Consultations on Lender Risk Sharing for Government-Backed Insured Mortgages

Submission to the Department of Finance

Prepared by Canadian Bankers Association

February 28, 2017

The Canadian Bankers Association (CBA) is pleased to present the views of the banking industry as part of the Department of Finance's *Consultations on Lender Risk Sharing for Government-Backed Insured Mortgages*.

The CBA works on behalf of 61 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The CBA also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness.

Overview

As outlined in the *National Housing Act* (NHA), the federal government's underlying objective for mortgage default insurance is to expand access to residential mortgage financing and homeownership. As significant mortgage lenders in the country, banks play a major role in realizing this objective by originating and underwriting insured mortgages.

It is the banking industry's view that mortgage default insurance – while facilitating expanded access to housing – is not a substitute for sound underwriting practices and appropriate due diligence and risk management. Banks in Canada are prudent lenders that manage risk carefully. They closely monitor housing market conditions as well as household debt levels to ensure that Canadian households can continue to effectively manage their financial obligations. Banks undertake extensive stress testing on their mortgage portfolios to ensure that their clients have the ability to repay their loans even if interest rates increase.

The federal government has proposed a policy of lender risk sharing through a deductible on insured mortgages that default. A deductible would, the Consultation Paper argues, ensure that the incentives of all parties to an insured loan are aligned. This alignment, it is suggested, would support the appropriate assessment and pricing of risks and achieve ancillary objectives, such as reducing taxpayer exposure or rebalancing the distribution of housing risk between public and private sectors.[1]

The banking industry questions whether a deductible is the most effective way to achieve these objectives given the already prudent approach banks take in underwriting insured mortgages, and ongoing shifts in the nature of mortgage risk due to market and regulatory changes. The industry believes that policy alternatives should be considered that achieve the same ends, but are simpler and less disruptive to the existing lending structure, while continuing to meet the objectives of the NHA.

This submission outlines a number of issues that the federal government should consider when assessing whether to introduce a lender deductible on insured mortgages.

[1] International Monetary Fund (IMF) Country Report No. 14/29, p.15.

Lender risk sharing, through a deductible, would have many implications that could undermine the objectives of the NHA. As lenders account for higher expected losses, borrowers are likely to face higher costs and/or reduced credit availability. The impact would be particularly acute for first-time homebuyers. Regionally, it would have a disproportionate effect on Canadians living in rural or remote areas and single-industry towns where housing markets tend not to be liquid (particularly in times of economic stress). It would also have a proportionally greater impact on certain housing types (e.g. mobile homes and small condos). Some of the borrowers affected may migrate to the shadow/private lending marketplace, where there are fewer consumer protections.

A deductible would also disproportionately disadvantage regional and smaller lenders who are more reliant on insured mortgages, leading to reduced competition in the mortgage marketplace. In the long run, this could harm Canadians by making the financial system less competitive, innovative, equitable and efficient. It would also have pro-cyclical implications, particularly with respect to credit availability during times of economic stress. Moreover, implementation of a deductible would also carry significant operational costs. And as a structural reform, it would be difficult to reverse, even if unintended or negative consequences emerge.

Canada's housing finance system has demonstrated considerable resilience and stability over time. The historical success of Canada's system creates a strong presumption in favour of existing arrangements – any major structural deviation should therefore be as evidence-driven as possible, and conditioned on a fair appraisal of long-term implications for households, lenders and the broader economy.

The introduction of a deductible would represent one of the most significant structural changes to Canada's housing finance system in half a century. It is therefore imperative that the federal government be able to demonstrate that the full cost of implementing a deductible would result in even greater benefits to Canada's housing finance system, and that no obvious alternative could achieve similar net benefits. A deductible would add a degree of complexity and uncertainty to a system that has hitherto worked simply and efficiently, and served Canadians well – including during the most recent global financial crisis.

This document is structured as follows:

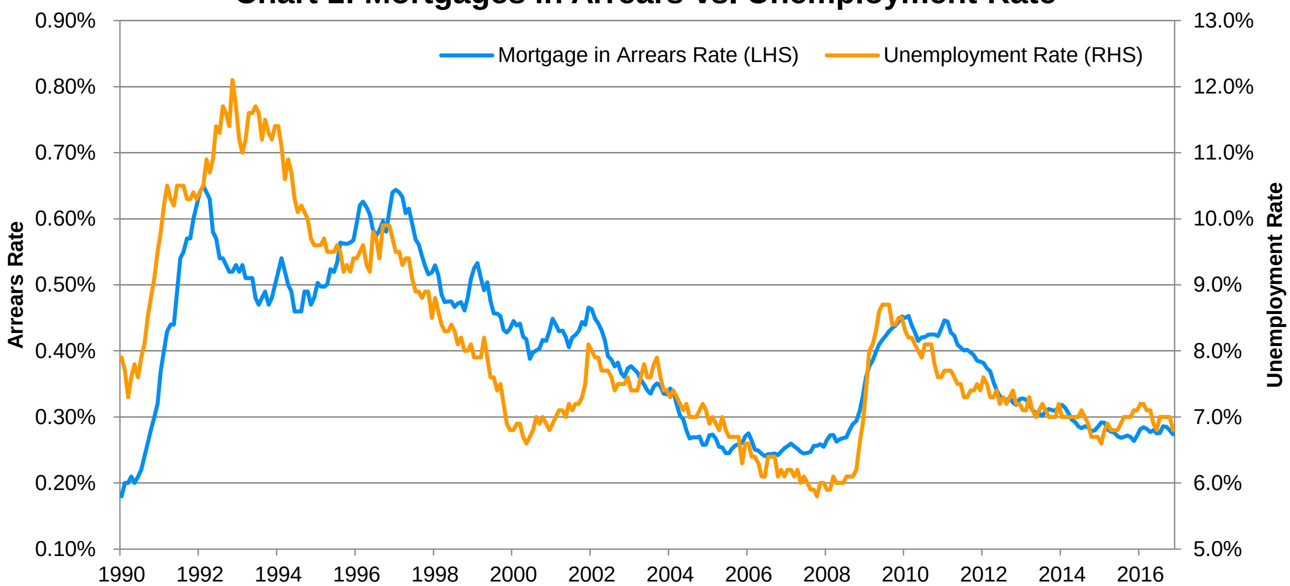
- **Section 1** reviews key aspects of Canada's housing finance system and their relevance to lender risk sharing. It also considers banks' role in mortgage insurance, and how Canada's housing finance system has evolved since the financial crisis.
- **Section 2** discusses the lender-risk sharing proposal and raises some concerns around its purpose, design, and long-term implications. Particular attention is paid to the key considerations highlighted in the Consultation Paper on mortgage pricing, lender competition and financial stability. A couple pragmatic alternatives to a lender deductible are also discussed.

