Mortgage Investments for Trusteed Pension Plans

CENTRAL MORTGAGE AND HOUSING CORPORATION

The book is also available in a French Ed

"Mortgages present an attractive, safe and profitable long-term investment."

This was the consensus developed by speakers at the Skyline Hotel, Ottawa, during a special conference on "Mortgage Investments for Trusteed Pension Funds" sponsored by Central Mortgage and Housing Corporation on June 26, 1968.

Emphasizing the urgent need for more sources of mortgage funds, CMHC President H. W. Hignett, chairman of the conference, said in his opening remarks, "Residential construction in Canada now exceeds two billion dollars annually and more than half of this amount has come from the private mortgage market. But the magnitude of future residential housing programs will require almost a doubling of private investment".

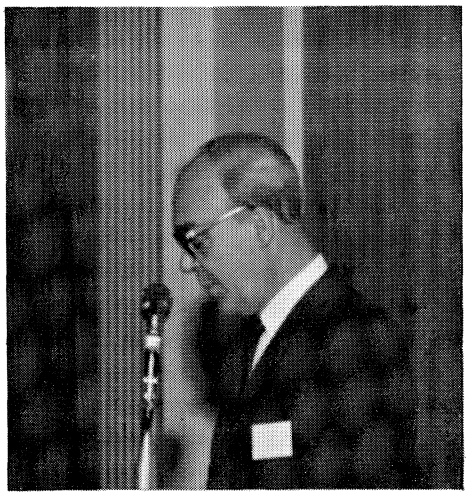
"Housing and living conditions have an important bearing on the future development of our country. This conference therefore has greater meaning for each of us - and for every Canadian - than just quality high yields and a more advantageous investment of pension dollars."

"We have been most fortunate in arranging for an outstanding and eminently qualified group of men to speak today. We hope their messages will offer convincing proof of the many reasons why insured mortgages are a prime area of investment."

Speakers and panelists included ranking public servants, bankers, investment advisers, and administrators of trusteed pension funds. Collectively, they represented more than 300 years' of experience in Canadian mortgage and financial practices.

An audience of 160 representatives of pension funds and investment firms listened intently as the many advantages and modern techniques of participating in the secondary mortgage market were explained. Investments in both National Housing Act and conventional mortgages were endorsed.

Full texts of all speeches are contained in this booklet. Each describes growth possibilities in the secondary mortgage market and encourages greater capital investment by the trusteed pension funds.



Mr. H. W. Hignett
President of CMHC
Chairman of the Conference

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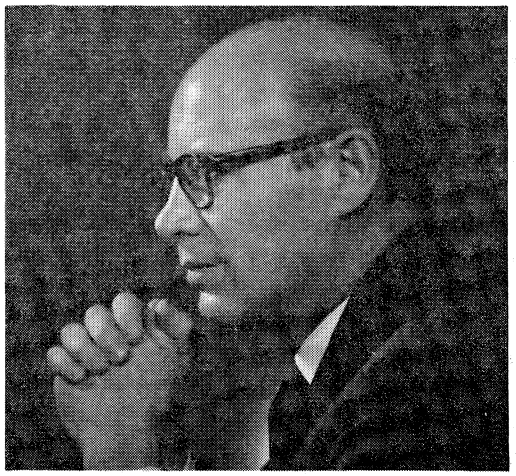
The Capital Market and Housing

KEYNOTE SPEAKER

Mr. Bryce was born in Toronto and educated at Toronto, Cambridge and Harvard Universities. He began his career as an economist with the Sun Life Assurance Company, Montreal, and in 1938 joined the Department of Finance in Ottawa. During World War II he was Secretary to the Government Economic Advisory Committee and in 1946 was appointed the first Canadian Director of the International Bank in Washington. He was appointed Assistant Deputy Minister of Finance and Secretary of the Treasury Board in 1947, Clerk of the Privy Council and Secretary to the Cabinet in 1954, and to his present position, Deputy Minister of Finance and Receiver General of Canada in May of 1963.



R. B. Bryce

Mr. Chairman, I should begin by complimenting you and your corporation on your initiative in organizing this conference on what we in the Department of Finance regard as an important subject.

I must compliment you also on your nerve in inviting me to be your first speaker. For one thing, I represent your biggest competitor in the capital markets, selling hundreds of millions of dollars a year in marketable government bonds both for refunding and for the raising of new cash. You can hardly expect me to do a hard sell in your favour against the bonds which I must sell in order to finance Central Mortgage and Housing Corporation, along with others. Secondly, the Department of Finance may not be considered a good example to those whom you have invited here today, in terms of our own investment practices. We dispose of about a billion dollars a year in funds accruing in pension plans but we do not invest any of it directly in mortgages, though much of it goes indirectly into mortgages as well as other important investments. In the last fiscal year we invested about $600 million of Canada Pension Plan funds, virtually all of it in provincial government obligations as the law requires. These funds of course were used for a variety of important provincial purposes. The $352 million of funds we accumulated last year in our own employee pension plans we invested, as the law requires, in book liabilities of the Government of Canada. These monies are used for the general purposes of the Government of Canada, including very large sums that we are investing through CMHC in housing, amounting last year to nearly $700 million.

Notwithstanding the risk you run therefore in inviting me to speak to this group, I am very glad that you did so. The Department of Finance is concerned with the economic situation and economic policy as a whole, as well as with financial problems. We are of course particularly concerned with the capital market, not just because we are a major borrower in it. We have a vital interest in the capital market for its constructive role in channeling Canadian savings into the various end uses which they must serve in our economy. Of these purposes one of the most important is housing.

Although housing and related urban facilities and development are a subject that falls within provincial jurisdiction under our constitution, the Government of Canada has played a very substantial role in housing since the end of the last war, and has been held by the public to be responsible to a greater degree than perhaps its jurisdiction and capability in the field warrant. However, our Departmental interest goes back beyond that time. It was my illustrious predecessor as Deputy Minister of Finance, Dr. W.C. Clark, who persuaded the government of the day to put before Parliament the Dominion Housing Act of 1935, which was later transformed into the National Housing Act of various vintages. He felt that improvements in the financing of housing offered one of the best long term solutions to a number of the problems that were plaguing Canada in the depression. I think we would all concede now that he was right and that his vision was wholly justified.

When World War II was over, housing and the general lack of accommodation was one of the most serious problems facing Canada. Not only was it needed for our returning servicemen, but in addition a tremendous backlog of demand for housing had been generated by the low level of building during the depression and the war. It was made effective by the accumulation of savings during the war period. This was also the time of the unprecedented rate of increase in family formation out of which came the baby boom of the late '40s.

The subsequent years have seen a tremendous increase and improvement in our housing stock. The proportion of families sharing accommodation with other families has declined from 10% to 4%. Our population has increased rapidly. Vast numbers of people have been enabled to move from rural areas into the cities.

Now we face another wave of abnormal demand for housing. The children of the baby boom period are reaching marriageable age and we must expect a considerable increase in the level of family formation. In addition a relatively high level of immigration is adding to the demand. Furthermore the increasing affluence of the young and the increasing need for specialized housing for elderly people are giving rise to large demands for separate housing units. All these features will not only increase the number of housing units that will be required in the next few years but will change somewhat the emphasis on the type of units demanded. Over 60% of the demand will probably be for rental housing and much of it in apartments.

Meanwhile the Economic Council of Canada has in its last report reminded us of the enormous rate of urban growth that we must anticipate in the next fifteen years. Already more than 70% of all Canadians live and work in cities and towns. By 1980 it is estimated that 80% of our population will be urban - and three out of five will live in 29 large city complexes of 100,000 or more. It appears that our existing metropolitan areas will have to absorb most of these people unless regional planning leads to more decentralization than now seems probable.

Urban growth of this magnitude will pose many problems that are new in nature and in scale for all of us involved in city building.

Already we see the problems of this massive urbanization demonstrated around Toronto. In that area where so many wish to live, the growth and the influx are creating a demand for accommodation that is outpacing the growth in the housing stock. The cost of serviced land has risen to a point where it seems out of proportion to the total value of a house or the incomes of those who want it. Increasing numbers of families are turning to the government for special housing assistance. The federal government and the provincial government are both pouring huge amounts of capital into public housing of one sort or another to supplement what the private market is providing.

Experience in the last three years has shown us the way in which the widespread competition for capital has had a constraining influence on the quantity of housing that can be provided. Since mid 1965 the demands for capital by business for its investment and by government for its many requirements have made it expensive and difficult to secure the finance necessary to meet the demands for housing. In 1966, after six successive years of increased house construction, housing starts fell off very substantially to a total of 134,000, following a record performance of 166,000 in the preceding year. Last year saw an equally dramatic comeback, when starts again reached nearly the levels of 1965. In very large measure, however, this was only possible because of a very heavy commitment of funds from the federal government, which totalled approximately $850 million, including reinvestment of the repayments on earlier loans.

Last year it became apparent that the government could not go on financing housing on the scale that was implied in this huge volume of commitments. The Government of Canada has had to reappraise not only the high rate of growth in its expenditures that has been proceeding during the middle '60s, but also the rapid growth and large scale of its lending operations. The government has become in recent years a large financial intermediary itself, borrowing money both from its own employee pension funds and in the market in order to re-lend it through such agencies as the CMHC, the Farm Credit Corporation, the Northern Canada Power Corporation which finances power projects in the Atlantic area, and Atomic Energy of

Canada Ltd. which is participating in the financing of nuclear reactors in Ontario and Quebec and an advanced high tension direct current transmission line in Manitoba. All these financing operations and others that we are involved in, such as financing Air Canada, are for purposes that are useful to the Canadian people and the development of the Canadian economy, but they add greatly to the amounts which the Government of Canada must borrow year in and year out whatever the state of the market, over and above any budgetary deficit that it may incur for reasons of fiscal policy or urgent necessity.

The government has therefore faced the necessity as part of its review of its financial operations, to limit and reduce its lending operations, including the amount it can lend to CMHC for housing purposes.

In dealing with this situation, the government decided that it would need to reduce very substantially the financing of mortgages in the form of direct lending on the part of CMHC. Instead emphasis is being given to the more specialized types of housing that are essentially variations of public housing. These include public subsidized housing for those with low incomes, and loans to non-profit corporations for low rental accommodation for elderly people or other special groups. It includes as well loans to finance housing for students, which are now reaching quite large aggregates annually, and loans, of which part are written off, to finance the construction of sewage works in a major effort to reduce water and soil pollution in Canada. These are all large and growing programs and will absorb nearly the whole of what can be provided from public funds through CMHC.

As a consequence it has become necessary to rely on the market for the financing of ordinary rental housing, and owner occupied housing. We have to give more attention therefore to private financing of housing and the conditions and circumstances that affect it. That of course is where this conference comes in.

It is unfortunate that this rapid increase in the demands for housing, and the need to rely on the market to finance so much of it, should have come at a time when capital is scarce both internationally and in Canada, and when interest rates are at historically high levels as a result of both international and domestic circumstances.

The chief measure that has been taken in the past year to make possible the greater volume of market financing has of course been the increase in the maximum interest rate on government insured mortage loans. Late in 1966 a modest increase in this rate was permitted under the National Housing Act but it failed to attract sufficient private funds into the mortgage market. Consequently it was decided last year to use fully the authority available in the Housing Act to permit the interest rate on insured mortgages to be as competitive as possible with other demands for capital.

This relative freeing of the interest rate last fall brought an immediate response from approved NHA lenders. In the closing months of 1967 their commitments for NHA mortgages were four or five times the volume of a year earlier. The upswing carried through into this year though there have been some signs of it moderating in April and May, as institutions endeavored to make their commitments as early as possible this year in the new circumstances. There is no doubt that this action in regard to interest rates has placed housing in a better position than it was previously. Taken in conjunction with the rapidly expanding number of units being constructed under public housing programs, it should lead to housing starts this year of at least 175,000 units. The market is showing a very substantial preference for financing apartment houses or the acquisition of single-family dwellings by individual customers of the financing institutions, leaving a serious problem for house builders who should be able to get mortgages arranged on houses built for sale.

The fact that we will have achieved a reasonably satisfactory aggregate level of housing starts this year should not lead us to disregard the urgent problem that lies ahead. Economists have estimated that an average of about $2 billion annually must be channeled into housing from the private sector from now until the end of 1970. That would be nearly double the amount made available by these sources for residential construction last year, 1967. Looking

further ahead, it is evident that if forecast housing requirements are to be met, increasingly large flows of mortgage funds must be secured by the building industry from the market. The financing of these flows through all the various institutions in Canada is clearly one of our major economic problems ahead. The strong demand that will exist should pose a major opportunity for the capital market if it can adjust to the prevailing conditions.

During the past decade the mortgage component has been the fastest growing sector of the capital market. In the ten year period up to the end of 1966 mortgages held by our traditional mortgage lenders climbed by $15 billion, from $8 to $23 billion in all. This represented a growth rate of 11% per annum as against a rate of 8% for all other forms of capital market debt.

The life insurance and trust companies have now increased their mortgage holdings to more than half their portfolios. Mortgage loan companies now have almost 75% of their assets in mortgages. In the middle '50s, after the legislation was changed to permit the chartered banks to invest in NHA mortgages, they became major lenders in this market but their activities dwindled away as the ceiling on bank interest rates restricted them. Following the revision of the Bank Act last year and the termination of the interest rate limitation thereunder, the banks were able to enter the conventional mortgage field as well as the NHA mortgage field. They have done so in a large way and we estimate they have approved something of the order of $350 million worth of residential mortgages since that time.

The increase in the yields on both conventional and NHA mortgages in the past year, as compared with the yields on long term bonds, suggests that a high level of purchases of mortgages can now be expected from the traditional mortgage lenders - the trust and loan companies, the insurance companies, and now the banks. If we are to achieve the levels of mortgage lending that are required in order to meet the demands in the next few years at least, the flow of funds from the existing approved lenders must be supplemented very substantially through the attraction of funds from other sources.

This matter has concerned us in Ottawa for many years now. We have made an effort to develop a secondary mortgage market. From 1961 until 1965 CMHC held a series of mortgage auctions as part of this effort. They demonstrated the feasibility of selling packages of mortgages to investors who wanted to take advantage of the high yield offered, and the insured feature of the NHA loans, but who were not in a position to originate or administer a portfolio. Arrangements have been made whereby CMHC or one of the approved lenders operating under the Act will undertake administration for a fee.

The purchase of mortgages on such a basis has proceeded in recent years even without our auctions and the arrangements for having mortgages administered by others seem now to be an accepted and workable feature.

Under these plans there is now available on the market a good supply of a uniform type mortgage with an insurance feature that amounts to a complete government guarantee. We have recently been encouraged to see that the private lenders are beginning to recognize the merit in such mortgage marketing operations and that at least one of the major institutions is now giving it a prominent place in its operations.

The purpose of today's conference of course is to suggest that those of you who administer pension funds should look critically at the opportunities available to you in the purchase of these mortgages, particularly National Housing Act mortgages. We have noted that the pension funds in Canada have only about 1/8 of their holdings invested in mortgages, either directly or via the pooled funds of trust companies or the segregated funds of insurance companies. Similarly only about 13 1/2% of the funds administered by trust companies in estate, trust, and agency accounts are invested in mortgages. Here are funds in large volumes, much of which may well be available to meet the housing requirements of the nation over the next few years on terms that are favourable by comparison with other investments available in large amounts.

I think all of us have been impressed with the growth in recent decades of pension funds and the scale of the assets they comprise. I will not endeavor to trace the history of such funds

from their beginnings in the '20s through the unhappy period of the '30s, and their great expansion under wartime and post-war conditions. Most of you will know this history better than I do.

I feel that I may legitimately, however, call to your attention the fact that our favourable treatment of pension funds under the income tax laws has been of great assistance in this development. Naturally it has been of more importance during and since the war when tax rates, both for employing corporations and for many of the individual contributors, were increased, and the deductibility of pension contributions from income for tax purposes became more significant. Indeed it became of such well known importance that we had to extend a similar tax opportunity to others in the form of registered retirement savings plans in order to preserve equity between employees and others. Now we have of course recommendations from the Royal Commission on Taxation that would be particularly favourable to pension plans, especially in the inducements offered to them to acquire and hold equity investments in Canadian corporations. The present tax provisions are available to bona fide pension plans without imposing very much in the nature of conditions apart from the requirement that nearly all the income of the plan must be derived from sources in Canada, a requirement which does not appear to have been a serious restriction upon the acquisition of foreign equity securities.

In recent years several provincial legislatures, and Parliament, have passed laws applicable to employee pension plans and bearing upon their investments. One of the chief purposes of such plans was of course to protect the position of the contributors and beneficiaries under the plans and to make a number of the benefits portable under suitably defined conditions.

Under this legislation Canada and the provinces, in agreement, have also laid down certain requirements concerning investments, as you are probably aware in more detail than I am. While the insurance legislation has in general been the model for the investment regulations applicable to pension plans, the absence of any restriction on the proportion of pension assets that can be invested in Canadian real estate or in Canadian or foreign corporate equities, providing there is an adequate earnings record, is a degree of freedom that must be very welcome to those of you managing the plans, particularly at this time. This flexibility certainly permits a reasonable balance to be maintained between investments in equities and investments in securities fixed in money.

It is our hope that when you examine the freedom of action that you have under the laws, and the returns available on various investments, you will come to the conclusion that investment in mortgages, whether conventional mortgages or NHA insured mortgages, is desirable in the interest of your beneficiaries.

I do not propose today to enter into any detailed comparison of the relative virtues of bonds and mortgages. Others who are better able to do that than I will speak to you this morning and the matter will be discussed this afternoon by a distinguished panel able to express expert views upon it. It may be that you will draw our attention to some features of the NHA mortgages that we should re-examine in order to render them more attractive to investors.

I do feel I should say a word before closing, however, about the prospect for fixed interest securities as compared with equities, in the present situation.

We hear of course a great deal about the concern on the part of many classes of investors over the danger which persistently rising prices may cause to the real value of assets denominated in money. The last two Ministers of Finance have made clear their recognition of this problem and its importance. They have also made clear that this is one of the factors which make inflationary price and wage and other cost increases dangerous and troublesome in our modern economy. These reactions of the capital market have given inflation a new bite that we all have to take into account.

On the other hand I think we must recognize, particularly this week, that governments and legislatures have shown a willingness to act against inflation. Last week the United States Congress finally passed a very difficult and unpopular tax measure to check inflation and specifically to check the consequences upon it in the capital market. Here in Canada we have

seen a government put through tax measures for anti-inflationary reasons at a time when unemployment was high enough to worry many people, and to return to Parliament with a substitute measure after one bill for this purpose had been defeated. Now we have seen that government returned in a general election despite criticism of its anti-inflationary measures. I think that you can derive some encouragement from the willingness of the Canadian people to support anti-inflationary policies and restraint in government expenditures.

