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True North In Canadian Public Policy

Straight Talk

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Jane Londerville on Mortgage Financing

In this instalment of Straight Talk, MLI talks to mortgage finance expert Jane Londerville about government backing for residential mortgages in Canada, including recent federal reforms to the Canada Mortgage and Housing Corporation (CMHC), the largest insurer of residential mortgages in the country.

Jane Londerville is an Associate Professor of Real Estate at the University of Guelph and the author of the 2010 study *Mortgage Insurance in Canada: Basically Sound but Room for Improvement* and *Briefing on the Canadian Mortgage Finance System (2012)*, published by the Macdonald-Laurier Institute.

MLI: In 2010 you wrote a paper for the Macdonald-Laurier Institute suggesting that although the CMHC and mortgage insurance in Canada was basically sound, there were some improvements that should be made. Let's start with a summary of those improvements.

Londerville: Let me start, as the MLI study did, by saying overall the system works really well right now because the federal government sets prudent criteria for loans to home buyers, offering assurance to both CMHC, with its status as a crown corporation, and the private insurers allowed to compete with CMHC. Canadian banks cannot lend to someone who has no documented income and have that loan insured. It just will not happen. We have been much more cautious than the U.S. in ensuring the ability to pay on the part of those seeking mortgage loans.

The main improvement I suggested, and still suggest, is to remove a troubling government-based distortion between private firms and the CMHC. Right now the government guarantees 90 percent of the value of mortgages insured by private companies but 100 percent of those insured by CMHC.

The result is simply not a level playing field, with results clearly visible in practice. Particularly during the financial crisis, we saw that CMHC continued to write mortgage insurance while there was a drop-off in what the banks sent to the leading private insurer, Genworth Financial Canada, because banks were so tight on capital that the extra capital reserves they had to hold to cover even that 10 percent guarantee gap made a substantial difference to them.

MLI: So the government should level the playing field for CMHC and private firms?

Londerville: Yes. Either all participants should be at 100 percent guarantee, or zero guarantee, or something in between. It could be the 90 percent private firms now get, if the mortgage insurance portion of CMHC was spun off. The key thing is that all participants should enjoy the same level of protection. Such a change would mean more competition in the mortgage insurance business. Right now, for instance, CMHC has about 70 percent of the market for mortgage insurance. This is not accounted for by differences in services provided by CMHC versus its competitors.

MLI: The 2012 federal budget did make some changes with respect to the CMHC, though not this one.

Londerville: Yes. CMHC mortgage insurance coverage has increased from $350 billion to $550 billion over a three-year period, so I am sure there is some concern about what exposure there is out there for the government. And one thing the government has done in response is to put CHMC under the supervision of the Office of the Superintendent of Financial Institutions, whose responsibilities already include federally regulated deposit-taking institutions like banks and credit unions, insurance companies, and federally regulated private pension plans. Given that CMHC's role has changed over the years so that much of their current role involves financial activities such as provision of mortgage insurance and packaging and sale of mortgage backed securities, this change in oversight seems appropriate.

MLI: Were these changes generally positive even if they didn't include the main one from your paper? For instance, there was a change in the treatment of "covered bonds". That's a bit technical, so please explain what they are, what the changes were, and whether they were good.

Londerville: Covered bonds are issued by banks and are a little bit like mortgage-backed securities issued by CMHC, but they are issued by banks. They are also similar to regular bank bonds, except instead of being backed by the overall credit of the bank they are backed by a particular, specified pool of mortgages the bank holds. So even if the bank went bankrupt, the owners of the covered bonds would have a direct claim on these actual mortgages, thus reducing their risk of loss. These are relatively new in Canada though they have been used in Europe for ages; there are now about $30 billion of them issued in this country.

MLI: So is the government changing the legislation for covered bonds as they become more important?

Londerville: Actually, the government did better than that. They've been saying we need to set up some legislation for this new financial instrument, and now they put some policies together and asked for consultation on them. So instead of just putting out legislation for people to start picking apart, they asked what they need in the legislation.

MLI: Are covered bonds backed by government-insured mortgages?

Londerville: This is an important question to which the government has answered "no". Some banks were actually paying premiums to insure mortgages that didn't legally need insurance, because the law only requires insurance if the home buyer is borrowing 80 percent or more of the value of the house. Insuring them made the bonds more marketable, especially on international markets. It is likely that the government restriction on including insured mortgages in covered bonds will have an impact on the banks' ability to sell these instruments and will increase rate of return they will have to provide to market them, making mortgage funds more expensive. However, some foreign investors are not permitted to buy covered bonds if legislation is not in place, so having the legislation is helpful. It is not clear whether the positive effect will outweigh the restriction on insured mortgages.

