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Mortgage Insurance in Canada

Basically sound but room for improvement

by Jane Londerville

MLI

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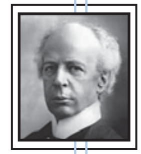
True North in Canadian Public Policy



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Mortgage Insurance in Canada

Basically sound but room for improvement

by Jane Londerville

Author photo by Martin Schwab

Executive summary

Canada's mortgage insurance system gives our housing market a solid foundation. Home buyers who cannot make a 20 percent down payment are required to insure their mortgages against default and government, in turn, guarantees against a default on that insurance. This system encourages sound loans while protecting lenders, borrowers and the entire financial system from unreasonable risk.

It served us admirably in the recent financial crisis. But it has one important failing: it denies consumers benefits from full competition by giving the public Canada Mortgage and Housing Corporation (CMHC) an unfair advantage over private firms.

As a public entity, CHMC mortgage insurance policies are 100 percent guaranteed by the federal government. But the government has chosen to give private mortgage insurance firm policies only a 90 percent guarantee.

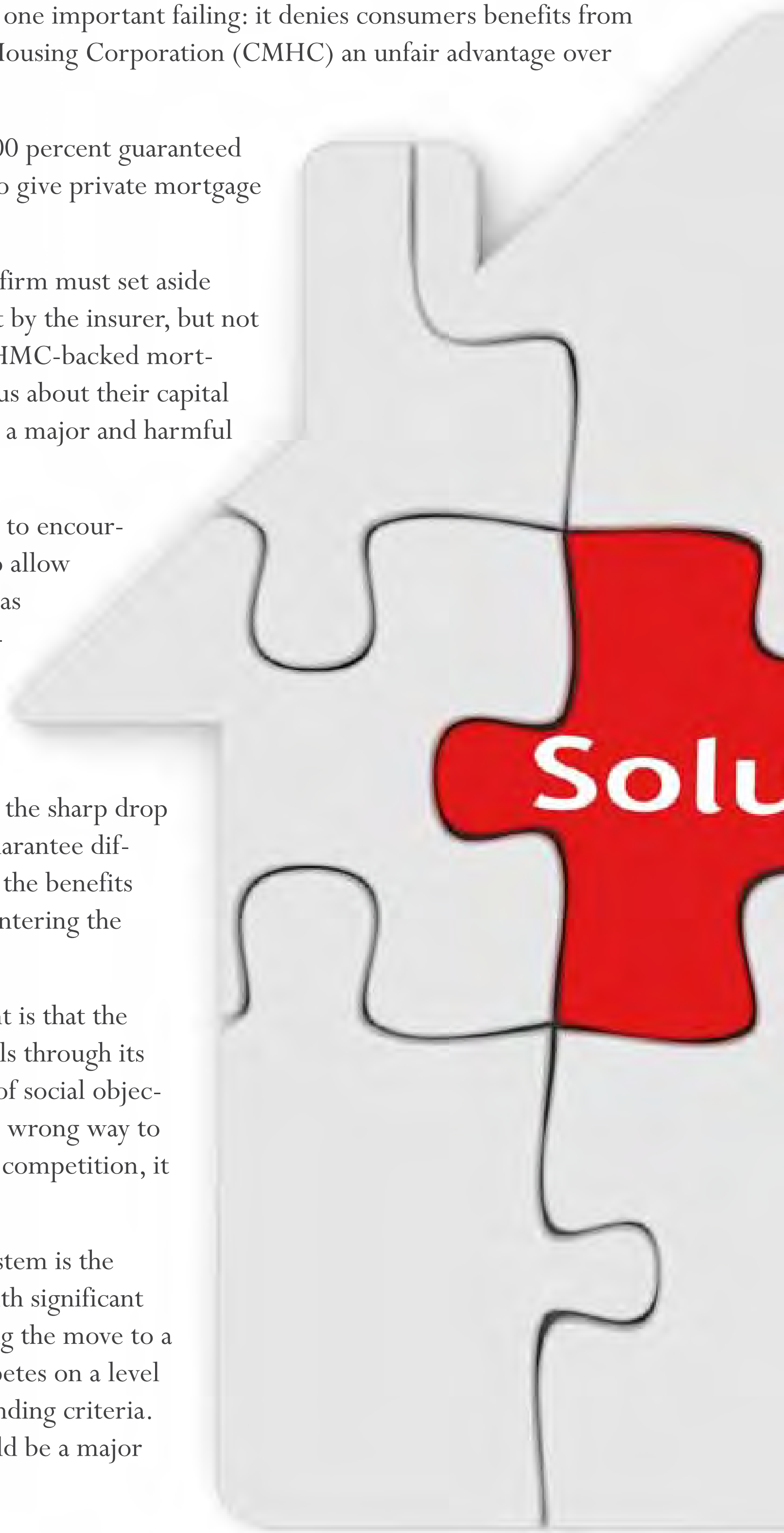
That means banks whose customers insure through a private firm must set aside some capital reserves against the remote possibility of default by the insurer, but not if they use the CMHC. Thus, rates of return are higher on CHMC-backed mortgages. And when profit margins are thin and banks are nervous about their capital reserves, as in the financial crisis beginning in 2008, it makes a major and harmful difference.

The policy contradicts the 2006 federal budget which sought to encourage greater competition within the MI sector. The decision to allow private competitors to the CMHC, beginning in the 1960s, has been fully justified by innovations in lending practices and reductions in mortgage insurance rates that have taken place especially since Genworth Financial Canada, the other major player, entered the market in 1995.

The failure of other firms to gain or maintain a foothold, and the sharp drop in Genworth's business after 2008, indicate that the unfair guarantee differential edge given to the CMHC is depriving consumers of the benefits of competition and discouraging new private insurers from entering the market.

The most plausible argument in favour of its special treatment is that the CMHC pursues other important social or environmental goals through its mortgage insurance business. But a so-called "cross-subsidy" of social objectives from the commercial operations of a public entity is the wrong way to pursue such goals. It deprives home buyers of the benefits of competition, it obscures accountability and it is unfair.

The key component of Canada's solid mortgage insurance system is the requirement that high loan-to-value mortgages be insured with significant government backing. The system can be improved by pursuing the move to a fully competitive model, wherein a CMHC MI spin-off competes on a level playing field under continued strong regulatory control of lending criteria. Removing the punitive differential in the guarantee rate would be a major step in creating a more homebuyer-friendly marketplace.



