Risky Mortgages – Deregulation of Canada’s Financial Market – Part 8

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In the previous segments,much focus has been placed on the banks, life insurance companies, and others in the financial space. However now, we’re going to slowly move on forward to the mortgage market, because this is inherently where the greatest risks to the Canadian economy lie.

In a nut shell, financial deregulation has occurred throughout all countries in the west, and has, to some extent or another, led to an increasing centralization of power. Deregulation

during the 1980's, and into the 1990's, allowed banks to lower their interest rates, and made it easier for companies to receive large loans, even if they knew it would be impossible to pay. With the current events of Europe today, their financial market has only buried itself deeper and deeper into debt. In many of the Eurozone countries, massive amounts of loans were given out and during a financial crunch such as now in 2012, the effects can plainly be seen on Portugal, Ireland, Italy, Greece, and Spain. These countries have been the most affected, and the worst off.

In this part, we look into the expansion of deregulation that occurred when the Conservative government received their first minority after a decade.

Included in the Budget Plan for 2006, titled: Canada's New Government, Turning a New Leaf, there were many measures stated to be implemented.

However, the new changes as outlined on page 83, would

allow new players entering the mortgage insurance market to gain access to that facility, and will be increasing the amount of business that can be covered under the Government's authority from 100$ billion to 200$ billion in order to keep pace with the increase in housing prices and the growth in the mortgage market. These changes will result in greater choice and innovation in the market for mortgage insurance, benefiting consumers and promoting home ownership

The Canadian Government's proposed solution was a radical change in fostering competition in the Mortgage Insurance Market.

At the time before the Budget was written, the Government promoted mortgage financing through a program that provided a government guarantee for companies that insure mortgage loans. This program did contribute to a competitive mortgage insurance market and for more affordable housing for Canadians.

The keywords in the sentence were "**promoting home ownership**" and "**innovation**" because this is exactly what the U.S. Government was intending on as well.

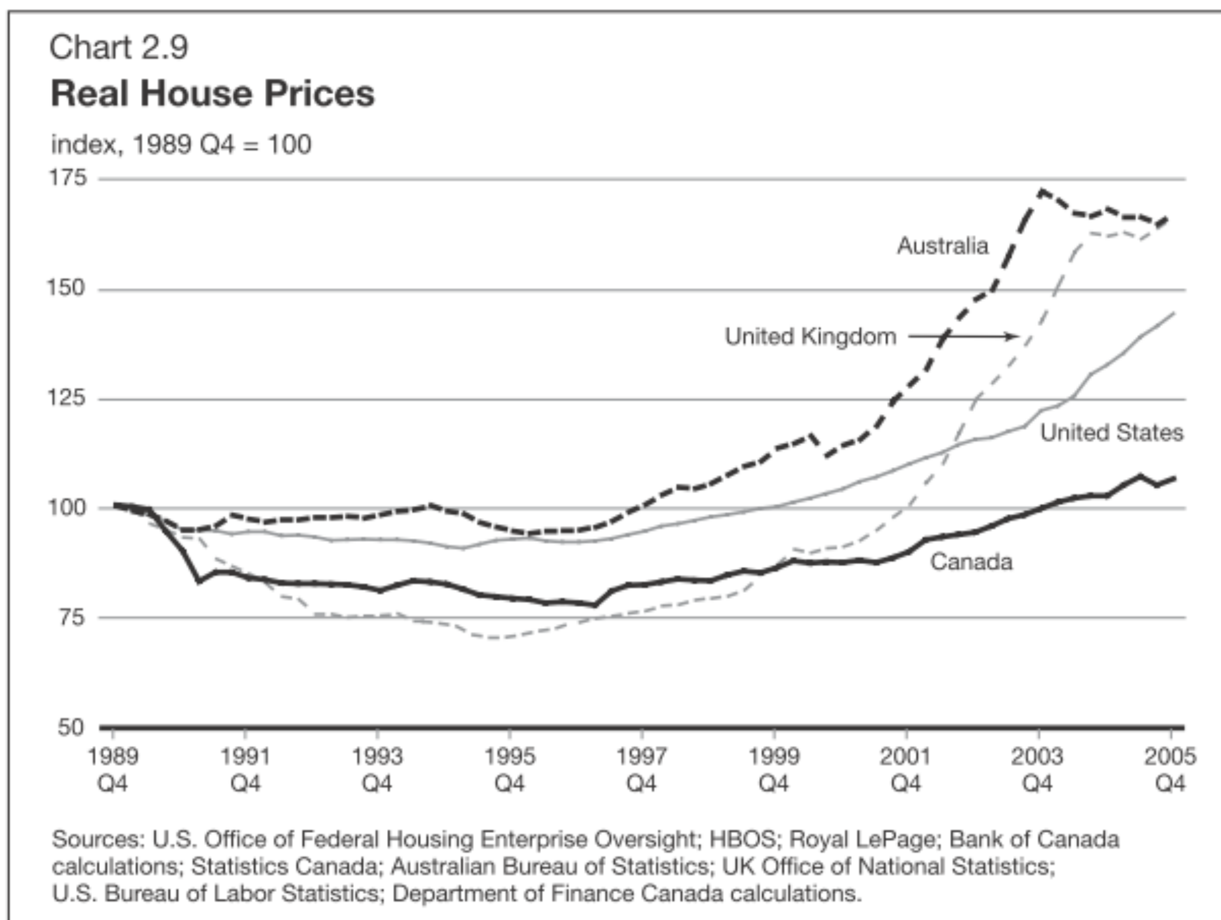
The strength in U.S. house prices was due to an artificial bubble that was created. Rising house prices stimulated housing construction