Section 1. Canada's housing finance system: a source of growth and stability

Canada's system of housing finance has been a source of economic growth and financial stability for over 60 years. Currently, the Canadian bank mortgages in arrears rate is 0.28% (a mortgage is considered to be in arrears if the borrower is more than 90 days behind on their mortgage payments). Since the 1990s, the rate in Canada has never climbed higher than 0.65%. This represents over two decades of stability, in times of both high and low unemployment and interest rates as well as a fluctuating Canadian dollar.

Because of prudent bank lending practices combined with a strong housing finance system, it has been the industry's experience that economic conditions – and unemployment in particular – have historically had the greatest influence on arrears rates (see **Chart 1**).

Chart 1: Mortgages in Arrears vs. Unemployment Rate

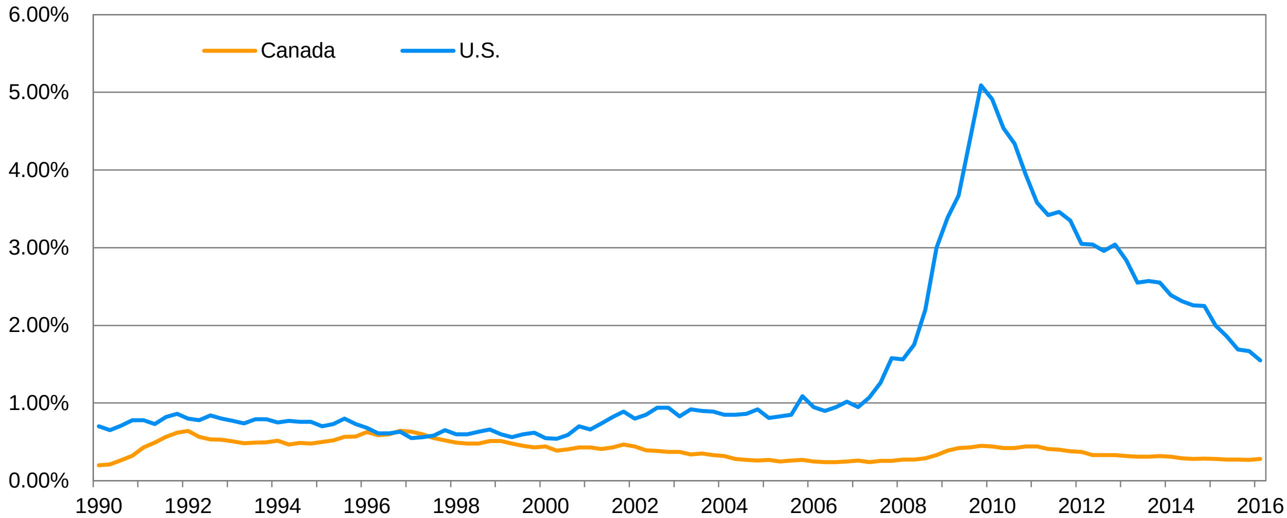


Source: CBA, Statistics Canada
Includes data from BMO, CIBC, HSBC Bank Canada, National Bank of Canada, RBC Royal Bank, Scotiabank, and TD Canada Trust. Canadian Western Bank, Manulife Bank (as of April 2004) and Laurentian Bank (as of October 2010)

At the onset of the global financial crisis, the International Monetary Fund (IMF) described Canada's market for housing finance as "sophisticated and highly advanced" with Canada's financial system demonstrating "remarkable stability".[2] The financial crisis highlighted the strengths of the Canadian model. While the housing finance systems of some jurisdictions created problems, Canada's system was a source of stability. When mortgage delinquencies spiked during the financial crisis in the U.S., the arrears rate in Canada remained steady and was an order of magnitude lower (see **Chart 2**).

[2] Vladimir Klyuev, Show Me the Money: Access to Finance for Small Borrowers in Canada, IMF Working Paper WP/08/22, January 2008.

Chart 2: Mortgages in Arrears - U.S. and Canada



Source: CBA, Mortgage Bankers Association
Includes data from BMO, CIBC, HSBC Bank Canada, National Bank of Canada, RBC Royal Bank, Scotiabank, and TD Canada Trust. Canadian Western Bank, Manulife Bank (as of April 2004) and Laurentian Bank (as of October 2010)

Furthermore, both during the financial crisis and the recovery that followed, mortgage lending in Canada continued to grow and support the economy. Between 2008 and 2011, mortgage lending in Canada grew 32%. To put this into context, over the same period, in the United Kingdom mortgage lending grew by only 4% and in the United States mortgage lending fell by 9%. The stability of Canada's housing finance sector contributed a shorter and shallower recession in Canada than those experienced in the U.K. and U.S.