Sommaire

Le système canadien d'assurance hypothécaire procure de robustes fondations au marché immobilier. Les acheteurs qui ne peuvent se permettre une mise de fonds initiale de 20 % du prix total de la maison doivent assurer leur hypothèque contre le risque de défaut de paiement. Le gouvernement, pour sa part, garantit cette assurance. Ce système encourage les prêts sûrs tout en protégeant les prêteurs, les emprunteurs et le système financier dans son ensemble contre les risques excessifs. Il nous a admirablement servi pendant la récente crise financière. Mais il comporte une faille importante : il prive les consommateurs des avantages de la concurrence en accordant un avantage indu à la Société canadienne d'hypothèque et de logement (SCHL) par rapport aux entreprises privées.

En tant qu'organisme public, la SCHL jouit d'une garantie de ses polices d'assurance hypothécaire à hauteur de 100 % par le gouvernement fédéral. Le gouvernement a toutefois décidé de n'offrir qu'une garantie de 90 % de chaque prêt aux sociétés privées d'assurance hypothécaire. Cela signifie que les banques dont les consommateurs s'assurent par l'entremise d'une firme privée doivent mettre de côté plus de réserves de capital pour se prémunir contre le faible risque de défaut de paiement par l'assureur, ce qui n'est pas le cas s'ils s'assurent avec la SCHL. Ainsi, les taux de rendement sont plus élevés pour les hypothèques assurées par la SCHL. Cela fait une importante différence et entraîne des conséquences néfastes lorsque les marges de profit sont minces et que les banques sont inquiètes à propos de leurs réserves de capital, comme ce fut le cas pendant la crise financière qui a débuté en 2008.

Cette politique contredit le budget fédéral de 2006, qui visait à promouvoir une plus grande concurrence au sein du secteur de l'assurance hypothécaire. Les innovations dans les pratiques de prêts et les réductions de taux qui ont été observées en particulier depuis l'entrée sur le marché en 1995 de Genworth Financial Canada, l'autre principal joueur, justifient pleinement la décision de permettre à des firmes privées de concurrencer la SCHL à partir des années 1960.

L'incapacité des autres entreprises à prendre pied sur ce marché, de même que la réduction soudaine des activités de Genworth après 2008, montrent bien que l'avantage accordé à la SCHL prive les consommateurs des bienfaits de la concurrence et décourage les assureurs privés. L'argument le plus plausible pour justifier un traitement spécial pour la SCHL est qu'elle poursuit d'autres objectifs sociaux ou environnementaux importants. Le recours à des « subventions croisées » pour financer des objectifs sociaux à partir des profits des opérations commerciales d'une entité publique est cependant une mauvaise façon de poursuivre de tels objectifs. Cela a pour effet de priver les acheteurs de maisons des avantages de la concurrence, en plus d'obscurcir la responsabilité des gestionnaires et d'être injuste.

Le principal élément qui garantit la solidité du système canadien d'assurance hypothécaire est l'exigence que les hypothèques à rapport prêt/valeur élevé soient assurées avec un soutien considérable du gouvernement. Le système peut être amélioré en le rapprochant davantage d'un modèle entièrement concurrentiel, dans lequel un organisme dérivé de la SCHL qui se consacrerait à l'assurance hypothécaire ferait face à la compétition sur la base des mêmes règles et cela, en étant toujours soumis à un strict contrôle réglementaire des critères de prêt. On accomplirait une avancée majeure vers la création d'un marché plus propice aux acheteurs de maison en mettant fin au taux différentiel de garantie des hypothèques et à ses effets nuisibles sur les acteurs privés de ce marché.

Introduction

Part of the trigger for the global financial crisis was poor mortgage lending practices in the United States. Some borrowers obtained home loans without a proper vetting of their incomes and other debts. Under the terms of these loans, borrowers could not afford the higher loan payments after a first few years of reduced interest rates even if they had the income they reported. Lenders had assumed that house values would continue to increase, and that rising values would protect the principal on such loans. To compound the problem, providers bundled the loans into securities in ever more complicated ways. It became impossible for investors truly to know the risk underlying the pool of assets in which they were investing.

In contrast, people around the world have praised Canada's financial system as efficient and well regulated. No financial institutions here needed bailout funds during the crisis. While the country has suffered through a recession, its effects were much less severe than in the U.S. Canadian real estate markets slowed significantly and prices dropped in some centres but in most cases housing markets have recovered substantially, unlike those in the U.S.

Part of the reason Canada has not experienced anywhere near the same levels of mortgage defaults as the U.S. is the national control the federal government has over the lending criteria used for housing loans. If a borrower needs a loan of more than 80 percent of the value of a home in Canada, this loan must be insured against default, either through Canada Mortgage and Housing Corporation (CMHC) or a private mortgage insurance company. The federal government provides a back-up guarantee for both publicly and privately insured mortgage loans, but the loans must meet strict lending criteria for this protection to hold. This ensures that mortgage lenders carefully scrutinize the documentation provided by borrowers for insured loans.

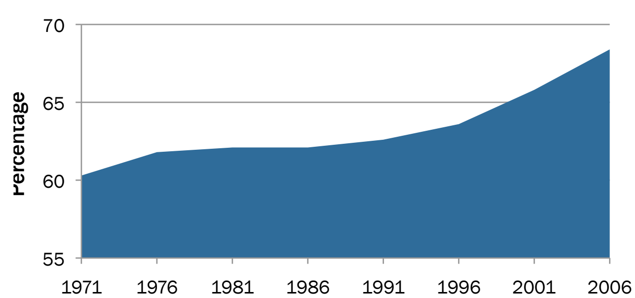
Although the Canadian system has weathered the global financial crisis well, we can still make improvements. The CMHC has an unfair advantage over private mortgage insurance companies in Canada because its loans are fully backed by the government, while those of its private sector competitors have a backup guarantee of only 90 percent. This difference affects the amount of capital a financial institution needs to hold. While the difference may seem small, during the recent very tight credit climate it has had a major and ongoing impact.

A better effort to level the playing field for CMHC and private mortgage insurers would increase competition and likely lead to lower mortgage insurance fees for consumers.

Background

More than two thirds (68.4 percent) of Canadians owned their homes in 2006 (see Figure 1), a high figure when compared to many developed countries and up from 65.8 percent in 2001. The Canadian government, through the CMHC, has frequently asserted a core objective of increasing the accessibility and affordability of home ownership for Canadians. We assume that home owners maintain their dwellings better than landlords and move less frequently than renters, thereby improving the quality of housing and stability of neighbourhoods. The acquisition of a home is the largest single lifetime purchase for most households, and is often used to build savings for retirement years or as a bequest to children. When surveyed, most Canadians express an aspiration to own their own home at some point in their lives. While the rate of homeownership is highly dependent on demographics and personal income levels, government policy also has a significant role to play.