and boosted employment in housing related industries. Households with the willingness and ability to spend had accumulated housing wealth through equity withdrawals and mortgage refinancing were the major contributors to the ‘growth’ that was seen in consumer expenditures.

But it wasn’t just a housing boom, the US financial crisis also involved **“predatory loans”** that the banks had engaged in, as well as over leveraged positions through derivatives trading, repeal of regulations such as **Glass-Steagall Act** that separated commercial banking from investment banking, collusion between the major Wall St banks and the rating agencies that were supposed to mark on the

health of their debts, and collateralized debt obligations through subprime housing loans.

To begin, the graph below depicts the charting of real house prices between 4 nations:



As can clearly be seen, it was around the year 2000 that housing prices started their upward

hill. This was hot on the heels of the dot.com crash that sent the Nasdaq tumbling. Many have argued that policies enacted in 2000 went on to fuel yet another bubble but this time in the mortgage insurance markets.

The rise in housing prices in the US was due to several key significant reforms which were aimed at deregulating the market, including the repeal of the Glass Steagall Act. There was also the Commodities Modernization Futures Act that was passed on financial markets as well.

In comparison to the other nation's, Canada's housing rise was much more modest, which explains it's prudent regulations at the time.

So what caused the housing boom in the US? One factor was because of low long-term interest rates that boosted house prices and consumption in the U.S., which in turn pushed the personal savings rate down. The US was also carrying a trend of negative trade deficits. The challenges present in the Canadian scenario were different than that experienced in the US, and this is because the regulatory framework was much stricter, and more conservative. Yet even these standards were opened up in favour of competition. This created a shift in mortgage insurance standards, which are described below.

Brief History of Mortgage Insurance Market

Mortgage insurance was concocted as a strategy in the 1930s by the U.S. government's

Federal Housing Administration in order to promote home ownership during the Great Depression. The effects of it, proved to be a major factor behind the North American housing boom that occurred in the postwar era. Because banks and other lenders would shy away from borrowers with less than a 25% down payment as higher risk clients, mortgage insurance thus gave people with smaller down payments an improved risk profile.

If a homeowner were to default on their payments with the lender facing a loss following foreclosure, mortgage insurance would cover the difference and turn a high risk customer into a zero-risk customer. Due to this, “potential” homebuyers that received a steady income would still have been able to own a

home much sooner, even if they had little in savings.

The mortgage insurance concept came to Canada in 1954 when its exclusive provider was the precursor to CMHC. The Crown corporation had the mortgage insurance business to itself until the 1970s, when several private-sector firms tried and failed, over the next 20 years, to establish themselves. In 1995, private mortgage insurer Genworth entered the Canadian market, and since then, has been an able competitor. In 2006 when the Conservative Government came to power, it advocated for more deregulation by promoting competition in the mortgage insurer's market, which allowed for another entrant to enter as well.

In 2007, AIG United Guaranty, a subsidiary of New York-based American International Group (AIG) Inc., made its entrance, offering a product for buyers who could essentially place 3% of the homes purchasing price. And the payments would have been able to have been spread over 30 or 40 years. Before this time, Genworth Mortgage Insurance Canada was the CMHC's sole competitor, with CMHC commanding roughly 70% of the market and Genworth holding the other 30%.

