Public Mortgage Loan Insurance in Canada

by Jacques Beaupré

OVERVIEW

This article examines the public mortgage loan insurance system in Canada under the auspices of the National Housing Act (NHA). NHA mortgage loan insurance was established in 1954 by the Parliament of Canada to allow approved lenders to make mortgages with a lower minimum downpayment. Mortgage loan insurance compensates the approved lender for financial losses arising from borrower default, making mortgages with less owner equity as safe as those with more. Through default insurance, borrowers with downpayments as low as 5% have access to mortgage financing at terms and conditions comparable to those with much higher equity. NHA mortgage loan insurance is administered by the Canada Mortgage and Housing Corporation (CMHC), a Crown Corporation established by the government of Canada. In 1995, CMHC provided mortgage insurance for approximately 41% of all mortgages in Canada. Since its introduction over 40 years ago, public mortgage loan insurance has assisted nearly 3.1 million borrowers in the financing of some $120 billion worth of real estate, in a nation of approximately 30 million people.

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INTRODUCTION

The economic and social importance of housing explains its high priority among all levels of government. A well-functioning housing sector enables the marketplace to be the primary vehicle to meet the shelter needs of society. Market inefficiency exacts a high cost from society; consumers will have fewer shelter choices and will pay higher housing costs. The consequence is a larger housing affordability problem for governments to solve, hence more pressure on taxpayers to subsidize the disadvantaged. From a macroeconomic perspective, a dysfunctional housing sector reduces growth and jobs.

Homeownership is an aspiration for many Canadians. Sixty-three percent of Canadian households own their own homes. Owner-occupied housing represents an important national asset, an investment of personal wealth, and for most owners, a major source of retirement savings. It provides owners with greater protection against increases in shelter costs and control over their environment. Homeownership encourages individual responsibility, self-help and social stability, it also benefits renters indirectly, as the dwellings left vacant filter down to increase the supply of rental housing, as tenants shift to homeownership.

THE CANADIAN SYSTEM OF HOUSING FINANCE

Canadian housing investment typically involves debt financing. This relationship means that a shortage in mortgage funds constrains housing supply and an increase in mortgage rates amounts to an increase in housing costs.

The Canadian system of housing finance is a well-integrated part of the larger capital market and is not a stand-alone system. It is based almost entirely on private-sector funds from chartered banks, trust and loan companies, life insurance firms, caisses populaires, credit unions, pension funds and mortgage investment brokers. Banks, including their subsidiary trust and loan companies, are the dominant supplier of home loans. Figure 1 shows the relative market shares in 1995. Funds for mortgages are generally raised by deposits, including guaranteed investment certificates (GICs) that are sold to savers. Federally supported mortgage-backed securities have been available since 1987, but have a relatively small market share. Unlike some OECD countries, which feature contract savings, there are no special direct mechanisms to channel funds into the Canadian housing market.

Although it is influenced by the free play of supply and demand, the government of
Canada maintains a strong, national, facilitative presence in the system of housing finance. Canada uses Crown Corporations to pursue public policy in a number of ways. Canada Mortgage and Housing Corporation (CMHC) is the tool for direct federal involvement in housing. CMHC is a Crown Corporation under Part I of Schedule III in the Financial Administration Act (FAA), a category for those public enterprises that are non-commercial or non-competitive or non-self-sustaining.

Indirect presence in housing through other federal departments or agencies also occurs, primarily because the policies they administer affect housing. The Department of Finance provides a rebate of 36% of the goods and services tax paid on eligible newly constructed homes in order to preserve housing affordability. Revenue Canada also administers the Home Buyers' Plan, which allows first-time buyers to withdraw temporarily up to $20,000 tax-free from their Registered Retirement Savings Plan (RRSP) for downpayment purposes. The Income Tax Act exempts principal residence from the capital gains tax, but disallows mortgage interest deductibility, making homeownership a tax-neutral transaction funded by after-tax money.