Figure 1: Canadian Home Ownership 1971-2006



Source: CMHC

In the past, government programs designed to encourage home ownership included two features. We have offered grants to prospective first-home buyers with lower incomes to use for a down payment, and we have excluded from income taxation some savings set aside and ultimately used to purchase a home. These types of programs, however, can add significant direct costs to government budgets.

The most effective way to ensure market access for all those who are financially able to afford home ownership is to establish an efficient mortgage finance system. In this regard, "The Canadian finance system [is] one of the most stable and accessible in the world."[1] While the Canadian government has encouraged home ownership in a variety of ways, mortgage default insurance (MI) is one of its most successful methods. A special type of credit insurance, it allows regulated lenders the comfort of lending a higher percentage of the home sale price without creating excessive risk for depositors or investors.

Until 1954, when banks were first permitted to lend based on mortgage security, the main institutional holders of mortgage debt in Canada consisted of trust, loan and insurance companies. A Bank Act revision in 1992 allowed banks to acquire trust companies and investment dealers, and since then they have captured the majority of the Canadian mortgage market. At the end of 2008, deposit-taking institutions held 62 percent of outstanding mortgage loans, and banks held almost 80 percent of this. This is equivalent to nearly half the mortgages in Canada, compared to a corresponding figure for banks in 1970 of 10 percent.[2]

Until 1935, the typical loan-to-value ratio for home loans in Canada stood at 50 percent; purchasers needed to accumulate the remaining half. In that year, the Dominion Housing Act (now the National Housing Act, or NHA) allowed for joint lending of up to 80 percent of the value of a home, with 75 percent of the funds from a lender and the rest from CMHC. By the late 1940s, the typical maximum loan-to-value ratio from a private lender had risen to 66 percent and the maximum NHA loan remained at 80 percent. Only with the introduction of mortgage insurance (MI) in 1954 did loans higher than 80 percent of value become available. That opened the ownership market to a much broader range of households.[3]

Mortgage insurance allows financial institutions to lend a higher percentage of the value of a property because it protects them against loss in case of borrower default. Over time, the cost to taxpayers of a well-run MI program should be zero, because the insurance fees charged by the program should be sufficient to pay all claims and expenses and to build ample capital reserves. Operating such a program should require no government subsidies or taxes forgone. At little cost then, MI has proven to be a highly effective and efficient way to increase the availability of mortgage financing for aspiring home buyers and therefore makes home ownership a reality for a greater percentage of the population. In short, "The main advantage of a government mortgage guarantee is that it puts considerably less pressure on the government budget than other direct or explicit means of financial support."[4]

A mortgage loan that exceeds 80 percent of the lending value of a home is considered as having a high loan-to-value ratio (high LTV). High-LTV loans have proven over time to present considerably higher risks than home loans with a higher percentage of equity invested by borrowers. The Office of the Superintendent of Financial Institutions (OSFI) therefore requires all regulated lenders that offer high-LTV loans – including chartered banks – to reduce their risk exposure by securing for them qualified government or private mortgage insurance coverage.[5]

Again, this insurance provides protection to the financial institution (and ultimately its depositors and investors) in the case of a borrower's default on the mortgage. In Canada, insurance covers 100 percent of the loan and borrowers pay an up-front fee to purchase this protection for the lender.[6] The fee increases with the risk of the loan. Since borrowers have less of their own funds invested and are more likely to walk away from their investment when adverse financial or personal circumstances arise, the risk of loss rises with the loan-to-value ratio. The likelihood is also greater that the value of the house may drop below the level of the mortgage debt, since the initial margin between the house price and the loan amount is less.

In most countries where mortgage insurance is offered, it has two main purposes:

- To expand home ownership opportunities for first-time buyers, those with little in the way of a cash down payment, and for those whose uncertain ("informal") income is unacceptable to lenders without the added protection afforded by MI.
- To provide a guarantee on loans that can then be sold by the lender into securitized pools, which allows the recycling of proceeds to increase available funding for new mortgage loans.

The greater availability of mortgage funding for the primary market can help put downward pressure on interest rates for borrowers. Mortgage securitization (MBS) is less important in Canada than in the U.S., where approximately 60 percent of mortgage originations are securitized. But MBS issuance has become a growing alternative source of funds for Canadian lenders. CMHC's introduction of Canada Mortgage Bonds in 2001 helped increase this new funding source. The insurance placed on these loans is an important component of making the bonds attractive to investors.

In most countries where mortgage insurance is offered, it has two main purposes: To expand home ownership opportunities for first-time buyers, and to provide a guarantee on loans that can then be sold by the lender into securitized pools.

The cost of MI to the borrower is not insignificant. For example, the mortgage insurance charge for a family buying a $300,000 home with a 5-percent down payment would amount to about $8,000 – and considerably more if the borrower or the loan exhibited certain identifiable higher risk features. Government policy must ensure two goals: that the rate charged for MI protection is, on the one hand, sufficient to maintain adequate reserves to pay all future claims and that at the same time consumers are not overcharged for this protection.

Regulation of mortgages and mortgage insurers

The Canadian government provides a catastrophic guarantee to back up all public and private mortgage insurers authorized to provide this financial protection to regulated lenders. Since the first adoption of "Basel I" capital requirements for financial institutions in 1988,[7] CMHC-insured mortgages were considered to be backed 100 percent by the Canadian government (the so-called "sovereign guarantee."). This meant that these assets were equivalent to government debt and therefore required no risk-based capital reserves to be held by regulated Canadian banks holding CMHC-insured mortgages. In order to allow private mortgage insurers to compete with CMHC, the federal government opted to provide these firms with a backup guarantee as well – effective only in the event of company insolvency. It covers less, the equivalent to 90 percent of the risk exposure on their insured loan portfolios.[8]

This backup government guarantee of privately insured loans is a critical component of Canada's MI system. In practice, it allows the federal government to set prudent criteria for all loans which are insured and thus covered under this guarantee. If insurers – and insured lenders – do not follow these criteria, the loans are no longer guaranteed in the event of insurer insolvency, and they therefore become less attractive to lenders.

