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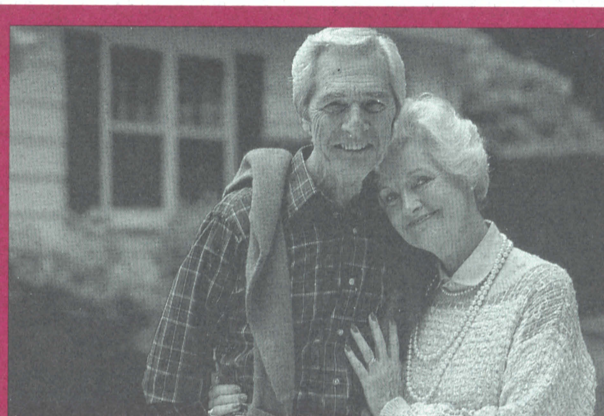
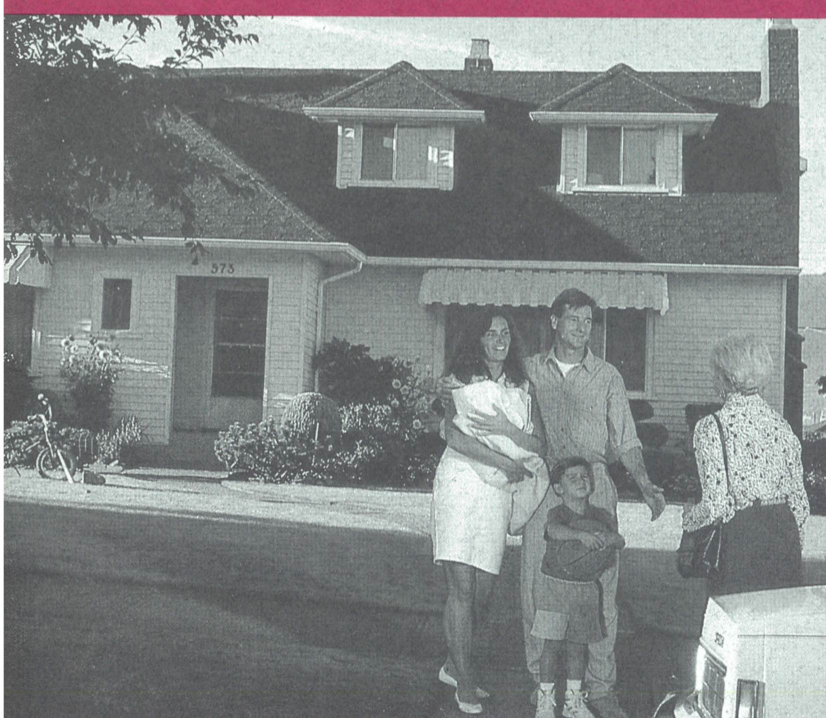
Consultation on Innovative Uses of Public Mortgage Loan Insurance





NHA 6604

Consultation on Innovative Uses of Public Mortgage Loan Insurance

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1
INTRODUCTION

National Housing Act (NHA) mortgage loan insurance has been the federal government's basic instrument for the creation, maintenance and refinement of the housing finance system in Canada for 38 years. NHA insurance ensures equal borrower access to home loans in all parts of the country through general cross-subsidization of premiums and fees. The insurance facilitates innovations in housing finance and promotes competition in the mortgage market, while achieving its mandated financial self-sufficiency over the long run.

The federal government reviews NHA insurance from time to time because the needs of mortgage borrowers and the market within which these needs are met are fluid. The last such review was conducted in 1986. Through an extensive process of public consultation, new products and procedures were adopted the following year.

This paper has been prepared by Canada Mortgage and Housing Corporation (CMHC), the housing agency of the federal government. CMHC wants to begin a dialogue with Canadians about NHA insurance of two new housing finance alternatives: home equity conversion to enable older homeowners to cash in home equity while remaining in their own home, and shared equity financing as a funding source for downpayment and/or interest-rate relief. In the fall of 1990, participants in the first-ever Canadian Housing Finance Conference showed considerable interest in these alternative mortgage instruments.

The consensus of opinion to emerge in the coming months will send a strong message, through CMHC, to the federal government about whether or not Canadians want their public mortgage loan insurance to facilitate these new housing finance alternatives and how such insurance should be broadly structured.

The ideas and proposals put forward in this paper are guided by two basic principles. Because housing finance is in the federal domain, the national standards embodied in the NHA should be part of the policy framework, therefore ensuring that Canadians everywhere can derive equal potential benefit from NHA insurance. Moreover, the fundamental characteristic of NHA insurance as a commercially viable enterprise competing fairly in the marketplace at no cost to the federal government should be preserved.

The substantive aspects of NHA insurance of home equity conversion and shared equity financing represent ideas in some cases and proposals in others. These different approaches are necessary because CMHC does not have answers to all the questions. Therefore, the consultation results are expected to provide assistance to CMHC in converting ideas into proposals and in refining proposals into recommendations.

2
Consultation Process

CMHC wishes to keep the public informed of work now under way on two potential innovative uses of NHA insurance. Through this paper, CMHC invites consumers, including seniors organizations, financial institutions, the housing industry, provincial, territorial and municipal governments, and other interested associations and individuals to participate in the consultation. Those who wish to respond are invited to write directly to CMHC by August 31, 1992.

In recent years, consensus building has been a critical variable in the formulation of federal housing policies, and this consultation is no exception. NHA insurance has had an impressive record of levering the private sector to help housing consumers to meet their financing needs with their own resources. That is the historical context within which the upcoming open and extensive dialogue with the key players will take place.

CMHC will synthesize and use the results of this consultation as an input into the recommendations which will be made to the Minister of Public Works, who is responsible for CMHC. This will be followed by a submission to Cabinet toward the end of 1992.

3
HOME EQUITY CONVERSION

3.1 BACKGROUND

Financing Needs of Older Homeowners

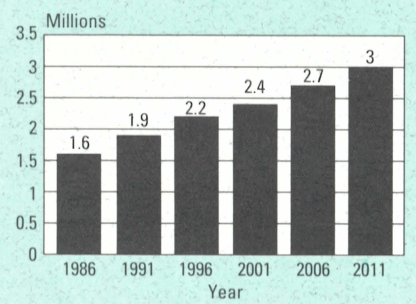
By the year 2000, Canadians aged 65 and over will make up 14 per cent of the population, compared with 11 per cent now. Nine in ten older Canadians live in their own homes rather than in institutions. Typically, older Canadians own their own homes (65 per cent), and most of these homes (90 per cent) are mortgage-free. Home equity is often the single most important source of wealth for these 936,000 older homeowners — especially those who have modest incomes.

According to a survey conducted for CMHC in 1987, three-quarters of older Canadians would prefer to stay in their own homes as long as possible. Twenty per cent indicated that they would consider cashing in home equity to pay for in-home care to eliminate or postpone the need to be institutionalized.

