RESEARCH REPORT

The Evolution of Mortgage Loan Insurance in Canada

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OVERVIEW

The system of housing finance in Canada today is well integrated into the larger capital market. It is based almost entirely on private-sector funds. There are no special direct mechanisms to channel capital funds into the housing market. As a result, housing must and has been able to compete with other demands for capital. The functioning of the housing finance system is influenced by the free play of supply and demand, nonetheless the federal government maintains a strong facilitative presence. Equal access to low-downpayment mortgages by borrowers in all parts of Canada is ensured by way of the 35-year old public mortgage loan insurance program, while the availability of long-term mortgage funds is promoted through the recently introduced National Housing Act mortgage-backed securities initiative.

HOUSING FINANCE SYSTEM

Housing investment in Canada usually involves debt financing. The main supplier of mortgage funds is private-sector financial institutions whose membership includes chartered banks, life insurance companies, trust companies, loan companies, caisses populaires and credit unions, pension funds and mortgage investment brokers.

In 1988, institutional lenders issued $45.9 billion of mortgages on 686,208 dwelling units. Chartered banks dominated the market with 52 per cent of the residential mortgage business. Behind them were trust and loan companies, securing respective market shares of 24 and 15 per cent. Life insurance companies, once key players in housing finance, captured just 7 per cent of the activity. Mortgages are typically made with proceeds generated by the sale of guaranteed investment certificates or other similar interest-bearing instruments to savers. Life insurance companies and pension funds are the exceptions. Consequently, most mortgage-lending institutions are margin or spread lenders which perform the intermediation of investments and risks.

Because mortgage interest rates had historically tended to lag behind general movements of competing interest rates, mortgage lending had been a residual activity whose supply would increase as business borrowing contracts and decrease as it expands. For that reason, government mortgage lending had been used actively in periods when the supply of private funds was inadequate. This inverse relationship had disappeared by the late 1960s as a result of the gradual integration of the mortgage sector into the overall capital market through the removal of outdated regulations. Today, governments also rely on private-sector funds to finance government-sponsored housing, using public mortgage loan insurance as a lever. Public funds may be made available where such financing is inappropriate or for residual lending in cases where funds are unavailable from lenders.

It is important to also mention the non-institutional sector in mortgage lending. While its market share is not fully known, the key sources of personal mortgage funds include vendor-take-back financing to facilitate sale to a buyer and private investors who make their funds available through accountants, lawyers or mortgage brokers.

There is always a certain proportion of houses being purchased without involving mortgage loans. It is believed that the incidence of cash transactions is on the increase. One reason, which is a legacy of the high interest rate experience during the early 1980s, is an aversion to debt financing. Another reason is a larger population of affluent move-up purchasers and elderly homeowners who are in the market to trade down. Still another reason is the non-deductibility of home mortgage interest in Canada's income tax system.

Mortgage-backed securities (MBS) have been recently introduced in Canada. This instrument allows the packaging of mortgages into smaller denominations and because it carries a guarantee of timely payments by the federal government of principal and interest, it is attractive to a broad base of investors. MBS is now an important source of mortgage money with terms of five or more years.

PUBLIC MORTGAGE LOAN INSURANCE

Most financial institutions in Canada are prohibited by governing regulations to make high-ratio mortgages, presently defined as lending in excess of 75 per cent of the property value, unless these loans are insured under the National Housing Act (NHA) or unless the amount of the mortgage that exceeds the prescribed maximum is insured by a private mortgage insurance company.

The concept of high-ratio financing was introduced by the federal government in 1935. It was brought in as a means to address the housing shortages of the day and to stimulate employment at a time when the economic recovery following the Great Depression was showing signs of slowing down. High-ratio financing appeared in the form of mortgages funded by three-quarters private and one-quarter public money. This government's share in the lending meant that private lenders could in effect make mortgages up to 80 per cent of the property value (for each $100 of property value, the downpayment was $20, government's share of the mortgage was $20, and the lender's share was $60) as compared to the otherwise 60 per cent legal loan-to-value ratio maximum. The joint loan system was also supported by a Pool Guarantee Fund designed to compensate lenders for mortgage losses which might be larger because of lower downpayment requirements.