The backup guarantee effectively established limits on the types of high-LTV loans eligible for mortgage insurance in Canada. For instance, the maximum permissible LTV ratio for insured loans on rental properties (i.e. not owner-occupied) was reduced in early 2010 from 95 percent to 80 percent. Risky investor loans with an LTV higher than 80 percent can no longer secure MI coverage. Because qualified MI providers can no longer insure such loans, lenders will no longer make them. This effective brake on excessive risk-taking – one example of many – reduced the probability of catastrophic losses.

In addition, Bill C-13, the Budget Implementation Act of 2006, transferred the authority to amend the limit on backup guarantees from Parliament itself to the Minister of Finance. That action made this authority a much more powerful and useful regulatory tool.[9]

The government's insolvency guarantee determines the level of risk-based capital that mortgage lenders are required to hold on their balance sheets, so it is very important to them. The OSFI now applies the more recent "Basil II" capital requirements to insured mortgage loans.[10] CMHC loans still have a zero-percent risk weighting – requiring no capital allocation by the insured lender, since the government guarantees these loans at 100 percent and they are regarded as equivalent to sovereign government debt. Privately insured loans carry a 5 percent risk weighting, reflecting the fact that the federal government backs guarantees from private insurers at only 90 percent, rather than 100 percent.

This greater-than-zero regulatory capital requirement for lenders makes privately insured loans inherently less attractive than those insured by the CMHC. The incremental capital requirement imposed upon lenders for using private MI coverage rather than what the CMHC offers – however small it may appear – means that every loan insured with the CMHC will produce a higher rate of return on capital than if it were insured by a private MI provider. This differential regulatory treatment, particularly in the post-crisis banking environment, places Canada's private insurers at a significant competitive disadvantage relative to their government-sponsored counterpart.

Private mortgage insurers in Canada are required to pay funds into a guarantee fund (the functional equivalent of a re-insurance premium) in order to obtain the government's 90 percent backing in the event of their demise. Should insured lenders ever be called upon to use this insolvency backup to pay claims, the government has two alternatives before it has to seek funding from the national treasury (i.e. the taxpayer). First, it would look to the recoverable value of the homes securing the non-performing loans at the base of the claims, and at any of the private insurer's residual equity. Second, it would have the ability to call upon the reserves accumulated in the guarantee fund.

CMHC and mortgage insurance in Canada

The federal government requires the CMHC to run its mortgage insurance business at no cost to the taxpayer. Accordingly, the agency continually evaluates its mortgage insurance fee structure to ensure that it is adequate to cover the risks assumed, yet also competitive with the rates charged by private insurers (which are also regulated). Although the CMHC is not regulated by OSFI, it does apply the capital requirements of this agency to determine its reserves and, in fact, endeavours to exceed these levels by 50 percent.

In 1997, the CMHC did not have sufficient reserves to cover all its incurred claims, and needed government intervention to assure that it remained adequately capitalized. Since then, the CMHC has raised its premium rates. It has also become more cautious about building and retaining sufficient MI premium earnings as reserves during housing boom periods, in order to cover the market downturns that inevitably follow.

Table 1: CMHC Mortgage Insurance Business (millions of dollars)					
Year	**2005**	**2006**	**2007**	**2008**	**2009**
Insurance in Force	273,700	291 400	345 200	407 700	472 564
Premiums and Fees Received	1,492	1,383	1,740	2,132	2,464
Net Insurance Claims Expense	119	209	315	372	1,112
Net Income	951	981	1,022	999	742
Retained Earnings set aside for Capitalizations	3,406	3,731	4,258	5,423	5,937
Source: CMHC Annual Report, 2009					

Table 2	
Ministry of Finance edict July 2008, effective October 2008	**Ministry of Finance edict February 2010, effective April 2010**
▪ Minimum down payment raised from 0 to 5 percent ▪ Maximum amortization period shortened to 35 years from 40 years ▪ Established minimum credit score for borrowers ▪ New standards for documenting borrower income, assets and property value	▪ Minimum down payment for non-owner-occupied properties increased from 5 to 20 percent ▪ Maximum LTV on refinanced loans lowered from 95 to 90 percent ▪ Borrowers opting for a variable rate mortgage must have sufficient income to qualify for the loan at the higher 5 year fixed term interest rate

Through year-end, 2009, the CMHC had weathered the most recent financial turmoil without substantial erosion of its reserves (see Table 1). Claims in 2009 were much higher than in previous years (and higher than projected by the CMHC) due to the global recession and its adverse impact on borrowers' incomes and home prices. However, driven mainly by a higher than anticipated increase in new insurance written, the CMHC's reserves actually increased beyond expected levels in 2009.

The rate of mortgages in arrears – defined as more than three months of payments not received – has hovered around 0.5 percent in Canada for more than a decade. That rate actually fell to 0.3 percent during the early stages of the financial crisis and then rose to approximately 0.4 percent. This performance compares favourably with the U.S., where reported default rates were 9.7 percent at the end of 2009, up sharply from a rate of 2.4 percent in 2002.[11]

We can attribute the relatively low levels of mortgage arrears in Canada partly to the more stringent underwriting criteria which the Department of Finance requires lenders to apply on high-LTV loans that all are required to carry MI coverage. To ensure insured loans were not excessively risky, the Ministry tightened these criteria in 2008 and again in 2010, as a reaction to the mortgage meltdown in the U.S. (see Table 2).

Private mortgage insurers in Canada

Since its introduction in 1954, mortgage insurance in Canada has evolved substantially. Initially it applied only to National Housing Act (NHA) mortgages on newly built homes. In 1979, an expanded Act included coverage for existing homes. In 1963, the Mortgage Insurance Company of Canada (MICC) began to provide private mortgage insurance.

Legislative changes in 1970 greatly expanded the potential role of private MI. Since then, several private insurance firms have come and gone in Canada; mainly they play a relatively minor role compared to the CMHC.

In 1995, GE Capital Mortgage Insurance Company (now Genworth Financial Canada) entered the Canadian MI market by purchasing the dormant MICC. Since then, Genworth has invested far more capital and competed more aggressively with CMHC than its predecessors. This happened despite the regulatory hurdles discussed earlier that give CMHC a continuing competitive advantage.