Income after retirement typically drops 30 per cent or more. As a result, people who own homes and are unable to afford the same pre-retirement level of housing may need to sell their home and buy or rent more affordable shelter. The conversion of home equity into cash can be used to hold off that need. It can also create a ready cash source to enable those who do not have an affordability problem to fund, for example, in-home care services, which would otherwise result in the sale of their home against their best long-term interest.

The availability of home equity conversion in Canada is at the initial stage (see Appendix A for details). In the United States, the Department of Housing and Urban Development is currently facilitating home equity conversion through Federal Housing Act mortgage insurance as a demonstration project.

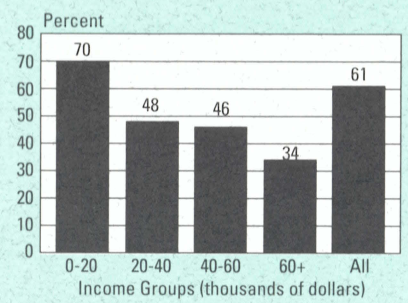
Figure 1. Projection of the Number of Households Aged 65 and Over



Source: Statistics Canada 1990.

The number of households with head aged 65 and over is projected to increase by 60 percent in 20 years, from 1.9 million in 1991 to 3 million in 2011. Over the same period, the total number of households is projected to increase by 36 percent.

Figure 2. House Value as a Percentage of Total Assets of Seniors



Source: Statistics Canada 1984.

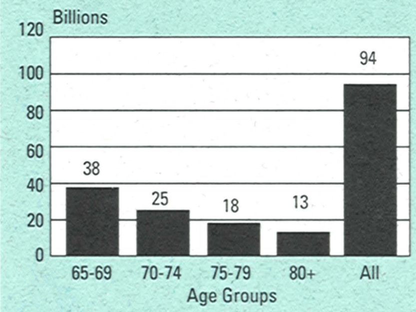
The house is the main asset of owner households aged 65 and over, as it represents, in aggregate terms, over 60 percent of their total wealth.

Home Equity Conversion

Home equity conversion is commonly understood to be the generation of cash by borrowing against home equity from a lender. The home is mortgaged by the borrower to provide an interest to the lender. The borrower retains occupancy rights until the loan has to be repaid because the cash is generated from home equity through a mortgage loan, rather than through the sale of the home.

A loan to withdraw home equity is not so different from a loan to finance the purchase of a home, the major exception being in the manner of loan repayment. A loan to finance the purchase of a home increases home equity as the loan is paid down, while a loan to withdraw home equity reduces equity as the loan balloons because of the deferral of loan payments. A mortgage loan to withdraw home equity builds debt and, for that reason, it is sometimes called a reverse mortgage loan.

Figure 3. Home Equity by Age Group



Source: Statistics Canada 1988.

Home equity of all owner households with head aged 65 and over was valued at $94 billion in 1988.

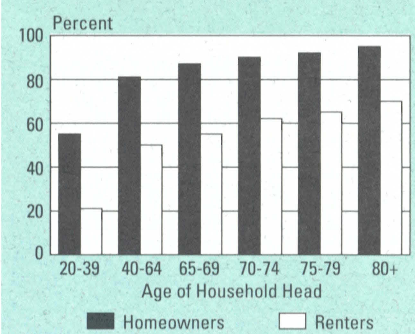
Home Equity Conversion Lending

The purchase of a home in Canada is typically financed by the equal payment mortgage (EPM). Under the EPM, the borrower must make a series of equal monthly payments to the lender reflecting the borrowing cost during the term governing the rate of interest (usually from 6 months to 10 years) while the loan is being amortized so that the mortgage debt is fully repaid within the amortization period of the loan (usually 25 years).

By contrast, a mortgage loan to convert home equity into cash does not have a scheduled loan amortization and involves no periodic mortgage payments. The accrued interest is added, from time to time, to the original loan amount. The reimbursement of the original loan and the accrued interest take the form of a lump sum, balloon payment when it becomes due. The funds to discharge the balloon payment mortgage (BPM), upon which home equity conversion is based, are expected to come from all or a portion of the net sale proceeds of the mortgaged property. This completes the withdrawal of home equity.

Figure 4. Mobility of Canadian Households

Did Not Move in Five Years



Source: Statistics Canada 1990.

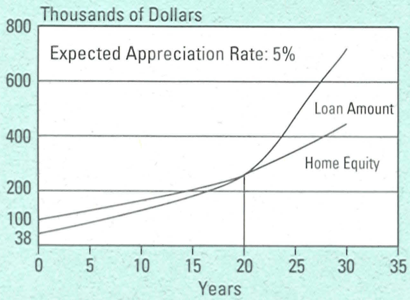
Home equity conversion is intended for those who do not wish to move. In 1990, over 90 percent of owner households with head aged 65 and over had not moved in five years.

Balloon Payment Mortgage

The relative characteristics of the EPM and the BPM are illustrated in the following example. Suppose the loan amount is $50,000, the rate of interest is 10 per cent, and the period of reimbursement is 20 years. Under the EPM, the monthly payment is $475.83, for a total of $114,199 over 20 years, $64,199 of which represents the interest cost. Under the BPM, because loan reimbursement is deferred, the same $50,000 will balloon to $351,999 in 20 years, $301,999 of which represents the interest cost.

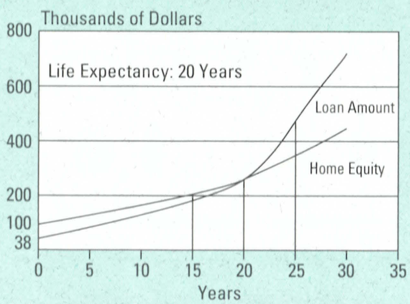
As a general rule, at a certain level of home equity conversion chosen by the borrower, the corresponding amount of cash is determined in a manner such that, given the rate of interest on the loan and the assumed rate of property appreciation, the balloon payment as of the expected due date,

Figure 5. Balloon Payment Mortgage



At a 10 percent interest rate, a 5 percent appreciation rate, and a 20-year life expectancy, the conversion of $100,000 home equity would generate cash of almost $38,000. After 20 years, both the loan and the appreciated home equity would balloon to $265,330.

Figure 6. Impact of Longevity Risk



Suppose the house price appreciation rate is 5 percent and the interest rate is 10 percent. If longevity is five years longer than expected, the loan amount will exceed the appreciated home equity by $93,559. If longevity is five years less than expected, the loan amount will be $45,003 less than the appreciated home equity.

plus incidental expenses, should not exceed the then prevailing market value of the mortgaged home securing the loan.

For example, suppose the rate of interest is 10 per cent, the mortgaged home is assumed to appreciate 5 per cent a year and the BPM is expected to be due in 20 years. The cash corresponding to the conversion of $100,000 of home equity, before taking incidental expenses into account, is $37,689. While the 10 per cent rate of interest will cause the loan to balloon from $37,689 to $265,330 in 20 years, the $100,000 of home equity, appreciating 5 per cent annually, will increase to $265,330 in the same number of years, thus matching the ballooned loan amount.