The standard Canadian mortgage instrument consists of regular payments (e.g., weekly, biweekly, monthly) of principal and interest, with a fixed interest rate during the term that can vary from six months to 10 years. The loan amortization period is typically 25 years. A minimum downpayment of 25% is required, by virtue of the federal Bank Act, unless the mortgage loan is insured. A mortgage loan is considered "high-ratio" when the downpayment is less than 25%, and all high-ratio loans must be insured, either publicly with NHA insurance or by a private insurer.

Mortgage lending involves some degree of risk for lenders. Mortgage loan insurance provides approved lenders with a guarantee of repayment and eliminates the risk they take when making mortgage loans. It therefore protects approved lenders against loss due to default on mortgage loans. As such, approved lenders are more confident, thus making more mortgage loans to more people and making it easier to get a mortgage and buy a home. Mortgage insurance also allows purchase of a home sooner, since downpayments are lower than for low-risk mortgages that do not require insurance.

Mortgage insurance is the cheapest means through which borrowers can obtain low downpayment financing and lenders can obtain default protection. Canadian mortgage borrowers generally enjoy levels of access, pricing and choice that are comparable to those associated with approved lenders' prime corporate customers. In less than one generation, mortgage loan insurance has caused approved lenders to change their views of home loans from a risky, residual activity they should avoid, to a safe, mainstream product for which they should compete.

**NHA MORTGAGE LOAN INSURANCE**

National Housing Act (NHA) insurance has been a key policy instrument of the federal government in the creation, maintenance and
refinement of the system of housing finance in Canada. Equal access to home loans in all parts of Canada is ensured by way of a public mortgage loan insurance scheme, while the availability of long-term funds is promoted through the securitization of mortgages with a federal guarantee. In the context of a market-based system of housing finance, the policy regime aims to facilitate new mortgage choices and promote a more efficient market. The assets and liabilities created by the provision of mortgage insurance are placed in a separate fund, the Mortgage Insurance Fund (MIF).

In 1954, NHA mortgage loan insurance replaced a public-private joint loan arrangement with a new insured loan system, based strictly on private-sector loanable funds. Under the previous system of joint loans, federal funds made up 25% of the loan amount, the interest rate on the federal share of the joint loans was subsidized, appraisal and inspection costs were absorbed by the government, and federal loan loss guarantees were provided at no cost to the approved lenders. Along with changes to the Bank Act, NHA insurance increased the supply of mortgage funds by permitting banks to become NHA-approved lenders. This also allowed any person or company to invest in NHA-insured mortgages, provided the loan servicing was undertaken by an approved lender. This enabled the federal government to withdraw the use of public funds, except as a mortgage lender of last resort.

The introduction of NHA insurance in 1954 was motivated by a desire to promote housing affordability and to eliminate dwelling shortages. This was achieved by restricting the availability of NHA-insured financing to new residential construction below prescribed loan limits. The approach also standardized mortgage lending practices. The legislation empowered CMHC to buy NHA-insured mortgages from, or to sell them to, NHA-approved lenders, provided that the servicing was retained by the approved lender. This liquidity facility offset the banks' historical preference for business loans over other types of lending.

The public policy mandate of NHA insurance in the mid-1960s and throughout the 1970s was driven by the political climate of doing more in housing. During this time, the mandate of the NHA insurance expanded beyond supporting only the construction of new, affordable homes. NHA insurance was gradually redesigned to further consumer access to housing finance: (1) existing homeownership loans became insurable, to the benefit of first-time homebuyers; (2) insurance eligibility was extended to existing rental loans; (3) product eligibility criteria were expanded; (4) homeownership and rental premiums were cut by one-half; and (5) riskier mortgages initiated under the federal Assisted Home-Ownership Program and the Assisted Rental Program subsidy schemes were insured without any additional premium.

At a broader policy level, the objective was to harmonize NHA with conventional lending, with a view to integrating the mortgage market into the larger capital market to compete effectively with other uses of capital. This integration was seen as a way to further reduce the counter-cyclical behavior in the supply of mortgage funds. To that end, the minimum NHA term was reduced from 25 years to five years, and then to one year, marking the beginning of the renewable mortgage. The Bank Act was also amended to permit banks to make conventional (non-insured) mortgages.