Mortgage default insurance: origins and purpose

As highlighted in the Consultation Paper, the federal government's role in housing is guided by the objectives of the NHA, with the Canada Mortgage and Housing Corporation (CMHC) implementing these objectives, in part, through its supply of mortgage default insurance.

Mortgage default insurance protects lenders and investors against losses due to borrower default, while expanding access to home mortgage financing and homeownership.[3] For instance, it helps lenders extend home financing to remote and/or rural areas, where property markets tend to be illiquid.[4] By insulating lenders against credit risks, mortgage default insurance also serves to stabilize an economy's financial sector, particularly in times of economic stress.[5] Mortgage default insurance also helps grow capital market opportunities for mortgage funding, stimulates economic activity through increased housing construction and activity, and strengthens mortgage lending standards

---

[3] Roger Blood, Mortgage Default Insurance: Credit Enhancement for Homeownership, Housing Finance International.
[4] Indeed, according to Statistics Canada, Canada has a homeownership rate is 69% - similar to that of Australia, and higher than that of the U.K. (64%) and the U.S. (63%).
[5] Roger Blood, Mortgage Insurance; http://hofinet.org/themes/theme.aspx?id=52

and stability. It is a policy instrument used in more than thirty countries around the world, including Australia, New Zealand, the U.K., the U.S., Hong Kong and South Africa.

The current mortgage insurance system was established by the NHA in 1954, whereupon CMHC introduced mortgage loan insurance for borrowers with a down payment of 25% or less for the purchase of new homes. The basic purpose was to make home ownership more accessible. While its intent remains the same, the program's characteristics have since evolved: the current rules state that mortgages made by federally-regulated financial institutions (such as banks) with a loan-to-value ratio (LTV) of 80% or over must be insured against borrower default throughout the life of the mortgage. Federally-regulated financial institutions may also require mortgage default insurance when a borrower has less than an 80% LTV, if the property is in a remote location or if the borrower is qualifying under a special program considered higher risk. Mortgage default insurance is supplied by either the CMHC or one of two private mortgage insurers – Genworth or Canada Guaranty.[6] Mortgage insurers are regulated by the Office of the Superintendent of Financial Institutions (OSFI).

In order to qualify for mortgage default insurance, potential borrowers must abide by certain requirements around the value of the home, credit score, source of down payment, and debt servicing capacity. The insurance covers the difference between the borrowers' outstanding debt and the realizable value of the collateral property securing the mortgage. It also covers certain other default costs (e.g. legal fees, property maintenance and disposal) up to certain limits. The premium varies by LTV and product, is paid by the borrower to the lender (which is then passed on to the mortgage insurer), and is typically added to the principal amount of the loan and repaid over the same amortization period.

Under the current structure, CMHC receives a 100% guarantee from the federal government, while Genworth and Canada Guaranty receive a 90% federal guarantee. The guarantees are exercised in the event of an insolvency. Because of its role as guarantor, the federal government has the authority to set underwriting criteria for insured mortgages. For the benefit of this guarantee, CMHC and the private mortgage insurers pay a risk fee to the federal government of 3.25% and 2.25% of premiums written, respectively. Under OSFI's Capital Adequacy Requirements, CMHC-insured residential mortgages held by banks are assigned a low risk weight. For those mortgages insured by the private mortgage insurers, banks must set aside capital to cover the 10% portion of the remaining exposure.

Role of banks in mortgage default insurance

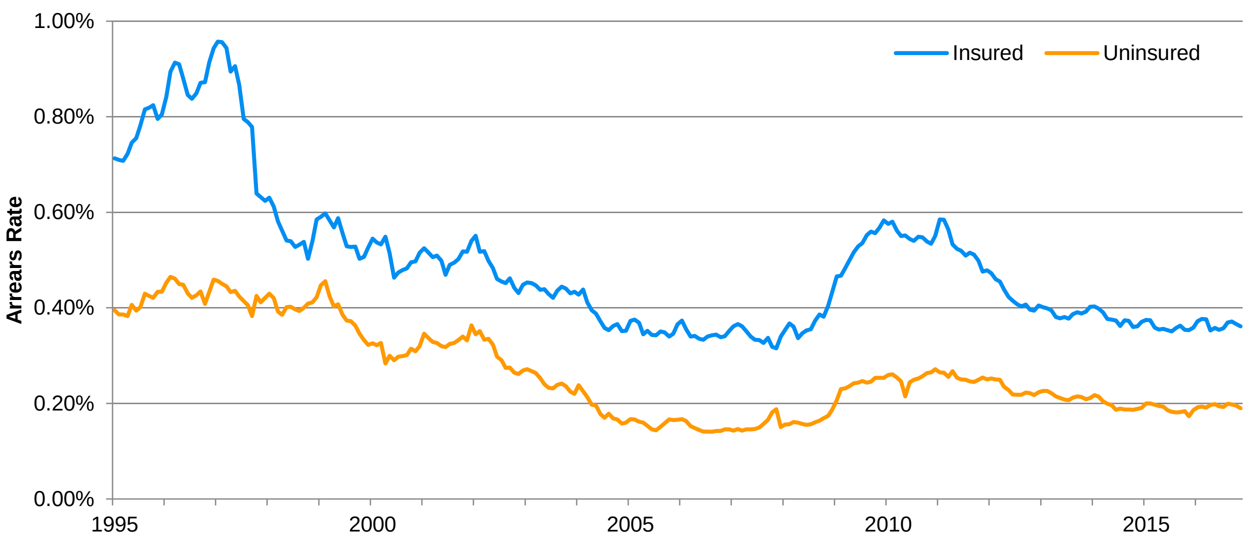
As mentioned earlier, the underlying objective of mortgage default insurance is to expand access to home mortgage financing and homeownership. As the primary mortgage lenders in the country, banks have a major role to play in realizing this objective through the origination and underwriting of insured mortgages. It is the banking industry's view that mortgage default insurance – while facilitating