Lending Risk of Balloon Payment Mortgage

In practice, the rate of interest may not be constant during the loan period, the actual appreciation may be larger or smaller than the assumed level, and the BPM may mature earlier or later than the anticipated due date. Consequently, the balloon payment may be larger or smaller than the underlying security. If the underlying security does not cover the balloon payment, on account of higher mortgage interest rates or insufficient property appreciation or prolonged loan maturity, the lender would suffer a financial loss. Mortgage loan insurance transfers that risk, for a premium, from the lender to the insurer.

Public Mortgage Loan Insurance

Governing regulations prohibit most financial institutions in Canada from making high-ratio mortgages, presently defined as lending in excess of 75 per cent of the property value, unless these loans are insured under the NHA or unless the amount of the mortgage that exceeds the prescribed maximum is insured by a private mortgage insurance company.

The system of insured loans was enacted in the NHA in 1954 to provide protection to lenders against specific losses in the event of borrower defaults. Since its inception, public mortgage loan insurance has assisted 3.1 million borrowers in financing nearly $120 billion worth of real estate; in doing so, it has achieved a number of important public policy goals.

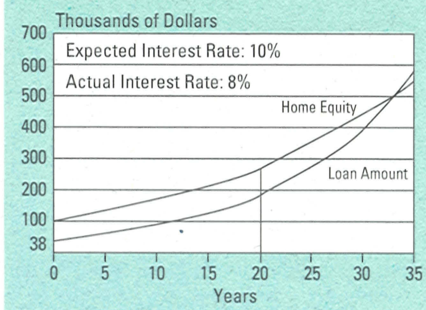
Public Policy Foundation of NHA Insurance

NHA insurance has ensured equal access to mortgage financing everywhere in Canada. It has supported other government initiatives, such as the leverage of private sector funds to finance the production of social housing.

NHA insurance has assisted the mortgage market to adjust to changing economic conditions by facilitating the emergence of innovative mortgage instruments and a secondary mortgage market. It is the building block of NHA mortgage-backed securities which, through the guarantee of timely payments, provide a new funding source for mortgages of varying terms and improve the liquidity of mortgages in secondary trading.

Because NHA insurance transfers mortgage risks totally to the insurer, it has contributed to the solvency of financial institutions and enabled small, sub-national lenders to compete effectively in a mortgage market which would otherwise be dominated by large, national financial institutions.

Figure 7. Impact of Interest-Rate Risk

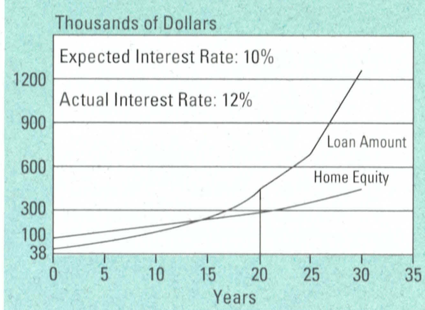


If the interest rate is 2 percent lower than expected, the loan amount will equal the appreciated home equity some 13 years later than expected. This lower interest rate will give the homeowner a net equity of $84,384 in 20 years, after loan repayment with interest.

Self-Financing NHA Insurance

The liabilities of insuring against borrower defaults are pooled within the Mortgage Insurance Fund (MIF), which is mandated by the federal government to operate on a self-financing basis. At the end of 1990, the insurance in force in the MIF totalled $52.8 billion. Within the self-financing MIF, general premium cross-subsidization is the means to achieve the public policy objectives of NHA insurance. Cross-subsidization implies pricing NHA insurance at levels that take into account wide variations in risks and administrative costs.

Figure 8. Impact of Interest-Rate Risk



If the interest rate is 2 percent higher than expected, the loan amount will equal the appreciated home equity some 5 1/2 years earlier than expected. Consequently, the loan amount will exceed the appreciated home equity by $122,328 in 20 years.

3.2 POLICY FRAMEWORK

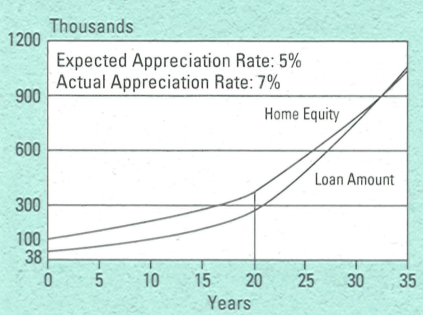
Canadian System of Housing Finance

The system of housing finance in Canada today is well integrated into the larger capital market and is based almost entirely on private-sector funds. There are no special direct mechanisms to channel mortgage money into the housing market. As a result, housing must compete with other demands for capital, which it has been able to.

The housing finance system is influenced by the free play of supply and demand; nonetheless the federal government maintains a strong, national facilitative presence. Public funds may be made available in isolated cases, where such financing is more appropriate or where residual lending is warranted because private capital is unavailable.

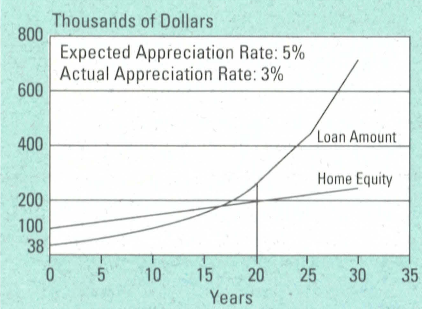
From a market efficiency perspective, NHA insurance of home equity conversion would help make the Canadian system of housing finance more complete. As a matter of good public policy, the provision of NHA insurance would enrich equal borrower access, promote consumer satisfaction, and encourage industry innovation and competition in a cost-effective fashion, while preserving the fiscal integrity of the MIF. These

Figure 9. Impact of House Price Risk



If the appreciation rate is 2 percent higher than expected, the loan amount will equal the appreciated home equity some 12 1/2 years later than expected. This higher appreciation rate will give the homeowner a net equity of $121,638 in 20 years, after loan repayment with interest.

Figure 10. Impact of House Price Risk



If the appreciation rate is 2 percent lower than expected, the loan amount will equal the appreciated home equity some 5 1/2 years earlier than expected. Consequently, the loan amount will exceed the appreciated home equity by $84,719 in 20 years.

characteristics are the basis for the following policy framework within which the NHA insurance parameters are proposed.

Enrich Equal Borrower Access

The primary public policy objective of NHA insurance is to ensure equal access to mortgage financing. In operational terms, equal access is achieved by applying a set of national insurance parameters and underwriting guidelines with, where appropriate, geographic variations. New NHA insurance products should be made available to Canadians on relatively similar terms and conditions, regardless of where people choose to live.

Promote Consumer Satisfaction

Innovative mechanisms in housing finance are often complex and generate specific pros and cons that are not always obvious or suitable to everyone. While NHA insurance of a specific mortgage design does not imply CMHC's recommendation of its use, CMHC has a vested interest in doing what it can to encourage successful implementation in the marketplace. Consumer satisfaction is the cornerstone of long-term success of any new mortgage technique.