Since April 2007, all mortgages with less than a 20% down payment have been considered as High-Ratio Mortgages. Thus they require High-Ratio Mortgage Insurance, and in the 40 years before April 2007, the downpayment requirement was set at 25%. High-Ratio

Mortgage Insurance has protected lenders from borrowers who may otherwise default on their mortgages.

High-ratio mortgages account for slightly less than half of all mortgages originated in Canada, and are a major reason why Canada has had one of the highest home ownership rates in the world. Mortgage insurance premiums have been paid by the homebuyer on the amount of the downpayment, not on the basis of creditworthiness or geographic location.

Government policies in favour of more competition were initially intended on establishing better rates on High-Ratio Mortgage Insurance for borrowers and better terms as well. However, the unfortunate consequence of this "Race to the bottom"

competition, was that it also allowed for many Canadians to receive access to Mortgage Insurance with 0% down. This meant that many Canadians received loans they would not have otherwise been able to have received if the lending practices were kept ***prudent***, and it also helped to boost housing prices. Some pundits have argued that the by product of the competition in the mortgage insurance market has led to a reigniting of a housing bubble, and as with all bubbles, will be due for a readjustment in value soon. This part of the debate will be explored in a future discussion.

The Players

Canada's mortgage insurance industry is not entirely government-run but it has certainly been government-controlled. The Canada

Mortgage and Housing Corp. (CMHC), a federal Crown corporation and government agency, has commanded more than two-thirds of the mortgage insurance business in Canada and has protected lenders against borrower default by guaranteeing home loans. Its' mandate has always been to ensure affordable home ownership for all Canadians.

Their private-sector competition has come from Genworth Financial Canada, (part of the General Electric conglomerate) and AIG . And since it is managed by only 3 players, the profits have been very good. According to the federal Bank Act, every mortgage from a federally regulated institution with a down payment of less than 25% is required to carry mortgage insurance. Last year, 45% of all

homebuyers, or 500,000 Canadian families, were required to buy a total of $1.6 billion worth of mortgage insurance.

From a lender's standpoint, there's an incentive to allocate a portion of their insurance business to private insurers. For one, it keeps CMHC further from monopoly status. In addition, having multiple insurers gives lenders options when a file doesn't meet one insurer's guidelines.

The issue

An investigation done by Jacque McNish and Greg Mcarthur in March 2009 into banking and insurance sources found, that new mortgage borrowers signed up for an estimated $56-billion of risky 40-year mortgages, and more than half of the total new mortgages approved

by banks, trust companies and other lenders during that time. These sources also estimated that 10 % of the mortgages, worth about $10-billion, were taken out with no money down.

Former CEO of private mortgage insurer, Triad Guarantee Inc., was the one who spearheaded his company's aborted push into Canada, and said that the proliferation of high-risk mortgages could have been mitigated if Ottawa had been more watchful. He said,

There was a lack of regulation around the expansion of increased risk.

Indeed, there was significant risk. This high-risk mortgage lending had been rampant throughout 2007, up until early 2008 when the Government finally reined in on this policy.

The Globe investigation had revealed that AIG's Greensboro, N.C., mortgage subsidiary launched a quiet lobbying campaign in 2004 with senior U.S. executives and a former CMHC official to push open the doors to Canada's mortgage insurance market, where some of the world's highest insurance rates are charged. On May 1, 2006, AIG's mortgage insurance division had registered with the lobbying commissioner's office and this was coincidentally the day before the federal budget revealed that new players would be allowed into Canada.

When the 40 year amortization periods were offered, certain banking and insurance officials were very concerned. One bank executive had warned the Bank of Canada's chief financial

stability officer, Mark Zelmer, in a meeting that "**the government has got to put an end to this.**"

Another U.S. insurance executive who asked not to be named had told the Globe, "**Quite honestly I was surprised [the 40-year mortgage] was seized upon so eagerly by the Canadian banks and borrowers.**"

You hear all the usual excuses: 'It's a cash-flow management tool, people will pay off their mortgage ahead of time.' But in reality it just becomes a mechanism for borrowing more than you probably should have.

An important change mentioned in the 2006 budget was when Finance Minister Flaherty announced that not only would Ottawa guarantee the business of U.S. insurers, but

that it would double the guarantee to 200$ billion, up from $100 billion. This would mean that if there were an event where the mortgage insurers faced a liquidity crisis, the Canadian Government would have double the allocated Government capital to assist them, directly from taxpayer funds.

This could have unintended consequences. The last thing the Canadian economy would need, would be a taxpayer bailout of mortgage insurers.