In 1986, on behalf of the federal government, CMHC undertook an extensive review of NHA mortgage insurance. It was intended to refocus NHA insurance on the basis of promoting, at no cost to the federal government, homeownership access and rental construction. During 1987 CMHC successfully implemented the new federal directions in public mortgage loan insurance that were developed as a result of the 1986 review and public consultation. The public policy objectives of NHA insurance were re-defined to: (1) ensure geographic equal access to mortgage financing at the smallest feasible downpayment and the lowest possible cost to all borrowers; (2) assist the mortgage market to adjust to changing economic conditions; and (3) play a supportive role to other government initiatives.

Premium cross-subsidization is the means of achieving the public policy objectives of NHA mortgage insurance. 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 product initiatives including second mortgage loan insurance, portfolio insurance for existing loans and insurance for movable home loans were introduced. In addition, premiums for mortgages with lower loan ratios and underwriting fees were reduced.

Under the capital adequacy rules for the Bank for International Settlements (BIS) accord, banks do not have to put up any capital for holding NHA-insured lending. However, they are required to capitalize their portfolio of privately insured loans at a rate of $4 for every $100 in such investment.

**PUBLIC-PRIVATE COMPETITION**

Private mortgage insurance began on an informal basis in 1963 by the Mortgage Insurance Company of Canada (MICC). The business strategy of 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 ineligible 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 because NHA-insured loans were subject to an interest-rate ceiling until 1969.
Privately insured, high-ratio loans were eventually recognized in legislation in 1970. This regulatory change, in conjunction with favorable 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 1976, Insmor and Sovereign were amalgamated under the Insmor name. In 1981, a merger of Insmor with MICC occurred under the MICC name. These events were precipitated by increased default rates and decreased insurance demand.

In 1994, MICC sold its operation to GE Capital Mortgage Insurance Company (GECMIC), a subsidiary of a network of companies held by General Electric (GE) in the United States. Prior to GECMIC, competition between public and private insurance was defined by MICC’s practice of targeting limited segments of the market. Competition between the MIF and the MICC was in the lower-risk segment of the market, primarily on the basis of product differentiation at the margin and service. The entry of the Canadian GECMIC subsidiary was an indication that neither CMHC nor the federal regulatory regime is an artificial barrier to new firms entering the market.

HOW NHA MORTGAGE LOAN INSURANCE WORKS

CMHC insures repayment of eligible first mortgage loans supplied by NHA-approved lenders for the construction of single- or multiple-unit dwellings for rental or ownership, in the purchase, refinancing an improvement of existing houses for ownership and existing rental projects, and in the conversion of nonresidential buildings to housing projects. There is no provision for the insurance of commercial or industrial projects or loan development unless they are part of a residential project; even in these cases the commercial or industrial portion of the insured loan is severely limited.

Borrowers must apply for mortgage insurance through an approved lender. To be an approved lender, an institution must apply to CMHC, and the Corporation will examine the applicant’s experience, expertise, capitalization, nature of business, and ability to make and service NHA-insured mortgages. The lender must meet other criteria as well before the status of approved lender under the NHA is granted.

To obtain mortgage insurance, the borrower pays an application fee to cover the costs incurred by CMHC in reviewing the application. The basic NHA premium for first mortgage homeownership loans ranges from 0.5% to 3% of the loan value, depending on the ratio of the loan to the lending value and the number of mortgage advances. Insurance for a second mortgage loan is available on a comparable basis. The premium can be paid in a lump sum or it can be added to the mortgage loan to be repaid in monthly installments.