Preserve Fiscal Responsibility

NHA insurance is designed to enable the federal government to substitute risk for expenditure in levering private-sector capital to meet the needs of mortgage borrowers. Users of NHA insurance pay a premium, which reflects risks and costs and which takes into account general premium cross-subsidization within the self-financing MIF. The introduction of any new NHA insurance products must preserve that fundamental characteristic of public mortgage loan insurance.

Harmonize with Established Practices

Large fixed start-up costs are often a barrier to mortgage innovation or to its widespread adoption in the marketplace. These costs can be minimized if the innovation is designed as an extension of an existing compatible product so that it can be delivered through existing business systems and documentations in a cost-effective manner. Maximum administrative economy should enable small, local or regional lenders to compete with large, national financial institutions on an equitable basis.

Promote Competition and Creativity

Because the needs of borrowers are diverse and fluid, a specific mortgage instrument can be packaged in a variety of ways to serve specific market niches. CMHC wants to challenge the creativity of the financial community, to ensure that the largest possible number of borrowers can find a product in the marketplace to meet their precise needs. A variety of choices will encourage lenders to compete on the basis of service and product differentiation. The end result will be a more complete system of housing finance with the lowest feasible prices and the best possible terms and conditions.

3.3 ACHIEVING POLICY FRAMEWORK

Overview

The provision of NHA insurance is intended to enable NHA-approved lenders, regardless of their size or market area in which they serve, to supply loans to convert home equity in a relatively risk-free manner. In exchange for a premium, NHA insurance would protect the lender against the peril of any deficiency in the mortgaged property as the collateral of the BPM plus eligible incidental expenses.

The borrower's liability would be limited to the mortgaged home because of NHA insurance protection. As a result, the borrower's personal covenant would normally not be available. As well, the borrower would have the comfort of knowing that the BPM could not be called on demand, except under a set of reasonable circumstances that are consistent with the security of the borrower.

Respecting Equal Access

Equal borrower access would be achieved through a set of program parameters and underwriting guidelines and procedures reflecting national standards and, where appropriate, geographic variations. In operational terms, rational generalization of some risk variables, such as house type or age of the borrower, could be used to generate relatively similar NHA insurance terms and conditions across Canada.

Delivering Consumer Satisfaction

Loan Due Date: Home equity conversion is premised on the withdrawal of home equity without loss of occupancy rights. Under this premise, the

BPM should not become due because the mortgaged home is no longer an adequate collateral for the loan. Rather, the BPM should be paid off when the borrower dies, or if the mortgaged home is sold or permanently vacated, or if the borrower violates the conditions of the loan, such as failure to maintain the property or to pay property tax, whichever occurs first.

Sales Surplus or Deficit: When the BPM is due, the borrower or the borrower's estate could either make the balloon payment to pre-empt the lender's power of sale or allow the lender to sell the property to retire the loan. The borrower or the borrower's estate would be entitled to receive any surplus from the disposal of the property after deducting the balloon payment and eligible incidental expenses. In the event of a deficiency, the lender would make a claim under the insurance, not against the borrower or the borrower's estate.

Cash Withdrawal: The cash generated from the conversion of home equity would provide the funding source of a line of credit from the lender making the loan. Under this line of credit, the borrower would normally make a series of cash withdrawals from time to time as the need arises, subject to annual withdrawal and aggregate credit ceilings. The borrower would be allowed to make a lump-sum cash withdrawal, provided that the purpose is to fund the purchase of an income stream or to meet other cash needs as approved by CMHC on compassionate grounds. These two options could be combined.

Interest Clock: The accrual of interest would begin the moment any cash is withdrawn under this line of credit and would continue until all these cash withdrawals are repaid with interest on or before the due date of the BPM. Alternatively, a borrower who chooses not to use this line of credit would owe nothing when the BPM is due.

No Tied-Selling: Because home equity conversion is the generation of cash through the BPM, it is independent of the manner in which the cash is to be used. Therefore, any bundling of the generation of cash and the utilization of it will move away from the concept of home equity conversion to the practice of tied-selling of financial products. Tied-selling tends to make the pros and cons of the individual transactions less transparent to the unsophisticated consumer, and to prevent the consumer from shopping independently for the best possible terms and conditions.

The loan might not be eligible for NHA insurance if the borrower is required, as a condition of obtaining the loan, to use the loan proceeds to purchase a financial product, such as an income stream, from the supplier of the BPM, or from a specific financial institution, or from one of the financial institutions on a list.

Disclosure: The terms and conditions to effect home equity conversion should be understandable to the borrower. Complete and proper lender disclosure could be based on the itemization of the terms and conditions and the articulation of the consequences of these terms and conditions.

Borrower Ratification: Unlike ordinary mortgage financing, which builds equity as the loan amortizes, home equity conversion builds debt, which increases over time at an increasing rate as a result of interest compounding. Thus, home equity conversion after several years is, for all intents and purposes, an irreversible transaction and the loan to effect that typically cannot be repaid except through the sale of the property. Against that backdrop, it is important to ensure that the use of home equity conversion reflects the fruit of the borrower's sober second thought.

It is proposed that the consumer be required to ratify the transaction on or before the expiry of a cooling-off period, after which the transaction would become null and void if not ratified. During the cooling-off period, the consumer is expected to review and reaffirm the decision to enter into home equity conversion, possibly with the help of arm's length counselling.

Additional Home Equity Conversion: As noted earlier, at a certain level of home equity withdrawal chosen by the borrower, the corresponding amount of cash generated is driven by informed forecasts of price appreciation, interest rate and life expectancy. The cash amount increases as the assumed house-price increase goes up and as the assumed interest rate and life expectancy go down. Conversely, the amount of cash decreases as the assumed house-price increase goes down, and as the assumed interest rate and life expectancy go up.

In practice, house prices appreciate at different rates across markets and by housing types. These differences could be recognized by providing the borrower with the option of requesting a professional reassessment of the prevailing market value of the mortgaged home. Where, on a cumulative basis, the actual appreciation is larger than the assumed level, the difference between the two could be considered as uncommitted home equity, subject to the maximum rate of home equity conversion, and be potentially eligible for partial or total conversion into cash.

Similarly, if interest rates turn out to be lower than the assumed level, the loan would be smaller than the assumed amount. The difference between the two could be considered as uncommitted home equity,

subject to the home equity conversion ceiling, and be potentially eligible for partial or total conversion into cash.

New mortgage and NHA insurance documents would be required if the borrower wants to convert some or all of the uncommitted home equity established as a result of the lender's review of the theoretical depletion of home equity against the actual level.

Compassionate Exceptions: Life expectancy data is normally accepted as a reasonable indicator of longevity. However, borrowers who have terminal illness deserve special consideration. On a case-by-case basis, the benchmark life expectancy could be adjusted downwards. The adjustment formula should be compatible with the practices now being used by the insurance industry to commute immediate life insurance benefits to clients with medically-verifiable terminal illness, on compassionate grounds.