A competitive MI marketplace benefits Canadian home buyers for important reasons. Changes in MI products brought about through competition in the market over the last few years include:

- Insured mortgages are now portable to a new property (and their value can be increased if the homeowner is trading up). This saves legal fees, new insurance fees (although if the loan is increased as it is moved, some fee may apply) and other costs of paying off the old mortgage and registering a new one on the new home.
- Insurance is available on refinancing, allowing homeowners to take equity out of their principal residence to consolidate debt or for another purpose.
- MI is available for up to 95 percent of the purchase price of the house, requiring a smaller down payment and allowing home buyers to enter the market earlier.
- In 2001, Genworth-insured mortgages became eligible to be included in MBS pools. That allowed Genworth to compete more effectively with the CMHC in a product area valued by lenders, especially "Schedule II" non-retail banks that rely upon securitization for their funding.
- Both the CMHC and Genworth Mortgage lowered insurance fees by 15 percent in 2003. That demonstrated the impact of competition on the cost of mortgage insurance.[12]

On the face of it, MI competition has brought Canadian consumers many of the benefits one would expect, and the government did expect, in introducing it. The question naturally arises, therefore, whether the Canadian market is as fully competitive as it could and should be. And here the evidence is not encouraging. Although private mortgage insurance companies have existed in Canada since the 1960s, CMHC has always dominated the MI market. In its 2009 Annual Statement, Genworth reported it had $223,842 million worth of insurance in force at the end of 2009, compared with a $472,564 million total in force for the CMHC. This gives the CMHC a 68 percent share of total insurance in force – slightly higher than its 65.8 percent share in 2008. Of course a market can be competitive with a very small number of firms, but when one public firm has two thirds of a market, only one rival and a regulatory advantage it is worth investigating how significant that advantage is.

Potential private entrants certainly seem to find the Canadian mortgage insurance market hard to break into. The federal government announced in its 2006 budget that, in order to encourage greater competition with the CMHC, it would license more private MI companies. Though its total housing and mortgage volume is only about one-tenth the size of the American market, Canada has the second largest MI market in the world. It therefore represents an attractive potential market for private providers seeking to grow internationally.

Following this announcement, affiliates of four U.S.-based mortgage insurers were approved to enter the Canadian market.[13] Shortly thereafter, however, capital pressures caused by the global financial crisis and the U.S. mortgage meltdown caused all four parent companies to terminate these new MI ventures. Only one of these four initiatives produced any continued expansion in Canada's field of MI competitors; in 2010, AIG United Guaranty sold its Canadian MI operation. That resulted in a new entity, the Canada Guaranty Mortgage Insurance Company, jointly owned by the Ontario Teachers' Pension Plan and National Guaranty Mortgage Holdings Inc. As the only Canadian-owned private MI company, Canada Guaranty is expected to be a viable entry into the market, and to increase the level of competition among mortgage insurers.

Table 3 Genworth Financial Canada Net Premiums Written (millions of dollars)

Year	2005	2006	2007	2008	2009
Net Premiums Written	461.3	594.2	983.6	706	306

Source: http://investor.genworthmicanada.ca/phoenix.zhtml?c=230629&p=irol-reportsAnnual, and Mohindra 2010

Since Genworth Financial Canada is now a separate public company, spun off from its U.S. parent in 2009, it is possible to track its financial performance separately. Table 3 lays out Genworth MI's net premiums written for the past five years; this represents "sales" of new mortgage insurance since 2005.

A comparison of CMHC's financial results in Table 1 with Genworth's results in Table 3, especially for the most recent two years since the onset of the global financial crisis, uncovers a disturbing trend. Genworth's "premiums written" fell by 28 percent from 2007 to 2008, and fell by a further 57 percent in 2009. At the same time, the CMHC's premium revenue increased 18 percent in 2008 over 2007 and grew an additional 16 percent in 2009 versus 2008.

Once again the CMHC's regulatory advantage seems to loom large. During this time, banks in Canada were extremely skittish about their levels of capital. They faced some exposure to losses from investments in subprime MBS, and considerable uncertainty about how housing and other real estate markets would fare in Canada and about the depth and length of the recession in the country. As a result, banks became extremely cautious in their lending policies. The numbers in Tables 1 and 3 seem to show that lenders favoured the CMHC over Genworth between 2007 and 2009.

Unless Genworth made a major counterproductive change in the way it did business, the CMHC introduced dramatic improvements in its operations, or some other major change can be identified in Canada's MI market coinciding with the fiscal crisis, the difference between 90 percent and 100 percent federal backing, with the resulting difference in capital reserve requirements, is the compelling and central explanation. Since there is no evidence that these other explanations are correct, the focus of policy reform is obvious.

Mortgage insurance in other countries

Many countries around the world use mortgage insurance to enhance their housing finance systems for reasons already cited. MI increases homeownership by improving access to affordable, low-down-payment mortgage financing. It also assists in developing a secondary mortgage market by enhancing the credit protection for MBS, thereby bringing new sources of funds to primary mortgage lenders.

MI programs in several other countries with competitive features or experiences might offer some useful insight on possible ways to enhance MI competition in a Canadian setting. While over 30 countries offer some kind of MI program to home mortgage lenders, only a few have experience with both public and private MI providers. The most notable of these include the U.S., Australia, Mexico, and Hong Kong.

The United States

The United States first developed a government mortgage insurance program in 1934[14] through the Federal Housing Administration (FHA), long before Canada. That country is by far the largest market for MI in the world, and part of the reason for this is the standard mortgage instrument in the U.S. Mortgages there commonly have a 15- or 30-year term, with variable rates or fixed interest rates for this whole time period. If rates fall, mortgagors can refinance at the lower rate for a relatively small cost, which leaves interest-rate risk with the lender.

Since it is difficult to match them with a savings instrument in order to guarantee a profitable interest-rate spread, these instruments are not attractive for financial institutions to hold on balance sheets. As a result, lenders frequently sell mortgages into securitized funds; a guarantee of MI facilitates these sales.

The FHA provides mortgage insurance nationally. As the U.S. equivalent of the CMHC, the FHA enjoys a full sovereign guarantee and the highly favourable risk-based capital treatment which that confers on its MI program. The FHA is part of the U.S Department of Housing and Urban Development (HUD) and has no independent financial regulator; however, it is required to undergo a rigorous annual review conducted by a qualified private sector actuarial firm. The Veteran's Administration also provides mortgage insurance for veterans in the U.S.