There are a number of criteria for the approval of an NHA loan insurance application. The minimum downpayment is generally 10% of the property value, or 5% for qualified first time home buyers. The downpayment must come from the borrowers’ own resources. It is the responsibility of the approved lender to review applications for NHA-insured mortgages, follow prudent lending practices and adhere to the provisions of the NHA and National Housing Loan Regulations. In the case of homeownership, the underwriter specifies the level of risk that the loan represents according to a series of criteria. One criterion is the borrower’s ability to service the mortgage, which is the ratio of the sum of principal repayments, interest charges, property taxes and heating costs to gross income. The CMHC benchmark is 32% of gross income. In addition, the borrower’s maximum ratio of total debt payments to gross income must be generally less than 42%. These ratios are seldom considered independently, as many lenders are prepared to allow some trade-offs. The credit worthiness of the borrower is another criterion and is based on employment stability, credit records, personal characteristics and financial references.

Since the mortgaged property is the primary security for the loan, this may involve inspections and appraisals of the property. At the time of application, construction plans may be checked to ensure that they conform to acceptable standards. During construction, monitoring occurs by CMHC to ensure reasonable conformance to the plans.

If the loan is approved, CMHC issues a legally binding commitment to provide mortgage loan insurance to the approved lender subject to the satisfaction of conditions stipulated by CMHC.

Mortgage Insurance Fund (MIF)

The mortgage insurance fees and premiums charged to borrowers are pooled in the MIF. Cash in the fund is invested mainly in government securities. The funds are used to pay out claims that may arise. The federal government ultimately backs the MIF with a guarantee, should the fund be unable to cover claims.

In the event of a default, when mortgage payments are in arrears, approved lenders traditionally wait for a certain period before starting any legal action against a borrower. A default can arise due to factors other than arrears, such as the use of the property for purposes other than those for which the mortgage was granted or non-payment of municipal taxes. When default appears to be imminent, the approved lender chooses the next course of action.

In order to effect a claim on the Mortgage Insurance Fund for a defaulted loan, the approved lender servicing the mortgage must acquire clear and marketable title to the property, file a claim with CMHC and convey the title to CMHC, clear of all encumbrances.
Full payment is then made in cash by CMHC from the MIF for the amount of the loan principal outstanding, defaulted interest within stipulated limits, legal costs and other specified charges. The approved lender may alternatively choose the deficiency settlement technique in which the approved lender sells the property and claims only the unrecovered balance of the loan.

Once title of the property is conveyed, the Corporation either administers the property or sells it for an amount equal to an approved target price. If there is a loss, it is absorbed by the MIF. If appropriate, CMHC may make improvements to the property that are necessary to improve health, safety or security attributes for the benefit of tenants, in order to minimize the loss.

Small properties are sold on the market through real estate agents, while large properties are put up for sale on the market through a process known as "Request for Proposals," or other sales techniques.

**RECENT DEVELOPMENTS**

**First Home Loan Insurance (FHLI)**

In 1992, mortgage insurance for 95% loan-to-value ratio financing was introduced for first time home buyers through the First Home Loan Insurance (FHLI) initiative. Since its inception, a total of 340,980 home buyers have taken advantage of FHLI. In 1995 alone, a total of 97,837 mortgages were insured under FHLI, accounting for nearly 54% of all homeowner mortgages underwritten by CMHC during the year.

FHLI applies to new homes, as well as to resale homes, provided it is the borrower’s first principal residence. Payments for principal, interest, property taxes, heating and 50% of condominium fees cannot exceed 35% of the borrower’s gross family income, and the borrower's total debt loan cannot exceed 42% of gross family income.

Maximum house prices are also applicable to FHLI applicants. They range from a maximum house price of $125,000 to $250,000, depending on the market.

**Business Process Innovations**

Increasing competition in the mortgage industry coupled with technological advances require CMHC to pursue continuous improvement in its mortgage insurance operations. Products, services and systems are constantly updated to meet changing client needs and expectations, and to ensure MIF profitability.

CMHC is in the process of introducing *emilii*, a new computer-based underwriting system that will enable the Corporation to process NHA mortgage insurance for existing homeowner units more quickly and at a lower cost. The system also includes a decision support capability to assist approved lenders in assessing risks and processing applications. An automated approval option provides for instantaneous decisions on loan insurance applications. Loan approvals can be provided within minutes of receiving the applications online. Under another option, authority for the commitment of NHA insurance is being delegated to approved lenders that have demonstrated an ability to commit above-average quality business.