Right of First Refusal: Many Canadians believe a house is much more than a place to dwell. It is a family home, which should pass from one generation to the next. That belief could be preserved by giving the right of first refusal to the borrower and the borrower's estate to acquire the BPM from the lender on demand when it becomes due in order to avert the sale of the mortgaged property to a third party.

Preserving Fiscal Responsibility

NHA insurance of home equity conversion should be made available to Canadians at no cost to the federal government. For that reason, the design of this insurance could incorporate measures to reduce the potential risk to a level where the residual is insurable by a premium structure that is marketable and consistent with MIF self-sufficiency.

Conversion Ceiling: The maximum insurable conversion rate could be up to and including 75 per cent of the lending value of the property. However, there could be no ceiling on house value or loan amount. The premium could be a single, up-front charge, expressed as a percentage of the amount of home equity conversion. The premium could be deducted from the cash available to the borrower under the line of credit.

Clean Title: Because the insurance is intended to treat only house-price, interest-rate and longevity risks, the perils of building disrepair and arrears in property tax or in utility payments would not be part of the premium calculation. These unfunded risks should not be allowed to jeopardize the value of the property as the security of the BPM. Therefore, the borrower should discharge any existing mortgage or claim registered against the property unless CMHC approves otherwise. The borrower could choose to use the cash converted from home equity to pay off any such outstanding mortgage or claim. In a similar vein, the borrower should not cause the registration of any additional encumbrance after the initiation of the BPM unless CMHC approves.

Enforcement of Loan Conditions: As a last resort, CMHC should be able to authorize the lender to withdraw cash under the borrower's line of credit or to claim against uncommitted home equity to eliminate building disrepair on the borrower's behalf or to cure any arrears in property taxes or utility charges or other housing-related payments.

Income Test: The borrower is responsible for property tax, utilities, and repairs and maintenance. These housing-related expenses should not represent a disproportionate share of the borrower's income after the conversion of home equity, because income after retirement will typically decline and the cash generated through home equity conversion is finite.

To keep the NHA premium structure at the lowest feasible levels, it would not be appropriate to charge extra for insuring against borrower inability to afford housing-related spending. Instead, it would be more reasonable to require the borrower to demonstrate, after the conversion of home equity, an ability to maintain housing-related expenses within a prudent ratio of income.

Deficiency Settlement: To maximize insurance administrative economy, the lender could be expected to exercise the power of sale if the mortgaged home is acquired upon the maturity of the BPM, and to claim against the insurance, where appropriate, on the basis of the deficiency between the BPM and the sale proceeds of the mortgaged property, plus eligible incidental expenses.

Harmonizing with Established Practices

NHA home equity conversion insurance should follow established practices in mortgage lending and loan insurance as closely as possible. As well, it should resemble lenders' line of credit lending based on home equity, except for the lack of minimum monthly interest payments and principal repayment on demand.

BPM Interest Rates: Under the protection of NHA insurance, other things being equal, the interest rate on the BPM to withdraw home equity should be competitive with the interest rate on the EPM to accumulate home equity. The rate of interest on the BPM could be fixed for the duration of the loan, or fixed during the term subject to change at agreed intervals, or variable, although any interest-rate adjustment should not reduce the maximum cash funding the line of credit.

Underwriting: Sound insurance underwriting should prevail on a case-by-case basis, within a set of market-sensitive, NHA terms and conditions. An underwriting fee should be levied.

Eligibility Restrictions: The borrower should be free to use the cash generated from the conversion of home equity for basic necessities of life or, subject to CMHC approval, in any other way. Any type of housing structure intended to be occupied by its owner as a principal residence could be eligible for NHA insurance. However, a dwelling being used exclusively to generate rental income should not. A dwelling should not be in a state of disrepair unless the borrower agrees to use the cash generated from home equity conversion to first cure the problem.

There might be no minimum age requirement on the borrower. As a general rule, the younger the borrower the smaller the amount of cash generated from home equity conversion and the smaller the financial benefits from withdrawal of home equity.

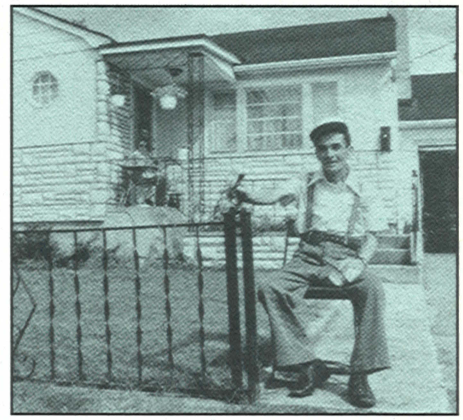
Promoting Competition and Creativity

The NHA insurance terms and conditions proposed above are intended to illustrate, for consultation purposes, one of the potential variations that is within the defined policy framework. Other possibilities may present just as much or more potential to pass the tests of good public policy.

Consequently, the proposals should not be interpreted as a way of using NHA insurance to standardize home equity conversion. The policy intent is to use the proposed NHA insurance terms and conditions, or others that are compatible with the defined policy framework, to help lenders bring unique, creative products onto the marketplace to meet their competitive objectives and to enable them to respond to the varying needs of as many borrowers as possible.

Like the mortgage to fund the purchase of a home, the loan to withdraw home equity will not be static over time. The NHA insurance terms and conditions are proposed with a view to facilitating lender refinement of home equity conversion products from time to time to capitalize on new business opportunities, as well as to cope with changing operating environments.

3.4 SUMMARY



Basic Questions

The basic policy questions in the insurance of home equity conversion lending under the NHA are:

- **Do Canadians want to be able to obtain NHA-insured financing to effect the withdrawal of home equity?**

- **Do Canadians believe the proposed NHA insurance terms and conditions represent a reasonable balance between CMHC's aim to facilitate housing choices for older home-owners and its mandate to operate NHA insurance in a sound, business-like fashion?**

- **What are the potential options for refining the proposed NHA insurance terms and conditions as summarized below?**

- **Are there better ways to respond to the housing finance needs of older homeowners that are available to CMHC within its express mandate and consistent with today's economic and policy environments?**

Summary Proposals: Equal Access

1. Nationally-applied insurance terms and conditions are based on generalization, where feasible, and reflecting geographic variations, where appropriate.

Summary Proposals: Consumer Satisfaction

2. BPM becomes due when borrower dies, or if home is sold or vacated, or if loan conditions are violated.
3. Borrower receives surplus sales proceeds, but is not liable for shortfall.
4. Borrower withdraws cash under line of credit from time to time, or in a lump sum to either purchase an income stream or for a purpose approved by CMHC on compassionate grounds, or both.
5. Interest accrues after cash is withdrawn and continues until BPM is repaid on or before due date.
6. Use of loan proceeds is not a condition of loan from lender.

7. Loan terms and conditions are itemized and their consequences are explained.
8. Borrower ratifies home equity conversion during cooling-off period.
9. Borrower may request conversion of uncommitted home equity into cash.
10. Exceptions are possible on compassionate grounds in the event of terminal illness.
11. Borrower gets right of first refusal in property when BPM becomes due.