Those concerned about these inflationary dangers will naturally seek to take refuge in equity securities or in foreign securities. It is obvious, however, that the bulk of the capital requirements of Canada will have to be financed in the future as they have been in the past by borrowed money, repayable in money. It is evident to all of us on reflection that the bulk of Canadian savings will have to find investment, through various kinds of Canadian institutions, in fixed money obligations. One way or another we will have to make this system work. One way or another we have to maintain sufficient price stability that the system can work.

Economists have been studying seriously the central questions of unemployment and inflation since the path-breaking work of John Maynard Keynes in the middle thirties. We have learned since then a good deal in principle and in practice about running modern economies. We have found in recent years that it is more difficult than the theories would suggest. Nevertheless I am confident that both those who are engaged in the process as experts and those who must take the decisions as responsible politicians or investors will find a way to make the system work.

In the meantime I cannot see where pension funds and other large investors can possibly find outlets for their large flow of funds unless they buy fixed interest securities. When this is recognized and when the alternatives are examined I would suggest that a reasonable appraisal of the opportunities available will lead to a decision that mortgages should find a substantial place in pension fund portfolios in the next few years.

John R. Ferguson

Mr. Ferguson, Securities Adviser, Bank of Canada, is a Chartered Financial Analyst. He also holds Degrees in Economics and Commerce. Since 1961 he has been associated with CMHC's efforts to develop a secondary mortgage market in Canada. Before joining the Bank he was with Consolidated Paper Corporation Ltd., and Nesbitt, Thomson Co. Ltd.

New Sources of Mortgage Funds from Improved Portfolio Management of Pension Funds

The demand in Canada for mortgage funds for housing is continuing to grow at a faster rate than the available supply. There is obviously a need to develop new private sources of mortgage money. The Government of Canada has long been aware of this problem. In 1954 with the introduction of insured mortgage loans it set the stage for the development of a secondary market in which existing mortgages could be bought and sold. Approved lenders originating government insured loans were permitted to sell them to other investors provided the servicing of the mortgages was retained by an approved lender. With the existence of such a market, the institutions that have been the traditional sources of mortgage money might offer for sale some or all of their own mortgage portfolios in order that the proceeds from such sales might be employed in the financing of new homes.

In order to assist further in the development of a secondary market for mortgages, the Government, through its Central Mortgage and Housing Corporation, introduced in 1961 a series of auctions by which mortgages from CMHC's own direct loan portfolio were offered for sale to the market. Altogether fourteen auctions were held and over $300,000,000 of National Housing Act mortgages were sold, a significant proportion of which found its way into the portfolios of pension funds and other investors who would not otherwise have invested in mortgages. The auctions were successful also in that they encouraged an interest in mortgages on the part of certain financial intermediaries, and resulted in the development of uniform methods for determining prices and yields on packages of mortgages.

In Canada today there are a number of very competent dealers in mortgages who are in a position to supply, at attractive rates, existing mortgages and commitments for new mortgages to investors who do not originate mortgages. In spite of all that has been done, however, and in spite of the availability of suitable mortgage investments, the secondary market has been slow to develop. Notwithstanding many attempts that have been made to sell mortgages to trusteed pension funds and similar investors, there has been limited success, not only in Canada, but also in the United States, in the development of secondary markets for mortgages.

Trusteed pension plans would seem to be a logical source of mortgage money, for they represent an extremely large pool of funds and are growing at a fast rate. Yet the statistics of mortgages held in trusteed pension plans in both Canada and the United States indicate that this market continues to be largely untapped.

In Canada, the Dominion Bureau of Statistics publication "Trusteed Pension Plans, Financial Statistics 1966" indicates that only 9.3% of the assets of such plans was invested directly in mortgages. This proportion remained unchanged from 1963 to 1966 and was only slightly higher in 1966 than the 8.3% of mortgages held in 1960. However, Canadian trusteed pension plans also invest indirectly in mortgages mainly through participating in those pooled funds of trust companies that are invested in mortgages. It is understood that if such pooled fund mortgage investments in 1966 were added to direct mortgage investments in that year, the total would represent

about 12% of the total assets of trusteed pension plans in mortgages.

There is evidence that the proportion of mortgage holdings of trusteed pension plans in the United States is considerably lower than in Canada. A recent release of the United States Securities and Exchange Commission shows that mortgages held in private non-insured pension plans at the end of 1967 amounted to about 5.5% of the total assets of these plans.

How does one account for this obvious lack of success in tapping trusteed pension funds for mortgage money? There are two possible answers to this question. The first answer, and that which has had fairly wide acceptance in both the United States and Canada, is that housing mortgages are not in fact suitable investments for trusteed pension plans. A general acceptance of this view over the years has resulted in many attempts having been made to compensate for this weakness on the part of mortgages by creating a new investment instrument that is secured or backed by mortgages and resembles a bond or debenture, but may at times be referred to as a trust or participation certificate.

This view continues to have general acceptance in both countries. Last October, the President of the Federal National Mortgage Corporation, Mr. Raymond H. Lapin, stated at the Annual Conference of the Mortgage Bankers Association that he realized mortgage bankers had worked long and hard to draw pension funds into the mortgage market and he doubted if they were any more satisfied with the results than he was. He went on to say that the ability to convert the mortgage instrument into a security instrument is more necessary today than ever before. He referred then to a proposal before Congress that would authorize F.N.M.A. to sell trust certificates against its secondary market portfolio. He mentioned that although some mortgage brokers had had limited sales of collateral trust notes, others had carefully investigated the market for mortgage-backed securities only to be dissuaded by a narrow spread between mortgages held and the cost of borrowing in the securities market. Mr. Lapin felt that this was a serious roadblock, but it seemed to him that the spread has been narrow because there has not been developed an organized marketing system nor generated a large enough volume of mortgage-backed securities. He felt that neither of these objectives could be attained by the private market, particularly when participants are unwilling or unable to absorb the start-up costs. Thus, according to Mr. Lapin, the proposal that F.N.M.A. sell trust certificates against its secondary market portfolio may make it possible for F.N.M.A. to overcome existing hurdles to the development of a mortgage-backed security.

Whether the availability of F.N.M.A. trust certificates will result in a significant penetration of the pension fund market is questionable. At a meeting in Chicago of the Mortgage Bankers Association last February, a panel discussion was held on "New Concepts of Marketing Mortgages". One of the panelists representing a firm that had been attempting for some years to sell mortgage-backed securities to pension funds was most pessimistic. He advised the mortgage bankers in attendance that the pension fund market could fairly well be written off as a source of mortgage funds for housing, that pension funds were not traditionally mortgage lenders and would never be anything but a very marginal source of mortgage funds.

In Canada a number of attempts have been made over the last decade or so to form companies that would hold mortgages and sell debentures secured by mortgages and these ventures have either failed to come into existence, or if they have done so, have met with limited success.

It would seem that the answer that mortgages are not suitable instruments for pension funds, but can be made suitable by changing their form, may not be an adequate reply to the question of why the pension fund market is so difficult to tap for mortgage money.

The second answer to this problem and one that so far has had too little attention concludes that the mortgage is a useful and attractive investment for pension funds and if pension funds are not taking advantage of these investment opportunities, then it is not because there is anything wrong with mortgages, but rather because there is something wrong with the overall financial administration of trusteed pension fund moneys.

How does one test this latter thesis? It may be claimed that the thesis has been tested and found to be true, for in spite of the fact that trusteed pension funds in Canada hold a relatively

small proportion of their assets in mortgages, a number of pension funds in this country have invested a considerable portion of their portfolios in mortgages and can affirm that their experience with mortgage investments has been excellent.

For example, the pension fund of the Bank of Canada, has held mortgages in its portfolio since 1955 and these investments now amount to about twenty-five percent of the total assets of the fund. The servicing of these mortgages has been carried out by six different servicing agents, and the pension fund has yet to experience a single mortgage foreclosure. Moreover, the Chief Accountant of the Bank affirms that the mortgage portfolio has involved far less administrative work than has either the corporation bond or municipal bond sections of the fund.

Other pension funds in Canada have had a similar experience with mortgage portfolios and are in a position to confirm that the mortgage is a useful and attractive investment instrument.

If one should accept the thesis that the mortgage is a satisfactory investment for pension funds, then one must conclude that if pension funds generally are not taking advantage of the availability of mortgage investments, then they are not acting in their own interests and this may often be the result of inadequate portfolio management. This is not to say that there are not well-managed pension funds in Canada. However, figures produced by the Dominion Bureau of Statistics showing the composition of the total assets and investment income of all trusteed pension funds, indicate that these assets are not being employed to produce an adequate return.

One can find numerous reasons for the less than adequate management of many pension funds. There are examples of fairly large pension funds that are self-administered, but the investment of the funds may be the part-time responsibility of one or more busy financial executives with little time to spare. Necessarily then funds will be invested with a minimum of effort and for the purpose of maximizing safety of the assets and with too little regard for maximizing profitability. The financial executives will undoubtedly steer clear of securities about which they are not knowledgeable, including mortgages. Sometimes the busy financial executives will have the assistance of pension fund investment committees and these committees may meet infrequently and may often produce mediocre investment results. If the persons involved have had some experience with bonds and stocks, it is not too often likely that they will be familiar with mortgages, and will tend to keep away from these and other investments with which they are not familiar.

It is not fair, however, to look upon all trusteed pension funds as a uniform group. One can place these funds for convenience in at least three different groups. In one group there are pension plans that are still restricted by legislation or by-laws from investing in anything but provincial or municipal bonds and these of course have not provided a market for mortgages. A second group includes a limited number of pension funds that have not only become sophisticated investors in mortgages, but have graduated in some cases from straight mortgages to real estate investments and to mortgages with an equity participation in the property being mortgaged. This group of pension funds would seem to be growing, and likely the next annual publication of pension fund statistics from D.B.S. will bear this out. The third group of pension funds in Canada may be the largest of the three classes, and these can generally be said to have had less than adequate management.

Many pension funds are turned over to trust companies to be managed and such trust companies have been paying considerable attention to this function of their operations in recent years. The Dominion Bureau of Statistics reports that in 1966 there were 2,530 pension funds administered by trust companies, representing 73% of the total number of trusteed pension funds in Canada. However, these funds represented but 33% of the total assets of all trusteed pension funds in that year. Individually managed pension funds numbered 862, representing 25% of all trusteed pension funds, but 54% of their total assets.

Trust companies, however, do not always have full discretion as to how the pension funds under their administration will be invested, but may often be directed as to how funds are to be invested, and this of course will affect the performance of certain pension funds.

Many corporations however are quite happy to have a trust company completely manage their

pension funds. However they are not always willing to pay sufficiently for this service, and competition between trust companies for such business may have tended to keep the charges lower than they would otherwise be. If this is true and trust companies with over 2,500 pension plans under their administration are not charging sufficiently for their services, then one might wonder how they can afford to pay for the kind of expertise they are using in performing their portfolio management services. Undoubtedly if those companies who place the full management of their pension funds in the hands of trust companies are becoming interested in ever increasing returns in terms of performance, then they should also be willing to pay an adequate price for such results.

A contributing factor in the lack of attention that has been given in the past to more adequate portfolio management of pension funds in Canada has been a lack of interest until recently in the use of adequate measures of investment performance. There is growing interest today in this subject and a considerable amount of work is being carried out in both the United States and Canada with a view to improving such measures. One reason for the interest in measures of performance is that pressure is increasing from employees' associations and from unions for improved pension benefits, and there is a growing recognition that one way to provide improved benefits without increasing contributions is to increase the return from the investment of the fund's assets. Most actuaries will verify that an increase of 1% in yield from a pension fund portfolio will usually permit an increase of from 20% to 25% in the pension benefits that can be provided.

There has been a tendency in Canada to consider the management of a portfolio of securities as quite different from the management of any other kind of business and consequently there has been too little stress placed on the application of normal management procedures. Pension funds are important businesses and the simple principles of business management that apply to any business concern should be applied to the management of pension fund portfolios. There is the same need for planning for both the short and the longer term, including the stating of objectives, for proper organization and sufficient staff so that plans can be effectively carried out, for the co-ordination of the activities of all those that have to do with the administration of pension plans, the accountants, the actuaries, the benefit administrators and the portfolio managers, for they are all working presumably towards the same goals, and for the application of the principles of control, proper reports and measurement of results in order to insure that the business will meet its planned objectives.

Pension fund portfolio managers must be permitted to make securities sales involving capital losses when it is in the interest of the overall profitability of the pension fund to do so. If such action is not taken when reasonable market opportunities are available for doing so, then it will become increasingly difficult to make portfolio adjustments at times when markets are difficult. Too many pension funds in Canada today are apparently frozen into many low yielding securities that might have been moved out of portfolios when opportunities were available.

It would appear now that there is promise of considerable improvement in the area of pension fund portfolio management. Trust companies have been paying considerably more attention to this area of their operations and individually-managed pension funds are also showing more interest in improving their performance. With these trends it is most likely that pension fund moneys will become more readily available in the future for the purchase of securities with attractive yields and this will undoubtedly tend to broaden the market for mortgages.

It is also most probable that improved portfolio management practices applied to pension funds will influence the management of portfolio assets of unions, churches, universities, company profit sharing plans, etc. All of this will tend to remove an important obstacle to the development of an effective secondary market for mortgages, and Canada should be able to lead the way in this development.

In the meantime, dealers in mortgages who desire to tap the pension fund field and other non-traditional sources of mortgage money, will be well advised to study their market and to know it better. They should become more knowledgeable in the portfolio management problems

that have resulted in this market being such a difficult one to penetrate in the past. With trends that are currently in progress, the prospects are much better for its penetration in the future but the mortgage dealer who is able to discuss the objectives and techniques of portfolio management is going to be able to play the most important part in accelerating the development of a secondary market for mortgages.

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The views expressed in this article are the personal views of the speaker and no responsibility for them should be attributed to his employer.

Howard M. Cunningham

Mr. Cunningham holds a Degree in Commerce and Administration from Queen's University. He joined Canada Packers in 1939. He has been Sec-Treasurer of the Employees' Profit Sharing Plan since 1953 and of the Retirement Plan Trust since 1959. His appointment as Asst-Treasurer, Canada Packers, came in 1963.

Mortgages as Pension Fund Investments

The thought has crossed my mind that there may be some connection between this invitation to speak and the fact that the Canada Packers Retirement Plan has about 60% of its assets invested in mortgages, and that all of these happen to be of the NHA variety. In fact, the 60% will soon become 70% or perhaps a little higher than that. It is pretty clear that we are out of step with general practice, since I believe Canadian retirement plans on average have only about 10% or 12% of their funds in mortgages.

A question which frequently occurs to us, worded rather inelegantly, is: "Are we crazy or is everyone else crazy?" Obviously, if we have departed from sanity, we have not yet recognized that fact. We all know that self diagnosis can be dangerous; so it occurred to me that this might be an excellent opportunity to describe our symptoms in some depth and let all of you reach a verdict as to our sanity or lack of it. If you decide that we are still within the pale, there may be a few things in our experience which you will find useful. If your verdict is that we have indeed lost our marbles, please don't feel that any public announcement is necessary.

Some of you may have already concluded that at best, we can't be very bright, for with 60 or 70% in mortgages, our common stock holdings must be much too low. That is a reasonable assumption but there is one extenuating circumstance in our case. We have a Profit Sharing Plan, operated separately but comprising pretty much the same group of members. The Profit Sharing Plan assets are about $16,000,000 or about half the size of the Retirement Plan, and are invested virtually 100% in common stocks, - always have been and presumably always will be. The fifteen-year experience of this common stock fund has shown an average gain of about 10% per year compounded. While we are not entirely satisfied with that performance, at least we are aware that it has been and probably still is possible with common stocks to obtain a slightly (and maybe a considerably) higher return than is offered by NHA mortgages, - subject, of course, to some risk and to a good deal of uncertainty as to what the eventual return will be.

So, we don't look on NHA mortgages as substitutes for equities, but as more profitable substitutes for lower yielding, and often less safe, fixed-income investments.

We first became seriously interested in NHA mortgages in the latter part of 1960, and made our first purchase commitments in 1961, for reasons that seemed then and still seem very compelling. The NHA interest rate ceiling then was 6 3/4%. By concentrating on apartment mortgages we were able to have them serviced for us at 1/8% or sometimes less. So we had available a very safe investment (I don't think I need to dwell on the safety factor here) yielding about 6 5/8% at a time when the alternative fixed-income investments were Government of Canada bonds yielding 5 to 5 1/4%, and Provincials and Corporates yielding only a little more at about 5 1/4 to 5 1/2%. So it seemed to us, and still seems to us, that you don't pass up lightly an investment that is as safe or safer than alternatives and that gives you an

extra 1% or 1 1/2% return. In fact you don't pass it up at all unless there are very potent reasons for doing so; and if there are such reasons you can usually define them in a quantitative way and calculate their possible or probable effect.

Back in 1961 there was one such reason that bothered us a little and that was a rather arbitrary CMHC regulation which prevented the borrower and the lender from agreeing that the mortgage could not be discharged prior to maturity, after an initial 10-year period. Fortunately for all concerned, that particular regulation has now been abandoned, or at least the 10 years has been extended to 25 years. At that time one of the objections we faced was this: "What happens if interest rates go down to say 4% and the mortgagors then decide to pay off the mortgages soon after the end of the ten-year period?" This of course has turned out to be one of the world's most non-existent problems but at the time it seemed plausible or at least conceivable. We were able to make a pretty simple calculation to prove to our satisfaction that even if that interest rate decline had occurred, and long-term bond prices had risen as a result, a yield differential of 1% in favour of mortgages would have been enough to absorb the hazard of early repayment.

It was also clear of course that mortgages were a much better choice than bonds if interest rates went up. That was pretty hard to visualize at the time, but it certainly has happened. So the 6 3/4% mortgages we bought in 1961 at par are worth less than par today. I think we could sell them if we wished at a price of about $88 to $90 which would be about a 9% gross yield. However, in the meantime, we have received principal repayments representing part of the original mortgages at full face value, so that our decline on average is less than 10%. But the bonds we sold (or refrained from buying) in order to acquire these mortgages have come down not 10% but about 20%. For instance, we sold C.N.R. 5 3/4% of 1985 at $108 or thereabouts, and I believe they are now quoted about $87 to $88. Provincials might be down a little less and corporates probably a little more. And the mortgages have given us an extra 1% or 1 1/2% interest return in the meantine which has been extremely useful and which has permitted pension improvements that otherwise might have been impracticable.