FHA-insured loans are made by HUD-approved lenders. The upfront MI fee has been 1.5 percent and on top of this buyers with a small down payment also paid a monthly MI fee. In 2010, the upfront fee was reduced to one percent, with corresponding increases in the monthly payment. At the same time, changes allowed borrowers to cancel the insurance once their loan met certain risk criteria, based on the term of the loan and the current LTV ratio. This aligned FHA insurance with private MI conditions.[15]

The U.S. system is very different from the Canadian one. For instance, FHA loans are subject to insured loan limits which vary by market. The purchaser of a home in Buffalo, for example, cannot take an FHA-insured loan if the loan amount is more than $276,250. Presumably the intent is to use government MI to assist more moderate-income households with a home purchase. By contrast, CMHC in 2003 removed any limits on the price of a house on which it would insure a mortgage loan. That action allowed it to compete even more directly with private MI companies.

Reintroduced in 1957, private MI providers in the U.S. – in contrast with the FHA's product – face no price or loan limits on houses eligible for an insured mortgage loan. As with all other types of insurance in the U.S., MI is regulated by the individual states, pursuant to a specialized set of MI-specific regulations developed over time. Private MI firms receive no government backing and therefore lenders who rely upon private MI protection receive more limited risk-based capital relief.

Private MI firms are subject to additional "quasi-regulation" under a federal statute which requires Fannie Mae and Freddie Mac[16] to recognize private MI coverage only from firms that are certified pursuant to Fannie and Freddie's respective MI-qualification standards. Fannie Mae and Freddie Mac will not purchase privately insured loans from uncertified MI providers.

> Unlike in Canada, the public and private MI providers in the U.S. are also viewed by the marketplace as serving somewhat different, though also overlapping, sectors of the housing market.

Therefore, in order to be viable market participants, private mortgage insurers must secure and maintain Fannie and Freddie certification and generally align their underwriting approval criteria with these two secondary market agencies. In addition, the major credit rating agencies serve as quasi-regulators of the private MI firms since they also depend upon rating-agency recognition of their claims-paying capacity.

Unlike Canada, the U.S. makes no blanket requirement that all mortgage loans over 80-percent LTV be insured. But lenders there often insure these loans in order to sell them in the secondary market, either immediately or some time later, after origination. In particular, Fannie Mae and Freddie Mac generally require qualified MI coverage on all loans over 80-percent LTV which they purchase and/or securitize.

Private MI companies in the U.S. typically insure only the top portion of the loan ("first loss coverage"). That generally covers only the top 20 to 25 percent, with deeper coverage also provided depending upon the needs of the investor – including Fannie Mae and Freddie Mac.

The history of direct competition in the U.S. between the public FHA and the private MI firms includes issues relating to a less-than-level playing field. But, unlike in Canada, the public and private MI providers in the U.S. are also viewed by the marketplace as serving somewhat different, though also overlapping, sectors of the housing market.

For example, the FHA program is subject to statutory loan limits as noted above, whereas private MI programs have no such loan limits. (This loan limit was raised in 2008 and that action increased the share of loans insured by FHA/VA in that year.) The relative share of private versus FHA-insured loans has varied over time, but since 1990 the private MI sector as a whole has had a much larger share of annual insured loans in the U.S. than in Canada.[17] The private mortgage insurance field in the U.S. is very competitive; as of 2009, seven firms were writing new MI coverage.

The U.S. mortgage market is still struggling to recover from the subprime crisis.

The U.S. mortgage market is still struggling to recover from the subprime crisis. The Federal Housing Finance Agency has put Fannie Mae and Freddie Mac into conservatorship. As a result of rapidly rising default rates, the private MI industry lost money in 2007 and 2008 and is experiencing financial stress, with low share prices and poor or no credit ratings. An inability in the current climate to raise funds easily to shore up capital reserves is constricting their ability to write new business.

In addition to private and FHA MI, some states operate government-sponsored MI programs within their own geographical area. These programs have varied design features whose regulatory and capital treatment also varies. Most state-sponsored public MI programs differ from both their federal and private MI counterparts in that borrower eligibility includes household-income limits. While these state MI programs compete to some extent with both the national FHA and the private MI firms – and enjoy some competitive advantage over the latter, similar to that in Canada – the issue is partly defused by the social targeting of the state-based programs to borrowers of limited financial means.

Australia

Prior to 1998, four competing companies, three private and one government-owned, provided mortgage insurance in Australia. The government-owned MI company, the Home Loan Insurance Corporation (HLIC), was formed in 1965 and in the 1980s to early 1990s held approximately 45 percent of Australia's total MI market.[18] In the mid-1990s, the Australian government decided it was no longer necessary for the government to play a direct role in providing mortgage insurance. The mortgage market was operating efficiently and private sector mortgage insurance was well established, competitive, and available at reasonable cost. In December, 1997, the government passed legislation to allow for the privatization of the HLIC. GE Capital (now Genworth) subsequently purchased the company and entered the Australian MI market.

Over the next few years, U.S.-based PMI purchased two of the three other private mortgage insurance firms in Australia. Following these actions, three competing private insurers – Genworth and PMI, along with Royal & Sun Lenders Mortgage Insurance – provided mortgage insurance in both Australia and New Zealand. (New Zealand does not have a government mortgage insurer).

In terms of some product design features – like 100 percent coverage and lump-sum prepaid MI fees financed as part of the mortgage loan amount – the mortgage insurance system in Australia is similar to Canada's. But it is dissimilar in two key respects:

- Australia has no regulatory mandate for lenders to use MI.
- Australia provides no backup government guarantee for private MI coverage.

Although MI is not obligatory in Australia, most lenders require that loans over 80-percent LTV value carry MI coverage. The growing and important role of private-sector securitization in the Australian mortgage market drives this requirement. To make them marketable to investors, high-LTV-ratio loans generally need credit enhancement such as mortgage insurance.

Australia provides a prime example of the development over time of a well established private-sector MI industry that alleviates the need for the public sector to remain involved in this business, with the risk it posed to the government's balance sheet if a single government entity insuring most of the mortgages in the country should mismanage its affairs.

Mexico

For some years prior to 2004, Mexico's sole MI provider was FOVI, a flawed government-run program not viewed by the private banks as a reliable financial backup. Mexico restructured FOVI and launched its reformed MI program in 2004, with the new entity re-named Sociedad Hipotecaria Federal (SHF). Initially, SHF originated loans and provided MI to other lenders.

At the same time, the country invited private U.S.-based mortgage insurers to participate as reinsurers to Mexico's reformulated public MI program, with the intent, over time, for these private insurers also to enter a new competitive MI marketplace as direct writers of coverage. Though SHF has indicated that multiple private competitors are welcome in Mexico, and several U.S.-based firms did enter the market, Genworth at present remains the only active private mortgage insurer and reinsurer.

