example, certain types of mortgages prohibit unscheduled principal payment by the mortgagor. These mortgages form “Non-prepayable” NHA MBS. Mortgages that allow the mortgagor to make principal prepayments form “Prepayable” NHA MBS.

As these characteristics impact the cash flow paid to investors, they should be carefully considered prior to making an investment decision.

NON-PREPAYABLE NHA MBS

The mortgages in non-prepayable pools do not allow for principal prepayments. As a result, monthly income includes (i) interest, and (ii) a pro rata portion of the amortized principal.

On non-prepayable NHA MBS pools, the scheduled principal paid out prior to maturity typically represents less than five per cent of the original principal amount. For example, on a $20,000 five-year non-prepayable NHA MBS, an investor could expect to receive approximately $461 of principal during the first four and one half years.

The remaining principal, or $19,539, would then be repaid during the final six months.

MULTI-FAMILY AND CLOSED POOLS

Non-prepayable pools fall into two categories. Mortgages on privately-owned properties, such as nursing homes and apartment buildings, form "Multi-Family" pools; mortgages on government-subsidized social housing properties form "Closed" pools. These two types of NHA MBS are similar in every respect except that, under extreme economic conditions, a privately-owned property could be foreclosed, resulting in an early repayment of principal.

PREPAYABLE NHS MBS

Prepayable pools (also known as "Open" pools) consist of mortgages on single-family properties where mortgagors are granted prepayment privileges. Prepayment activity generally increases during periods of declining interest rates, when mortgagors are likely to take advantage of refinancing opportunities. Conversely, prepayment activity tends to slow when rates are stable or rising.

Because of prepayments, the amount of cash flow generated by a prepayable pool each month will vary. For example, it is not unusual for prepayable NHA MBS to prepay as much as 50 per cent of the original principal amount prior to maturity. Prepayment penalties, if levied against the mortgagors, may be passed on to NHA MBS investors, depending on the terms of the pool.

RRSP AND RRIF ELIGIBLE

NHA MBS are eligible investments for Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and Deferred Profit Sharing Plans (DPSPs). Due to the relatively high frequency of cash flow, they are best suited to investors for whom income is a prerequisite.

PRICE VOLATILITY

As with all fixed-income instruments, the market value of a NHA MBS will fluctuate inversely with interest rates. Consequently, if an investor wishes to sell their investment prior to maturity, they will find that the market value at the time of sale will depend on prevailing interest rates at that time.

An investor who holds the investment to maturity will be unaffected by day-to-day fluctuations in market value.

TAX REPORTING

Each monthly payment is broken down into its principal and interest components on the investor's statement of activity. For tax purposes, principal payments are a return of capital and not investment income. Interest payments (reported on a T5) are taxable as investment income. Upon maturity or prior sale, a capital gain or loss will occur to the extent that proceeds of disposition differ from the original purchase price. An example follows:

Original Principal Amount	80,000
Pool Factor at Purchase	.9950
Remaining Principal Amount at Purchase *(80,000 x .9950)*	79,600
Purchase Price	98
Pool Factor at Sale	.9770
Remaining Principal Amount at Sale *(80,000 x .9770)*	78,160
Sale Price	102
Pool Factor at Maturity	.9600
Remaining Principal Amount at Maturity *(80,000 x .9600)*	76,800
Value at Maturity	100

Example 1 – Investment is sold prior to maturity

The difference between the Remaining Principal Amount (RPA) at purchase and the RPA at the time of sale reflects principal repayment of $1,440. All principal payments are returned at par value. The gain or loss is calculated as follows:

1,440	x	(100 - 98)	=	$ 28.80
78,160	x	(102 - 98)	=	$3,126.40
Total Gain				**$3,155.20**

Example 2 – Investment is held to maturity

The difference between the RPA at purchase and the RPA at maturity reflects principal repayment of $2,800. All principal payments are returned at par value. The gain or loss is calculated as follows:

2,800	x	(100 - 98)	=	$ 56.00
76,800	x	(100 - 98)	=	$1,536.00
Total Gain				**$1,592.00**

CONCLUSION

Government-guaranteed NHA Mortgage-Backed Securities are a popular income investment due to their convenient monthly income stream, high quality, competitive return and flexibility. As well, investors are able to choose between prepayable and non-prepayable pools, depending on their individual income needs.

Due to the monthly cash flow, NHA MBS are particularly well suited to a Self-Directed RRIF, where high liquidity is an advantage.

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