BACKGROUNDER

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Distributing the Risk: Mortgage Default Insurance

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SUMMARY

Mortgage Default Insurance (MDI) is mandatory in Canada for residential purchases where the purchaser's down payment is between 5% and 19.99%.[1] Most MDI premiums fall in the range between 2.4% to 6.6% of the mortgage amount. The idea behind MDI is to increase the protection of lenders in the event that a borrower defaults on their mortgage, that is, fails to make the outstanding payments. Countries that have adopted MDI in the housing market increase home buyers access to the real estate market, simply by distributing the risk of the lender between the lender and the insurer. This redistribution of risk enables lenders to offer lower mortgage rates and provides them with more protection against mortgage defaults. However, as the risk is distributed between the lender and the insurer, the cost is usually borne by the purchaser.[2]

The general requirements to qualify for MDI in Canada are quite simple: (1) the property must be located in Canada; (2) the property being purchased must be below $1M; (3) the minimum downpayment is not lower than 5% for purchase prices up to $500,000 and 10% for the remaining purchase price over $500,000; (4) the purchasers total monthly housing costs must not exceed 32% of their gross income (Gross Debt Service - GDS); (5) the purchasers total debt load must not exceed 40% of their gross household income (Total Debt Service - TDS); (6) the purchaser also needs to factor in estimated closing costs of 1.5% to 4% of the purchase price (e.g. lawyer fees, GST, land transfer, etc.).[3]

MDI costs are passed onto the borrower and are included in the overall mortgage price. MDI premiums are generally calculated based on the size of the down payment, the lower the down payment, the higher the MDI premiums. It is generally argued that without MDI purchasers would typically pay higher interest rates and additional administrative fees, and most often the cost of MDI premiums to the purchasers is offset by what the purchaser would have otherwise paid in higher interest rates and additional administrative fees.

Table 1. Mortgage Default Insurance.[4] Canada Mortgage and Housing Corporation.[5]

Loan-to-Value	Premium on Total Loan	Premium on Increase to Loan Amount for Portability
Up to and including 65%	0.60%	0.60%
Up to and including 75%	1.70%	5.90%
Up to and including 80%	2.40%	6.05%
Up to and including 85%	2.80%	6.20%
Up to and including 90%	3.10%	6.25%
Up to and including 95%	4.00%	6.30%
90.01% to 95% — Non-Traditional Down Payment**	4.50%	6.60 %

Premiums in Manitoba, Ontario and Quebec are subject to provincial sales tax. The provincial sales tax cannot be added to the loan amount.

** Down Payment Requirements — Traditional sources of down payment include: Applicant's savings, RRSP withdrawal, funds borrowed against proven assets, sweat equity (<50% of min. required equity), land unencumbered, proceeds from sale of another property, non-repayable gift from immediate relative, equity grant (non-repayable grant from federal, provincial or municipal agency). Non-traditional sources of down payment include: Any source that is arm's length to and not tied to the purchase or sale of the property, such as borrowed funds, gifts and 100% sweat equity.

Table 2. Mortgage Default Insurance Cost Example

Purchase Price	$200,000
Down Payment (17.5%)	$35,000
Mortgage amount (82.5%)	$165,000
Mortgage Default Insurance Premium with Portability	6.20%
Mortgage Default Insurance Premium	$9,900
Total Mortgage borrowed	$174,000

HISTORICAL OVERVIEW[6]

In 1944, the Federal Government of Canada introduced the National Housing Act which consolidating the patchwork of housing legislation across Canada at the time. The National Housing Act gave the federal government a central role in home financing throughout the country. The federal government established the Central Mortgage and Housing Corporation (now known as the Canada Mortgage and Housing Corporation - CMHC) on January 1, 1946. CMHC's primary function was to administer the National Housing Act, the Home Improvement Loans Guarantee Act, and provide discount facilities for loan and mortgage companies.

Over the past 72 years, CMHC has been involved in numerous different initiatives. In the 1940s with the conclusion of World War II, CMHC focused on providing much needed social and rental housing for low-income families and housing assistance to returning war veterans. In the 1950s, CMHC changed its focus to community building. CMHC provided grants to cities, providing them with the funds to tear down derelict buildings and build municipally-owned public housing projects. With the expansion of the National Housing Act in 1954, chartered banks were allowed to enter into the mortgage loan insurance field, assuming additional mortgage risks with only a 25% down payment on the purchase price. In the 1960s, CMHC's focus moved from community building to municipal planning, co-operative housing projects and multi-unit apartment housing.