Our experience convinces us that NHA mortgages are the best fixed-income investment when interest rates are rising, - or if you like, are less unprofitable than bonds under the conditions of the past few years. Similarly, a hard look at to-day's alternatives convinces us that this margin of superiority is even greater now. A yield differential of anything close to 2 1/4% per annum over Canada bonds and 1% or so over corporates, with the long "lock-in" periods now available, puts NHA mortgages far ahead of other fixed-income investments. I have found that excellent investment opportunities sometimes stay around for a surprisingly long time; then suddenly they are gone, or their price goes up to a level where they are no longer obvious bargains. I suspect this may happen to NHA mortgages and that one of these days we'll look back and wonder why we didn't buy more when we could obtain a net yield of close to 9%.

There were some fairly lengthy periods over the past few years when we made no new mortgage commitments, because the NHA interest ceiling seemed too low in relation to other investments. I am sure it was too low, but hindsight would indicate that we would have been better off to acquire mortgages even in those periods instead of bonds. We still have a few bonds dating from those times, consisting of two categories; one is convertibles, the other is bonds we wish we had never heard of.

Our present policy is to buy only NHA mortgages, common stock and real estate, - no bonds. We do buy new bond issues, but only when we think we can sell them promptly at a profit to someone less convinced than we are of the superior value of NHA mortgages.

I've mentioned some of the reasons why we have bought and are buying mortgages, but what about all the reasons one hears about for <u>not</u> buying mortgages? We have had a great many such reasons advanced to us.

No. 1 is, of course: "Mortgages are not marketable; you're stuck with them permanently." And of course it's true that you can't easily and conveniently sell mortgages at any quoted

market price; so they are not an investment which I would urge on anyone where the expectation is that the mortgage will have to be sold prior to maturity in order to raise necessary cash. This implies the need for any retirement plan to take a realistic fresh look at its probable cash requirements and plan its investments accordingly. Those cash requirements may not be as large now as they looked a few years back because of the impact of government "locking-in" regulations.

Incidentally, if you encounter a sudden unexpected need for cash, I understand that any holder of NHA mortgages is entitled to the privilege of borrowing money from CMHC on the security of the mortgages. We have never had occasion to use this privilege, but we did at one point go so far as to make sure it was available quickly if needed.

On the question of marketability, our own experience has been that mortgages have been much more marketable than we had expected, and bonds quite often less marketable than expected. In looking up our records, I find that in the past five years we have actually sold more than $7,000,000 of supposedly non-marketable NHA mortgages and, at a modest profit. (In a few cases, which are a little hard to pick out from the summary, these were mortgage retirements with our consent rather than sales.)

In every case these sales were made not because we needed the cash, but because investors offered us prices high enough so that we could take the proceeds and reinvest them (usually in new NHA commitments) at higher yields. Any type of investment which lets you start off earning the highest available safe yield at the time, and along the way lets you transform a substantial part of it into even higher yields, deserves, we think, to be considered a pretty desirable type of investment.

If I may, I would like to suggest that CMHC take one further step to squelch the myth that mortgages are non-marketable. I should say partial myth because it's partially true; there is no assured market for them. But if CMHC could undertake to act as a buyer of last resort, in the same way that it acts as a lender of last resort, I think it could quickly demonstrate that NHA mortgages are in fact a highly marketable instrument. If, for instance, they stood ready to buy NHA mortgages at a yield equal to the current maximum, or even slightly higher than that, they would provide assurance of liquidity, and the cost should be extremely low, - a minute fraction of the cost of some schemes we have heard proposed. For in all likelihood CMHC would not have to buy any significant amount of mortgages; pension plans and other investors should be eager to buy such offerings as they would be more attractive even than new mortgage commitments. Personally, I don't intend to wait for that to happen as the bargains available right now look as good as any we are likely to encounter later.

What other reasons are advanced for not buying mortgages? There is the one about the profit to be made by buying bonds and reselling them after a few years at a higher price, thus supposedly improving your total yield. It hasn't worked quite that way recently, but let us suppose that interest rates are going to decline about 1%. So why not buy bonds at a slightly lower yield than mortgages, and sell them in a year or two at a profit? The real point is: What do you do with the cash at that time? Do you put it back into new bonds, which by definition then will be lower yielding? In that case you haven't achieved much, - merely a capital gain at that point as an inducement to accept a lower yield from that point on. Well, why not buy bonds now and sell them at a profit in the future and at that time buy mortgages? You know the answer: The same factors which produce the profit on the bond will by then have lowered the available interest rates on mortgages, maybe by a lot more than we think now.

With one important exception, I think bond trading profits of this kind are largely illusory. Basically, whatever long-term yield you buy now is, subject to minor changes through reshuffling, the yield you get for the term of the instrument. Therefore, if you buy a bond yielding 7% or 8% when you could buy an equally safe or safer mortgage yielding close to 9%, I think you are speculating. This may be an odd definition of speculation, but in fact you are giving up 1% or 2% per year, - equivalent to a present value of maybe 10% or 20% of your cost on the assumption that somehow you are going to recover that 10% or 20%. Partial speculation if you

like, but I suggest it is speculation with the odds loaded against you.

The exception is new issues of bonds, where the buyer has a distinct advantage, and where retirement plans can and I think should buy those issues that are likely to show a quick profit. But you can do this with very little bond inventory, or preferably no bond inventory, because the most dependable profits seem to be those that are realized before you even have to pay for the bonds. This too is speculation, but with the odds very much in your favour.

In the meat packing business we try to keep our inventories at a minimum for a number of reasons including the risk of shrinkage and spoilage. In the inflationary atmosphere of the past few years these risks, particularly shrinkage, seem to apply to bonds as well.

Another objection to mortgages: "What about accounting and administrative problems?" Our experience is that they really don't exist. The servicing agent collects the monthly payments, handles all the details and remits the proceeds each month or each six months as agreed. Similarly on purchases or sales of mortgages, the servicing agent or broker can handle it all quite painlessly. In particular, in dealing with blocks of mortgages which were serviced by CMHC, we have been greatly impressed with the competence of the CMHC staff in handling collections, and their great helpfulness and speed in facilitating transfers of mortgages. If you have any problem, you only have to phone Mr. Rae or any of the CMHC staff and you'll get fast cheerful assistance and I think you will be very favourably impressed with its quality.

Another, I think, imaginary objection: "What about unfavourable publicity if we have to foreclose on a mortgage?" Our experience has been that all the monthly payments come in with such monotonous regularity that there are no collection problems. We did at one time buy a block of house mortgages where a couple of accounts were in arrears for some reason, and the servicing agent later recommended foreclosing in one case. We don't even know the name of the mortgagor, and since the mortgages are normally registered in the name of the servicing agent, the mortgagor never heard of us. All that happened was that in a few months the principal amount of the mortgage showed up on a monthly remittance statement.

Another objection which I haven't heard for many years. I don't suppose anybody thinks this way any more, but the suggestion once was made: "Since our yield on bonds is above our actuarial assumption, why bother with mortgages?" The answer, as I am sure any actuary will tell you, is that in making pension plan investments actuarial assumptions are something which should be studiously ignored. Whether you have a final-earnings plan or, as we have, a career-average plan, the real liability, - the sum you require to pay pensions at the level you will think appropriate in the future, - is at a rough guess possibly twice as large as the liability figure in your actuarial statement. Of course, you would have to be very inept to earn as low an investment return as your actuary probably assumes, but the important point is that a return of 5% or 6% or maybe 7% could be grossly inadequate to do the job that will need to be done. To cope with present and future inflation, we need to earn every extra dollar we can with reasonable risk, and this means getting maximum mileage out of every type of investment, whether fixed-income or equity.

That's enough about objections. What else is good about NHA mortgages besides high yield, safety and possibility of a profit? Well, in the meat packing business we are very conscious of the value of by-products, and we have found that NHA mortgages can produce some valuable by-products, provided we make efficient use of them. The by-product with by far the biggest potential is, I think, the opportunity to get a piece of the action, - to acquire on favourable terms an ownership interest (or option on such an interest) in the mortgaged real estate or some other piece of real estate. At first, developers were very reluctant to let pension funds or anyone else in on this gold mine, but as mortgage money has become scarcer and more expensive, and as the equity behind a mortgage has thereby become a little less golden in colour, we have found developers actually suggesting that we buy a piece of the equity. (On occasion they might even give us a piece of the equity but this I understand might contravene one of these CMHC nuisance regulations about initiating a mortgage at a discount. Under the

conditions which now exist, that seems to me to be another outmoded regulation and I would hope that CMHC might consider junking that one.)

In any case, even if you have to pay for it, the mortgage lender is in a very favourable position to discuss acquisition of an equity interest. Our last discussion went something like this:

Developer: "Equity? At 9% interest you're already getting the equity."

Us: (meekly) "Maybe you're right."

Other discussions have on occasion been more fruitful.

It seems to me that most Canadian retirement plans, including our own, have been woefully slow in recognizing the value of real estate as an equity investment, and its special attractiveness for pension funds. Retirement plans supposedly receive their investment income free of tax; yet in fact they don't in the case of common stock investments. For the earnings applicable to that stock are subject to corporate income tax at say 50%. An individual investor recovers some part of this through the 20% dividend tax credit, but a retirement plan and its members receive no comparable benefit. When the dividends or even capital gains are eventually paid out to a pensioner, the whole payment is treated as part of his taxable income. Now, one way to avoid this tax penalty is to invest in equities which are not corporations and which therefore are not subject to corporation income tax. The most obvious example is real estate as such, rather than shares in real estate companies. Let's assume that you invest $1,000,000 in a piece of real estate which generates net earnings, before income tax, of 10% or $100,000 a year. That 10% is not a very spectacular return but it's all yours; the income tax department doesn't appropriate 50% of it before it reaches you. If that same $1,000,000 were invested in common stock of a corporation subject to a 50% tax rate, the corporation would need to earn $200,000 or about 20% on your investment, in order to have $100,000 of net earnings applicable to the shares you own.

This very decided tax advantage, plus the excellent investment record of real estate in the recent past and over a very long period, does not of course guarantee automatic profitability for any real estate investment, but surely it demands that retirement plans stop ignoring this very important sector of investment opportunity. We hear complaints, and quite justifiable ones, that it is not possible to buy stocks in Canadian companies in various growth industries, while at the same time we have this tremendous investment opportunity under our noses and do very little about it. Compared with buying stocks, it's not as easy to do, not as easy to acquire investments, not as easy to sell to the Trustees or whoever has to approve investment policy, but at a time when this country is in desperate need of apartments and houses, surely we should be doing a great deal more than we are. It is not our responsibility to solve the housing problem but some progress towards that end could be a by-product of sound investment decisions.

As I mentioned, NHA mortgages provide one type of entrée into this field. And if you have mortgage bankers or brokers offering you mortgages, it can be productive if you suggest that first you want a good leaseback or some other prime piece of real estate.

One would think that Governments, which are interested or should be interested in productive pension plans, and which clearly are interested in doing something about the housing crisis, would encourage pension plans to invest in real estate. But it apparently has never occurred to the lawyers who draft pension plan investment regulations that there could be such a thing as an honest, profitable investment in real estate. In this I am not thinking particularly of the federal government, as some of the most inappropriate investment regulations originated in Toronto in the Pension Benefits Act. This is or was a very worthwhile piece of legislation with useful advances in portability and funding requirements. But some of its investment regulations date from the horse and buggy days and were of doubtful validity even then.

When you and I fail to object strenuously enough and publicly enough to useless or harmful regulations, these regulations are assumed to be respectable, - and they spread. In this case they have been copied by other provinces and (with a few changes) by the federal Pension Benefits Standards Act. This federal Act was clearly intended to cover only companies exempt

from provincial pension legislation. But, in a classic example of bureaucratic wastefulness, this Act has in fact been extended to a great many firms which have thousands of employees enjoying the full protection of provincial pension acts but which have one or two or a handful of employees (e.g. an aircraft pilot) deemed to be under federal protection. I think this is an infringement on provincial sovereignty; I know it is an infringement on common sense. This is how governments in small doses, manufacture inflation, by using taxpayers' funds to supply "protection" to pension plan members who would be much better off without it and who in any case are already receiving the identical protection from provincial governments. All it takes is a federal Order-in-Council as spelled out in the Act, but nobody bothers to pass it.

I think there is some hope that Ontario will improve its investment regulations, but this will fail to help a great many Ontario-based corporations (and their pension plan members) unless the federal government recognizes its appropriate sphere and passes that Order-in-Council. In the meantime, we are burdened under both Ontario and federal law with such absurdities as this: "Investments in real estate ... shall be made in Canada and only for the production of income." In other words we are forbidden to make capital gains, except maybe accidentally.

More serious obstacles exist in provisions like the following, which also originated in Ontario and was copied by Ottawa: "The total investment ... in any one parcel of real estate or in any one leasehold shall not exceed 1% of the book value of the total assets of the pension plan." In other words, it is alright to buy little bits and pieces of real estate, which under today's conditions probably can't be operated in an economic manner, but you are forbidden to build or acquire an apartment house of reasonable size unless your plan happens to have assets of a few hundred million dollars. And the Ontario Pension Commission's interpretation of "investment" in this context is not the amount of money you invest, but this amount plus any mortgages that may exist against the property. I suppose Ottawa has the same interpretation but I am not sure.

What possible basis is there for this tremendous bias against significant real estate investments, and almost to the same extent against leaseback investments, when the same provincial and federal legislation will let a pension plan invest up to 7% of its assets in anything it feels like except a piece of real estate, - unsecured loans, stock in any mining prospect or promoter's dream? Surely real estate investments are not seven times as bad as anything else that you could possibly think of.

Once you get beyond this 7% basket clause, you are confronted with some pretty formidable obstacles in the way of a productive investment programme. For instance, you can't buy stocks or other investments unless they comply with the requirements of the Canadian and British Insurance Companies Act. Even assuming that these are reasonable restrictions for insurance companies (and that may be an overly charitable assumption) surely it is clear that the needs of retirement plans are altogether different from the needs of life insurance companies. Insurance companies have liabilities expressed in fixed dollar terms; pension plans in any real sense do not, because they must in their investment programmes do everything humanly possible to cope with the threat (or the certainty) of continued inflation. Governments have not succeeded in giving us any high degree of protection against inflation; maybe, the world being what it is, they can't. What they can do and have failed to do, is to recognize that inflation necessitates changed investment approaches and demands that pension plans be permitted, encouraged and urged to follow, much more than they have, a programme of maximum productivity in investment programmes, something that will give them the best possible chance to cope with and maybe even get a little ahead of inflation. And this requires greater scope to utilize the advice of our investment counsellors and the lessons of our own experience, not useless, outmoded restrictions. Pensioners and pension plan members are being poorly served by governments which permit just about any investor in Canada to buy the most productive investments here or abroad that he and his investment advisers can unearth, - but denies this privilege only to retirements plans. Anyone else can buy U.S. growth stocks without limit;

not retirement plans. Anyone else can buy Canadian or foreign mutual funds; retirement plans can buy only mutual funds which are crippled by the same restrictions as apply to retirement plans themselves. The record shows clearly that pension plans (especially the smaller ones) could very profitably hold part or all of their equity investments in the form of shares of the better managed mutual funds; why should they be prevented from doing so?

If the government cannot protect pension plan members from inflation, or from bureaucratic lethargy, the least it might do is stop abusing these members with laws which discriminate against them.

I have wandered a long way from my subject of mortgages because I think legal restrictions, no matter how well-intentioned, have passed the point of diminishing returns and are in great danger of doing more harm than good. And the fault lies not only with Governments, but with you and me because we haven't yelled long and loudly every time inappropriate legislation is introduced. We were talking recently with our consultants about improvements in our pension plan, improvements made possible to some extent by NHA mortgage investments. The consultants said "Sorry you can't introduce that improvement; the Pension Commission won't permit it." And this is a government commission set up to protect the interest of pensioners and pension plan members. It's very easy for governments to drift from a constructive effort to merely going through the motions of complying with an Act. And this may produce exactly the opposite effect from that intended.

I hope there are some people here who may be able to persuade the framers of these pension regulations that investment approaches have changed and should change, that pension plans exist for legitimate purposes and not really for the purpose of defrauding the Department of National Revenue, and (if I may stray a little further from the subject) that Deferred Profit Sharing Plans also exist for legitimate and very productive purposes. There is a Section 105Q of the Income Tax Act, covering deferred profit sharing plans, which in my biased view is probably the most dreadful piece of legislation you could find if you spend the next ten years in an unremitting search. No real estate at all in that one, not even 1%. No unlisted stocks; no basket caluse. And a tax of 100% of the value of any "non-qualified investment". In short, a blatant abuse of the power to tax or to threaten to tax.

If I may attempt to summarize these remarks in a couple of sentences, they are these. We have a tremendous investment job to do. In the equity end (including common stocks and real estate,) we need a more aggressive, imaginative, profit-seeking approach, and we need to demand legislation which encourages rather than frustrates this aim. The other aspect of our attack on inflation, - and a very important aspect, - should be to get the highest possible safe yield on fixed-income investments. I am sure by the time today is over you will know exactly how to do that.

W. Peter Carter

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Single-Family House Mortgages as Investments

I am sure all of you can remember the nursery rhyme about "The old woman who lived in a shoe and had so many children she did not know what to do". If we substitute Canada for the old woman, a house for the shoe, and for her children the number of Canadians needing homes now and in the next five years, the nursery rhyme could well apply to our housing situation today!

Canada faces a housing shortage that is in danger of becoming a full-blown crisis. We all know, at least in a general way, that the Economic Council of Canada has said we need 750,000 new housing starts between 1966 and 1970 if we are to meet minimum demand for housing. We know too that in the first two of those four years -- 1966 and 1967 -- housing starts totalled 297,000. They are running at a higher rate so far this year but even if we do achieve the 200,000 annual rate reported at the end of April, we must still have well over 250,000 new starts in 1969 to meet our minimum needs.

I say we know these things "in a general way" because none of us in this room have been faced recently with the problem of trying to find adequate housing for our families on an income of say $7,000 per annum - and it is estimated that in 1967 over half our non-farm families had an annual income of less than this.

But let us agree that Canada has a serious housing problem. All right, why? Why do we, one of the wealthiest nations in the world, seem incapable of building enough new housing each year to meet even our minimum needs? We have no shortage of land. Our construction methods are among the most sophisticated in the world. We certainly have, in total at least, enough money and our financial system is among the best. There is no government decree to say that we cannot or should not build new houses; on the contrary - governments have preached themselves hoarse exhorting us to build more and better housing. In other words, we have all the tools. But we do not seem to be able to do the job.