CMHC also recently introduced a Direct Deposit Option (DDO) which permits approved lenders to remit mortgage insurance premiums and fees electronically from approved lenders to the Corporation. In 1995, 61,000 receipts were processed using DDO, representing 16% of total receipts. The DDO system was further developed and expanded in 1996. This initiative has reduced administrative costs per loan and eliminated paperwork.

The efficiency of the claims payment process has been improved through the introduction of the Accelerated Claims Payment Plan (ACPP). Overall claims costs have been reduced through electronic funds transfer, streamlined claims payment procedures and training initiatives.

**Figure 2. NHA Mortgage Insurance in Force**

![Graph showing NHA Mortgage Insurance in Force over years 1981 to 1995.](source: Canadian Housing Statistics, CMHC, 1995)
ACHIEVEMENTS OF MORTGAGE INSURANCE

More than 3 million NHA-financed dwelling units, or approximately one-third of Canada's housing stock, has been financed with the use of mortgage loan insurance. At the end of 1995, the value of insurance policies in force was $113.3 billion. Figure 2 shows the growth of insurance in force over the years.

The ability of borrowers to make a lower downpayment through mortgage insurance makes homeownership accessible to more modest-income households. Mortgage insurance also promotes rental construction because of the higher mortgage amount when it is compared to the usual level granted under conventional financing. Since NHA insurance fully protects against default losses, the approved lender charges, and the borrower enjoys, the lowest feasible interest rate. This is particularly important to borrowers living in small, rural or remote communities because they are able to have access to mortgages on a basis equal to those in urban centers. Figure 3 presents a profile of NHA-insured loans approved in 1995.

Figure 3. NHA-Insured Loans in 1995

- The average loan amount was $121,557
- 13.4% of the loans were less than $90,000
- 20.9% of the loans were $150,000 or more
- 44.2% of borrowers had a gross debt-service-to-income ratio of 20.1-27.0%
- 10.5% of the loans had an initial term of one year
- 50.2% of the loans had an initial term of five years
- 87.7% of the loans had an amortization period of 25 years
- 79.3% of the loans had a ratio of loan to lending value of 85.1-95.0%


By facilitating the emergence of innovative mortgage instruments and a secondary mortgage market, loan insurance has assisted the mortgage market in adjusting to changing economic conditions. It has supported other federal policy initiatives as well, such as leveraging private-sector funds to finance the production of social housing and assisted housing programs designed for employment-generation purposes. And 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.

Financial Performance

The financial performance of the MIF is closely related to economic cycles. Throughout most of the 1970s, the Fund experienced significant earnings growth contributing to the accumulation of a surplus of over $600 million. In the late 1970s and early 1980s, the MIF experienced significant losses on claims and fell into a deficit position of nearly $800 million. Throughout the remainder of the 1980s and early 1990s, net earnings grew and a modest surplus was re-established.

MIF losses do not indicate any inadequacy in the current premiums but have been due mainly to the losses in the under-priced insurance on loans initiated under former federal subsidy programs. Under favorable economic conditions, the higher profitability in the business written with the current premiums is large enough to cover the losses in the old under-priced business. This, however, may not occur in difficult economic times when profitability is consequently lower.

The MIF had a surplus of $8 million at the end of 1995. An actuarial evaluation of the Fund confirmed its solvency as of September 30, 1995, and it is expected to remain profitable in the foreseeable future.

LOOKING AHEAD

Challenges

The Canadian housing market is undergoing significant changes as a result of a number of domestic and international socio-economic factors. These changes will shape the housing finance system in Canada in the years to come.

Overall, Canada has a relatively mature housing market. The demand for new housing has fallen significantly in recent years as most of the baby boom generation, the predominant age cohort group, has purchased homes. In 1995, new housing starts in Canada fell to the lowest level in 35 years. While demographic factors are the primary cause of this reduced level of activity, a low level of consumer confidence was also a factor. Figure 4 illustrates the decline in annual housing starts since 1970.