The joint loan system was replaced by the new insured loan system under the NHA in 1954 which provides protection to lenders against specific losses in the event of borrower defaults. Since its introduction, public mortgage insurance has assisted nearly 2.8 million borrowers in the financing of some $106 billion worth of real estate, and in doing so, it has achieved a number of important public policy goals. It has been the means to ensure equal access to mortgage financing at the smallest feasible downpayment and the lowest feasible cost to consumers (one-quarter of one per cent interest rate advantage until 1969 when prescribed interest-rate ceiling was removed from the NHA) in all parts of Canada. By facilitating the emergence of innovative mortgage instruments and a secondary mortgage market, it has assisted the mortgage market to adjust to changing economic conditions. It has supported other government initiatives, such as levering private sector funds to finance the production of social housing and assisting housing programs designed for employment generation purposes. Because NHA insurance transfers mortgage risks totally to the insurer, it has contributed to the solvency of financial institutions, and enabled small lenders to compete effectively in a mortgage market which would otherwise be dominated by large financial institutions.

Private mortgage insurance began on an informal basis in 1963 by the Mortgage Insurance Company of Canada (MICC). The business strategy of the MICC was to make mortgage loan insurance available to the segments of the market not being served by NHA insurance. Prior to 1966, existing housing was not eligible for NHA insurance and it was not until 1979 that the removal of stringent loan limits had made NHA-insured financing available to higher priced homes. In addition, some lenders had preferred to obtain MICC insurance as NHA-insured loans had been subject to interest-rate ceiling up to 1969.

Privately-insured high-ratio loans were eventually recognized in legislation in 1970. This regulatory change, in conjunction with favourable demand conditions and underwriting results, led to the entry of The Sovereign Mortgage Insurance Company in 1972 and Insmor Mortgage Insurance Company in 1973. In 1978, Insmor and Sovereign were amalgamated under the Insmor name and in 1981, a merger of Insmor with the MICC under the MICC name took place. These events were caused by increased default rates and decreased insurance demand.

While mortgage insurance protects lenders against default, the premiums are most often paid by borrowers. The basic NHA premiums for first mortgage homeownership loans, which are normally added to the loan amount, range from 0.5 to 3 per cent, depending on the ratio of loan to lending value and the number of mortgage advances. CMHC also offers insurance for second mortgage loans with premiums at competitive rates. The benchmark mortgage instrument in Canada features fixed interest rate and equal monthly payments during the loan term. If the rate of interest on the mortgage varies during the loan term, there is a premium surcharge of 0.25 per cent. The basic NHA premiums for rental loans, range from 1.5 to 3 per cent, depending on the economics of the investment. Where there is a non-residential component in the project, there is a surcharge of 1 per cent on that portion of the insured loan. In addition to loan premiums, borrowers are also required to pay underwriting fees to offset the processing expenses. The premium and fee schedules of private mortgage insurance are competitive with the NHA's.

There are a number of criteria appropriate to the approval of high-ratio homeownership mortgages. The minimum downpayment is 10 per cent of the property value. Since the mortgaged property is the primary security, the lender must underwrite in a prudent manner. This may include inspections and appraisals of the property. One indicator of the borrower's ability to service the mortgage is the ratio of the sum of principal repayments, interest charges, property taxes and heating costs to gross income. The CMHC benchmark ceiling is 32 per cent. Generally CMHC's maximum ratio of total debt payments to gross income is 42 per cent. These ratios are seldom considered independently as many lenders are prepared to allow some trade-offs. The credit worthiness of the borrower is another criteria. This is established on the basis of stability of employment, credit records, personal characteristics of the borrower, and financial references.

NHA insurance settles claims in two ways. In most cases, after the title to the property has been conveyed to the insurer, the lender will receive a cash settlement which includes principal

outstanding, interest arrears, and legal and any other reasonable costs of acquisition. Alternatively, the lender may choose the deficiency settlement technique in which the lender sells the property and claims only the unrecovered balance of the loan. Private mortgage insurance is required by regulations to incorporate a third claim settlement option for certain classes of loans. This allows the lender to retain title to the property and the insurer to limit its liability to 25 per cent of claim amount.

NHA INSURANCE EXPERIENCE

The ability of borrowers to meet their monthly payments, and the net equity in their mortgaged property (influenced by general market conditions) are the primary sources of mortgage risks. The latter has been commonly accepted as the stronger of the two. This is because borrowers who cannot meet their monthly payments are not likely to default as long as there is net equity, while borrowers with zero or negative net equity have a higher propensity to default even though they are able to continue to meet their mortgage obligations.

These two sources of mortgage risks are influenced by many factors. Some of them are uncorrelated or micro in nature which affect borrowers at the individual level. Others are correlated or macro in nature which affect many at the same time. Examples of primarily uncorrelated factors include marital breakdown and death, and they almost always translated into borrower inability to service the debt. Examples of macro factors include over-building or economic recession resulting in declining housing prices and thus erosion of net equity. These events adversely impact a large number of borrowers in similar circumstances, and it is this large measure of correlation which tends to make mortgage risks not easy to insure.