If there were any one answer to why we are not able to do the job -- and I hasten to agree that there is not -- it would have to be simply that as a nation we are not putting enough of our money into new housing.

The reasons why we do not are complex and varied and, I suggest, at least partly the product of tradition. I will examine some of these reasons more closely in a few moments.

My primary purpose here today is to discuss single-family house mortgages as investments. I am here to discuss them because you, as managers of Canada's major pension funds, represent a pool of money that now totals over $8 billion and which is growing by almost $1 billion per year. And $8 billion is roughly equal to the total expenditure, in current dollars, on new housing in all of Canada in the five years 1963 through 1967.

I am not suggesting that the purpose in life of pension fund managers is - or should be - to ensure that the housing sector gets enough money. Clearly your primary purpose and responsibility is to manage the funds under your trusteeship in the most efficient, profitable way possible

consistent with the long-term needs and security of the contributors to your pension plans.

But I do suggest that Canadian pension fund managers could fulfil their responsibility equally well, and perhaps better, by investing a larger proportion of their assets in residential mortgages. And I suggest that Canadian pension fund managers as a whole have tended, probably as a result of tradition and habit, to overlook or underestimate two key facts about single-family house mortgages. These facts are - first and most important;

(1) Single-family house mortgages are a relatively more attractive investment than many now being made by pension funds.

And second -

(2) Many of the very people who are setting aside part of their income for investment through your pension funds are at the same time struggling to get adequate housing at reasonable cost. Greater investment in single-family house mortgages would ease Canada's housing problem and thereby directly benefit many of those contributors who are now using your pension funds to provide financial security for their old age.

Before I elaborate on these two points I should state that it is my firm opinion that a secondary mortgage market is the one segment of Canada's otherwise sophisticated financial structure that has not yet developed the breadth and efficiency it should have -- and this is one major reason why the housing sector is not getting the flow of funds it needs.

Some steps have been taken in the past. Central Mortgage and Housing Corporation encouraged the development of a secondary mortgage market by conducting auctions of blocks of mortgages originated by the Corporation in the years 1961 to 1965. In aggregate they sold some $300 millions to institutional investors. But an auction is at a particular point in time and an investor has to have the cash available to buy at that time - which may not be convenient to him. With auctions the seller dictates the time of year investors can buy mortgages and certainly this must be a barrier to some buyers.

The answer is to offer mortgage blocks for sale on a continuous basis, thereby available for purchase by investors at a time convenient to them....something which may not be possible in the case of Central Mortgage. Some other mortgage lenders have tried to do this and sold approximately $460 million of National Housing Act insured mortgages to pension funds in the years 1954 to 1964. But they encountered difficulty in assembling suitable packages of modest dollar amounts with a reasonable geographic distribution, in warehousing the mortgages originated and in providing efficient administration. One further impediment was the relative lack of liquidity of mortgages compared to other securities.

The factors I have described have combined to discourage mortgage lenders from undertaking mortgage banking on a large scale. Until a few years ago lenders were able to supply sufficient money from their own assets to satisfy mortgage fund demands, so no large secondary market was needed. The situation today is quite different - no longer can we rely on the traditional mortgage lenders (insurance companies, trust companies and latterly, chartered banks) to find the necessary cash for long-term mortgage investment on the scale needed to help solve our housing problem. Other sources must be developed, and I believe it would be mutually beneficial - to pension funds and the contributors to these funds - if residential mortgages formed a larger portion of fund assets than they do today.

In saying this, I must be frank in confessing to a direct personal interest. As I am sure you are aware, I have been heavily involved for some time in developing my own institution's mortgage banking plan, so it is natural that I should feel strongly on the subject. Indeed, it is my hope that the Royal Bank's plan may substantially help to develop a truly effective secondary mortgage market for Canada.

I return now to the two facts about single-family house mortgages that I mentioned earlier. The first is that this type of mortgage investment is today a better investment than many others now being made by pension funds and other institutional investors. Let me tell you why.

Consider first the fundamental checkpoints for any investment -- yield, safety, administration, accounting, and liquidity.

YIELD

First mortgages consistently produce a higher yield than do bonds of comparable quality and term. Mortgage yield can only be quoted approximately since, as many of you know, a non-corporate borrower has rights of prepayment, the exercising of which will slightly affect yield. But long experience indicates an average actual maturity period of close to half the remaining contractual term. It is sound custom therefore to assume an actual life of one half the remaining contractual maturity period and yields on mortgage offerings follow this convention.

SAFETY OF INVESTMENT

Investors in residential mortgages are protected in many ways:-

Firstly, National Housing Act mortgages are insured against capital loss by Central Mortgage and Housing Corporation, in effect by the Federal Government. The insurance feature allows for a cash payment in the event of default of one hundred per cent of the amount of principal outstanding plus allowances for legal expenses and loss of interest.

Second, Conventional mortgages are restricted by law to advances of not more than 75 per cent of property value, so buyers of these mortgages know that there is a minimum equity above their security of at least 25 per cent. In addition, it is possible for an investor to obtain insurance against default and loss of principal on Conventional mortgages through a Canadian insurance company whose only business is insuring mortgages. In our own case the Royal Bank guarantees the investor against capital loss for the first five years of the term of the mortgages being purchased and provides in the event of default for a cash payment of principal plus interest.

Third, applicants for both Conventional and National Housing Act mortgages are carefully screened by mortgage lenders before mortgages are granted, as are the properties which serve as security; thus the possibility of default is remote indeed. It may interest you to know that fewer than 30 of some 36,000 mortgage accounts for which I am responsible are more than 90 days in arrears and this is not unusual in the residential investment field.

Fourth, mortgages on the properties taken as security nowadays are almost always certified as valid first charges by qualified and practicing Canadian lawyers or notaries. Therefore, there is little chance of an investor finding himself not in a first mortgage position at all times. At the Royal we go one step further by warranting to investors that all mortgages sold are valid first mortgages and thus the investor is completely protected if for some reason a mortgage is found not to be a valid first charge.

ADMINISTRATION

The net return on any investment is affected by the efficiency with which that investment is administered. Most lenders continue to do all the necessary servicing on mortgages purchased by investors. The servicing fee is a matter of negotiation between the investor and servicing agent but generally on residential mortgages it is three-eighths of one per cent per year, calculated on the reducing mortgage balances.

Administration agreements of lenders vary but all of them set forth the obligations and responsibilities of the servicing agent and the investor. The servicing agent is usually responsible for safekeeping of the mortgage documents, handles all clerical and supervising functions necessary to control repayment of the mortgages and often guarantees to exercise the same degree of care in the administration as if the mortgages were still in its own portfolio. Therefore, the day-to-day problems of administration need not concern investors - owning mortgages is as easy as holding other long-term securities.

ACCOUNTING

The method by which remittances are made to an investor by the servicing agent is also a matter for negotiation. As with my remarks on Administration I can only speak in general terms but usually the servicing agent forwards a monthly remittance to an investor together with a report showing balance particulars, totals and giving details of all transactions concerning the accounts. The investor is constantly aware of his mortgage portfolio's position.

While discussing accounting I would like to refer very briefly to our friend - the computer. Until recent years mortgage accounting was an exacting and onerous task. Today it is quite different. Through central computer accounting investors have access to an "instant" picture of all mortgages in their portfolios and this picture is generally by type, rate and maturity. The computer has revolutionized mortgage accounting and I'm told by the experts that we are only just entering the computer age.

LIQUIDITY

Institutional investors, probably because they are used to the characteristics of bond investments, often state that the only mortgages of interest to them are those on say apartments where they can get a 20-year non-callable feature. But consider for a moment the potential advantages to liquidity of a mortgage that has a callable feature.

The general trend of interest rates in recent years indicates that the investment manager who maintained a high degree of liquidity would be in a better position to take advantage of higher yields than one who was locked in to a large degree in fixed-term investments.

A study of interest rates over the past seventeen years shows that apart from brief periods of slight declines, average interest rates have gradually but steadily increased. That means simply that the portfolio manager could very probably reinvest his liquid funds for a yield as high as, or higher, than the previous investment.

Consider a more specific case. Compare the cash flow generated by a $100,000 block of residential mortgages put out at 8% for a 25-year term and the cash flow from $100,000 worth of 8% 25-year corporate bonds. Assume that, in keeping with Canadian experience as I have already mentioned, the mortgages were paid off in full at the end of the twelfth year. The principal and interest cash flow from the mortgages over the twelve years would be just under $110,000 compared with $96,000 earned interest from the bonds. There would be about $74,000 in principal owing on the mortgages and thus available for new investment if the mortgagors in fact prepaid. But the bond capital would be locked in for another 13 years - of course, the investor could sell, though possibly at a loss. It seems to me that the additional flexibility and liquidity of the mortgages would be a distinct advantage to the alert sophisticated portfolio manager.

And finally, while considering liquidity, let us remember that a large secondary mortgage market will lead to the development of an active trading in mortgages which in itself will mean liquidity if needed by investors. As an encouragement to this objective my organization is prepared to enter into buy-back agreements with investors who purchase mortgages from us, thus introducing guaranteed sale prices and even more liquidity into mortgage banking.

Now consider the second key fact I mentioned earlier -- that greater investment of pension funds in single-family house mortgages would ease Canada's housing problem and directly benefit many of those contributors who are using your pension plans to provide financial security for their retirement years.

Of the total assets of some $8 billion today, Canadian pension funds have invested some $700 million, or just over 9% of their assets, in mortgages; they have about 20% of assets in equity stocks and about 60% in bonds. Now $700 million is a substantial amount of money and the Canadian housing problem would have been sorrier than it is if that money had not been made available.

But let's look at those figures in more detail. Seven years ago, at the end of 1960, pension funds had just over 8% of their assets invested in mortgages, as against today's 9%. In other words, pension funds have increased the proportion of assets invested in mortgages by only one percentage point in seven years. During the same period, percentage of assets invested in bonds declined from 77% to about 60% and percentage invested in equity stocks jumped from about 7% to around 20% today.

I am not presumptuous enough to suggest that those shifts in portfolio balance should have gone in another direction, although I share the concern of a number of authorities at the high proportion of new investment in equities that went outside Canada. However, I do suggest the time has come for pension fund and other investment managers to take a much more objective look at mortgages, especially single-family house mortgages, as a desirable investment.

Any investor has to consider a variety of alternatives and a wide range of complex considerations that bear on each. That is especially true in today's conditions of rising interest rates, of economic uncertainty, and of widespread expectation that rates may climb yet higher. I do not think that those conditions mitigate against mortgage investments to any greater degree than they do against other forms of investment. In some aspects, in fact, today's conditions enhance the attractiveness of mortgage investment. Mortgages are a sound profitable investment vehicle and the need for more mortgage money to ease this nation's increasingly acute housing problem is clearly evident.

As an illustration, suppose that Canada's pension funds over the next five years increased to 25% the proportion of total assets invested in mortgages. That would mean an injection of about $3 billion of new money into the mortgage field from this one source alone. That amount of money would provide upwards of 200,000 new housing units. Similarly appropriate increases in mortgage investments from other institutions would swell the supply of mortgage funds to a point that might even come close to meeting demand.

The Economic Council of Canada estimates that a minimum of 2.5 million new housing units will be required in the 10 years between 1970 and 1980. That estimate was based on the assumption that we manage to meet our minimum requirements up to 1970 -- and there seems little likelihood that we will. And those figures do not take into account that an estimated one million Canadians are now living in sub-standard housing. To use another measure, the Economic Council expects that by 1980 Canada's 29 largest cities will together require as much new housing as the entire national demand in 1970. And these are minimum estimates.

I believe the interests of pension funds, their contributors and Canada as a nation all coincide in calling for a real increase in the application of pension fund monies to the housing sector.

The need for a substantial increase in mortgage funds is beyond question. If we could together provide enough to bring the supply of funds closer to the need one of Canada's most urgent social and economic problems would be well on the way to being solved.

W. H. McDonald

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New Techniques of Real Estate Financing

The subject of this address "New Techniques of Real Estate Financing", is rather broad in scope, and in dealing with several facets of it there will be insufficient time to do more than just brush the surface. On the other hand, it is the kind of subject about which one can set his own terms within reason, and this I would like to do under two main headings:

Real Estate Debt Financing
and
Real Estate Equity Financing

Under the first there are three main categories which can be discussed within the context of new techniques. They are:

(a) Ordinary Mortgages (NHA or Conventionals)
(b) Mortgage-Backed Debt Instruments
(c) The New Look in Mortgage Industry Institutions

REAL ESTATE DEBT FINANCING

(a) ORDINARY MORTGAGES (NHA OR CONVENTIONALS)

Apart from the record high interest rates which we are now experiencing, the new techniques associated with mortgages are primarily the improvements which make them more attractive as investments, particularly NHA's. One is the ability to lock in the investor's call protection for up to 10 years less than the mortgage term. The use of income property mortgage loans as a means to attract an opportunity to acquire an equity participation (about which I will say more a little later) is another example. On income property loans, including commercial properties with long term leases, the amortization and in some instances the term, have been lengthened to as much as 35 years in response to the new high interest rates. This is a good move provided there is no erosion in sound appraisal practices.

It is unfortunate that all these improvements from the investor's viewpoint make the single-family mortgage less attractive by comparison and add to the pressures building on this segment of the mortgage market. I am not one of those who believes that there is no place for single-family mortgages in the pension fund mortgage portfolio or that it is difficult to justify the slightly lower net yield they offer. There is still merit in a portfolio balanced between single-family and income residential mortgages, between NHA and conventional mortgages, and between residential and commercial conventional mortgages. In many cases as well, the single family mortgage will be a stepping stone into the mortgage market for the fund that has yet to make its

first mortgage investment. In others it will be the bridge to carry the investor who previously has acquired only NHA mortgages over to the broader range of conventional mortgage investments.

Another subject of interest is the advent of private mortgage insurance for conventional mortgages. Although relatively new, such insurance is now firmly established, and you no doubt will be hearing more about the activities of the Mortgage Insurance Co. of Canada later in the program from M.I.C.C.'s president, Gardner English. This development continues to be important, both the 75% ratio plan and the high ratio plan under which the prime lender and Central Covenants Ltd., an investment company established for the purpose, jointly make an 87 1/2% loan insured by M.I.C.C. Under both plans, smaller apartment mortgages are now included. Some of the benefits to the investor of the high ratio mortgage are not as great by comparison because of the recent narrowing of the gap between conventional and NHA mortgage interest rates, and to this extent are postponed to the future. The history of the availability of mortgage funds is cyclical, and in some periods the shortage swings have been no more severe than the surplus ones. To be lulled therefore in this present period of shortage is to ignore the past. A reasonable component of high ratio M.I.C.C. insured mortgages on existing single family houses in a mortgage portfolio will, I feel sure, one day be a valuable source of attractive "rollover" mortgage business, as it has been in the past.

A new development in the mortgage industry which I would like to be able to bring to your attention, but which unfortunately continues to elude us, is the development of a secondary mortgage market for both NHA and conventional mortgages. I am using the term secondary mortgage market in its broadest sense. The occasional mortgage trade continues to be made, but they are so infrequent that at any given time it is difficult to obtain a firm market price quote. There continues to be laudible efforts to sell mortgages, for instance the Royal Bank's recent venture into this area of activity, and I suppose other slight progress is made from time to time. However an effective, active market on a broad basis does not exist, and in my view the most important difficulties standing in the way are:

(1) Lack of regular and steady sources of supply available for immediate delivery. The portfolio investors and lenders such as life insurance companies, trust companies, pension funds, and except to the extent noted, the chartered banks, are primarily not sellers but investors for their own account. CMHC, when it offered blocks of mortgages at auction prior to mid-1965, partially played this role but with only limited success.

(2) Lack of regular and steady buyers as distinct from primary lenders who process their own loans. In the U.S. the fact that F.N.M.A. (Fanny Mae) stands ready as a buyer of last resort has stabilized the market there, although the new move to purchase by a weekly auction (a misnomer as Fanny Mae is not really auctioning money) may bring about a basic change in the U.S. market. It is too soon to know as the auction began only a few weeks ago.

(3) Lack of adequate credit facilities to warehouse mortgages. In the event that we acquire a Canadian equivalent to the U.S. Fanny Mae in future, such warehouse credit would be easier to establish, for instance with the Canadian chartered banks.

In the absence of a secondary mortgage market, the system of originating mortgages against a prior take-out commitment by an investor, works quite well. It is difficult for an investor though, particularly if he has only operated in the environment of the bond market where transactions are completed with relative speed, to accept the detailed technicalities and time schedules of mortgaging. To compensate however, is the high yield that can be earned on such mortgages for forward delivery, not only higher than bond yields, but higher than what the yields would be if the investor were buying on an established secondary mortgage market for immediate delivery.

(b) MORTGAGE-BACKED DEBT INSTRUMENTS

Mortgage bonds have been well known for some time, one of the principal users being the

chartered banks, who prior to the last revision of the bank act, found this a convenient way to avoid certain of the bank act restrictions against making mortgage loans. An indirect method of investing in the same type of instrument, and one that also has been available for several years, is the purchase of debt of a company such as the Canborough Corporation established to undertake a secondary mortgage market function using mortgages, in the case of Canborough, entirely NHA's, to secure its debentures.

The development which I would like to discuss now is the new approach of converting a mortgage to a bond, using NHA mortgages, although the technique can be applied equally to conventional mortgages. It should perhaps be mentioned for the sake of clarity, that the investment is essentially a mortgage investment, the bond concept merely being added to give certain additional attractive features. In this type of transaction there is no corporate credit to secure the bond and no other security except the real estate and the mortgage borrower's covenant to repay, plus, in the case of NHA's, the Government insurance. Why then use a method that is cumbersome to set up and needs a complicated trust deed on top of mortgage documentation which in itself is not simple? The answer is to be found in the versatility that is created, without the loss of any of the essentially good characteristics of the mortgage and the insurance securing it. For example, it allows participation by a small fund in larger and sometimes higher yielding mortgages and gives increased marketability and transferability of the bonds. The standardization realized by using the same trust deed in all transactions is another asset. Under certain circumstances moreover, a choice of maturities may be available, and if desired repayment to the investor can be adjusted to a semi-annual or other basis. None of the favorable characteristics of income property mortgages are lost - non-call for 20 years or more, a legal investment, the investor remains anonymous as the trustee is the mortgagee, and the servicing agent makes collections and takes legal action in his own or the trustee's name.

For these advantages, the investor gives up something on the net yield, but until he has reached the stage where he can make larger mortgage investments directly, or unless he is willing to participate directly with other investors in a larger mortgage, he may consider this a fair exchange.

