MORTGAGE
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CANADA

# Mortgage Professionals Canada's Submission to the Department of Finance Re: *Balancing the Distribution of Risk in Canada's Housing Finance System*,

February 28, 2017

Mortgage Professionals Canada is Canada's mortgage industry association representing more than 11,500 individuals and over 1,000 companies. We have representation in every province and territory. Our membership includes mortgage brokers, mortgage lenders, mortgage insurers and industry service providers. As a result of this diversified membership, we are uniquely positioned to speak to issues impacting all aspects of the mortgage origination process.

Our membership plays a significant role in the Canadian housing market. To put this in perspective, the mortgage broker channel originates 33% of all mortgages in Canada and nearly 50% of mortgages for first-time homebuyers, representing approximately $80 billion dollars in annual economic activity. As a result, we are able to speak to the broad marketplace impacts of the federal government's consultation regarding lender risk sharing for government-backed insured mortgages.

First, we would like to thank the government for the opportunity to provide input into the decision-making process regarding risk sharing for government-backed insured mortgages. We strongly believe that any change to the mortgage finance system requires extensive industry consultations in order to ensure that the government understands the concerns of the industry, and the expected and potential implications of any changes made.

Before we begin with our comments on the specific risk sharing provisions, it is important that any discussion of risk sharing for government-backed insured mortgages include the implications of the recent changes that the government made to mortgage insurance and eligibility. This is because the market is still adapting to the October 3rd changes to mortgage insurance and eligibility, and the recent changes to Capital Adequacy for mortgage insurers set by OSFI. We believe, on the heels of these changes, that now is not the time for government to consider implementing further changes, especially initiatives focused on insured mortgages. Mortgage Professionals Canada presented a detailed submission to the Standing Committee on Finance in February that outlines in more detail how these changes are negatively impacting Canadian mortgage consumers, which can be found here.

Therefore, we argue that the proposed risk sharing for government-backed insured mortgages would be negative and detrimental to the financial stability and security of the Canadian housing market for the following reasons:

1. The current system is "sound, with strong foundations that promote financial stability, including robust regulation, prudential supervision of regulated financial institutions, and high underwriting standards"[1] and without a moral hazard problem.
2. The proposed model will increase the costs for insured mortgages and could create significant regional price disparities.
3. The proposed model could potentially increase the risk of insolvency for some lenders and fundamentally change the mandatory insured mortgage structure.
4. Finally, if the government is concerned about tax-payer risk and consumer indebtedness, continuing to target the insured mortgage space with national policies will further impact first-time home buyers who are not responsible for any distortions within the Canadian housing market.

[1] https://www.fin.gc.ca/activty/consult/lrs-prp-eng.asp

**Sound, financially secure, system with strong foundations**

The foundations of our mandatory mortgage insurance system are strong and Canadians enjoy "one of the most efficient and accessible housing finance systems in the world" (Department of Finance)[2]. The current structure has been serving Canadians and tax-payers well, with Canadians benefiting from a high percentage of home ownership, at 69%[3], which has been relatively stable for the last decade. This high rate of home ownership has benefited the middle class in Canada, with the average Canadian household having an estimated net worth of $726,000, which includes $263,000 in home equity. Net worth as a percentage of disposable income has reached a record high of 843%.[4]

Mortgage insurance pricing in Canada is backed by actuarial models and undergoes significant stress testing to ensure that insurers are adequately capitalized to withstand a housing crisis. CMHC, for example, confirmed in November that their "capital holdings are sufficient for even the most extreme scenarios"[5]. There is therefore scant evidence to suggest that the default risk exposure to the Canadian tax-payer warrants these significant alterations of the mortgage insurance model.

Canada benefits from having competition within the mortgage insurance industry by having three competing insurance companies; Genworth Canada, Canada Guaranty, and CMHC. This competition, in addition to strict regulatory criteria as prescribed by OSFI, helps ensure a very high quality of underwriting standards for insured mortgages. This high quality helps spread credit risk over the entire national portfolio, which provides transparency in mortgage pricing and access, and creates access at equivalent pricing for all areas of the country. A strength of this system is that it ensures that lending is available and consistent throughout the business cycle regardless of regional economic circumstance. Therefore, the current model appropriately finds the balance between providing access to affordable home ownership, while minimizing risk and preventing tax-payer exposure.