The NHA insurance experience during the first 20 or so years was favourable. Because of supportive economic conditions, there were few defaults and, as a result, reserves in the Mortgage Insurance Fund were increasing steadily. However, since late 1970s, there have been indications of the Fund's inability to pay all future claims for insurance in force (see Appendix One). In addition to this actuarial deficit, there have been periods when cash deficiency in the Fund necessitated borrowings from the federal government.

There are three factors which contributed to the actuarial deficit in the Fund: (i) the decision to reduce all premiums by half in 1969 in response to public pressure to bring down the cash surplus in the Fund; (ii) actual losses on the mortgages, initiated during the 1970s under two housing programs funded by

federal subsidies, that turned out to be considerably higher, due to over-building, than the levels which had previously been anticipated (the federal government has recognized this premium deficiency and provided compensation to the Fund totalling some $555.6 million to-date); and (iii) massive losses as a result of the 1981-82 economic recession in Canada and the severe impacts of weak oil prices on the energy-based economy of the province of Alberta over the past several years.

The steady improvement in the actuarial position of the Fund over the last few years reflects continual national economic growth and effective management of NHA insurance. In particular, premiums now reflect the risks incurred and are established at a break-even position. The actuarial deficit of the MIF will be effectively eliminated in the near term and is expected to remain in a relatively stable position during the foreseeable future.

REVISIONS TO NHA INSURANCE

In 1986, Canada Mortgage and Housing Corporation, on behalf of the federal government, undertook an extensive review of NHA insurance. Canadians were asked to provide inputs on important issues such as program objectives, operating approaches and public/private competition in the market.

During 1987, CMHC successfully implemented the new federal directions in public mortgage loan insurance developed as a result of the review and consultation. The new initiatives were designed to strengthen the MIF and to reaffirm equal access to mortgage financing in all parts of Canada as the primary public policy objective of the program. This objective and those of assisting the mortgage market to adjust to changing economic conditions and supporting other government initiatives are to be accomplished while pursuing the goal of a self-sufficient MIF.

Cross-subsidization is the means to achieve these objectives. Thus, sufficient low-risk, low-cost business must be underwritten to cover the cost of high-risk, high-cost business. To maximize the cross-subsidization potential and to provide consumers with more appropriate choices, new program initiatives were introduced. These included second mortgage loan insurance, portfolio insurance for existing loans for the purpose of packaging into mortgage-backed securities, and insurance for moveable home loans. In addition, premiums for mortgages with lower loan ratios and underwriting fees were reduced.

As well, streamlined existing default management and claim settlement procedures, and new insurance claim settlement options are being introduced. These measures are designed to

prevent defaults in some situations and to reduce claim losses in others. Recent expansion of the NHA Mortgage-Backed Securities Program to include social housing projects has resulted in substantial savings in subsidy costs as a result of lower interest rates.

In situation where risk to the MIF is prohibitive and would jeopardize the goal of a self-sufficient MIF, cross-subsidization is not used to support mortgage loan insurance. Insurance is restricted for mortgages in special risk communities unless satisfactory risk sharing arrangements are secured. For mortgages initiated under programs funded by government subsidies, where risk is believed to be excessive or unsupportable by marketable premiums, prior agreement for reimbursement from the government for losses incurred by the MIF are required.

NHA insurance was introduced some 35 years ago, and changes have been made from time to time to ensure its relevance in a continually evolving marketplace. These changes have been guided by the fundamental principles of program objectives in harmony with the housing finance needs of Canadians. The program will continue to be responsive to these principles as it continues to evolve in the future.

APPENDIX ONE

NHA Insurance Experience
1976-1988

	Defaults	Net Income (Loss)	Recovery of Losses from the Federal Government	Year End Actuarial Deficit
	(Units)	Million Dollars		
1976	782	*	0	**
1977	2,562	*	0	**
1978	8,733	*	0	**
1979	16,929	*	0	**
1980	12,080	*	0	**
1981	8,296	*	0	**
1982	6,332	(21.0)	0	253.0
1983	7,757	(260.3)	0	513.2
1984	10,077	(580.5)	307.6	786.2
1985	11,478	58.2	0	727.9
1986	5,629	46.7	248.0	433.3
1987	4,179	175.2	0	258.1
1988	3,177	142.0		116.1

* Not available.

** Prior to 1982 the accounting for the MIF had been on a cash basis. Thus, the figures are not comparable to those after 1981 which have been put on an actuarial basis. The latter means premiums are earned and recognized as revenue in relation to the expected incidence of losses over the full life of the mortgage.

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