(c) THE NEW LOOK IN MORTGAGE INDUSTRY INSTITUTIONS

The changes which are taking place are two-fold. Many of the older institutions are taking on a new look and developing new techniques and fresh institutions, some of whom are playing an intermediary role, have entered the field. I have already mentioned Mortgage Insurance Company of Canada, Central Covenants, and the Canborough Corporation. Our own company is perhaps another example. In Canada we do not have a mortgage banking industry as it has developed in the U.S., but I suppose we and a few similar companies come close to performing on a regular basis a number of the functions of a mortgage banking company, and on certain occasions all of these functions.

Banks and trust companies are looking into the future anticipating the provision of services which will encourage and assist the flow of fixed term funds into the mortgage market. The result of the total effort of all these segments of the industry, combined with the improvements in the mortgage as an investment which I have already mentioned, cannot help but contribute to a more efficient and effective industry. Some results are even now in evidence. The simplification in documentation, particularly service contracts, and the method of handling mortgage payments through bulk accounting are but one example. The development and execution on behalf of the investor of combination mortgage/equity deals, about which I will go into greater detail shortly, is another. The trading of blocks of mortgages between two portfolio investors, including facilities for settlement and transferring of servicing is still another.

REAL ESTATE EQUITY FINANCING

I would now like to turn to the second main subject which I mentioned I would like to talk about - "Real Estate Equity Financing". This concept and more particularly the specific approach to equity participation by institutional lenders, is one of the most interesting, but in some ways confusing, in the mortgage business today. Based on the amount of attention which the subject has received recently, one might conclude that the new technique of equity participations plays the most important role in real estate finance. In actual fact I suspect that the percentage of projects which are financed with an equity participation is not yet significant when compared with the volume of business done on a regular basis. The reason that the subject has generated interest in excess of its importance seems to be the belief held by some people in the mortgage and real estate industry that this type of financing is quite profitable for the investor and represents for him the perfect solution to combat the current inflationary trends in the economy. A third reason might be the impending increased need in the construction industry for equity financing of all kinds in great volume. These assumptions, while more or less right, ought to be critically examined, and for this purpose I would like to divide my remarks into four major segments:

1. The factors which induce institutional investors to seek equity participations.
2. Some of the more important underwriting considerations related to such participations.
3. The popular forms they take.
4. The potential future for this kind of financing.

In my opinion, there are several reasons why institutional investors are or will be attracted to equity participations. First, they hold out the promise of higher yields at a time when there is increased pressure building up on institutional investors to earn a higher return on all their investments. For example, deposit institutions, because of competitive pressures to pay higher rates of interest on deposits, continually must seek new techniques for improving yields if they are to maintain their position in the industry and attract their share of the savings dollar. Similarly, if life companies are to reduce the cost of insurance and produce acceptable dividend returns for their policy-holders or shareholders, they must constantly work to improve portfolio yields. In the case of pension funds, the need to improve investment yields is just as great; moreover the desire of employees for greater pension benefits will bring close scrutiny of fund earning capacity by trade unions. The possibility of stringent funding requirements and closer supervision by Governments, are additional pressures building on the pension fund portfolio manager.

A second and one of the more compelling reasons for institutions to take an interest in equities, is the impact of inflation on the long term value of fixed term security portfolios. In this era when economists appear to accept a 3% annual increase in the cost of goods and services as a minimum, there is pressure on all institutions which may be limited to a large percentage of fixed income investments to do everything possible to hedge against such inflation. In the pension field, competition from common stocks will add to the interest by portfolio managers in real estate investments which have growth prospects.

A third reason is that as the outside pressures for increased yields and protection against inflation intensify, the statutory and policy limitations within which investment managers and trustees operate will gradually be liberalized to meet such demands, and broadening of basket clauses will enable investors to consider financial vehicles which previously were not available.

Fourthly, as a result of the severe shortage of mortgage funds, basic changes in the money market have taken place in recent years. In this climate borrowers who previously were reluctant to do so, will entertain a suggestion that they give up "a piece of the action" to obtain needed debt funds, or to gain a slight concession on the rate; also in some cases to overcome a shortfall in the equity funds required for larger projects. In respect of the latter, the opportunities in the future appear impressive based on the Economic Council forecast of population increases and housing needs. A rough estimate over the next five years would be that something

in excess of $500 millions could be needed to finance the equity contributions on multiple residential housing alone. If one adds to this the opportunities to participate in financing commercial and industrial buildings which will be needed to sustain a rising population at the rate we can reasonably anticipate, it will be seen that there could be a severe shortage of equity capital facing us. The result of this will be that investors and lenders who are now aware that they have in the past provided 100% financing for a modest fixed interest return, will in future be in a favorable position to obtain a share of the profits which their mortgage financing helped to make possible.

Before going into greater detail on the different types of equity participations, I would like to take a moment to discuss some fundamental principles which our company believes are of prime importance in evaluating real estate equity opportunities. First of all, we feel that there should be an actual investment of funds by the institutional investor (in the case of NHA apartments for instance this is essential to avoid a violation of the NHA regulations prohibiting the borrower being charged bonuses or discounts). So-called free equity in whatever form it might take could turn out to be more costly than if it had been paid for. Secondly, we take the view that the borrower and developer should be compatible. Problems arise when their tax status is different unless the participation is, for example, in common stocks. Continuity of ownership and management also poses questions where an institution and a private individual attempt to form some kind of partnership.

We believe moreover that the term equity participation implies participation in equity risk in addition to an opportunity to make profits; therefore anyone hoping to reap the fruits of the equity investor must be prepared to take the corresponding risks. Such risks include the acceptance of more liberal underwriting, or the investing of funds at an earlier and therefore speculative stage of the development of the project. This means making loans involving higher loan to value ratios, lower constants and lower interests rates, also the so-called front money deals in which the lender is required to invest early in the project, thereby accepting higher risk.

Another important underwriting principle we emphasize is the necessity of considering larger projects and therefore bigger loans. In our view, projects in such major cities as Toronto, Montreal and Vancouver have grown in size in response to the economics of high land costs and efficient large-scale building techniques. Experience and reliability of developers thus becomes a more important consideration. Altogether it is the largest projects that lend themselves to equity participations for these reasons. Developers requiring equity investments of less than $250,000 should be able to command sufficient capital from their own or private sources. If institutional equity capital is sought for these projects, there may either be a marginal property or a marginal developer, or both.

Finally, it is our view that variable income properties more readily lend themselves to equity participations than do fixed income properties. This of course relates back to a point made earlier that one of the chief reasons for seeking equity participations is the desire to hedge against inflation. Therefore variable income properties such as apartment houses, and multiple tenant and industrial buildings are more likely to experience higher income streams as prices rise than are properties encoumbered by long term leases.

Now let us discuss more specifically the different types of equity participations:

1. Conventional real estate investments plus additional compensation in the form of a share in the equity position.
2. Unconventional financial vehicles which for convenience could be called "basket clause" investments.
3. The so-called "front money" deals where the funds are invested at the earliest and most speculative stage of the development.

In the first category would be included the simplest forms of equity investment, first mortgage, the first mortgage bond, the sale lease-back (this has a first cousin, the sale buy-back, which for the moment I will ignore). First mortgage and first mortgage bond participation would in

this context include a call on either the income stream or the residual.

An institutional lender wishing to participate in the income stream will prefer to receive a percentage of the gross income rather than the net. The gross amount is more readily ascertained and therefore there will be less room for argument between the partners. For this reason however, this method is resisted most strongly by the borrower. If agreement can be reached only on the basis of the percentage of the net income, then to avoid disagreements, net income should be defined in advance by limiting expenses to taxes and such items as insurance paid, plus a fixed percentage of the gross. Should the property have a relatively fixed income stream, the participation could be taken in the form of an interest in the residual. In this respect agreement would provide that upon expiration of the tenant's lease or some agreed upon time thereafter, an actual conveyance of the property would be made to the investor or transfer of the agreed upon portion of the owning company's shares. In either event there are difficulties. In the first case the lender's opportunity to participate is postponed for many years and its value therefore subject to substantial discount; in the second, depending on the size of the percentage ownership of shares, the lender may find himself in the position of being a dissident but impotent minority shareholder.

The sale lease-back is one of the best known types of equity participation. For many years, mortgage lenders have entered into these arrangements with developers or commercial tenants, but they considered the technique only as a device for providing maximum financing rather than a means to participate in equity profits. They forfeited an inflation hedge and capital appreciation because they granted the lessee long term reduced rent renewal options or re-purchase options which history has since shown bear no resemblance to the value of the property at the time the option is exercised. Such lenders have become less liberal in granting renewal and re-purchase options and now many of them insist that if they are to take substantially all the real estate risk, they should receive a percentage of the benefit of any appreciation in capital or rental value.

The sale lease-back of land using a lease-hold mortgage has recently become quite popular. The real estate is split into a fee and a lease-hold estate, the investor purchases the fee, usually for its fair market value, leases it back to the developer and makes a conventional mortgage loan on the lease-hold estate. This can apply to NHA insured mortgages on apartments as well. The arrangement can provide that the investor is to receive a percentage of the income stream, however in the case of NHA's, because of the prohibition mentioned previously, the participation can relate only to the ground rent payments and these of course affect the appraised value of the lease-hold estate. In my view this prohibition requires a review in the light of the new approach to the maximum NHA interest rate so that some participation should be possible with NHA's provided the statutory maximum interest rate is not being exceeded by the combination of the participation plus the coupon rate. In the case of sale lease-backs, the advantages to the builder are clear. He receives higher ratio financing and has 100% depreciable assets. Since he has sold the non-depreciable part, the land, his overall constant may be lower since the land investment normally is not amortized. The investor for his part receives a higher fixed return on his investment (unless he has purposely reduced his interest rate to acquire a more attractive participation) plus a contingent return based on the success of the project, and in addition obtains a substantial residual interest through ownership of the land.

The second group of equity participations include the techniques utilizing what I called "basket clause" investments. These may or may not be available to all investors, depending on their legal limitations. In the general category would be first mortgage loans exceeding the legally prescribed loan-to-value ratio, second mortgages and wrap-around or blanket mortgages. It is readily admitted that these are devices for financing a higher percentage of the project cost than is normally available. To this degree the investor is participating in the equity risk position but has an opportunity to share in the profits, either in the form of a higher return, a contingent payment, a long term interest in or call on the equity, or the opportunity to trade

on the leverage made available because of a prior lien.

The first example is the case of a first mortgage loan exceeding the legally prescribed loan to value ratio or second mortgage. The lender could receive a participation in the cash flow in addition to a fixed return 200 - 500 basis points higher than the basic mortgage rate, but of course this would not be available in respect of NHA mortgages. In the case of a wrap-around or blanket mortgage in which the lender advances funds in excess of the unpaid balance of an existing first mortgage, (the ratio of both loans could even be within the lender's legal limit) and then receives a constant payment based on the total of the two loans, the lender in effect is trading on the leverage created by the first mortgage in precisely the same way that the borrowers do. In all these cases the lender could seek an additional contingent payment based on the performance of the property.

The third group of equity participations is the so-called "front money" deal where the investment is made at the earliest stage of development. The commitment of funds could be substantial and be in the form of either cash or credit and made at a time when construction has not commenced or buyers or tenants have not been found.

An example of one of the common arrangements in respect of commercial projects calls for the investor to put up or arrange to have put up most, if not all, the cash required, while the developer contributes his time and management skills at little or no cost to the joint venture partnership. The debt money may or may not be put up by the investor. In the case where the investor is putting up substantially all the equity money, he usually will require that he take priority as to the return of his investment and possibly as to control of the owning and operating entity. The actual amount and the form of the investor's return will vary, depending on all the circumstances and the risks involved. In the case for example of an apartment or an office building, the developer and investor could split the net income 50-50 after the investor has been re-paid his investment plus a return.

Perhaps a few general observations about the future of equity participations would be helpful before I close these remarks. It seems to me that some, but not all the types of equity participations I have mentioned are here to stay. The ones which may be temporary are those that have developed recently only as a result of the improved bargaining power of lenders in a tight money period. In this group will be found most of the more or less conventional financing techniques with "kickers" where the lender is not doing anything imaginative. As money market conditions ease and real estate financing becomes more readily available these participations will fall by the wayside. The basket clause loans should continue to have acceptance but the degree will depend on the extent that legal limitations are eased. Such loans will have a more lasting effect because even in periods of easy money the supply of such funds is rarely adequate and the cost when this kind of financing is provided by non-institutional sources is quite high.

The "front money" deals could increase in popularity. The sources for such funds will in future not be sufficient to meet the increased demands; moreover builders will prefer to have institutional partners due to the fact they have the financial strength to wait out temporary imbalances in the real estate market and also provide a continuing source of funds for future projects.

In closing my remarks, I would like to leave you with one thought - real estate financing which has had a chequered career in the past, will in my view have an entirely different future. All construction in the years to come, and as I mentioned there is no forseeable limit to the future building needs of the nation, will more and more fall within the domain of the large corporation. It will consequently, and this will apply particularly to housing, become organized along corporate lines. Real estate financing therefore, while it will become no less profitable and imaginative will take on greater stability and the entire real estate investment industry will be organized and supervised to its own benefit.

Harry Weitz

Mr. Weitz holds a Masters Degree in Economics from University of Toronto. He has served as statistician with CMHC and economist with Dept. of Labour. He was departmental representative on the Task Force for the Canada Pension Plan. In 1963 he moved to DBS where he is now Chief, Pensions Section, Labour Division.

Trusteed Pension Funds

Pension plans in Canada have been growing at a rapid pace over the past few decades. According to a recent Dominion Bureau of Statistics study, in the five-year period between 1960 and 1965 alone, pension plans increased 50%, to some 14,000 plans all told. It is estimated that today there are approximately 15,000 plans in operation, covering 2.3 million persons and generating well over $1,100 million a year in contributions - (this is exclusive of the some $800 million contributed annually to the Canada and Quebec Pension Plans).

Of the 15,000 or so pension plans in Canada about a quarter, 3,500 in all, are trusteed covering approximately 70% of total pension plan membership, indicating, of course, that large firms tend to use the trusteed approach to pension funding. These funds accounted for nearly 70% of the $10.5 billion in assets for all pension plans. Consequently, trusteed plans make up the largest segment of private pension plans in Canada in terms of membership, assets and contributions. Indeed, these funds rank third in terms of asset values behind only banks and insurance companies.

As you know there has been a tremendous growth in the assets accumulated by trusteed pension funds. The extent of this growth is set out in the report "Trusteed Pension Plans, Financial Statistics" published annually by the Dominion Bureau of Statistics. Chart I, based on this report, demonstrates the rapid rise in fund assets over the fiscal periods 1960-61 to 1966-67. As may be seen, the total asset value of these funds more than doubled from $3.6 billion in 1960-61 to $7.3 billion in 1966-67. According to preliminary estimates these funds are now at about the $8 billion level. This represents an average growth rate of about 12% per year.

Let us look at how these funds are invested. Chart 2 illustrates the changing investment pattern over the first half of the 1960's. The most pronounced trend apparent from this chart is, of course, the shift from fixed income securities to equities. While the proportion of assets held in provincial, municipal and corporate bonds remained relatively constant over the period, there was a sharp decline in Government of Canada Bonds from 18% in 1960 to just under 7% in 1966. At the same time holdings in stocks both common and preferred increased from slightly over 7% in 1960 to nearly 17% in 1966. The proportion held in mortgages over this same period, as you can see, remained relatively constant. In 1960 slightly over 8% of the book value of assets held by trusteed pension funds were in the form of mortgages, mostly in NHA's, and in 1966 the proportion was just slightly over 9%.

When we say that over 9% of pension funds are in mortgages, we tend to understate the situation, since this represents only the direct investment in this type of security, and does not take into consideration indirect investment in mortgages through participation in pooled pension funds of trust companies. Chart 3 illustrates this point. As can be seen, in the fiscal year 1966-67 aggregate pooled pension funds held over 40% of their total assets in mortgages, mostly conventionals. If it can be assumed that the same ratio applies to pooled funds units held by trusteed pension plans, then 40% of these pooled fund units represent an indirect investment in mortgages.

This indirect investment brings the total proportion in mortgages held by trusteed pension funds up to around 12%.

As a matter of interest, also shown on Chart 3 is the investment pattern of "segregated funds" made available by insurance companies as a medium for pension investment. These funds have all of the characteristics of the trust company pooled funds and have a comparable investment pattern. Perhaps because of their long experience with mortgages, insurance companies also have a high proportion of their segregated funds in this type of asset. This 28.7% in mortgages, most of which was in conventionals, amounted to $39 million in 1966-67.

Now let us examine more closely the direct investment in mortgages - that is the portfolio of mortgages purchased by the trusteed pension funds, exclusive of the indirect investment in mortgages through pooled funds of trust companies. Most of the direct investment in mortgages is by the larger pension funds, i.e. those with assets of $5 million or over. Smaller funds tend to turn to pooled funds as an investment medium. For example in 1966-67 the large pension funds held $630 million out of the total direct mortgage investment of $676 million by all trusteed funds.

The 9% of pension fund assets in these mortgages is an average figure which does not reveal the whole story. It is something like that old story of the statistician who drowned trying to cross a river with an average depth of 2 feet - there was a lot under the surface he did not see. Similarly here, although in aggregate 9% of the assets are in mortgages, yet individual funds ranged anywhere from zero to 25% and even as high as 65%. This wide range, of course, is the product of differing investment policies and philosophies of pension fund managers as well as statutory restrictions placed on certain funds established for employees of the various levels of government - particularly at the municipal and provincial levels. Legislation establishing pension plans for employees of municipalities, school boards, and some of the provincial governments in many instances specify the types of allowable investment. For example, the Ontario Municipal Employees Retirement System covering most of the municipal employees in the province is limited by legislation to investment in provincial bonds.

As may be seen in Chart 4 mortgage portfolios constituted a relatively constant share of total assets over this seven-year period. Although the proportion remained relatively constant, in real terms the volume of funds directed to mortgages increased, and increased quite sharply over this period. This, of course, is due to the fact that the base i.e. the total trusteed pension funds more than doubled in terms of their assets at book value in the first half of the 1960's.

From the chart we see that in 1960-61 mortgage holdings of trusteed pension portfolios amounted to $299 million of which $195 million were in NHA's and $104 million in conventionals. By 1964 pension funds held over half a billion dollars in this asset alone and climbed to $676 million by 1966 with $391 million in NHA's and the balance, $285 million, in conventionals.

To complete the picture we must look at the pooled funds of trust companies. As pointed out earlier, in 1966, 40% of pooled fund assets were in mortgages. On this basis it is estimated that in that year an additional 3% of pension assets were indirectly invested in mortgages through pooled funds. Similar estimates have been made for the previous years and these are shown in Chart 4(a). It can be seen that while in 1960-61 pooled funds accounted for a modest portion, this rose gradually to 3%.