Summary Proposals: Fiscal Responsibility

12. Home equity may be converted into cash up to 75 per cent of lending value of property.
13. Single, up-front insurance premium could be deducted from line of credit.
14. Any existing mortgage or claim registered against property should be discharged, unless CMHC approves otherwise.
15. No additional encumbrance is allowed unless CMHC approves otherwise.
16. Lender may withdraw cash under line of credit or use available home equity to pay tax or utility arrears or for dwelling repairs.
17. Housing-related expenses should remain within prudent ratio of borrower income.
18. Lender is entitled to deficiency claim settlement.

Summary Proposals: Established Practices

19. Home equity conversion lending should be harmonized with current mortgage and insurance practices to the extent possible.
20. BPM should offer competitive interest rates and terms.
21. Sound, market-sensitive insurance underwriting should prevail, and an underwriting fee should be paid.
22. Eligibility limits loan purpose to basic necessities of life unless CMHC approves otherwise, and to principal residence and homes in good condition. There is no minimum borrower age.

Summary Proposals: Competition and Creativity

23. Variations are insurable, provided they fall within policy framework.

4
Shared Equity Financing

4.1 BACKGROUND

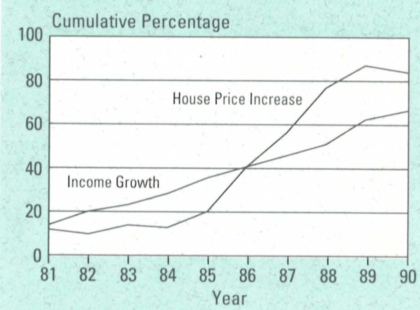
Barriers to Homeownership

Promoting homeownership represents good public policy. The reasons are embodied in the fabric of the Canadian society, which has been and will continue to be strongly oriented towards homeownership. Survey after survey shows that owning a home is an aspiration and a driving force for most Canadians. Owner-occupied housing is an important national asset.

Renters who have the income that allows them to achieve homeownership still must overcome the barriers of accumulating a downpayment and coping with the interest costs, especially during the initial years of mortgage financing. Under the standard equal payment mortgage that most borrowers use, the constant monthly mortgage payments as a proportion of income decline as the borrower's income increases over time. Consequently, the burden of mortgage financing is higher during the early years of the loan and lower during the later years.

Mortgages designed to tap into alternative funding sources for the downpayment or the interest cost could enable an estimated 1 million renters across Canada to access homeownership. Ideas for these mortgage designs have started to emerge in the marketplace and are surveyed in Appendix B.

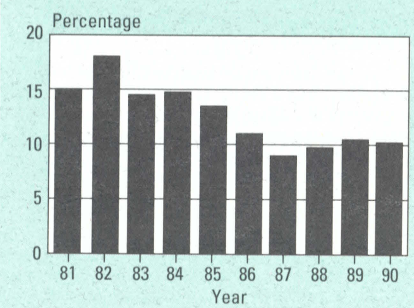
Figure 1. Income Growth Relative to House Price Increase, 1981-90



Source: Statistics Canada and Multiple Listing Services (MLS) which is a registered certification mark owned by the Canadian Real Estate Association.

In the four-year period beginning in 1986, homeownership moved farther out of reach each year for the average household saving for a home purchase.

Figure 2. Personal Savings Rate



Source: Statistics Canada 1990.

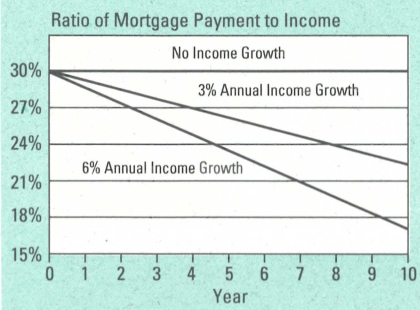
Lower personal savings rate means saving for a downpayment is more difficult.

Equal Payment Mortgage

The most common method of financing a home in Canada is the equal payment, fixed-rate mortgage. The borrower provides at least a minimum downpayment and repays the loan with periodic installments, usually monthly, over a loan amortization period that is typically 25 years or shorter. The borrower's equity in the house grows as the loan is paid off and as the house appreciates in value.

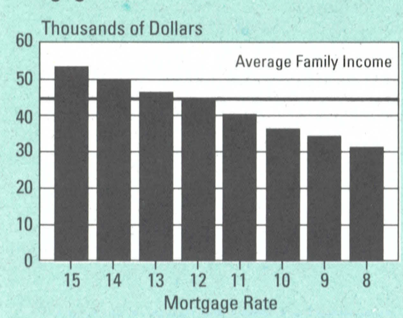
For the purpose of NHA insurance, borrower qualification is based on underwriting criteria, including a 32-per-cent gross debt service ratio, a 42-per-cent total debt service ratio, and a maximum loan-to-value ratio of 90 per cent (95 per cent for eligible first-time buyers under a two-year measure).

Figure 3. Debt Burden Under an Equal Payment Mortgage



Under an equal payment mortgage, the mortgage payment as a percentage of income falls over the life of the loan as household income increases. For a borrower whose income grows by 3 percent per year, a 30 percent initial payment/income ratio declines to 22.3 percent in 10 years, and to 16.6 percent in 20 years.

Figure 4. Required Income by Mortgage Rate



Source: Statistics Canada 1990.

If the mortgage rate is below 13 percent, the average Canadian household in the 25-44 age group has the income to carry a $100,000 mortgage. Once the mortgage rate rises above 13 percent, financing a house purchase becomes more difficult.

Cash gifts to the borrower from parents or other close relatives, grants from governments, sweat equity and secondary financing secured by very liquid assets are acceptable for downpayment purposes. Interest-rate buy-downs are recognized under the NHA within certain limits. The interest rate may be reduced by up to 3 percentage points for a minimum of three years, but the resulting mortgage interest rate is subject to a minimum level.

Shared Equity Financing

Shared equity financing of a house purchase is an arrangement whereby the non-occupant investor lowers the entry and/or carrying costs for the borrower. In return, the investor receives a share of the property appreciation. It involves a partial ownership agreement which enables the borrower to enjoy full ownership rights when complete ownership is achieved on or before a specific date. At the time of purchase, the borrower and investor agree on a formula for sharing the appreciation.

4.2 POTENTIAL INSURANCE PARAMETERS

Overview

NHA insurance of shared equity financing is proposed so that the cash-poor borrower would be able to access homeownership with the help of the cash-rich, unrelated investor, by trading off a portion of the future capital gains on the property for some downpayment or interest-rate concession. This would enable the borrower to purchase a principal residence by re-profiling the cash-flow burden over time. As a result, renters who lack the necessary capital in the short run, but who are in the early stages of their working life and who demonstrate good earnings potential, would have the opportunity to access homeownership.