Because the community of mortgage insurers is quite small, we can verify that collectively, they have become very good at self-policing their space. In fact, our members tell us that insurers are able to track mortgage applications that get shopped around from lender to lender looking to get insurance on a loan. In instances where individual applicants for an insured mortgage are initially declined by a lender due to underwriting reasons - the insurer or the lender may refuse the loan because they deem it too risky - the same individual may attempt to go through another lender to try again. Insurers have some ability to keep track of this and will be vocal with lenders if they think the quality of the loans that they are sending for insurance are not good enough. This also assists with fraud prevention in the marketplace.

Therefore, the system is set up in such a way that there is a disincentive for lenders to bring riskier loans to the insurers. If a lender is seen to be repeatedly submitting "bad" loans, the insurer may decide to limit the amount of business they do with that lender. The purpose of articulating this is to demonstrate that there are significant checks and balances within the existing system, on top of OSFI's regulations; the industry itself safeguards against bad loans being insured and protects the system against moral hazards.

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[2] http://www.fin.gc.ca/consultresp/06rev_40-eng.asp
[3] https://www12.statcan.gc.ca/nhs-enm/2011/as-sa/99-014-x/2011002/c-g/c-g01-eng.cfm
[4] http://www.dbrs.com/research/303853/canadian-housing-indicators-q3-2016.pdf
[5] https://www.cmhc-schl.gc.ca/en/corp/nero/nere/2016/2016-11-17-0700.cfm

In fact, it is understood that one of the primary objectives of risk sharing is to mitigate or prevent moral hazard between mortgage insurers and lenders. But, we argue that there is no evidence that moral hazard exists within our current system and our members tell us that lenders use the same underwriting practices regardless of whether they retain the loan or insure it and or securitize it.

The consultation paper is looking for feedback on what the appropriate assessment and pricing of risks ought to be to support and strengthen the housing system. We believe that the current system is already appropriately assessing and pricing risk because the current market structure provides efficient sharing of losses due to the market-wide nature of the risk and the benefits of pooling this risk.

The main statistical evidence we have for this is the extremely low arrears rate in Canada. According to data from the Canadian Banking Association, as of October 2016 only 0.28%[6] of bank mortgages are in arrears. This is an extremely low amount, which would indicate that lenders and insurers are adequately and appropriately adhering to strong lending and insuring underwriting practices.

Looking at regional data, compiled by CIBC[7], the arrears rates in Atlantic Canada are the highest at close to 0.65%, followed by the Prairies and Alberta at between 0.4% and 0.45%. The arrears rate in Ontario is the lowest in the country at 0.14%, this means for every 10,000 home owners in Ontario, only 14 are in arrears. These data points clearly indicate that our mortgage financing system is strong and working well to serve both home owners and tax-payers.

**Increasing costs**

There is no question of whether costs would increase from the proposed risk sharing models, the only question is how much. In our view, the increased costs, increased regional pro-cyclicality and decreased competition for consumers do not justify the suspected outcome of a marginal benefit to tax-payer exposure. We are skeptical that the proposed model will indeed benefit tax-payers.

As the consultation document acknowledges this model could change the competitive dynamics in the mortgage market by disproportionately impacting smaller lenders who have few or less cost-competitive funding sources. As we have outlined above, the new mortgage insurance rule changes have already hurt the competitive position of smaller lenders and introducing risk sharing would further create significant pressures on smaller lenders' business models.