Race to the Bottom

The policy recommendations as outlined in the Conservative budget encouraged new players into the market, however they had serious unintended consequences. The competition that occurred in the mortgage insurance

market created what I would term, a ‘race to the bottom’ effect in the mortgage market. Below are examples of this

- On February 25, 2006 the CMHC kicked things off when they announced intentions to offer homeowner mortgage loans amortized up to 30 years as part of a pilot project to improve access to home ownership and choice for Canadians as part of a ‘pilot’ project, intended to last 4 months.
- On March 16, 2006 Genworth had also announced that they would be raising amortization periods from 25 year periods to 30 and 35 year periods.
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- On June 28, 2006 the CMHC was Canada’s first mortgage loan insurer to eliminate homeowner high ratio mortgage insurance application fees. The 35 year

amortization was also offered as a mortgage product.

- On October 23, 2006 Genworth had announced that it would insure mortgages with amortizations up to 40 years
- Effective as of December 15, 2006 the CMHC had extended amortization periods available up to 40 years

As evident in just a span of 11 months, a massive race had already begun to take shape between CMHC, Genworth, and AIG. This was a significant change at the time and one that would come to haunt the Canadian economy many years later.

Back in 2006 when the 40 year amortization period was announced by CMHC, their vice-president Mark McInnis said, "**We're the third guys coming up to the plate with these products. AIG has done it, GE has done it.**

We’re just doing something that’s in the marketplace.“

In an interview with the Globe in 2009, CMHC vice-president Pierre Serré repeatedly pointed to the behaviour of his competitors when asked about the agency’s riskier products, explaining that CMHC’s rivals were the first to introduce the 40-year products.

When asked if he thought that the new U.S. insurers pushed CMHC into riskier policies, Mr. Serré paused. “**It’ s a tough one for me to answer. In retrospect you can look at all the individual things happening and you can link them together, but it’s a hard one to tell. We think we’ve done a prudent job of introducing these products and managing these products,**” he added, and he had

declined to explain how many 40-year and zero-down mortgages the CMHC had on its books.

Unfortunately, unlike in the United States, such figures are not made publicly available in Canada.

The CMHC's willingness to ease mortgage lending practices against private competitors, especially since being a Crown corporation and funded by taxpayers, has raised considerable criticism.

John Williamson, federal director of the Canadian Taxpayers Federation at the time advocated for privatizing CMHC. He said CMHC's move to compete with private sector insurers demonstrated the need to privatize the Crown corporation, which made a profit of $1-

billion last year. "**If this company wishes to be involved in the competitive market, they should be freed to do that by being privatized**."

And David Dodge, then-govenor of the Bank of Canada also criticized the CMHC's policy. In a letter obtained via freedom of information, Dodge weighed in on his opinion of the June 28 2006 announcement by the CMHC to announce up to 35 year amortization periods for mortgages.

He addressed his concerns to Karen Kinsley, then-CEO of CMHC and he wrote, "**I read with interest and dismay-that CMHC would offer mortgage insurance for interest-only loans and for amortization of up to 35-years.**" He added, "**Particularly disturbing to me is the**

rationale you gave that 'these innovative solutions will allow more Canadians to buy homes and to do so sooner."

Dodge called the new lending policies as steps that would contribute in driving up home prices making them even less affordable and he called the CMHC's actions as '**unhelpful'**. I would agree with his opinion, because when mortgage lending standards are lowered with longer amortization periods, it not only increases inflationary pressure, but it also can have unintended consequences such as inviting housing speculators.

To give credit to the Canadian regulatory system, housing speculation is curbed somewhat, due to the loans being ***full recourse mortgage loans***. This means a

homeowner cannot walk away from a mortgage loan. If an individual were to try, the bank that issued the loan would have legal rights to come after the homeowner including garnishing future wages to pay off the loan.

If the homeowner cannot afford the house any longer and the bank forecloses, than they would sell the house and chase the homeowner for the remainder of the balance on the loan that remains unpaid. The only way to get out of the problem completely would be to declare bankruptcy and have all their assets liquidated to pay the loan.

In present day today (March 2012), there has been significant debate into whether the CMHC's policies in recent years helped to re-ignite a housing bubble in this country, much

the same way Fannie and Freddie had done in the U.S. This debate will be addressed in a future article.

Finally, in July 2008, the Conservative Government did step in to seal the door on risky mortgages. Mortgage amortizations were limited to 35 years, and buyers were required to place a down payment of at least 5%. However the move has been seen as too little, too late, as now the housing market is largely due for a correction in value.