MLI: Should there be concern about the dramatic increase in insurance coverage by CMHC over the past 3 years, given the 100% backing?

Londerville: CMHC noted in their 2011 annual report that the average equity that borrowers in their insured loan pool have in their home is 44 percent due to repayment of principal over the years and increasing house values; this implies a loan-to-value ratio of 56 percent on average. In the 2011 annual report, CMHC reports that 75 percent of their loans are at less than 80 percent loan-to-value ratios based on current estimated home values and current loan balances. This indicates that concern about the amount of insurance in force rising so rapidly may be misplaced.

MLI: Changing direction slightly, I find it especially odd given this pattern of prudence that the federal Finance Minister recently said people were taking on too much debt, including mortgages, and that "I have tightened up the mortgage insurance market three times and I really do not want to do it again". He thinks that the banks are now tightening up. But what does he mean when he says he has tightened up the mortgage insurance market? And what can the Finance Minister do if he still thinks people are buying too many houses?

Londerville: They can adjust the rules for borrowing to buy a house. For instance, you used to be able to get a 40-year amortization period on your mortgage, for a short period of time, and they changed the regulations to cut it back to 35 years in October 2008 and then to 30 years in March 2011. Also, you used to be able to buy a house with a zero down payment, but in October 2008 the Finance Minister changed that and said you have to have 5 percent down. And you used to be able to buy a property to rent out to other people with 5 percent down, implying a 95 percent mortgage. In April 2010 that was raised to a minimum 20 percent down payment.

MLI: Is that in order to get government backing for your mortgage insurance, to get CMHC insurance, or just to insure your mortgage, period?

Londerville: These are all essentially the same. The banks are required to insure loans with less than a 20 percent down payment, through CMHC or a private insurer. The insurers won't write policies for which they can't get government backing and the government won't back insurance for loans where there's less than a 5 percent down payment (or 20 percent if it's to be rented not owner-occupied), so it's almost impossible to buy a house for yourself with less than 5 percent down payment or one to rent with less than 20 percent down. (In rare cases a bank actually might lend a very creditworthy borrower the remaining 5 percent at a higher rate, but that's not an issue for the vast majority of buyers.)

MLI: So essentially it is not legal to make excessively risky mortgages, because very risky mortgages must be insured by law, and the law says to get insured you must meet certain criteria that include avoiding too much risk.

Londerville: Right. And whether it was intentional or not, by (1) the government offering this 100 percent or 90 percent backing of these mortgage insurance companies and then (2) setting the criteria under which mortgages can be insured, while (3) requiring all mortgages where you're borrowing 80 percent or more of the value of the house to be insured, the mortgage finance system is very, very stable and safe for Canada.

MLI: Right, there is no Wild West out there.

Londerville: Yes, exactly.

MLI: I do have to raise one general question. Currently the government, explicitly to stimulate the economy by getting people to spend money by making it easier to borrow, is deliberately keeping interest rates low.

Londerville: Right.

MLI: Isn't it strange that they then turn around and worry that people are taking advantage of low interest rates to buy houses? After all, buying a house is meant to be one of the most sensible things you can do with your money.

Londerville: Clearly they are concerned about people taking out loans they can't afford to buy houses. That's why the other change they made, which was kind of sensible, was to say if you are going to get a short-term (say, one year) or variable rate mortgage and insure it, you have to qualify for that mortgage at the current 5-year interest rate which is going to be higher. The idea was you should be OK if rates went up when your short-term mortgage was up for renewal or if your variable-rate mortgage went up because they probably wouldn't go higher than the 5-year rate at least in the short run. Of course they could go higher, but it's still a bit of a safeguard.

In broader terms, the federal government keeps talking about the ratio of debt-to-GDP and debt-to-income (which reached 147 percent in 2011) and those kinds of things. Mortgage debt accounts for 2/3 of total debt and this proportion has remained relatively stable over time according to Statistics Canada. Certainly it could make lots of sense to buy an income property and get a mortgage at today's interest rates, rent it out and make money. If rates go way up, the ability to make the loan payments could be an issue for investors or home owners, but at the current time it makes economic sense to be borrowing at these interest rates.

MLI: Like anything else, your desire to do a thing does not change, but the probability to do it changes depending if the price goes up or down. If the price of buying a house goes down, taking into account the interest, then more people are going to do the math and rightly or wrongly say they can afford it.

Londerville: Right.