The impact that this would have on consumers would be twofold: an increase to prices and a decrease in accessibility. Lenders will have to significantly raise their rates in order to account for the additional risk placed on them, especially in areas with higher arrears rates, which indicated above are the Atlantic provinces and the Prairies. This will mean that many of the smaller lenders will either limit loan originations in these regions or increase their costs to a point that they are no longer competitive with larger lenders. Primary this is because there would be additional capital requirements for lenders. This will result in them decreasing how much they lend and increase their costs. This will impact lenders who currently operate nationally, but will have even greater impact on the regional lenders and credit unions across Canada. These institutions will become uncompetitive and/or be required to create regional based lending rates, which will place

[6] http://www.cba.ca/fast-facts-the-canadian-banking-system
[7] https://economics.cibccm.com/economicsweb/cds?ID=2272&TYPE=EC_PDF

additional financial burdens on the communities least able to afford to bear them. Ultimately, the consumer will bear these costs, which could have negative impacts on the broader economy.

We believe that the government's estimate that there will be a 30 bps increase in mortgage funding is low: most of the additional capital costs faced by lenders would directly translate into increased lending costs with little or no offset in lower insurance premiums. In addition, the administrative complexities associated with systems changes to implement risk sharing will be costly for lenders, resulting in additional costs that will be downloaded onto the insured consumer. When these cost increases are compounded with the cost increases associated with the October 2016 changes to mortgage insurance and eligibility, the government is at risk of creating a scenario in which their policies could result in an increase in interest rates that could cause the very pro-cyclical crisis it is attempting to avoid.

**Increased risk of insolvency for smaller lenders**

At this time, on the heels of the significant number of changes that have already been made with a presumed goal of ensuring marketplace stability, the introduction of risk sharing would be very detrimental to all lenders. As we have outlined, the imposition of additional costs to lenders would occur at a time when they could least afford it. We know from experience, and as we observed in the United States during their housing crisis, reduced access to housing finance exacerbated their recession. Here in Canada, there could be a risk of turning a slowdown into a crisis in short order. The proposed risk sharing models will further reduce competition and increase prices for consumers, immediately impacting those lenders who survived the first round of reduced competition from the mortgage insurance and eligibility changes, and OSFI's new capital requirements. What this will mean for consumers is yet another increase in mortgage rates driven by government policy, not the marketplace.

The imposition of these additional costs would likely cause many lenders to seriously reconsider whether or not they could still lend at a competitive rate in Canada. The structure of the risk sharing model, by leaving them on the hook for a fixed amount of a percentage of the default, would result in lenders bearing the first loss and increasing their risk of insolvency should large regional losses emerge. We are concerned that if there were to be a significant regional economic decline, that smaller more concentrated lenders would be at further risk of insolvency than under the existing model where risk is more broadly shared across the country. In an economically depressed area, regionally concentrated lenders could also face higher deposit withdrawal risks and deposit insurance risks because the local economy may not be able to fund the losses. The main driver of losses for small regional lenders and credit unions is not bad underwriting but rather job losses, thus mortgage insurance losses could compound this risk for lenders and add further pro-cyclical affects to the economy.

It is not just smaller lenders who would face this risk. While larger lenders may not be at the same risk of insolvency, they would still be negatively impacted by the structure of risk sharing. They may be forced to remove themselves from some markets as a result of losses, creating a diminished access to funds for communities that will need it the most. This could create mini-regional housing crises, where insurers, and ultimately tax-payers, now experience increased losses because of the risk sharing model. Instead of strengthening the current system, these proposed changes would weaken the structure and stability of our financial system and increase tax-payer exposure.

**Concern around indebtedness of insured mortgages**

The government is seeking feedback on whether risks in Canada's mortgage market are adequately priced and thus whether lenders are helping Canadians take on too much debt. The government has publically stated repeatedly that it is concerned about consumer debt levels in Canada and it is right to be concerned about the increasing loan-to-income or debt-to-income ratios as a sign of deteriorating household finance. However, it is our position that, given the overall health of the current mortgage system, the level of government concern seems unduly high. We would suggest an investigation into the impact of unsecured debt such as credit cards or car loans may be more appropriate if the government's aim is to improve the overall financial well-being of Canadians. Mortgages are backed by assets with a possibility to appreciate in value. Unsecured debt is not.