Shared equity financing would require NHA insurance to recognize mortgages secured by housing partially owned by a non-borrower who has an interest in the future appreciation in the value of the house. NHA-insured financing is currently available on houses co-owned by unrelated borrowers who both have occupancy rights, and to cash-poor borrowers who receive some downpayment or interest-rate assistance. It is not available to those who wish to use funds from an unrelated investor, who in return, has a hold on a portion of the capital gains.

Public Policy Objective

The objective of NHA-insured shared equity financing is to provide potential home-buyers with the choice of tapping into this new source of homeownership finance under relatively equal NHA insurance terms and conditions.

Preserving Financial Incentives of Homeownership

Maximum Appreciation Sharing: The investor's share of the appreciation in the home should not be allowed to exceed a certain maximum (for example, 75 per cent), because a borrower who has little or no equity accumulation potential in the home does not have the financial incentives to keep up with the mortgage payments or to maintain or improve the home. In a similar vein, some minimum borrower equity could be required.

Complete Ownership: The ultimate objective of shared equity financing is to achieve outright ownership over time. Therefore, it is appropriate to incorporate a maximum term in the shared equity agreement (for example, 6 years), during which the buy-out option can be exercised by the borrower at any time. The purchase price on which the buy-out is based should be established by independent appraisals at the time of the buy-out, as opposed to an assumption-driven pricing formula fixed at the initiation of the agreement.

Promoting Fair Contracts

Restrictions on Interest Buy-Downs: Any investor buy-down of interest costs should remain in effect for the entire duration of the agreement, and be subject to a maximum (for example, up to 50 per cent of the prevailing interest rates in the marketplace). To protect the borrower, the rate of interest upon which the buy-down is based should fall within the range of allowable interest rates for the purpose of NHA insurance. This would provide the borrower with an accurate understanding of the real benefit of the buy-down relative to the foregone property appreciation potential.

Initial Home Valuation: The initial value of the house must be fair. If the value of the house at the initiation of the agreement is below the market level, the investor's financial return when the buy-out is exercised would be unjustifiably high. Hence, independent appraisals should be required in order to establish the fair market value of the house.

Disclosure: Comprehensive disclosure to the borrower is necessary because of the novelty of shared equity financing for Canadian homeowners, and because of the long-term financial implications for the borrower. The borrower must be made aware of all aspects of the agreement, including division of property appreciation, fees and charges, additional costs which the borrower would not assume under financing options based on complete ownership, buy-out terms and conditions, cancellation privileges, and due responsibility and allowance for dwelling repair, maintenance and upgrading.

Minimizing Costs and Uncertainties

Borrower Affordability: Limiting the residual risk to a level consistent with a marketable premium structure will ensure the insurance of shared equity financing in a fiscally responsible manner. Reflecting prudent lending practices, the borrower should be able to afford the transaction within the available means. This would be verified through income and credit tests, especially to establish whether or not the borrower has the financial ability to buy out the investor by the end of the agreement or to carry higher mortgage payments when the interest-rate buy-down terminates.

Harmonization: To the extent possible, the insurance of shared equity financing would comply with current NHA practices and underwriting criteria. There could be no ceiling placed on the house price or loan amount, and all house types could be eligible. The only new aspect from the perspective of the lender would be the addition of an equity participation partner.

Investor Security: A registered claim on the home is one way to create and secure the interest of the investor. Alternatively, this type of financing could take the form of a co-ownership arrangement between the non-occupant investor and owner-occupant, with the former's interest secured with a part title to the property in proportion to the equity sharing.

4.3 SUMMARY

Arrangements based on sharing of property appreciation are a relatively common financing technique in the commercial arena, and are currently employed to a limited extent in housing finance. As its full potential has yet to be explored, NHA insurance is seen as a catalyst for the expansion of this type of financing or for the refinement of it.

The above potential insurance parameters for downpayment and interest-rate concessions are one feasible model. There may be better ways of structuring the insurance of shared equity financing under the NHA. There may also be other potential applications of shared equity financing, one of which is an alternative to strict conventional rental investment. Another potential application is a means to enable the borrower to trade away some equity growth for increased homeownership security against elevated interest rates at mortgage renewal or income interruption due to unemployment, illness or disability.

5
Invitation

CMHC views this consultation as a forum to allow all interested parties to freely express their views on a number of important policy questions. Individual answers will be used by CMHC to construct a clear consensus about what Canadians want their public mortgage loan insurance to do for them in the 1990s and beyond.

Parties who are interested in expressing their views on the proposed innovative uses of public mortgage loan insurance are invited to do so in writing.

Responses should be sent to:

Mr. E. A. Flichel
President
Canada Mortgage and Housing Corporation
700 Montreal Road
Ottawa, Ontario
K1A 0P7

Additional copies of this document are available from:

Canadian Housing Information Centre
Canada Mortgage and Housing Corporation
700 Montreal Road
Ottawa, Ontario
K1A 0P7
Telephone (613) 748-2367

Ce document est aussi disponible en français.

APPENDICES

APPENDIX A: CANADIAN EXPERIENCE WITH HOME EQUITY CONVERSION

There are three major differences between a mortgage loan to accumulate home equity (equal payment mortgage or EPM) and a mortgage loan to withdraw home equity (balloon payment mortgage or BPM).

The first difference is the manner of loan repayment. Under the EPM, the amortization of the loan is through periodic installments so that complete loan repayment is achieved on or before the end of a specified period of time. Under the BPM, the amortization of the loan is by way of a single balloon payment whose exact due date cannot be specified at the time of loan initiation.

The second difference is the application of the mortgage loan proceeds. Under the EPM, the borrower must apply the proceeds to the purchase of the home, otherwise the mortgage to provide an interest to the lender cannot be created. Under the BPM, the borrower can apply the cash freely, because the home upon which the mortgage loan is based is available as the collateral.

The third difference is the extent of the liability of the borrower. Under the EPM, the borrower's personal covenant is available, where provincial statutes permit. As a result, in the event of mortgage default, the lender can potentially recover any loan losses. Under the BPM, the concept of home equity conversion requires the limitation of the liability of the borrower to the mortgaged home.

In summary, the fundamental characteristics of a home equity conversion loan are: an unspecified due date of loan repayment, unrestricted application of loan proceeds, and absence of personal covenant. Canadians can borrow against home equity under a number of loan mechanisms currently available from lending institutions. These mechanisms are assessed in this appendix in the context of the three fundamental characteristics of home equity conversion lending.

Equity Take-Out Mortgage Loan

A home can be refinanced with a larger or a new mortgage loan for the purpose of equity take-out. While there is typically no restriction on the application of the loan proceeds, the loan must be completely amortized through a series of interest payments and principal repayments during a set period of time. Further, the borrower's personal covenant is generally available. Thus, equity take-out is not a suitable mechanism for the permanent conversion of home equity into cash.

It is also possible to secure equity take-out financing in the form of the BPM. However, the due date of the BPM is typically in 5 years and loan continuation is not a definite certainty. As a result, it does not fully meet the fundamental characteristics of a mortgage loan to effect the conversion of home equity.