In real terms this means that in 1960-61 there was $299 million in direct and $10 million in indirect investment in mortgages with the indirect portion increasing so that by 1963-64 total mortgages in pension funds were over half a billion dollars and by 1966-67 their value reached a high of $882 million.

What is the potential of pension funds as a source for mortgage investment? To answer this question let us look at the flow of new money into pension funds over the past few years. How much was available and how much was channelled into mortgages directly and through pooled funds? Chart 5 shows the annual new investment by all trusteed pension funds. This new money ranged from $416 million in 1960-61 to over half a billion dollars in 1963-64 reaching a peak in 1965-66. The drop to $709 million in 1966-67 reflects the effect of the Canada and Quebec Pension Plans which came into force on January 1, 1966. In 1960-61 of the $416 million of new

money available for investment in the whole range of securities held by pension funds, only $21 million went directly into mortgages and the pooled fund holdings accounted for about $2 million. The peak was reached in 1965-66 with $81 million going directly into mortgages and the pooled fund portion accounting for another $40 million. This total of $121 million amounted to nearly 16% of the new money. However, this dropped to 12% in the following year.

In summary, therefore, pension funds appear to be an excellent source for mortgage money in the foreseeable future. For example, even if funds continue to grow by only 10%, as in 1966-67, there will be some $800 million in new money available for investment. How much of this $800 million will be channelled into mortgages depends, of course, upon fund managers. Perhaps the more favourable interest rates together with this meeting today will stimulate greater interest and greater participation in mortgages as an avenue of investment for pension funds.

CHART-I

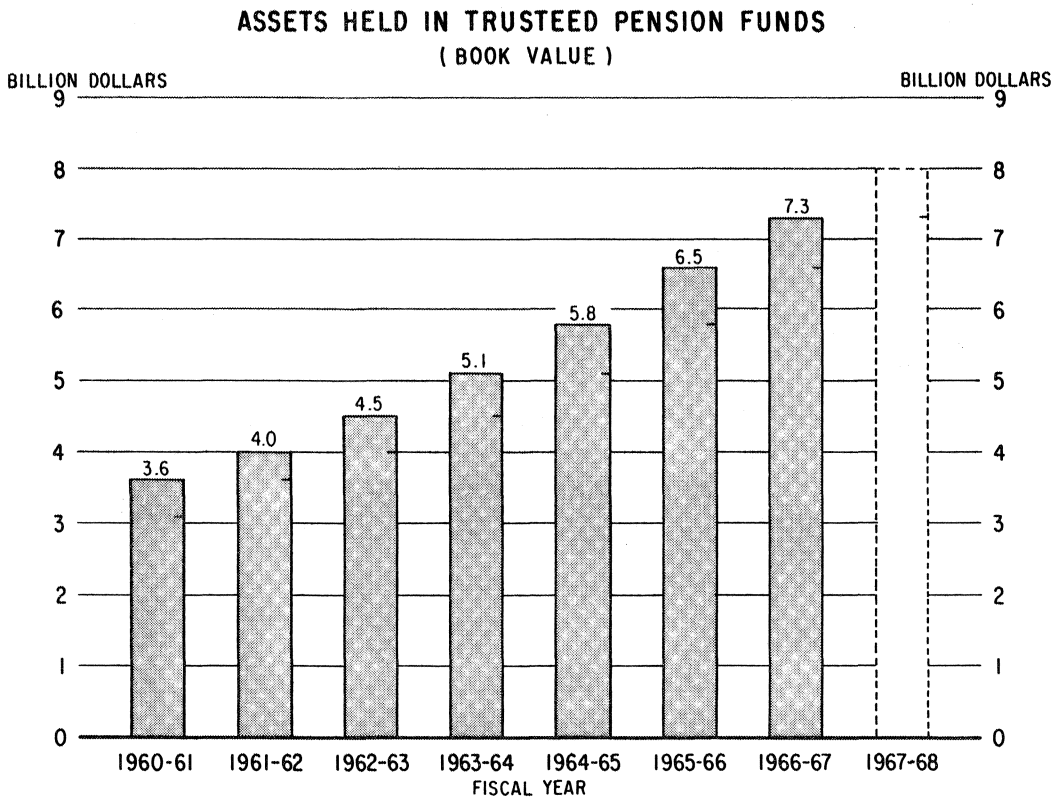


CHART-2

DISTRIBUTION OF ASSETS HELD IN TRUSTEED PENSION FUNDS
(BOOK VALUE)

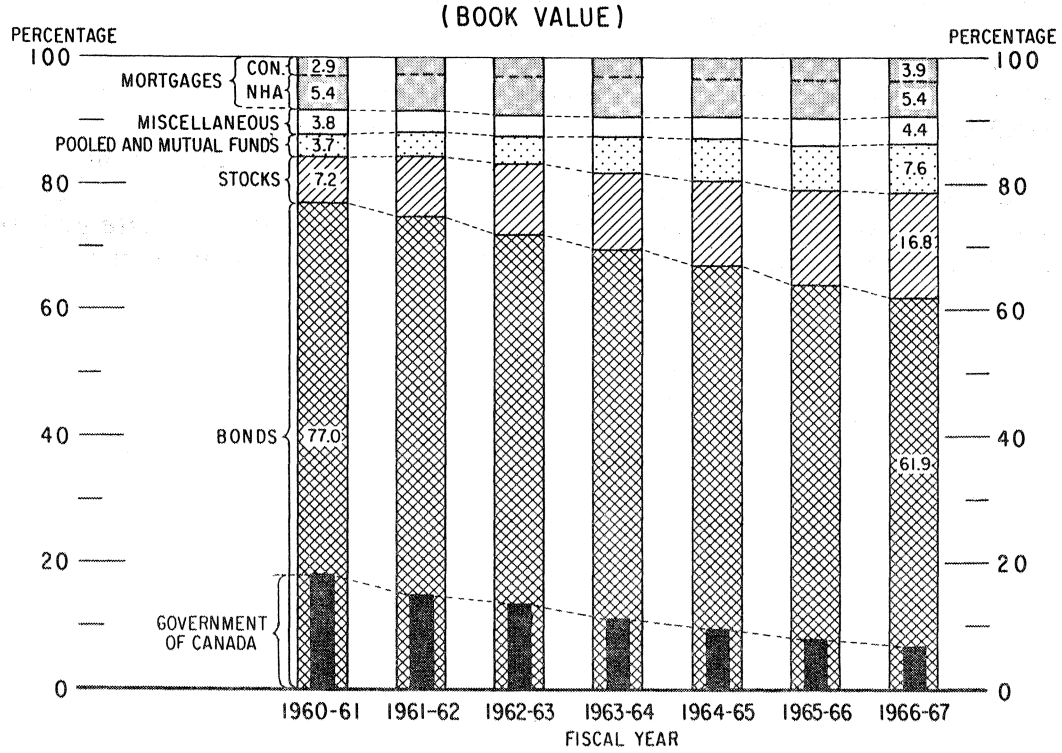


CHART-3

DISTRIBUTION OF ASSETS OF TRUSTEED, POOLED AND SEGREGATED PENSION FUNDS
FISCAL YEAR 1966-67

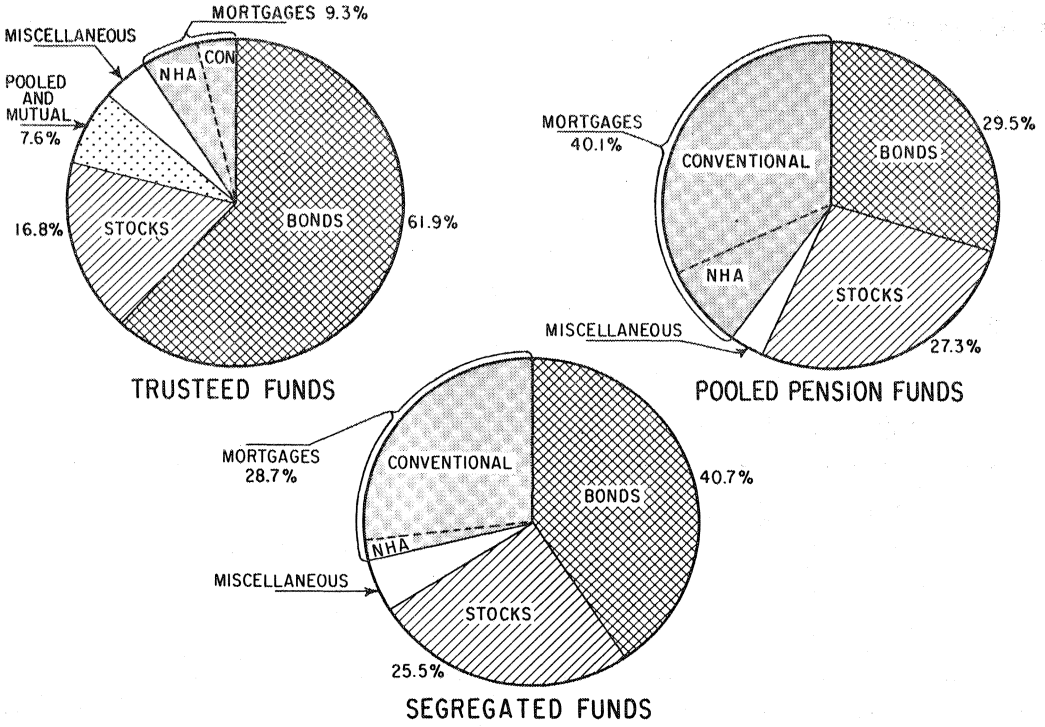


CHART-4

VALUE AND PERCENTAGE OF MORTGAGES HELD IN TRUSTEED PENSION FUND PORTFOLIOS

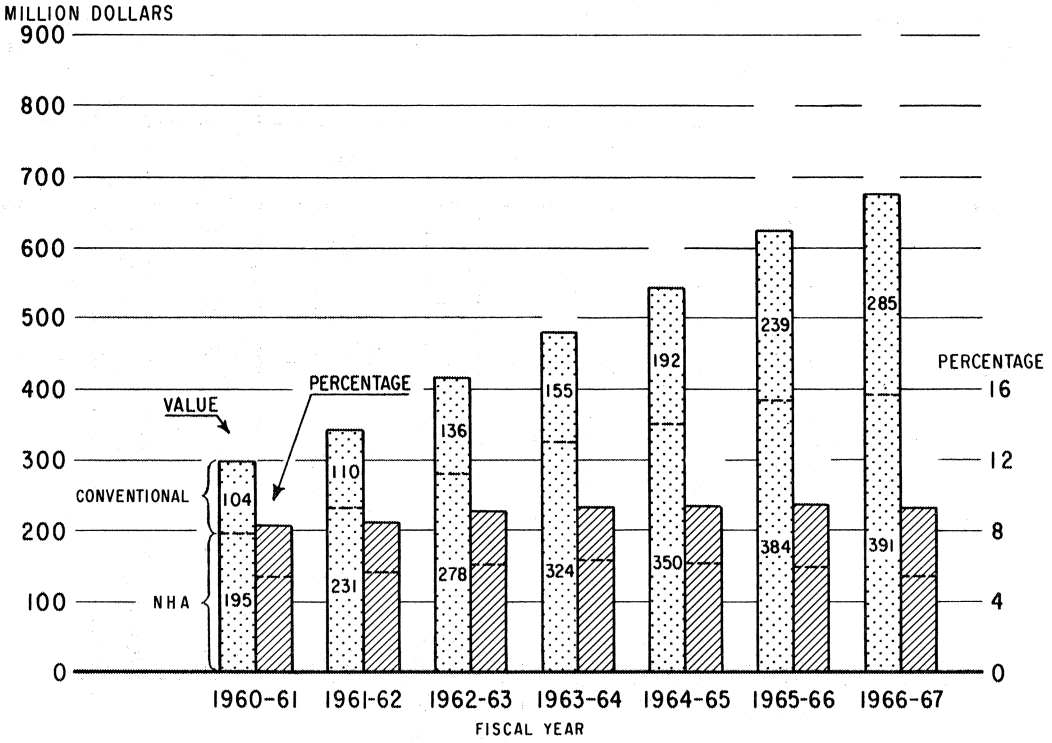


CHART-4a

VALUE AND PERCENTAGE OF MORTGAGES HELD IN TRUSTEED PENSION FUND PORTFOLIOS

(INCLUDING MORTGAGE ELEMENT OF POOLED FUNDS)

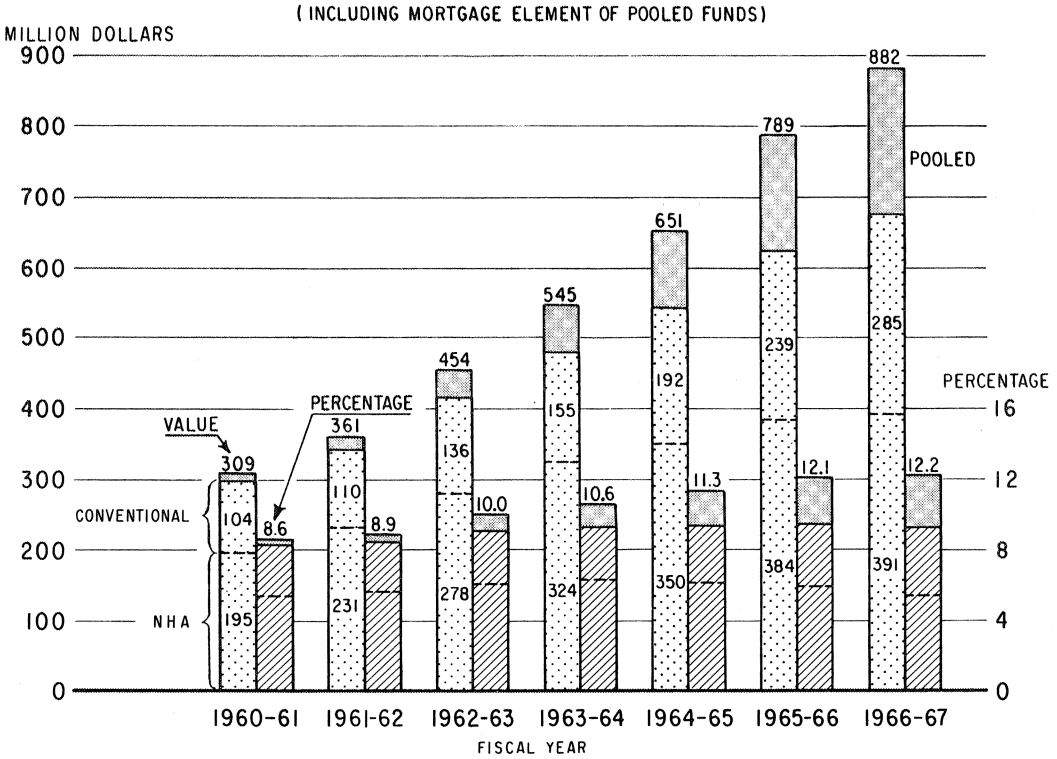
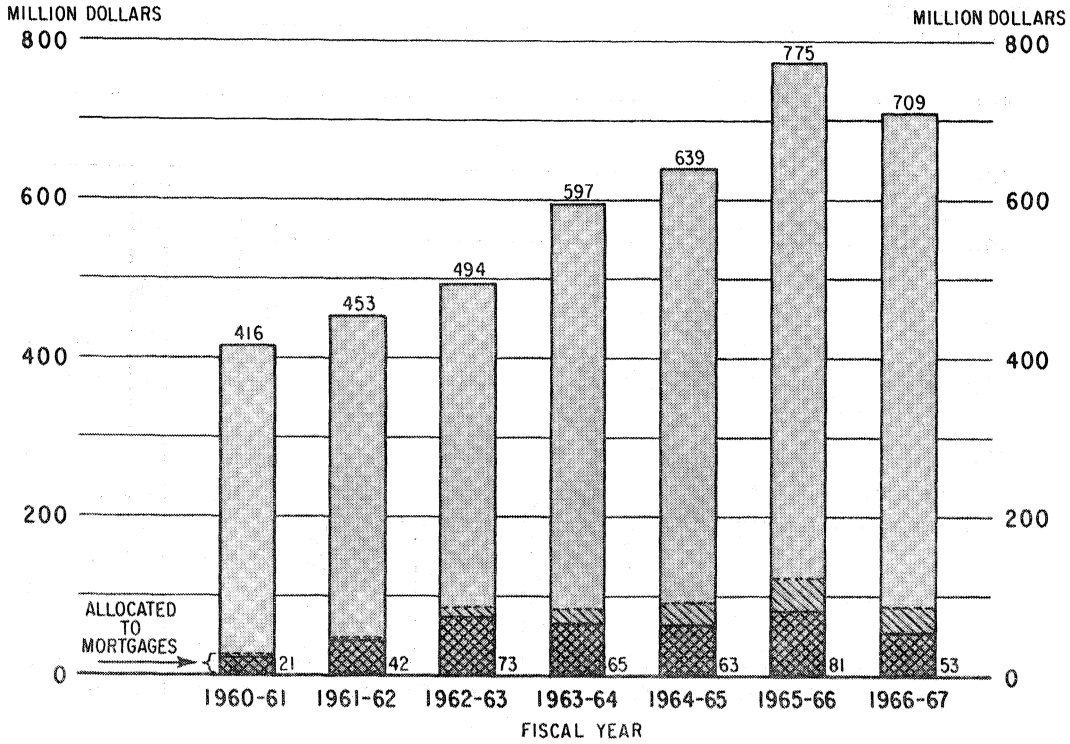


CHART-5

NET ANNUAL INVESTMENT IN TRUSTEED PENSION FUNDS AND AMOUNT ALLOCATED TO MORTGAGES



Panel Discussions
at
Afternoon Session

Mr. English holds a Degree in Business Administration from the University of Minnesota. Until 1946, he held senior appointments with the Mortgage Division, Investors Diversified Services Inc. Minneapolis. In 1946 he became Vice-President, Investors Syndicate Ltd. Winnipeg, and President, Mortgage Insurance Co. of Canada in 1964.

Gardner English

Panel Member

Ladies and gentlemen, I think you must have observed that the proceedings today have a strong evangelical flavor to them. Everybody on this side of the aisle is promoting mortgage investment and perhaps we seem to do so with the holy zeal of evangelists of an earlier day as well as the present one. We also say very nice things about each other. Some of the people here are my competitors and they said some nice things about my company this morning and I propose to say some nice things about them and their companies, so there is an element of brotherly love in this. So you are all very lucky people to be in this company and maybe our chief evangelist today, Herb Hignett, may invite you all about five o'clock to file up here to the prayer rail and give your proper obedience to the gospel of mortgage investment. I hope he does. I am only an assistant evangelist so I will press on.