In this environment the key to expanding and maintaining a competitive mortgage loan insurance environment is expanding housing affordability and choice. Consumers are demanding a broader range of housing finance products, as the current selection is limited. Certain borrowers, such as younger householders and recent immigrants, are presently underserved, and new initiatives could be considered to reach these groups. As the population of Canada ages, there is increasing demand for options to enable homeowners to withdraw equity from their property.

Housing finance products and practices have not kept pace with globalization and the emergence of the new economy. New patterns and styles of work are emerging and self-employment is growing in Canada. As part-time and contract work become more prevalent, incomes are becoming less regularized. The Canadian housing finance system, including mortgage loan insurance, can respond to these developments through the introduction of new products and services, and new approaches to underwriting. There is also the potential to introduce new mortgage

18

HOUSING FINANCE INTERNATIONAL
insurance products that will address the lack of consumer confidence resulting from some of these economic changes.

**CMHC’s New Mandate in Housing Finance**

Until recently, the public policy mandate required the MIF to fund equal access to NHA-insured financing everywhere in Canada, as well as other public policy objectives, in a self-sufficient manner through cross-subsidization of premiums and fees. This has meant that sufficient low-risk, low-cost business must be generated to compensate for the added cost of underwriting high-risk, high-cost insurance at the same premium and fee levels. The feasibility of cross-subsidization could not be created by charging excess premiums or fees in low-risk, low-cost insurance because competition would not allow for higher prices.

In late 1995, the government of Canada completed a review of CMHC’s mandate in housing finance. In its 1996 federal budget, the government indicated that the MIF would be operated on a more commercial basis. CMHC’s new public policy mandate in housing finance will be based on the following four policy objectives:

- To promote housing affordability and choice, with special emphasis on ensuring the availability of house financing for home buyers in all regions of Canada;
- To ensure market competition and efficiency in the market for mortgage loan insurance and guarantee;
- To protect an adequate supply of low-cost mortgage funds; and
- To contribute to the well-being of the housing sector in the national economy.

Commercialization is intended to respond better to market changes, to improve efficiency and to ensure a more competitive marketplace. It will provide CMHC with the tools and the flexibility to meet this competitive challenge. Failure to commercialize could have reduced CMHC to a residual insurer insuring mostly riskier loans and would compromise the self-sufficiency of the MIF and jeopardize the Fund’s financial capacity to achieve the public policy objectives of NHA mortgage insurance.

Commercialization means that NHA mortgage loan insurance will continue to be used to ensure that financing is available to homebuyers in all regions of Canada. CMHC will have the authority to develop and introduce a range of new insurance products and services, and flexibility in the area of pricing, based on risk and competitive considerations.

Commercialization will have a significant impact on the way CMHC does business. Leveling the playing field for private-public competition means that the MIF will adopt a capital structure similar to the private sector and will be expected to provide a return to its shareholder (the federal government). There will be greater emphasis on controlling costs and increasing the rate of return on MIF assets. As a commercial entity, there will also be increased emphasis on service to clients, new product opportunities and marketing strategies.

**CONCLUSION**

NHA mortgage loan insurance has played an integral role in the evolution of Canada’s modern system of housing finance. As a public policy instrument, NHA insurance has enabled Canadians, no matter where they live, to have access to mortgage loans at favorable terms and conditions, at no cost to the federal government. It has also created stability and fostered competition in housing finance among lenders.

NHA mortgage loan insurance must evolve in response to the changing housing finance requirements and preferences of Canadians, approved lender client needs and in response to competitive factors. Commercialization of the MIF will provide CMHC with the tools and flexibility needed to provide better service to clients and ensure a level playing field for public-private competition. Most importantly, CMHC will continue to pursue a public policy mandate in housing finance, with particular emphasis on expanding housing choices and improving housing affordability for Canadians.