The private reinsurance purchased by SHF was intended to have the dual benefit of reducing SHF's overall risk and initiating private MI companies into the Mexican market. It has accomplished both objectives. SHF also has a mandate to develop a secondary mortgage market; MI is expected to be an important component of this.

Unlike Canada, Mexico's system does not require MI on high-LTV mortgages, nor do the private MI providers benefit from any government backup. (Mexico's sovereign debt rating is not as high as that of the Canadian government.) Instead, as noted, private MI firms are intended to provide, for a fee, reinsurance backing to the government's MI program.

The strategic objectives of Mexico's managed evolution of public and private MI within the larger housing finance sector – the encouragement of broader home-ownership opportunities in the primary lending market and the increased flow of mortgage funding from the secondary capital markets via MBS – appear to be quite similar to those in Canada. Both of these goals appear, of course, within the overriding objective of developing a stable and self-sustaining national housing-finance system.

The intent in Mexico is a gradual phase-out of SHF as the private sector takes over the MI role. SHF has full government backing until 2013; the setting of this deadline is designed to entice private sector MI companies into the market.

Hong Kong

Like Mexico, Hong Kong is a relative newcomer to the use of mortgage insurance to enhance its housing-finance system. Banks there are not permitted to lend more than 70 percent of the value of the home if the price is less than HK$12M. With the introduction of MI through the public entity Hong Kong Mortgage Corporation (HKMC) in 1999, loans up to 90-percent LTV now can be issued, with HKMC insuring the portion of the loan representing the 20-percent difference in value. Originally available for homes valued up to HK$12M, as a result of the financial crisis this limit fell to HK$7.2M in 2010. In a similar manner to Mexico, HKMC uses private MI companies to reinsure its risk. As of March 2009, five companies were participating in this market.

Summary of findings

Many other developed countries envy Canada's housing-finance system, given its relatively strong performance through the recent financial crisis. As an integral component of this larger system, mortgage insurance has also stood up well to date, when compared to MI in some other countries, notably the U.S.

Furthermore, mortgage insurance has turned out to be a remarkably effective mechanism for helping to stabilize and sustain Canada's housing-finance system, even as it increases the availability of mortgage funds and reduces costs for Canadian homeowners. The collateral strength of the Canadian MI system has been evident through the global financial crisis, with CMHC's and Genworth's financial positions remaining strong despite faltering home prices, growing unemployment, increasing mortgage defaults and MI claims.

That said, incremental actions could further strengthen the Canadian mortgage insurance market and make it more competitive and potentially less costly for borrowers. We do have options for possible improvement.

Mandated mortgage insurance for loans greater than 80-percent LTV ratio is a critical component of the health of Canada's housing and mortgage finance markets. Because the U.S. does not explicitly require mortgage insurance on high-LTV loans originating there, both regulated and unregulated lenders exercised less restraint on undisciplined lending that led up to the financial crisis. Canada's primary market mandate to protect high-LTV home loans with MI coverage should remain in place.

Canada's regulatory rule-making for MI-protected high-LTV loan originations has proven an effective tool in controlling excessive risk-taking by lenders. That regime includes prudent limits relating to loan instrument, LTV ratio, credit scores, debt ratios, housing payment-to-income ratios, etc. (see Table 2).

A remaining issue is that private mortgage insurers have struggled to compete with CMHC over the years. They struggle because of CMHC's head start in mortgage insurance, its entrepreneurial approach in offering mortgage insurance, and the built-in advantage the agency continues to enjoy with respect to the 100-percent sovereign guarantee it alone receives from the government.

The Canadian government's back-up guarantee for all mortgage insurers in Canada is an important mechanism to regulate the risk of mortgage loans. However, the government's guarantee of 100 percent of CMHC mortgage insurance obligations versus just 90 percent of private insurer obligations provides a strong incentive for lenders to eliminate entirely their risk-based capital reserve requirements by choosing to insure with CMHC over any private provider. The discrepancy in the percentage of the government's backup guarantee between CMHC and the private insurers is an impediment to achieving robust competition in the Canadian mortgage insurance market.

Mortgage insurers sell their services to lenders, not directly to consumers. Borrowers are told they need mortgage insurance on their high-LTV ratio loan, but they are not asked which MI provider they prefer – nor should they care, since the fees are the same for each. However, lenders are always concerned about the level of capital they are required to maintain. That gives CMHC an inherent competitive edge over private insurers, as zero capital for MI translates into higher lender profit margins on CMHC versus privately insured loans.

In a less volatile economy, this difference might not have a strong adverse effect. But during periods of stress in the financial sector, it appears this difference becomes more important. While the current cost of capital is relatively low, Tables 1 and 3 above show how CMHC's mortgage insurance income rose while Genworth's fell during this most recent period of increased banking sector sensitivity to capital pressures. CMHC's market share rose at the expense of Genworth's share.

Another related policy concern regarding the growing concentration of direct MI risk exposure with the public provider is sheer size. CMHC's overall MI risk exposure from insurance in force increased 73 percent from 2005 to 2009, growing from $273.7B to $472.6B (see Table 1 above). The rapid current growth in CMHC insurance exposure necessitated a 71 percent jump in CMHC's total authorized insurance limit in force—from $350 billion in 2008 to $600 billion by 2010.

It appears that, in times of very tight capital, the 100-percent guarantee and its lower capital reserve requirement become a more important factor for lenders in their choice of a mortgage insurer. In order to level the playing field more effectively between Canada's public and private MI providers, several options for government action might be considered. As a practical matter, CMHC's 100-percent government guarantee cannot be reduced – it is a feature of CMHC's status as a Crown Corporation.

This apparent impediment to achieving an otherwise desirable policy objective need not be insurmountable. The means to reposition CMHC's Crown Corporation MI business as an affiliated non-Crown public entity expressly designed to compete more equally with private sector counterparts – including having a less than 100-percent government backing – may exist.

Conversely, we might also achieve a level playing field by increasing the government's backup guarantee for private insurers to 100 percent. That would result in zero lender risk-based capital on all high-LTV ratio loans. Lenders could then choose between the CMHC and a private mortgage insurer based mainly on considerations of price and service.

Given that insurers pay a fee to the government for their backup guarantee, and that this arrangement allows the government's financial regulator to set firm criteria for insured lending, an increase in the backup guarantee from 90 to 100 percent would not seem to present a significant additional risk of loss for the government. That would particularly be the case if the fees for the guarantee were readily adjustable, based on company performance. However, an option that seems to offer state support to large private firms when public budgets are under stress may not seem politically feasible to the government.