[6] As mentioned, the requirement had been set at 75% of LTV but was increased to 80% as part of the 2006 review of federal financial institutions framework after releasing a consultation paper that proposed removing the restriction on the basis it may have increased the cost of ownership for some Canadians (see: Budget 2005 Annex 6. An Effective and Efficient Legislative Framework for the Canadian Financial Services Sector). The original intent of the restriction was to protect financial institutions from the risk of fluctuating property values.

expanded access to housing – is not a substitute for sound underwriting practices and appropriate due diligence and risk management.

It has been suggested by some that, with respect to insured mortgages, banks and other lenders do not have "enough skin in the game". But such a view neglects the public policy objective of mortgage default insurance: to expand access to housing through the relief of credit risk of lenders.[7] Moreover, banks and other lenders are exposed to material risks and costs on insured mortgages in a number of ways. With around $1 trillion in both insured and uninsured mortgages outstanding, banks have a strong incentive and interest in ensuring that Canada's mortgage market remains healthy, sound and safe. Indeed, banks' policies and practices are largely consistent for insured and uninsured mortgages throughout the origination, adjudication, underwriting and collection cycles.[8] This system has contributed to low arrears rates across the banking industry for both insured and uninsured mortgages (see **Chart 3**)[9], as well as low loss ratios for the mortgage insurers.

Chart 3: Mortgages in Arrears - Insured* vs. Uninsured Mortgages



Source: CBA
*Note: Insured mortgages include portfolio insured mortgages as well as high ratio mortgages
Includes data from BMO, CIBC, HSBC Bank Canada, National Bank of Canada, RBC Royal Bank, Scotiabank, and TD Canada Trust. Canadian Western Bank, Manulife Bank (as of April 2004) and Laurentian Bank (as of October 2010)

Banks are already incented to properly originate, adjudicate and underwrite insured mortgages as deficient practices can result in claim rejection, and if these deficiencies persist, lenders risk the denial of new mortgage default insurance as well as rejection of new NHA Mortgage-Backed Security (NHA MBS) guarantee approvals.[10] Furthermore – as has already been highlighted – for those mortgages

[7] Indeed, Canada is not alone in using fully insured mortgages to expand access to homeownership. According to the Reserve Bank of Australia (Financial Stability Review, September 2013), other jurisdictions have fully insured mortgages such as Australia, New Zealand, and the Netherlands.

[8] Where there are differences between insured and uninsured mortgages, they exist because applications are assessed not just based on their own underwriting criteria but also that of the mortgage insurer.

[9] The average difference since 1995 in arrears rates between uninsured and insured mortgages is 23bps. The higher arrears rates for insured mortgages is on account of the higher LTVs that the mortgages are originated at.

[10] NHA MBS issuers are required to keep the 90-day delinquency rate in their mortgage pools below 1%. If delinquencies exceed this amount, issuers can lose access to new NHA MBS guarantees.

that are insured by private mortgage insurers, banks must set aside capital for the portion of the mortgage that is not government guaranteed.

Banks are also exposed to a number of costs that are not covered by mortgage insurance. These include: legal costs[11], customer servicing costs, property insurance/maintenance/taxes/heat[12], real estate commissions, property inspections upon vacancy, and collection expenses (such as customer touch points, negotiation and resolution). At a more general level, lenders have a strong incentive to prevent customer mortgage defaults, since this is typically accompanied by the loss of the customer's deposits, investments and other lending business.

The lender risk sharing proposal has been premised on the existence of poor risk management practices. However, there is no evidence to indicate such poor practices exist. Importantly, this suggests that the converse is also true, namely that the evidence does not appear to support the notion that risk management practices would be significantly enhanced under a lender risk sharing regime. Deductibles are typically implemented to change the behaviour of economic actors, but there is no evidence that a change in bank behaviour is needed and that a deductible is necessary. If ancillary objectives for lender risk sharing – such as reducing taxpayer exposure or reigning in household debts – are implicitly primary motives for reform, then policies targeting these concerns directly would likely be more appropriate and effective.

The question is not whether lenders should undertake a deductible. The real question is whether the benefits of a deductible to the housing finance system and overall economy outweigh its costs (including reduced access to and/or higher cost credit). The introduction of a deductible would represent a significant structural change to the current housing finance system that would be difficult to reverse. A deductible would add complexity and uncertainty to a system that has hitherto functioned simply and efficiently, and benefitted Canadians both socially and economically.

An evolving housing finance environment

With the objectives of containing risks in the housing market, reducing taxpayer exposure and supporting long-term stability, the federal government has made a number of recent changes to the housing finance system, while others are still in the process of being implemented (see *Appendix 1* for a list of reforms since the global financial crisis). These changes have resulted in a slower rate of mortgage lending growth, a shift in activity from CMHC to the private mortgage insurers, larger capital buffers for mortgage insurers and stronger insured mortgage portfolios. Indeed, these results address the issues the IMF highlighted when they first suggested changing the mortgage insurance product to involve more risk sharing, particularly their recommendation around increasing the market share of private mortgage insurers.[13]

---

[11] CMHC last updated its schedule for legal cost allowances in September 2006.