Canadian household net worth is increasing and is often missing when assessing the vulnerabilities around loan-to-income ratios. Laval University Economist Stephen Gordon has recently written, "increasing debt loads are not in themselves a sign of deteriorating household finances, especially when interest rates are falling".[8] Mr. Gordon does not dismiss the concerns that Canadian households should be reducing their leveraging ratios, but he points out that "asset holdings have grown more quickly, (than debt-income ratios), resulting in a deleveraging of household sectors balance sheet".[9] His view, which we share, is that focusing exclusively on the liabilities side of the household debt balance sheet is unsound and the conclusion should not be that we are in a position where debt is large enough be causing an economic catastrophe.

The Bank of Canada is often quoted raising the alarm regarding debt. But let's look at what they have actually said. Indeed, in their June FSR, they warned about increasing loan-to-income ratios and provided data that shows an increasing share of new mortgages have high loan-to-income ratios. This is a point we have heard the government cite repeatedly when asked the reason for the changes to mortgage insurance. However, what has been missing from this debate is a focus on whether this increase has been focused on insured mortgages or uninsured mortgages. The government has made significant changes to insured mortgages and the proposed risk sharing would be further focused on the insured space, but is this loan-to-income concern only occurring in the insured space?

The answer to that is not really. In fact, the proportion of mortgages with loan-to-income ratios greater than >450% of income increased for insured mortgages from 16% to 21% from 2014-15; whereas the increase for uninsured mortgages increased from 19% to 24%. [10] Therefore, the rate at which the increase in the loan-to-income ratio is increasing is the same regardless of whether the mortgage is insured or not and the percentage of total mortgages that have a loan-to-income ratio greater than 450% is actually higher among uninsured mortgages. Given these statistics, it is unclear how restricting access to mortgage funding for insured mortgages impacts the debt accumulation in the uninsured space.

Finally, the Bank of Canada, using Department of Finance data, provides a helpful breakdown of the regions where the proportion of insured mortgages have been rising the most[11].

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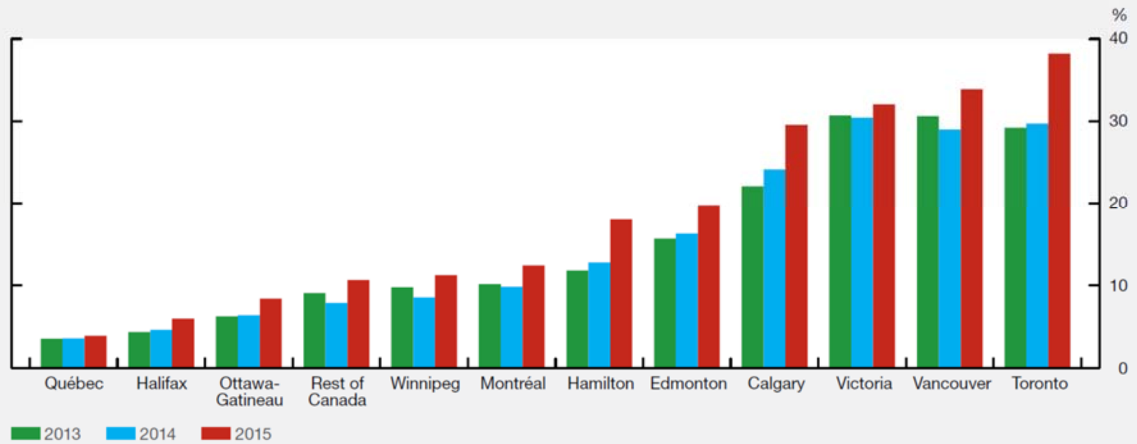
[8] http://news.nationalpost.com/full-comment/stephen-gordon-our-debt-binge-myth
[9] Ibid.
[10] http://www.bankofcanada.ca/wp-content/uploads/2016/06/fsr-june2016.pdf page 11/12
[11] Ibid.




This chart clearly shows that largest increases in the loan-to-income ratios are regional in nature and limited to major urban areas, most notably Toronto, Vancouver, Victoria and Calgary. This challenges the notion that there is a systemic problem across Canada requiring national changes to the insured mortgage market. If the real concern is the proportion of insured mortgages with high loan-to-income ratios, we believe the focus should be on developing a targeted approach to these regions. This is because the areas of the country that are most likely to suffer the greatest negative consequences of risk sharing (those with higher arrears rates) are not the ones that have the highest loan-to-income ratios, with the exception of Calgary.