Alternatively, we might consider privatizing CMHC's mortgage insurance business, as the Australians did, and leaving in place the government's 90-percent backup guarantee or whatever alternative level works best in a fully privatized MI market. Given the structure of mortgage insurance and performance in the market during the current period of economic stress, it is not clear that a continuing government role as a direct MI provider is absolutely essential.

As long as alternative government support mechanisms are able to assure continued full market coverage, responsible underwriting, and sufficient market competition to sustain operating efficiencies and cost savings for home mortgage borrowers, direct ownership may be unnecessary. On the other hand, full privatization may be a more radical step than other changes that could achieve the objective of a level playing field, and, as with the prior option, privatization may not seem politically feasible to the government.

The CMHC has also started to merge its housing initiatives relating to the encouragement of energy-efficient homes with lower mortgage insurance fees for those who buy such homes. As a result, those homeowners not buying energy-efficient homes, who may be lower-income households buying existing, older, cheaper houses, are effectively subsidizing the MI costs for those who are able to buy newer, more expensive, energy-efficient homes.

While energy-efficient housing is surely a laudable initiative for the government and the CMHC to pursue, a more suitable incentive in this case would take the form of an explicit public subsidy, rather than the less transparent policy of adopting a cross-subsidized premium within the public MI fund. The CMHC advances energy-efficient housing via cross-subsidies within its MI fund, which is also required to operate under the principles of business and commercial insurance. That suggests one reason why it might be advisable, if possible, to migrate CMHC's residential mortgage insurance "business" into a 100 percent-owned, but separate affiliated entity.

This type of corporate restructuring by CMHC could offer important corollary benefits that effectively address the competitive issue of a level playing field. Specifically, a "free-standing" government-owned MI entity, structured as a non-Crown Corporation, to operate CMHC's current residential MI program, could:

- Have regulatory and capital requirements more closely aligned with its private sector counterparts;
- Be subject to financial reporting, risk management and business practice requirements both more rigorous and more transparent than the current CMHC program, in many ways commingled with CMHC's other business and social-purpose activities. This should include a full annual actuarial review and a "dynamic capital adequacy test;" and
- Lenders relying on government-provided MI back-up protection but with less than a 100-percent guarantee, creating a degree of residual risk exposure on their high-LTV loan originations, are likely to behave more cautiously.

Canada has a very strong mortgage market and mortgage insurance system. The changes suggested should help to make it more competitive and efficient and to help lower fees for those borrowers who are unable to amass a large down payment – most typically the country's moderate-income first-time buyers.

Recommendations

If the objective of a housing finance policy for Canada is to improve and strengthen the competitive aspects of the country's current mortgage insurance system, then the following legislative or regulatory adjustments appear to have merit:

- Continue to require that all loans of more than 80-percent LTV be insured.
- Reposition the existing CMHC residential MI program into a newly formed subsidiary or affiliated government-owned corporation that is not a 100-percent guaranteed Crown Corporation but rather is a public sector entity structured to compete on a more level playing field with its private sector counterparts.
- Establish the government backup guarantee for this new company affiliated with the CMHC as the equivalent of the terms accessible by private MI providers – the current 90 percent, or some other amount suitable to market needs.
- Continue to have the federal government set lending criteria for high-LTV loans to ensure in a market downturn that no one insurer suffers catastrophic losses.
- Take whatever additional steps may be feasible to help assure that the regulatory regime and regulatory requirements for the new public MI affiliate of the CMHC is equivalent to that of its private sector counterparts.
- Take whatever additional steps may be feasible to help assure that the tax burden on the new public MI affiliate of CMHC is equivalent to that of its private sector counterparts.

Adopting these changes would narrow significantly – though not entirely eliminate, given its substantial current market share – the substantial competitive public MI advantage which CMHC enjoys as a Crown Corporation.

In turn, the more level playing field realized from strengthening competition among MI providers should benefit Canada's moderate-income first-time homebuyers. This benefit to homeowners should occur as the competitive focus shifts from disparate "back end" guarantees and capital regulations to up-front borrower and lender costs, service and product choice. Another result may be a greater focus upon the needs of financially stressed borrowers, who need individual "workout" attention in order to help resolve their mortgage arrears without losing their homes. Private MI companies have been creative in finding solutions to the arrears problems of mortgagors. It is better for them to work out a mortgage loan than to have to foreclose on a property and potentially not recover their full loan and arrears.

The government's use of mandated MI on high-LTV loans with government backing of both public and private MI providers, combined with the financial regulator's authority to tighten or relax loan underwriting standards and limits as needed, are gaining recognition internationally as "best practice" options for maintaining a stable and robust system of housing finance. The incremental policy steps outlined above present an opportunity to make Canada's MI system even better.

About the author

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12 Le Goff, op. cit.

13 AIG United Guaranty, MGIC, PMI, and Triad

14 Private MI existed in the U.S. prior to this time, but all such companies failed in the Great Depression of the 1930s prior to the formation of the FHA.

15 See www.fha.com.

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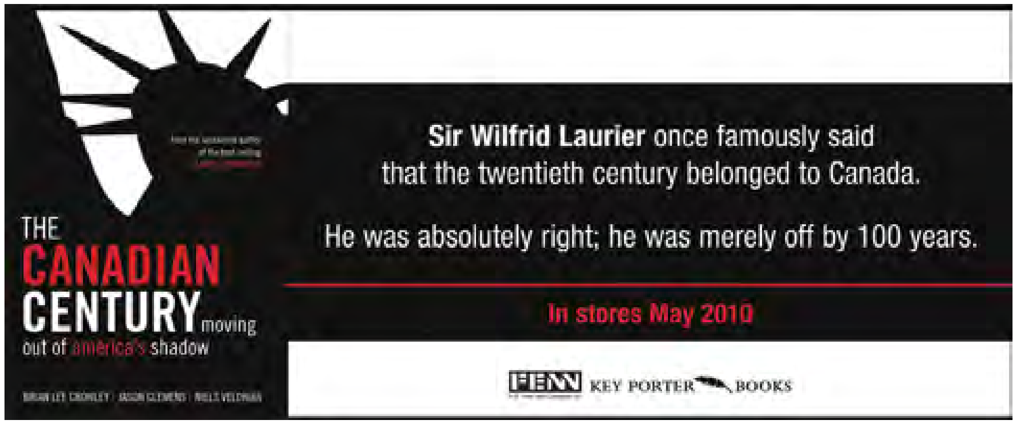

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