[12] While CMHC increased its property management fee allowance in July 2016, lenders will be exposed to losses on property management files that extend beyond a certain period of time.

[13] International Monetary Fund (IMF) Country Report No. 14/29, p.15.

During the financial crisis, mortgages outstanding grew annually by 13%. Partly as a result of the changes so far, mortgages outstanding are now growing about 5% a year[14] with most of this growth occurring in uninsured mortgage portfolios. This growth is reflected in the changing composition of bank mortgage portfolios. For instance, in 2011 insured mortgages made up about 60% of banks' total mortgage portfolios. This proportion has decreased to about 50%.[15] And currently, of borrower-initiated transactional mortgages, less than one-in-five are insured, down from 40% prior to the financial crisis.[16]

Furthermore, of the insured mortgages being originated, a greater proportion are being insured by private mortgage insurers. This shift towards private mortgage insurers has meant that banks have had to allocate greater capital to cover the portion of the insured mortgage not covered by the government's guarantee. In a recent speech, the CEO of CMHC noted that CMHC's market share has declined from approximately 85% in 2009, to about 50% in 2015.[17] In the first three quarters of 2016, CMHC's market share fell to around 46%.[18] As a result of CMHC insuring fewer mortgages than are expiring, the overall size of CMHC's insurance-in-force has declined from a peak of $567 billion in 2011, to $514 billion in August 2016, which has led to the overall stock of mortgage insurance shifting towards private mortgage insurers. Private mortgage insurers have increased their insurance-in-force from $266 billion to approximately $505 billion over the same period. CMHC's proportion of total insurance-in-force has declined from approximately two-thirds of the market in 2009, to 54% in 2015, with private mortgage insurers filling the void.[19]

In addition to the equity that the borrowers of insured mortgages have built up as a result of paying down their mortgages, mortgage insurers[20] themselves have built up capital buffers insulating the federal government from exposure to the mortgage market. For instance, in 2008, CMHC and Genworth had a combined capital base available for mortgage insurance of approximately $9.2 billion. As of August 2016, their combined capital base had grown close to $22 billion – an increase of 138%. In comparison, the insurance-in-force of both mortgage insurers had grown 55%. In other words, CMHC and Genworth had twice as much capital backing insured mortgages in 2016 than they did in 2008. With this expanded capital base, CMHC has recently stated that its capital holdings are sufficient for even the most extreme scenarios, such as a U.S.-style housing correction, an earthquake or an oil price shock.[21]

This growth in capital is the result of mortgage insurers consistently taking in more premiums than they pay out in claims. Since 2005, CMHC has received over $19.5 billion in premiums and fees,

[14] Martin Kuncl, Assessment of the Effects of Macroprudential Tightening in Canada, Bank of Canada Staff Analytical Note 2016-12.

[15] OSFI Regulatory Reports.

[16] Conversations with bank representatives.

[17] "Why Housing Matters to Canada's Financial Stability: Insights on Housing Market Risks and CMHC's Financial Stability Role" C.D. Howe Institute Roundtable Luncheon, March 16, 2016.

[18] Public disclosures of Mortgage Insurers, CBA Estimates.

[19] It is important to note that headline insurance-in-force volumes sometimes reflect the total amount of mortgages insured at origination and do not always account for the current outstanding balance of insured mortgages that is the result of borrowers paying down their mortgages and, correspondingly, increasing the equity in their homes. Hence, actual exposure from a taxpayer perspective is less than some headline insurance-in-force numbers might suggest. For instance, in 2015, Genworth reported that while its insurance-in-force was $405 billion, the outstanding balances of insured mortgages was approximately $184 billion.

[20] As a result of public disclosure, the focus on much of this section is on CMHC and Genworth.

[21] For more information on CMHC's stress tests, see: https://www.cmhc-schl.gc.ca/en/corp/nero/nere/2016/2016-11-17-0700.cfm

while paying out only $4.9 billon in claims. Similarly, over the same period of time, Genworth has earned $6.2 billion in premiums, while paying out $1.7 billion in claims. Together, this means that, since 2005, the difference between premiums earned by the two largest mortgage insurers and claims paid out was close to $20 billion.

The quality of insured mortgage portfolios has also improved. For instance, the arrears rates for both CMHC and Genworth have declined from their peaks during the financial crisis. CMHC's mortgages in arrears rate has declined from 0.47% in 2009 to 0.32% in September 2016, while Genworth's mortgages in arrears rate has declined from 0.28% to 0.10% over the same period. These arrears rates are even more impressive when the 12-month delinquency rates for insured mortgages are assessed. According to Genworth, while 0.15% of mortgages went into arrears within the first twelve months of being underwritten in 2007, the figure dropped to 0.02% in September 2016.[22] Similarly, Genworth reports that credit scores for transactional new insurance written have improved significantly from 716 in 2007 to 752 in September 2016 – with similar experiences reported in the Greater Toronto (GTA) and Greater Vancouver Areas (GVA).[23]

The federal government has implemented a number of housing finance changes that have resulted in a slower rate of mortgage lending growth, a shift in activity from CMHC to the private mortgage insurers, larger capital buffers for mortgage insurers, and stronger insured mortgage portfolios. Furthermore, updated standardized capital requirements for mortgage insurers have led them to increase their insurance premiums.[24] The regulatory capital requirements for deposit-taking institutions using internal models for mortgage default risk have also been updated. This means that, moving forward, capital levels will be impacted by increases in local property prices and/or to house prices that are high relative to borrower incomes.