MLI: Having said that, do you think the mortgage market is, if it makes any sense to use this word, over-heated? Are you concerned that Canadians are getting too heavily into residential real estate?

Londerville: No. I think there are a couple of spots that are of a concern like the condo market in Toronto—I just cannot believe that they can just keep building those condos and selling them. And Vancouver is very expensive and it has gone up a lot in the last few years. But there have always been these kinds of particular issues. I am not particularly concerned about the overall housing market.

MLI: The last thing that I want to ask is, in addition to the things that you have already recommended in the papers you have written, what are the main practical things that you wish the government would do to improve the frame work for mortgage lending and borrowing in Canada?

Londerville: I would like to see something I'm told once existed in the United States, though I do not know if it is still a requirement; namely, if you are a relatively low income borrower trying to qualify for a mortgage you have to go through an education program. I think any first-time buyer really should go through an education process. It does not have to be enormously elaborate, but it should cover the true costs to home ownership that people might not be aware of: Not just the purchase price, which is pretty obvious but insurance, maintenance, property taxes, land transfer taxes, and all of that stuff that you do not know anything about the first time you buy a house.

I also think that while we've tinkered with lending criteria for a long time, we should step back and review the basics. Right now, banks use slightly different numbers but basically they want you to have a maximum 32 percent gross-debt service ratio, meaning the total of your mortgage payment and property taxes is under 1/3 of your gross income, and a 42 percent or so maximum total debt service, meaning your mortgage payments, property taxes and any other debt payments you have like credit cards doesn't exceed 42 percent of your gross income.

I do a whole long rant when I teach real estate finance to 19-year-olds at the university, asking if they would really want to borrow that much. Those numbers may have made sense decades ago but perhaps not in today's world, particularly if you are 25 years old and just starting out, maybe thinking about starting a family. In that case somebody is not going to be working for some time or else you'll have daycare costs, which are a little bit like another mortgage payment, but this is not factored in to the affordability calculations at all because they're not technically debt. Also taxes take more of your gross income than they used to and many people also have deductions for things like company pension plans.

MLI: So all this would justify banks reviewing their baseline numbers. Would it also go into the education process?

Londerville: Yes. The course should get people to ask themselves, how much take-home pay do I really have? How much of that is allocated to various things I want to continue doing or have to continue doing to earn my salary, like a GO Train pass or whatever? How much do I have left over, realistically, to make a mortgage payment with? If you are making $200,000, the 32 percent and 42 percent numbers are probably not a problem, but if you are making $60,000 between two people and one of them might be taking some time off to look after an infant, those numbers are pretty scary.

So people should look at those numbers and so should banks. I have never borrowed up to the currently approved levels and even so I sometimes did not have a lot of cash left over at the end of the month. I think we could maybe be looking at those and it is probably heresy to say it should be different numbers for different income levels, but that might be the case.

MLI: Who should deliver this education? Are you talking about people going into the bank and getting a half hour presentation or would an independent agency do it?

Londerville: On the whole I think it's better not to have the bank do it because it creates a bit of a conflict of interest since they want to lend you money, although not so much that you can't pay it back. So, I think it needs to be something more independent. There were independent debt counselling groups set up in the States to do this sort of thing, and some of it could be on-line as well as face to face. I know that Genworth Financial

Canada has some educational material on their web site (http://www.genworth.ca/homeownership/index.asp) as does CMHC (http://www.cmhc.ca/en/co/buho/index.cfm), but these are resources rather than required programs.

MLI: Would you make people write a test to prove they had assimilated the material before they got approved?

Londerville: Yes.

Recommendations:

- Level the playing field by extending the same degree of government guarantee to private as to CMHC mortgage insurers.
- Review basic bank lending criteria in light of modern economic conditions.
- Require first-time buyers to take independently delivered education programs on the full cost of home ownership.

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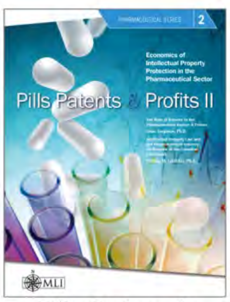

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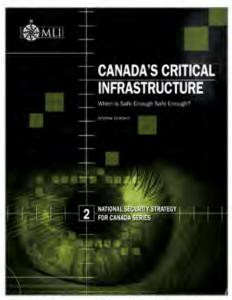

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Very much enjoyed your presentation this morning. It was first-rate and an excellent way of presenting the options which Canada faces during this period of "choice"....Best regards and keep up the good work.

—Preston Manning, President and CEO, Manning Centre for Building Democracy

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