If the concern is specifically loan-to-income ratios, then changes should be made to protect the entire market, not just the insured market. Following the changes to mortgage insurance eligibility in October and the increase in premiums for mortgage insurance created by OSFI's increased capital adequacy requirements in January, the proposed risk sharing policies could be the third successive change to disproportionately impact first-time home buyers. We do not believe its introduction would actually protect the marketplace to any greater degree than the existing model in place.

**Conclusion**

In conclusion, the proposed risk sharing models for government backed mortgage insurance would negatively affect Canada's smallest communities that have the weakest economies and housing markets in a disproportionate way. The trickle down impact of the proposed model will negatively affect Canadian consumers who benefit from the value of the mortgage broker channel. Canadian consumers, especially first-time home buyers, have been more and more inclined to use the services of a mortgage broker to provide choice, advocacy and support, and to assist in the technical requirements of mortgage qualifications.

The Canadian economy saw only modest growth in 2016, especially for the middle class, and the housing sector is one of the few strong performers that has been driving this growth. The Bank of Canada notes that the new rules being imposed will reduce growth in the Canadian economy, which

will hurt the middle class and risk sharing would magnify these concerns.[12] Given the global economic uncertainty and the risk that the new United States President's protectionist economic policies could have on the broader Canadian economy, we do not believe this is the right time for further action in the Canadian housing market.

Risk sharing is an unnecessary step to take in a mortgage market that is already the envy of the developed world for its sound fiscal security. Canada escaped a housing market collapse during the global economic downturn because of our strong fiscal and prudential policies, which provide stability over the business cycle for all regions in Canada. Risk sharing would reduce competition and increase prices for middle-class Canadians, while creating distortions in the regulatory framework that will undermine the stability and security of our financial system. We do not believe there is sufficient, if any, benefit to its introduction compared to the structures already in place in Canada's regulatory system and would put the housing market and financial system at risk.

[12] http://www.bankofcanada.ca/wp-content/uploads/2016/10/mpr-2016-10-19.pdf

MORTGAGE PROFESSIONALS CANADA — PROFESSIONNELS HYPOTHÉCAIRES DU CANADA

**About Mortgage Professionals Canada:**

Mortgage Professionals Canada is Canada's mortgage industry association representing 11,500 individuals and 1,000 companies. We have representation in every province and territory. Our 11,500 members include mortgage brokers, mortgage lenders, mortgage insurers and industry service providers. As a result of this diversified membership, we are uniquely positioned to speak to issues impacting all aspects of the mortgage origination process.

**Vision Statement**

To be recognized as the premier voice of Canada's mortgage broker channel and the leading authority on mortgage issues.

**Mission Statement**

To provide leadership, advocacy, education and information to ensure successful collaboration between the association, its members, regulators, and mortgage consumers.

**Objectives**

In order to help ensure an effective and efficient mortgage marketplace, Mortgage Professionals Canada works to:

- Promote consumer awareness of the benefits of dealing with the mortgage broker channel
- Advocate for member interests on legislative and regulatory issues
- Develop, monitor and promote responsible mortgage industry standards and conduct
- Deliver best-in-class training for mortgage professionals
- Provide timely and relevant information to members and mortgage consumers

**Our Proud History**

- Founded in 1994, Mortgage Professionals Canada (formerly CAAMP) draws its members from all segments of Canada's mortgage industry
- Mortgage Professionals Canada is actively involved in delivering professional development opportunities and hosts regional and national events across Canada
- Mortgage Professionals Canada serves as the industry voice with government, media and regulators
- Mortgage Professionals Canada's objective is to ensure the Canadian mortgage industry evolves into full professional status supported by the highest standards of professional practice
- In 2004, Mortgage Professionals Canada launched the Accredited Mortgage Professional (AMP) designation as part of an ongoing commitment to the Canadian mortgage industry
- Mortgage Professionals Canada consider it an obligation to arm its members with timely industry statistics, publications and research reports