In addition to these regulatory trends, the market has seen interest rates increase since November 2016. Despite the Bank of Canada holding the overnight rate at 0.5%, 5- and 10-year Canadian bond yields are up approximately 35bp and 45bp, respectively. This increase in the funding costs of mortgage lenders has already been passed on to mortgage borrowers through higher mortgage rates. Borrowers are highly sensitive to this rise in longer-term interest rates and commentators suggest that any further increases in the period ahead pose a material risk to housing affordability in the short- to medium-term. Increased global economic uncertainty is also a risk factor.

As a result of these regulatory and market changes, some lenders have already started to adjust their pricing structures to make mortgage pricing more risk-sensitive. For instance, in their mortgage pricing strategies, some lenders are taking into account the length of amortization. The effects of recent regulatory changes, in combination with higher interest rates, will make the purchase of a home more expensive due to higher and more risk-sensitive mortgage insurance premiums and mortgage interest rates. This will likely lead to further slowdown in mortgage growth and shift in insurance activity towards private mortgage insurers.

[22] Genworth Canada, 2016 Investor Day Presentation, Slide 23.
[23] Ibid, Slide 21.
[24] On January 17th, 2017, CMHC announced an increase to mortgage insurance premiums as a result of OSFI's new capital requirements that came into effect on January 1st. Genworth and Canada Guaranty followed. These premiums will be effective March 17th, 2017.

Given the already prudent approach banks take in underwriting insured mortgages, and ongoing shifts in the nature of mortgage risk due to market and regulatory changes, the banking industry questions whether a deductible is the most effective way to further the government's objectives. It would add further uncertainty to a rapidly evolving housing finance system, one that is changing in ways that may affect the government's original motives for reform.

Section 2. Considerations when implementing a deductible

This section discusses implications of a lender deductible on the supply and pricing of insured mortgages, lender competition, and housing market and financial stability.[25] It then considers several operational implications for lenders. It concludes by suggesting a couple pragmatic alternatives whose implementation would be simpler and less disruptive to the existing lending structure.

Implications for mortgage pricing, lender competition and financial stability

The implementation of a lender deductible would lead to a fundamental shift in the way lenders view high ratio lending with implications for mortgage pricing, lender competition, and financial stability.

Mortgage supply and pricing

A deductible would expose lenders to a higher level of loan losses than they were exposed to previously. This would require lenders to institute higher and more risk-based pricing or up-front fees for insured mortgages (as costs are passed on to borrowers) and/or lead to a reduction in lending. Bearing the brunt of this change would be first-time homebuyers, Canadians living in rural or remote areas and single-industry towns, and owners of certain types of housing (e.g. mobile homes and small condos). Canadians living in poorer economic regions where there is high/growing unemployment and/or declining populations are particularly exposed to this change (for some descriptive statistics on these communities, see *Appendix 2*). As lenders become more sensitized to the risk of property price declines in certain communities, the price on offer for insured mortgages is likely to decrease, potentially setting up a downward cycle of reduced demand and further property price declines. As alluded to earlier, all this has the potential to run against the spirit of CMHC's public policy mandate to provide access to mortgage financing. As such, it is important that the government undertake a campaign to ensure the average Canadian understands the impacts and implications of a lender deductible. Given the impact to smaller communities, it is important that the government take

[25] The Consultation Paper on Lender Risk Sharing has explicitly stated that, under a lender risk sharing policy, the risk exposures of the government-backed securitization investors and the government, as the sponsor of securitization arrangements, would remain unchanged. This is the presumption of the banking industry throughout the CBA's submission.

time to outline the proposed changes, particularly for constituents of those regions that will be most impacted.

The Department of Finance has said that lending costs will increase by only 20 to 30 basis points (bps) over five years, while CMHC[26] has suggested 10-50bps. Other stakeholders have put the cost much higher, at closer to 15-20 bps each year.[27] Costs may escalate further due to recent changes to the mortgage marketplace, as well as the effects of the policy on lender competition, which is discussed next.

Market participants expect that, as a result of the implementation of a deductible, premiums would be reduced to account for the reduced insurance coverage. A benefit of a reduction in the premium is that it could offset, to a certain extent, the impact of higher lending costs for the borrower. It is highly unlikely, though, that a reduction in the deductible will entirely offset the increase in lender costs. While lenders will need to be compensated for the increased frequency and magnitude of losses through higher risk-based interest rates or up-front fees, mortgage default insurers will continue to collect premiums to manage tail risks which are typically larger, though less frequent, in nature.

Lender competition

One key implication of a lender deductible is that smaller institutions who specialize in insured mortgages may find themselves squeezed out of the marketplace because they have fewer funding options available. Mortgage finance companies, in particular, would be forced to make significant adjustments to their business models in order to incorporate the change.[28] This could potentially result in a less competitive marketplace for mortgages. Indeed, there may already be adverse impacts to these segments due to recently introduced changes around portfolio insurance whose effects have yet to fully materialize.

A lender deductible would also lead lenders to set aside more capital against their increased exposure to losses. Those lenders without ready access to capital will find it more difficult to serve the insured mortgage market, potentially leading to reduced competition. The federal government will need to account for the differences between the monoline, non-prudentially regulated mortgage finance companies; federally or provincially-regulated deposit-taking institutions that largely use standardized approaches to credit risk weighting (e.g. trust companies and credit unions); and federally-regulated banks that use either an advanced or standardized approach to credit risk weighting.

The reform introduces a degree of counterparty risk into the system (i.e. the risk that the mortgage lender may be unable to pay the deductible when it comes due). This may lead to higher insurance premiums and less favourable funding arrangements for smaller, less capitalized lenders who carry

---

[26] Monday, February 13th appearance by Evan Siddall (President & CEO, CMHC) at House of Commons Standing Committee on Finance.