Home Equity Line of Credit

Most major deposit-taking institutions currently provide home equity line of credit (LOC) lending, secured by a mortgage, of up to 75 per cent of the lending value of the mortgaged home less any outstanding debts. While LOC terms and conditions vary from lender to lender, the provisions governing periodic payments and loan termination share many similarities.

The borrower must often pay at least the accrued LOC interest on a monthly basis. There is no due date for the repayment of the principal. However, the loan is typically callable on demand, in situations such as default or erosion of the loan security. The borrower is normally liable for any default-induced loan losses suffered by the lender.

Against the three fundamental characteristics of home equity conversion lending, LOC is not a suitable mechanism for the permanent conversion of home equity into cash.

Conversion of Home Equity into Income

A few financial institutions have introduced BPM lending with an unspecified due date of loan repayment and absence of personal covenant. However, the loan proceeds must be applied, in part, toward the purchase of a life annuity arranged by the supplier of the BPM. Because the borrower cannot freely use all the cash generated, the design of current annuity-based BPM does not fully meet the characteristics of home equity conversion lending.

Conversion of Home Equity into Cash

The borrower now also has the option of converting home equity into a LOC. The cash available under the LOC can be withdrawn by the borrower at any time for any purposes. Unlike the annuity-based BPM, the liability of the borrower of the LOC-based BPM may not be limited to the mortgaged home. While loan amortization involves a balloon payment downstream, the latest due date of the BPM is specified in the terms and conditions. This is not a desirable characteristic of the permanent conversion of home equity into cash.

A variation of this approach has recently been introduced, under which the borrower can take the cash generated through home equity conversion in a lump sum, without any restrictions on its uses. As well, the BPM has no specified due date and the personal covenant of the borrower is not available. This design carries all the fundamental characteristics of home equity conversion.

APPENDIX B: SHARED EQUITY FINANCING PLANS IN CANADA AND ABROAD

Various names are used to describe homeownership financing schemes based on shared equity. In Canada and abroad, these names include equity sharing, equity participation, equity partnerships, shared ownership, participatory financing, shared appreciation, and progressive ownership. Despite the terminology and regardless of the specific program parameters, they all work on the principle of exchanging home equity for the removal of homeownership barriers, including interest rates and downpayment, and are aimed at home-buyers who have incomes and savings that would otherwise be inadequate.

The limited number of homeownership schemes based on shared equity employ different applications of this type of financing. Some of these are described below.

Interest-Rate or Downpayment Concessions

Schemes involving interest-rate or downpayment concessions or both have surfaced in a small number of Canadian cities, mostly high-cost centres. This development is in response to the strong house-price appreciation and the higher interest rates that have increased the number of households short of the capital necessary for a home purchase. Firms that specialize in matching investors with home-buyers have precipitated the development of this type of shared equity financing. The fee structures vary from lump-sum payments at the time of purchase to periodic payments over the life of the contract, or a combination of both.

The challenge is that in every region of the country, not just demand-driven markets, there are people who cannot access homeownership because they lack downpayment funds or because their income cannot support the initial burden of mortgage payments.

Transaction Costs

An extension of shared equity financing is gaining popularity in the United States. Under this approach, the borrower's employer pays the closing costs and application fees, in return for a temporary share in the equity of the house. The investment return to the employer is mostly work-related, such as improved morale and productivity, less labour turnover and reduced absenteeism.

Under one type of program, the employer extends a loan to the employee for the transaction costs of the house purchase. In return, the employer holds an equity position in the home until the loan is fully repaid. The employee achieves full ownership once the loan is retired.

In Canada, firms that match investors with home-buyers for the purpose of shared equity financing incorporate all or part of the transaction costs into the deal. In addition, it is not uncommon for companies in Canadian resource communities to participate in shared equity financing arrangements with their employees through employer-assisted housing programs, involving downpayment reductions, interest-rate buy-downs, and transaction-cost subsidies.

Employee Compensation

In the United States, specialists in the use of real estate as an employee benefit have been working together with consultants in affordable housing to develop a model program to demonstrate how homeownership can be used as a form of employee compensation. The concept works on the principle of shared equity.

The employer and the occupant-employee become joint owners in a house, with the employer paying part of the downpayment and the employee carrying the mortgage. The employee receives equity shares from the employer over time until all of these shares are transferred to the employee. In accordance with U.S. tax legislation governing employee benefits, the employee is taxed on the market value of the transferred equity and on the imputed rental value of occupying the employer's portion of the property. The employer's benefits include salary savings — the logic is that the employee accepts lower wage levels or increases in return for this housing benefit — as well as annual tax write-offs from capital cost allowance and higher productivity.

Shared Ownership

Through participatory financing, shared ownership schemes operating in the United Kingdom and Australia enable the home-buyer to achieve eventual full ownership by progressively acquiring shares in the equity of a house. The occupant-buyer obtains mortgage financing to buy a part share, and pays rents on the remaining shares owned by the investor. The occupant progresses to outright ownership either by gradually buying more shares in the property at market value, with a corresponding reduction in the rent, or by selling the equity shares acquired and using the sale proceeds, which may include capital gains, to finance the downpayment on another home.

The limited number of shared ownership schemes abroad typically involve some government subsidies. However, they also aim to overcome the rigidities in their housing finance systems which arise from the inability to finance home purchases on the basis of future repayment capacity and, for that reason, present potential for unassisted market housing.

Most of these existing schemes have a 25-per-cent minimum share for the initial purchase, with subsequent purchases available in 10-per-cent lots. Typically, the occupant-buyer is responsible for maintenance and repairs, taxes, insurance and transaction costs. The investor is attracted by the prospect of capital gains on the disposal of the equity shares and by knowing that the occupant has a vested interest in caring for the property and is responsible for all expenses, except debt servicing. More importantly, the investor does not have to worry about negative cash outflow.

Leasehold Mortgage

One currently permitted form of equity participation for NHA insurance purposes is the leasehold mortgage. This is a mortgage secured by a house located on leased land. The financing of the house, the land, and any improvements to the property are separated: the land is owned by a third party and is leased by the borrower; the lender finances the improvements on the land with a leasehold mortgage; and the lessor holds an equity participation in the property in the form of an interest in the land. All capital appreciation of the property during the term of the lease accrues to the lessor, although the lease may contain a purchase option for the lessee. For the lessee home-buyer, it reduces the immediate cash requirements necessary to purchase a home by allowing the borrower to trade away future price appreciation on the land.

Retirement Housing

Shared equity financing for the purchase of retirement housing is starting to emerge in Canada. It allows seniors to purchase a portion (for example, 50 per cent) of a dwelling and to rent the remaining share from the developer or a third-party investor. Unlike the progressive ownership schemes operating abroad, the occupant's ultimate objective is partial ownership, not full homeownership. At a lower purchase price, it provides the occupant with the same security of tenure as in an outright purchase as well as the flexibility to resell. However, in return, the occupant-owner is entitled to only a portion of any appreciation in the value of the dwelling unit, in proportion to the equity share.

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