Our discussions today concern the whole spectrum of mortgage investment, the scope, sources, investment advantages, comparisons with other types of investment. This program has been designed to provide useful analysis from the standpoint of trusteed pension fund investors. The two most important characteristics of the desirability of a fixed income investment are security of principal, and yield. It has been noted today that mortgage loans provide the highest yield of any mid- to long-term investment. Security of principal has been a characteristic of mortgage loans for a hundred years or more on this continent. Although some losses were experienced in the 1930's the overall record has been excellent.

To obviate even the relatively minor losses of the depression years government-sponsored mortgage guarantee plans were instituted in the mid-30's in both Canada and the United States. We are all familiar with the very important contribution made to housing and mortgage investment by CMHC in Canada and the FHA in the United States. In the past decade mortgage insurance has become available from private mortgage insurance companies. This relatively new insurance concept has achieved an impressive scale of operations notwithstanding the money market stringency of the past three years. Mortgage insurance in force in the two countries through private mortgage insurance companies now amounts to over $4 billion. The Mortgage Insurance Company of Canada, commencing business four years ago this month, has processed nearly $300 million worth of privately insured mortgage business, all of it residential.

Now since this is a relatively new facility and concept in Canada I would like to describe for you the facility and the characteristics of the mortgage insurance contracts that are available through private corporate sources.

The Mortgage Insurance Company of Canada, (we have an abbreviation for that rather lengthy title, MICC, and I shall use that,) writes two kinds of mortgage insurance: high ratio loans providing for insurance of mortgages up to 87 1/2% of value per premium of 2%, the premium being paid by the borrower. We also insure conventional mortgages up to a level of 75% of value which is a level provided for by most trust and insurance investment organizations in Canada and the premium on this class of business is 1 1/4% and is normally paid by the lender.

I should like to emphasize for you, the audience today, that this second classification is one which might prove to be of use, particularly to those trusteed pension fund investors who have either made no mortgage investments at all or are only in the beginning phase for considering conventional mortgage lending, and would like to see some additional protection as to security.

We also insure small apartment building mortgages up to 75% of value for a premium of 1 3/4% and the limit of loan in this case is up to $500,000. I might say parenthetically that withstanding the fact that in the three large cities of Toronto, Montreal and Vancouver, alluded to in the morning session, where recent developments have seen perhaps a million dollar investment to be almost the minimum, there are still thousands upon thousands of smaller apartment buildings built in Canada, existing and created each year, of much smaller size. We direct this program to the area of apartment building loans of $500,000 and less and these might find a useful place in some of your portfolios. Now as to the type of security, 87 1/2% loans, the high ratio loans, are available on single-family homes, duplexes and triplexes up to $50,000. This is somewhat higher than the limits provided for under the National Housing Act and is perhaps a little more in keeping with the broader band of middle-class housing which is very abundantly produced now in the range from $20,000 to $30,000 and the mortgages which we insure in this area perhaps will suit the needs of some lenders or be an extension of the facility provided by CMHC in insured loans up to their limit of $18,000.

We insure loans, also, up to 83 1/3% of value on apartment buildings up to $500,000 loan amount at a 2% premium, again this premium paid by the borrower.

Now you have heard a lot today about the advantages of mortgage investment and I would like to touch briefly on the advantages of MICC insured loans. For one thing, the interest rate is selected by contract between the borrower and the lender. There is no control over the interest rate except the market influence. The higher dollar loan limits available under our loan plan provides a broader market from the investor's standpoint - he may have either loans of low average amount, middle-sized amount or up into the area of $40,000 to $50,000 housing if this is his preference. Loans are available both on new properties and on existing buildings. This is an important factor because a very substantial part of new mortgage investment every year is in the sphere of refinancing existing real estate.

An important point was touched on by one previous speaker, namely, the fact of double underwriting. Our loans are all originated and produced by experienced mortgage lending institutions, principally trust companies, loan companies, life insurance companies and chartered banks, who all examine each case with appropriate investment attention and care. The MICC underwriting staff repeats this process so that two skilled screening processes have gone on in the case of each investment.

Earlier speakers have touched on the relative simplicity of acquiring and having mortgages serviced for a trusteed pension fund investor and I won't labor this point which I think has been well demonstrated. MICC has, in its lender group, 35 of Canada's largest and most prominent financial institutions, all of whom have had long and extensive background in origination of mortgage loans as a source of supply and producers of our insured mortgages.

I would like to touch on one aspect of mortgage investment that was dealt with this morning and where I think there has been some misconception as to the investment impact. I refer to the early pre-payment privilege which is part of the Dominion Interest Act - any natural person signing a mortgage can pre-pay the principal sum after five years with a bonus of 90 days interest. This provision has given pause, I think, to some pension fund investors. The feeling that, with a decline in interest rates, the greater part of a portfolio acquired during a high level time, such as now, might disappear in very short order after the fifth year if we have a serious decline.

While I like to think of myself as a contemporary, in a broad way, of the people here, I know that my hair is grayer than some. And I had the experience of owning money for a period in the U.S. during the Roosevelt easy money period of the mid-30's and I made mortgage loans at interest rates as low as 4% - seems almost obscene, doesn't it? It was. In my investment firm,

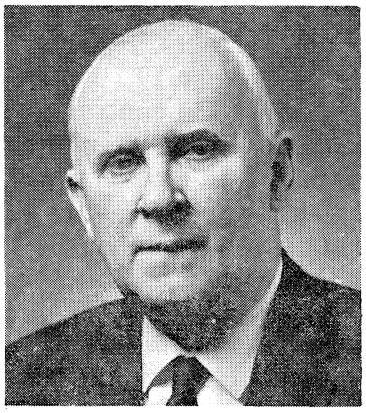
we had a large portfolio of mortgages bearing coupons from 5 3/4% to 6 1/2% and during the period between 1934-37 there was, in fact, some refinancing of higher rate contracts. However, one thing became very evident. Until the interest rate had declined by more than 1%, usually 1 1/2% to 2%, there was no broad move on the part of the borrower to refinance his contract.

There were two reasons for this. One is that it is expensive to go from one lender to another and refinance an instrument. It uses up part of your interest reduction profit. In fact, because of legal expense, there is no profit for the first four or five years to the borrower. The other is just inertia. People get accustomed to paying that $91.60 a month and they keep on paying it regardless of interest rate. It should also be remembered that for a long period of time that house loans have a higher interest rate than any other class of mortgage loan.

Traditionally, loans on income property, because of their larger size and other characteristics, usually bear from one-quarter to three-quarters of 1% less in coupon than house mortgages. Mr. Carter pointed out this fact this morning.

Now, I said I was going to say something nice about my competitors because they were so nice to me. First of all, let's pick Herb Hignett here. He is a very formidable competitor for me for size, prestige, age and all the rest of it. CMHC has done a very good job in providing two things - protected mortgage investment for investors and enormous influence on the financing and the housing of Canada over the last thirty years. Other plans for providing high ratio financing have been instituted by a variety of institutions. Mr. Carter described the Royal Bank's plan to you this morning and I think all of these have a place in our diverse mortgage market. In short, ladies and gentlemen, you have lots of facilities here to draw upon should you choose to channel some of your funds into mortgage investment.

Now, this is the end of this assistant evangelist's remarks and I want you all to remember one thing. When the roll is called up yonder, those who will be the most blessed will be those who have invested in mortgage loans and the most blessed of all, those who have invested in loans insured by MICC.



J. E. Henderson

Mr. Henderson, Asst-Treasurer Investments, Air Canada, is a Certified General Accountant. He also holds Diplomas from Cdn Bankers Assn and the Investment Dealers Assn. His experience includes corporation income tax assessment with Dept. of National Revenue. His duties now include Tax Accountant and Pension Fund Manager with Air Canada.

Panel Member

I would be indeed presumptuous if I imagined that I could add to the store of knowledge built up today by the many distinguished speakers who have preceded me. But I represent a large, and I believe, well operated pension fund, and it may be of interest to you to learn what we think of it all. Some 13 years ago, we were fully invested in government bonds and seeking to broaden our investment policy within the then terms of reference. The Insurance Companies Act provided us with an answer, NHA mortgages.

Today, some $100 million later, this fund is 37% in mortgages and I believe I am correct in saying - and I wish someone to correct me should he not agree - that we are the only pension fund which has created a wholly-owned subsidiary for the purpose of holding real estate.

I was somewhat surprised that a meeting such as this should have to be called - that it should be necessary to tell portfolio managers that mortgages are a desirable investment. We are not here to examine the merits of equity versus fixed-income portfolios; but assuming a fixed-income portfolio, I must conclude that if it does not include mortgages there simply has not been a thorough enough examination of the implications of compound interest. You know, there is a difference between understanding and being aware that you understand. It is a subtle difference, but I believe it is a very real one. You may judge this for yourself by seeing if you are surprised by the following.

Over the past five years there has been a spread of at least 1% between the conventional mortgage rate and the yield on bonds. If I were to ask you to lend me $10,000 at 7% for 25 years, amortized on a mortgage basis, the monthly payment would be $70.05. Seven per cent, twenty-five years. If you said no, but would lend it to me at 8% and leave the monthly payment the same, how much longer would it take me to amortize that loan? Ten years. Ten years longer, though the only change is a one per cent increase in the interest rate. You put out $10,000, and if you lend it at 7% your cash flow stops ten years sooner than if you lent it at 8%. Does that surprise you?

Now having said this, where do we stand, a major pension fund invested heavily in mortgages? If you have been listening, as I hope you have, to what has gone before, some of the statistics I am about to quote you, which are real statistics extracted from our fund, will fall into place and perhaps mitigate the fears that you have of this wild and woolly instrument.

Our bond portfolio yields presently 5.28%. I don't say this boastfully, I say it merely historically. Our mortgage portfolio is $45,600,000 and it yields 6.56%. We have $17,000,000 in unfunded commitments which will become funded by the end of 1969, bringing our total to $62,600,000. And the mortgage portfolio will then be yielding 7 1/4%. Like Mr. Cunningham, we are not in the bond business at present, so have no reason to believe that the bond portfolio will get anywhere close to this by the end of 1969. There could then be a spread of 2% between the two portfolios. I don't know how figures like this can fail to be impressive.

Now, we have had 36 single-unit dwelling foreclosures over the past 13 years giving us, on the average, a 0.9% foreclosure rate. Of this figure of 36, 34 have been generated by one servicer

and in one place. This represents about a quarter of the portfolio. The other three-quarters is virtually foreclosure-free. But these foreclosures have not been of any concern to us. We believe they developed quite normally and we have no complaints. The average loss has been $500 per foreclosure; $527 is the exact figure. This probably spreads to around $1,500 a year as a charge against mortgage income and, in my view, if taken into account, does not affect the yield. You have to go to the third decimal place before you need to change the yield. Legal expenses averaged $700, which is somewhat high. This is strictly a Quebec situation. In other provinces, legal expenses are far lower, probably only half as high.

We have mortgaged about 4,000 homes and at present have over 3,600 on the books. At the most then, we have had a couple of prepayments per month which, on a portfolio of our size, is negligible.

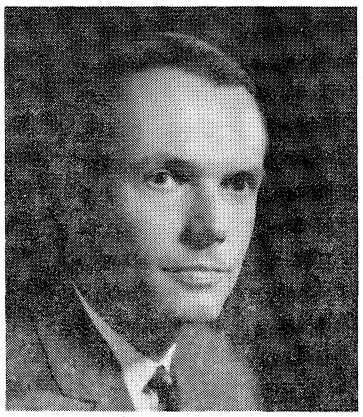
Now, I don't want to take up any more of your time than I have to because we are running late. I have here notes on the points that I feel a pension fund should examine carefully and should understand thoroughly before becoming involved in mortgage investment. But rather than give you my thinking on them, I am just going to give you the headings and invite questions when you have the opportunity to ask them. I am sure that my answers will allay any fears you might have of mortgages. They are:

Liquidity: increased cash flow - advantage or disadvantage.
The Lock-in Period: how significant in practice?
Yield: can it be calculated accurately?
Accounting: imaginary difficulties!
The Method of Acquisition: you should know the alternatives.

When you have properly evaluated these functions I am sure you, as we are, will be more than satisfied with the operation of a substantial mortgage portfolio.

I would like to make two more points. Mr. Cunningham's discourse was, in my view, probably the highlight of the day. I congratulate him very heartily. But I cannot agree with his insistence on the legislative changes he says are required to the Act - the two Acts involved. He operates a very well controlled fund, but this legislation is addressed to all funds, and I would suggest to Mr. Cunningham that the guidelines which the restrictions impose are useful and that he may some day find, as I do now, that he will be thankful to have had these restrictions imposed on him. Of course, there are changes I would like to see made, and I hope we will discuss these later. In the main, however, the legislation we are talking about does not seem to me unreasonable.

Now, real estate. Like Mr. Cunningham and most of the speakers who have addressed you before, I believe it is a responsibility of the managers of the vast pension fund pool to penetrate this subject in depth and to become real estate investors. As I have mentioned to you, we have a subsidiary, Penair Investments Limited, holding our real estate; this is an essential requirement if the pension fund has become the mortgagee on some of the properties held by the subsidiary. But, ladies and gentlemen, the dangers are great. Real estate is something you should not move into except with experience and with the most skilled advice you can find. I do not mean by saying this that I think you should back away. I am convinced that real estate is destined to become one of the major holdings of pension funds, notwithstanding that the difficulties associated with it are great. To overcome them will need courage, tenacity, and knowledge - but are these not the qualities which should govern the lives of people like ourselves?



Walter A. Keyser

Mr. Keyser, a Director of Gairdner and Co. Ltd. holds an Honors Degree in Business Administration. He has served with the Bank of Canada (Securities) and with his present Company as Manager, Money Market Dept. He is associated with CMHC's efforts to sponsor a secondary mortgage market and is active in all phases of real estate and mortgage marketing.

Panel Member

During the past seven years mortgages held by trusteed pension funds have increased as a percent of total assets from 8.3% to 9.3%. In contrast stock investments have increased during the same period from 7.2% to 16.8% of total fund assets - the entire increase occurring in the common stock portfolio. Obviously common shares and NHA mortgages are not directly competing forms of investment because they possess vastly different qualities and represent somewhat different investment objectives. However, I feel that the investment attributes of NHA mortgages have been as greatly ignored as common share investment would appear to have been emphasized by many fund managers.

It is difficult to defend this view by measuring comparative results and indeed if you had purchased a theoretical share of the TSE Industrial Index on July 10, 1961 - settlement date of the first NHA mortgage tender, your $103.82 investment at June 14, 1968, would be worth $162.22. Furthermore, at today's rate of dividend payments you would be receiving a dividend yield of 5.9% based on your 1961 investment cost. The average annual appreciation in book value would add another 8.35% per annum thereby providing a theoretical return of 14 1/4% per annum during the past seven years. This certainly would appear to have been a superior investment to that which many of us made in NHA mortgages that same day - 6.23% net for 23 years - 6 3/4% mortgages at a cost of 101-1/8 worth probably 90 in today's market.

Certainly the events of the past seven years provide a dramatic lesson of how to protect yourself through equity investment during a period of accelerating inflation. This is undoubtedly also a partial explanation for Government-insured mortgage rates being at 9-1/8%. However, isn't the real question - what should we do today to protect our employees during the next seven years and beyond? And, are the lessons of the past appropriate for planning the future?

It so happened that July 10, 1961 was a bad day for stocks and your purchase price happened to be at a ten-month low to which the Index has never since returned. By a similarly favourable coincidence today's prices represent an 11% recovery high from a fifteen-month slump that ended only three months ago. So let's study our stock portfolio's performance using the assumption that we purchased one theoretical share of the TSE Industrial Index every month since July 1961. On this basis today's market value is only 10.4% above our average portfolio cost, and today's dividend income provides a yield on average cost of only 4.16% for an overall theoretical yield including capital appreciation of only 6.9%.

Now how does this rate with the return from an NHA mortgage portfolio using the same assumption - that we consistently invested equal amounts of money at roughly equal time intervals in NHA loans? For my calculations I assumed that we invested these funds at the times of CMHC mortgage auctions between July 1961 and July 1965 and thereafter quarterly in loans at the rates prevailing after each adjustment to the NHA ceiling. In this fashion our NHA portfolio has produced during the past seven years a net interest yield of 6.53% per annum - only 3/8 of 1% below the 6.9% stock portfolio return which includes capital appreciation.

This gives rise to an obvious question. My share prices are all up and my mortgage values are mostly lower, so shouldn't we debit this against the mortgage yield? But isn't this a fallacy? Are you any less likely to sell your mortgages with their book loss than your stocks with their profits or, barring unforeseen events, are you likely to want to sell either? Besides mortgages mature at par - the Government guarantees it; so shouldn't we be concerned only with their rate of return? On the other hand we buy stocks for appreciation so shouldn't their performance be included in any such comparisons?

Furthermore, my mortgages are being paid off at par every month and in some cases are being prepaid at 1 1/2 to 2 1/3 point premiums which I have not included in my yield calculation. I also have not mentioned my 8.07% cash flow from the NHA portfolio nor included in my yield the extra advantage I gain from being able to reinvest this monthly amortization of mortgage principal at today's higher mortgage rates, or if I prefer, in stocks or bonds instead.

Now let's turn to opportunities in today's mortgage market. An 8 3/4% to 9% NHA net yield is readily available and provides a cash flow of 9 1/2% to 10% per annum. This compares with stock yields today of 4% or less and bond yields ranging between 6 7/8% for Canadas and 8% for quality corporate bonds. In seven years of dividend increases and market appreciation our very timely stock investment in July 1961 is only now able to boast a 5.9% dividend yield and an 8.3% per annum average capital appreciation. And the stock portfolio's ultimate value is not insured, its dividends are not insured and its day-to-day value is subject to many economic and technological factors at work both within and outside Canada.

It is therefore truly astounding that a 100% Federal Government-insured mortgage loan should be available to us at a 9 1/8% yield especially when Toronto-Dominion Centre can borrow at 8% and the Government itself at 7%. The manager of a very active pension fund told me in May 1965 that he would not buy my NHA's on less than 1% spread in net yield over Canada 4 1/2/1983. I sold them elsewhere on a 7/8% spread. Now the effective yield spread is approximately 2% per annum and many investors still seem reluctant to make mortgage investments.

I have been offered many reasons for this and they appear to fall into three problem categories:

1. The concept of 100% mortgage insurance is not fully appreciated and is in conflict with the more common concept of government-guaranteed debt which investment bylaws can generally accommodate.
2. Accounting and technical "hang-ups" arising from the unique form of security and principle repayment of a mortgage investment.
3. Pension fund bylaws or agreements that do not make provision for other than stock and bond investments.