[27] Canadian Mortgage Trends (2016). "Let the Consultation Begin". Available online: https://canadianmortgagetrends.com/canadian_mortgage_trends/2016/10/let-the-consultation-begin.html

[28] Bank of Canada (2016). Financial System Review December. "The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities."

higher counterparty risks, further constraining competition in the sector. To reduce counterparty risks emanating from lenders without capital adequacy requirements similar to federally regulated financial institutions, some form of capital equivalency measure should be put in place.

Housing market and financial stability

A lender deductible would have pro-cyclical implications. High ratio insured mortgages currently have a stabilizing effect on the market in areas where collateral risk is higher and property prices have a high likelihood of decline, for instance in areas lacking a liquid market. A deductible could impede this stabilizing effect in the future – e.g. during another prolonged recession – making it more difficult for lenders to manage during times of stress. The current mortgage insurance regime has historically served as an important counter-cyclical buffer. For example, Canadian lenders continued to provide mortgages to qualified borrowers in oil-impacted regions over the last couple of years, partly aided by government-backed mortgage default insurance.

Another key risk concerning financial stability is that, under a lender deductible regime, some lending could get displaced to the shadow/private lending marketplace where there is less transparency and weaker regulatory protections for consumers.[29] For instance, the December 2016 Bank of Canada Review noted that "borrowers affected … may seek out less-regulated, higher-cost lenders, such as mortgage investment corporations and private mortgage lenders".[30]

Lender risk exposure

The Consultation Paper outlines two potential approaches for calculating a lender's portion of loans losses. One approach − the first loss approach − requires making lenders responsible for losses up to a fixed portion of the outstanding loan balance at loan default. Mortgage insurers would be responsible for losses in excess of this level. An alternate approach – the proportionate loss approach – would base the lender proportion of loan losses on a percentage of total loan losses. They have differing implications for lender behavior, particularly in an economic downturn scenario. Depending on the structure of the deductible, lenders may need to make a decision between realizing on the security of a property or restructuring the debt.

If the federal government decides to proceed with the deductible policy, the banking industry would be interested in providing feedback on these two approaches.

Further operational considerations for lenders

This section explores some of the operational and administrative considerations that would follow from the introduction of a lender deductible. Costs associated with these changes are in some

[29] Some of these incentives could, of course, be partially offset to the extent that mortgage insurers reduce their premiums to compensate for lower expected losses.
[30] Bank of Canada (2016). Financial System Review December.

cases quite significant, and should be considered in any cost/benefit assessment of the deductible concept.

Systems changes

From the banks' operational perspective, an important challenge will be systems changes to create, validate, implement and audit new capital models for insured mortgages, with associated resources and technology. There would be additional costs associated with calculating accurate risk-based pricing on insured mortgages taking into account the collateral risk in different geographies, as well as overall portfolio tracking, monitoring and provision for credit loss (PCL) forecasting.

In terms of portfolio management, a distinction would need to be made, as lender risk sharing is phased in, between those mortgages in which a deductible is applied, and those mortgages that are fully insured. These distinctions are in addition to distinctions banks already make for portfolio insured mortgages. This would add further complexity to lenders' portfolio management and securitization programs, and would add to lenders' operational and regulatory costs.

Accounting systems and processes would need to be updated in order to: reconcile loss-sharing invoices provided by mortgage insurers, flag and track grandfathered versus loss-sharing accounts, and perform loss-sharing calculations. These systems and process changes could be further exacerbated if governments implement more targeted support for certain groups and geographies, in response to consumer segments impacted by lower availability of credit as a result of lender risk sharing. These elements will come at a higher cost in terms of managing individual programs for different segments or borrowers.

Property valuation

Questions arise around the role of property valuation with a deductible. Currently, mortgage insurers control the property valuation process and method for high ratio insured mortgages. If a deductible is applied, lenders would need to review the mortgage insurer's property valuation policies and practices. This review could also mean: lender initiated full appraisals before submitting to the mortgage insurer; purchase of Property Valuation Indemnity Insurance; or accepting risks associated with the current property valuation system. The costs associated with the additional property valuation would ultimately be borne by the mortgage borrower.

There could also be capacity constraints on the appraisal industry to handle increased volumes of appraisals. In the period before the property valuation industry fully adjusts to the increased demand for property valuations as a result of a lender deductible, borrowers taking out an insured mortgage may find it difficult to secure financing within the standard 5-day Condition of Financing clause. Borrowers could opt to waive the clause and risk losing part or all their deposit if they do not obtain adequate financing if the lender values the property lower than the purchase price.

Provincial considerations

It has been the experience of lenders that the claims process is longer in certain provinces, and as a result, the severity of loss may be greater in these provinces through no fault of the lender. Depending on the structure of the deductible, lenders may be incented to realize on the security of the home more quickly in these provinces to reduce the severity of the loss.

Exploring pragmatic alternatives

The federal government should consider alternatives to lender risk sharing which are relatively simpler, more targeted, and less disruptive to the existing lending market structure, yet still meet its stated objectives.

Increase the covered bond limit

Covered bonds are an alternative source of funding for lenders that contributes to the stability of the financial system.[31] They are debt instruments issued by a financial institution and secured by a segregated pool of high quality assets – primarily uninsured 1 to 4 unit Canadian residential mortgages. Covered bond issuers pay periodic interest and principal on the bond to investors, in accordance with terms that are set upon issuance. Insured mortgages are not permitted to be held as covered bond collateral. Neither the federal government nor CMHC provide any guarantees or backing for covered bond issues.