Some people identify these problems in a slightly different fashion. They view them as a shortcoming of the mortgage as an instrument for investment rather than as symptoms of somewhat incomplete or outmoded investment bylaws.

There is no doubt about this problem presenting a major impediment to the development of a secondary mortgage market. Altering hundreds of pension fund investment bylaws or accounting practices seems a much greater job than altering the form of the mortgage instrument until one realizes that a mortgage is the oldest form of security in common use today and around which a vast accumulation of laws and precedents occurred. Its roots in British Law date back to the 11th Century but the practice of lending on the security of land has been traced as far as the early Babylonian civilization.

Those solutions that involve altering the mortgage instrument, or substituting it with an instrument to which the mortgage is pledged, generally reduce the ultimate yield to the investor by at least 1/4 of 1% per annum and are sufficiently unique in themselves to require that the investor study them as closely as he would the mortgage investment itself. A direct purchase of an NHA mortgage is as simple as the purchase of any other kind of investment provided that the three problem areas have been dealt with beforehand. As you have probably guessed my solution to the main problem is update and revise your bylaws and practices to

accommodate insured NHA mortgages and stick with the traditional form of mortgage instrument for investment purposes. As for accounting and legal "hangups" - leave these to the specialists. They should not be allowed to influence your investment decision. You will pay an administration fee to your servicing agent for collecting mortgage payments so let him help you set up your accounting methods. A few brief meetings should be all that is necessary. Consult a lawyer on the first few transactions. He can provide you with advice concerning the standard forms of servicing agreement and assignments. Take blanket assignments of blocks of small individual house loans and look to the servicing agreement for protection on shared apartment loans or, if you prefer, separate assignments respecting each participant's share can be arranged. In any event the fees these specialists charge are small in relation to the big yields now available from mortgage investments.

Although it is possible and desirable to accommodate the concept of a 100% Government-insured investment by revising your bylaws where necessary, this does not accomplish the task of improving the appreciation for the value of NHA insurance. In spite of CMHC's efforts to improve and to publicize the virtual guarantee afforded by 100% NHA insurance there appears to exist a vague fear that some undefined but significant foreclosure expense might not be fully recoverable. This largely applies in the case of apartment loans where the legal costs of foreclosure conceivably could exceed the $250 provided for under the Act.

It is difficult to suggest that the Corporation consider any further extension of their insurance coverage since it already amounts to a full guarantee. However, to the participants in the secondary market the concept of "guarantee" is better understood than that of mortgage "insurance" and any additional insurance premium that might be assessed to the home buyer under such a guaranteed mortgage scheme would seem small indeed if it helps restore the former 1% spread between Canada bonds and NHA mortgage yields.

However, this is mentioned only as an aside to, and has no bearing upon, the main point that the NHA mortgage already possesses virtually a full Federal Government guarantee and to the extent that this fact may not be appreciated, it should be strongly emphasized now.

If the three problem areas I have tried to identify are the chief reasons for the existence of a 2 1/4% spread between Canada bond and NHA mortgage yields it then simply remains for us as keen observers of investment opportunities to place NHA mortgages in their proper investment perspective. I tried to make three points early in this talk:

1. that mortgages purchased on a regular investment programme during the past seven years would have produced almost as good an investment yield as common stocks on a similar programme basis even when capital appreciation of the stock portfolio is taken into consideration. (6.53% v.s. 6.90% per annum)
2. that book profits (on stocks) and book losses (on mortgages) are really an accounting concept having little to do with investment management in the long run.
3. that the lessons of the past are not necessarily applicable to the problems of the future.

The key investment consideration for the pension fund portfolio manager should be to determine the optimum split between assets to be held for liquidity and those available for long term or fairly permanent investment. Then, having determined the proportions of fixed-income and equity types of investment, proceed toward the goal of maximizing the yield on the fixed-income portfolio. It is my view that a portion of this portfolio should be dedicated to a regular mortgage investment programme not unlike that of a dollar-averaging stock buying programme.

Not only do NHA mortgages help maximize the yield on a fixed-income portfolio in the obvious fashion - with a high face rate of interest - they also create a higher rate of cash flow due to monthly repayment of principal and the occasional prepayment. This helps to increase the total dollars available to the portfolio manager for new and possibly more timely investments. This cash flow can exceed the interest return by an additional 1/2% to almost 2% per annum and during the past seven years could obviously have been re-employed at higher yield with longer call protection, or possibly in equities if the emphasis of your programme had shifted in that direction.

I have not touched on the marketability of NHA mortgages because I feel that this feature of the secondary market has been over-emphasized and is somewhat inconsequential in any event. Dealers in mortgages have not developed banking facilities to the same extent as dealers in bonds so trades take place chiefly on an agency basis. However, I can point to several individuals present today who have actively traded their mortgage portfolios during the past seven years. This has been possible mainly because yields from new mortgages have moved further and faster than bond yields and it has been generally possible to sell seasoned loans for immediate settlement at significantly lower yields than can be obtained for new loans on a future delivery basis.

This ability to commit future funds on a delayed takedown at a time when yields appear to be topping is another unique attraction of new NHA mortgages. However, I would rather leave this and the several other variations of mortgage or mortgage-plus-equity type deals for another day when I hope to have an opportunity to meet you all personally.

J. Grant Paterson

Mr. Paterson started his career with Crown Life of Toronto. By 1955 he was Manager, Mortgage Dept. In 1960 he transferred to Montreal Trust where he has held positions as Asst-Manager and Manager, Mortgage and Real Estate Dept. and Asst-Supervisor of Mortgages for Ontario. In 1966 he was named Supervisor of Mortgages for Canada.

Panel Member

I would like to tell you how an established trust company such as the one I represent can help you make mortgage investments with as little pain as possible and get rid of them just as painlessly should the need arise. The ease with which mortgage loans can be serviced is well known and I don't propose to discuss this aspect of mortgage lending.

How should a Pension Fund go about getting its feet wet in mortgage lending? If you don't want to hire your own mortgage staff and become registered as an approved lender under the National Housing Act, I recommend that you select an experienced company which is lending across Canada, to originate and service loans on your behalf. If your mortgage portfolio is not likely to be a large one the concentration of loans in any one city is not a matter of concern; however, you may consider it prudent to spread your loans to a number of cities, both for safety's sake and because of other considerations related to the nature of your business. Initially, your loans should be insured house loans; the complicated income loans should come later.

The decision to make mortgage investments is much easier to live with if one accepts the fact that as yet mortgage loans are not always immediately available, particularly if you are looking for the higher yields produced from income loans. If you intend to invest in mortgages on a continuing basis the investment of your funds can be regularized to a high degree after the initial waiting period. While it is impossible to be 100% accurate in forecasting construction schedules, things have a way of balancing out over the year. If you are anxious to invest funds as quickly as possible, you can do this by making your funds available to the builder during construction. If the loan is written under the National Housing Act, funds advanced during construction can be insured, although this does not eliminate all the risks of construction lending. Generally speaking, the trust company will arrange the construction loan to the builder and will deliver the loan to you on satisfactory completion of the project.

We find we perform best when we have an allocation and are informed as to the Pension Fund's mortgage requirements well in advance of the time when the monies will be available for investment. For example, if your cash flow forecasts indicate that funds will be available for investment in mortgages during 1969, we would want to be informed by not later than September of this year. This will allow us sufficient time in the case of new house loans for the loans to be originated with the builder, for the houses to be constructed and sold, and the loans delivered in accordance with your requirements. A lead time of more than 15 months is often necessary in the case of large income properties. An allocation of funds to the trust company in this way doesn't interfere with the Fund's right to accept or reject individual loans if they wish to exercise this discretion. We don't recommend this as necessary for house loans, particularly the NHA variety, but certainly all income loan submissions should be reviewed by you prior to approval.

On receipt of an allocation of funds we expect to be told if the Fund has any locational preference and what minimum net yield they are looking for. If interest rates fluctuate before

all of the loans are committed, the Pension Fund has the option of adjusting its net yield requirements on the uncommitted balance or of withdrawing the balance entirely. Nor do we mind holding completed loans to fit in with the Pension Fund's purchase schedule. Forecasting a date by which a house will be built and sold is a hopeless exercise and could be anywhere from 3 months to 2 years; we usually allow about 8 months. By the way, when the Trust Company is making the construction loan we take the risks during the construction period since if the house is not completed and sold to an approved purchaser, we don't expect you to purchase the loan.

In the case of income loans, if the builder's rental forecast is uncertain of achievement we usually retain a 15% or 20% holdback until the building is self-supporting, failing which the loan is reduced accordingly.

I know that pension fund managers cringe at the idea of committing themselves to purchase mortgages 12 to 18 months from now at rates which are current today. No one can tell what rate will be current when the mortgage is actually delivered but if you are determined to stay with mortgages on a continuing basis you will find, as do the insurance companies, that what you lose on the swings you gain on the roundabouts.

What kinds of loans should you look at today? Obviously, NHA loans are most attractive, especially on apartment projects. In defence of conventional lending, it can be stated that the delinquency rate for these loans compares favourably with the rate on NHA loans. The government guarantee must be very reassuring to an investor who is not knowledgeable in mortgage underwriting; however, the difference in risk between a properly appraised 75% conventional loan and a 90% to 95% NHA insured loan is negligible.

Not being restricted by the regulations of the National Housing Act the conventional lender is free to set his own terms of loan, and he can participate in the profits of the project in any number of ways. Up to now the only way an NHA lender can do this is to actually purchase shares in the development company, or go into partnership with the developer.

What about mortgage and equity participation combinations? While I have nothing against these proposals in principle, despite the widespread interest in this form of investment, I admit to being a sceptic as to their benefits. Usually the mortgage lender is required to give up 1/4 or 1/2 of 1% in mortgage rate which they hope will be more than offset by a share of the profits. The lender is not likely to make a deal with the large well financed builder who can get adequate financing without the lender's help. You are therefore left with a small builder who may not share your long term view of real estate investment. In analyzing these proposals from a set of plans the big question is, of course, has the builder done an accurate job of establishing income and operating expense estimates? We have seen some NHA loans that took 92% of the gross income to carry the building. A vacancy rate of 8% would, in these cases, wipe out all return on invested capital. I wonder too at the wisdom of levering on your own first mortgage loan. Really, at rates of 9% and 9 1/2% there is not much room for leverage. Perhaps it would be wiser to put your equity funds into a building someone else has mortgaged, preferably at less than the current interest rate. Before committing to one of these package deals I would therefore strongly recommend that you have an independent expert in real estate review the forecasts to see if they can be realistically achieved. I would also suggest that before you commit on your first such investment you speak to one of the life insurance companies who have had some experience in real estate developments and you may find that all that glitters is not gold.

One of the main criticisms levelled against mortgages by investment men is their lack of marketability as compared with other forms of investment. All of you are aware of the efforts of CMHC to encourage a secondary mortgage market but I wonder how many of you are aware of how an experienced company such as ours can facilitate the resale of mortgage loans. Our Company, for example, services over $800 million in mortgage loans for our own account and the accounts of over 100 investor clients. Some of our investor clients are investing on a continuing basis and some are not. Some are major insurance companies and many are small pension funds. Insurance companies do not generally trade in mortgages and frequently have additional funds seeking immediate investment. Having appraised the real estate originally and

collected the monthly instalments since payments started, we are in an excellent position to arrange a transfer of assets between two of our clients at a minimum of expense.

Of course, I am prejudiced in stating that pension funds should have at least 25% of their assets in mortgages; and that, by the way, is a purely personal opinion. Aside from the other advantages of mortgage investments, I can't think of a better way for a company which is allied to the construction industry to scratch its own back than by making some of its own pension funds available for the encouragement of house or apartment construction. Mr. Hignett will correct me if I'm wrong, but I don't believe you can make it a condition of an NHA loan that the builder must use your products; however, if your prices are competitive and your products acceptable, many builders will co-operate even if they cannot be obligated to do so.

The analysis and appraisal of large income properties is highly specialized and you should be entirely satisfied that the loans being offered to you from whatever source have been carefully scrutinized by responsible people, experienced in this work, regardless of whether the loan in question is NHA or conventional. Some investors will often make superficial judgments simply because a loan is NHA insured or if the yield offered is higher than average. While we recognize the value of an NHA insurance policy, the approved lender must act in a prudent way and underwrite the risks so that the possibility of foreclosure is remote.

Finding people to lend money to is never any problem - the trick is to get it back with the least amount of effort. Mortgage losses in Canada over the past 20 years or so have been negligible in comparison with the sums invested. This is not to say that mortgage men haven't made many mistakes, for they have, but fortunately inflation during this period has cured most of them.

Mortgage men are sometimes accused, and perhaps correctly so, of being overly pessimistic in outlook. Someone once defined a pessimist as one who lends money to an optimist. In my view, the combination of a knowledgeable optimistic developer and a knowledgeable pessimistic lender asking the right questions, will produce a successful real estate project.

Since we have no guarantee that inflation will continue, as you consider to whom you should entrust your funds for mortgage investment, the lender you select need not know all the answers, but he should at least know all of the questions.

W. R. Thomas

Mr. Thomas, a graduate of University of Toronto has been engaged in the financing of residential construction since 1946. He has experience in conventional first and second mortgages and NHA financing. Since 1966 he has been a Director and General Manager of the Canborough Corporation, a company specializing in NHA mortgages.

Panel Member

Just about everything that could possibly be said about a mortgage as an investment vehicle has been touched on, retouched and amplified by the people you have heard before me. One of the things that has been assumed, however, and I am going to take the chance that this was an incorrect assumption, was that everyone here knows just exactly how to go about buying a mortgage and how to deal with it.

Now we have touched on the technique of using servicing agents, how to buy a mortgage and what good service it can give you as an investment. But, if you have bought this idea, think it over tonight, and when you go to your office tomorrow morning you make the decision that you will buy some mortgages, what do you do? Where do you look for them? What are your decisions?

Basically, it boils down to this. You have a choice of either making a future commitment against a building not yet built, or buying a mortgage "off the shelf." Now, let us take choice (a), a building yet to be built.

Where do you look for this service. Mr. Paterson has suggested the trust companies. All the Canadian chartered banks originate and serve NHA and some privately insured mortgage loans. These two sources are available to you. Most real estate companies, and in particular one A.E. LePage, have developed a strong mortgage market. They are interested. They have a strong stable of builders with whom they can place you in contact. Morbank Investments in Ontario, Morguard Investments in Quebec, both originate and service mortgages, and have again a strong contact in the building community so that you may get your pre-committed mortgages through these sources.

Now, what do you see? You see plans. You see forecasts of income. You see pictures and you see a map. You are advised of the stability of the builder, the need for the particular building or buildings in the community and from here on, the originator carries the ball and will eventually present you with the necessary information to make the advances, if you are going to make advances. Or he will finally present you with the completed mortgage. He will either hand you the actual documents involved or a servicing agreement and an undertaking to hold the mortgage in trust for you.

Now, alternative (b). Let us suppose you would like to buy a mortgage that is already in existence. This has a number of advantages; (a) you can put your money out today; (b) you can see actually what you are buying.

Where do you get mortgages that are extant today. Most of the chartered banks, and in particular Mr. Carter of the Royal Bank of Canada, are offering mortgages for sale. Mr. Paterson suggested that his company and most of the trust companies in Canada would be happy to arrange to either provide you with mortgages out of their own portfolio or arrange to buy them from somebody else. The Canborough Corporation, which I represent, has a substantial portfolio consisting of residential and multiple-family dwellings right across Canada.

What do you do now? First of all you have to establish where you want to make your

mortgage loan. This is a matter of your policy. Do you want to make it within your own community or do you not care. As soon as you have decided the geographical location think in terms of rate. Existing mortgages carry coupons that vary between 6% and probably 9% at the moment. Do you want a low yield at a discount or do you want a current yield at par.

Having made these decisions, the procedure for actually buying the mortgage is quite simple. You can have a degree of flexibility which perhaps is not completely understood. You may receive the documents, the actual mortgage and the NHA Insurance Policy plus the survey of the property, plus the lawyer's report on the mortgage itself, and actually take physical custody of these. Alternatively, you can leave the mortgage documents, which are about a quarter of an inch thick, in the hands of your servicing agent, have an undertaking from him to service them, treating them as if they were his own. Similarly, the actual evidence of the debt can be in a number of forms, whichever is convenient to you. It can be by way of a blanket assignment, unregistered assignments, or a letter of undertaking. In other words, it can be as simple or as complicated as you wish to have it.

One final decision is required; an offering of older mortgages may include some on the "flat" payment pattern. Now a "flat" mortgage, as opposed to a "blended" mortgage, does not have a tax account. Each monthly payment on both types of mortgage consists of portions allocated to principal, interest and taxes. In a "flat" mortgage the tax portion is credited to principal; the mortgagor thus receives interest at the mortgage rate on the tax portion. Here is the only aspect of being a mortgage investor that could be annoying. When taxes are payable the mortgagee must come up with the money to pay taxes. Certainly the mortgagor has been paying extra each month to cover taxes and the cash has been received, but the mortgagee must make allowance in his cash flow for about $400 per mortgage to be on hand at tax payment time and suddenly increase the principal.

Apart from the easier cash flow prediction which goes along with "blended" mortgages, there is another advantage which should not be overlooked. Blended mortgages have a tax account. This account earns interest at "saving account" rates. At the moment this rate is established at 3%.

Comparing the two types of mortgage is quite simple. Flat mortgages upset the cash flow projection - blended mortgages actually earn money on the tax account.

Finally, lets look at what you receive from your servicing agent each month. First, of course, is a cheque covering the total of principal, interest and taxes received since the last remittance.

Accompanying the cheque will be a recapitulation of the principal balance after the last remittance, principal payments and a new principal balance. The amount received as interest in the month and the credits or debits to the tax account will be included. Deducted from the total remittance will be the servicing fee. Thus four entries in your books maintain your complete record of mortgages for a portfolio of from one to many thousands of mortgages. From time to time will be included the principal and bonus interest on prepaid mortgages.

Touching very briefly on the matter of servicing fees they are usually 1/8% of 1% of the principal balance outstanding, calculated monthly, on multiple family dwellings and 3/8 of 1% on singles. The Canborough Corporation services mortgages as well as using servicing agents and, on the basis of our experience, we would prefer to buy, and of course to sell, mortgages at a price that includes servicing. There is no question that the total fee is a fair one, but we do question the high fee at the beginning and the low fee at the end when one might argue that the work load is fairly constant.

There, then, are the decisions to make and the steps to take.