Covered bond issuance in Canada is capped at a regulatory limit of 4% of bank assets, which is lower than in most advanced economies. Raising the limit would increase private funding of Canadian uninsured mortgages and hence reduce taxpayer support for mortgage financing.

Permit mortgage insurers to purchase reinsurance

As a result of federal government restrictions, CMHC and private mortgage insurers are not able to use reinsurance as a risk management tool. However, reinsurance is used extensively by mortgage insurers in other jurisdictions, including Australia and the US.

Allowing mortgage insurers to diversify exposure internationally through risk transfer to reinsurers could lower taxpayer exposure and improve mortgage insurers' capital efficiency. Employing reinsurance would add a degree of counterparty risk to the housing finance system, but this would likely be no greater than the counterparty risk generated by a lender deductible.

[31] As noted on CMHC's website: http://www.cmhc-schl.gc.ca/en/hoficlincl/cacobo/cacobo_007.cfm

Conclusion

Canada's housing finance system has historically been a source of economic growth, resilience and financial stability. Mortgage default insurance, as currently structured, has played a key role within this system, by helping meet the NHA's objectives of expanded access to residential mortgage financing and homeownership.

The banking industry uses mortgage default insurance to extend financing to particular segments of borrowers who would otherwise have difficulty obtaining credit. It has never been a substitute for sound underwriting and appropriate risk management and due diligence.

This submission has questioned whether a deductible is the most effective way to rebalance risks within the housing finance system, particularly given the already prudent approach banks take in underwriting insured mortgages, and ongoing shifts in the nature of mortgage risk due to market and regulatory changes. The banking industry suggests that policy alternatives be considered that address the same ends, but are simpler and less disruptive to the existing lending structure.

If the federal government decides to proceed with a lender deductible, it could undermine some of the objectives of the NHA through higher costs and/or reduced credit availability for certain Canadians, reduced competition in the mortgage marketplace, and increased pro-cyclicality in times of economic stress.

A lender deductible would represent one of the most significant structural changes to Canada's housing finance system in half a century. It is therefore imperative that the federal government be able to demonstrate that the full cost of implementing a deductible will result in even greater benefits for Canadians.

Appendix 1: Recent regulatory changes to the housing finance system

- Reduced amortization periods for insured mortgages;
- Increased the minimum down payment on insured mortgages;
- Withdrawal of mortgage default insurance for home equity lines of credit (HELOCs);
- Reduced the amount that can be borrowed during refinancing;
- Introduced OSFI's B-20 *Residential Mortgage Underwriting Practices and Procedures* Guidelines (including lowering the maximum LTV on non-amortizing HELOCs and implementing a qualifying mortgage interest rate);
- Regularly review and monitors CMHC's commercial activities;
- Removed mortgage insurance for properties over $1 million;
- Introduced a statutory framework for covered bond while prohibiting the use of insured mortgages as collateral;
- Introduced the *Protection of Residential Mortgage or Hypothecary Insurance Act* for private mortgage insurers which empowers the Minister of Finance to set capital requirements for mortgage insurers;
- Placed CMHC under OSFI supervision;
- Placed limits on the utilization of portfolio insurance securitized through CMHC programs;
- Prohibited the use of insured mortgages in non-CMHC programs;
- Placed limits on CMHC's allocation of new NHA MBS;
- Instituted the payment of guarantee fees by CMHC to the federal government;
- Increased premiums and cut programs for mortgage insurance;
- Increased the timely payment guarantee fees for securitized vehicles;
- Introduced OSFI's B-21 *Residential Mortgage Insurance Underwriting Practices and Procedures* Guidelines;
- Increased total capital requirements for Canadian banks; and,
- *Revisions to OSFI's Capital Adequacy Requirements Guideline* (CAR) that emphasize that credit risk insurance is a risk mitigant (guarantee) that relies on the due diligence of a mortgage originator with respect to the requirements of a mortgage insurance contract. Furthermore, the Revisions extended the application of the downturn floor to insured mortgages.

Appendix 2: Canadian communities with high and/or growing unemployment and declining populations

There are numerous communities across Canada where there is high/growing unemployment and/or declining populations. These communities would be disproportionately affected by a lender deductible. For instance, the unemployment rate increased in 32 regions in Canada between 2012 and 2016 (see **Table 1**). Furthermore, there are 33 regions with a working age population of close to 9 million individuals with unemployment rates over 7%.

Table 1: Unemployment Rates

2016 Unemployment rate (%)	Number of regions[32]	2016 Working Age Population (000s)
15+	3	338
10-14.9	5	540
7-9.9	25	8,085
5-6.9	29	19,405
Less than 5	6	1,182
Total	68	29,550
Number of Regions in which the unemployment rate increased between 2012 - 2016	32	

Source: Statistics Canada Table 282-0123

Census data indicates over 2,300 communities experienced a population decline between 2006 and 2011. The decline averaged 12.7%, and almost 1,400 of these communities experienced a decline in excess of 5% (see **Table 2**).

Table 2: Population Declines Canada

Population Decline 2006-2011	Number of Municipalities	Average Decline %	Total Residents 2011	Total Residents 2006
75.1-100%	81	-97.1%	351	3,890
50.1-75%	34	-61.7%	1,838	5,029
25.1-50%	159	-35.1%	20,166	30,105
10.1-25%	502	-14.9%	259,856	301,587
5.1-10%	613	-7.3%	625,608	673,547
0-5%	969	-2.5%	3,160,395	3,228,573
Total	**2,358**	**-12.7%**	**4,068,214**	**4,242,731**

Source: Statistics Canada Census Tables

[32] Based on Census Boundaries