By the 1970s, CMHC concentrated on energy costs, quality of life of Canadians and the revitalization of deteriorating urban cores. The federal government would introduce the Assisted Home Ownership Program (AHOP) which provided access to the real estate market by low-income people and with its focus on revitalizing and preserving historic neighbourhoods and the promotion of downtown living, would transformed many run-down industrial areas into thriving urban centres. Introduced in 1974, the Residential Rehabilitation Program (RRAP) was designed to assist homeowners with repairing substandard homes to minimum health and safety levels along with improving accessibility for disabled persons. This program would lead to another initiative: the Winter Warmth Assistance Program. This program provided funds to Aboriginals who were in need of urgent repairs to housing in rural areas. By the 1980s, CMHC had shifted its focus to mortgage affordability with the introduction of mortgaged-backed securities as an alternative to investing in individual mortgages. With the introduction of mortgage-backed securities, an ample supply of low-cost funding became available allowing more access to homeownership by lower income purchasers. The 1990s brought about a focus on energy efficiency and resource conservation in home construction. CMHC created the Canadian Centre for Public-Private Partnerships in Housing (CCPP). The CCPP objectives was the fostering of public/private cooperation on housing projects. In addition,

CMHC introduced a new automated underwriting system that drastically reduced the application approval time down to seconds and making it much easier for homebuyers to obtain mortgage insurance.

In 1999, the federal government modified the National Housing Act and the Canadian Mortgage and Housing Corporation Act to allow purchasers to put a minimum down payment of five percent. This removed a significant barrier that many first-time home buyers faced when accessing the real estate market.

For the last 17 years, CMHC has focused on sustainability and innovation. Many provincial and local governments are concentrating on clean energy, the environment, and building affordable communities. In 2001, CMHC introduced Canada Mortgage Bonds which further increased the supply of low-cost mortgage funding and maintained very low mortgage rates. In 2004, CMHC introduced a 10% "green refund" on MDI for homeowners that buy energy-efficient homes or make energy-saving renovations to their existing home. In addition, CMHC introduced on-reserve loan insurance products which allows Band Councils or Aboriginal persons to access CMHC-insured financing for construction, purchase, or renovation of single-family homes or multi-unit residences on-reserve.

CURRENT ISSUES[7]

Mortgage rate stress test

New qualification rules have come into effect as of January 1, 2018. To qualify for mortgage insurance, a purchaser must now have a GDS ratio that does not exceed 39% (increased from 32%) and a TDS ratio that does not exceed 44% (increased from 40%). These higher ratios act as a "stress test" for purchasers providing them with a buffer in the event they are faced with a reduction in household income or higher interest rates. This buffer is intended to enable purchasers to continue to service their debts.

Low-Ratio Mortgage Insurance Eligibility Requirements

Lenders that insure mortgage loans using portfolio insurance[8] or other discretionary low loan-to-value ratio mortgages,[9] must meet the eligibility criteria that previously applied to high-ratio insured mortgages.[10] The new criteria includes maximum amortization periods of 25 years, a purchase price less than $1M, a minimum credit score[11] of 600, maximum GDS of 39%, maximum TDS of 44%, and if the property is a single unit it must be owner-occupied.

The Principal Residence Exemption

Homeowners in Canada are exempt from capital gains taxation when they sell their principal residence. However, four proposed changes have been introduced by the federal government to tighten up the tax exemptions. (1) non-Canadian residents who acquired a residence are not eligible for principal residence exemption if they sell the property in the same year they become a resident; (2) trusts will be eligible to designate a property, as a principal residence the property is specifically designated as a spousal/common-law partner trust, an alter ego trust, qualifying disability trust, or trust held on behalf of a minor child of deceased parents; (3) the Canada Revenue Agency (CRA) requires taxpayers to report the selling of real property for which the principal residence exemption is claimed; (4) the CRA has the authority to reassess taxpayers, beyond the normal assessment limitation period, in the event that the real estate sold by the taxpayer does not meet the principal residence exemption.

QUICK STATISTICS/DATA[12]

- CMHC Insurance-in-force (2016) $512 billion.
  (2015 - $526B, 2014 - $543B, 2013 - $557B, 2012 - $566B)

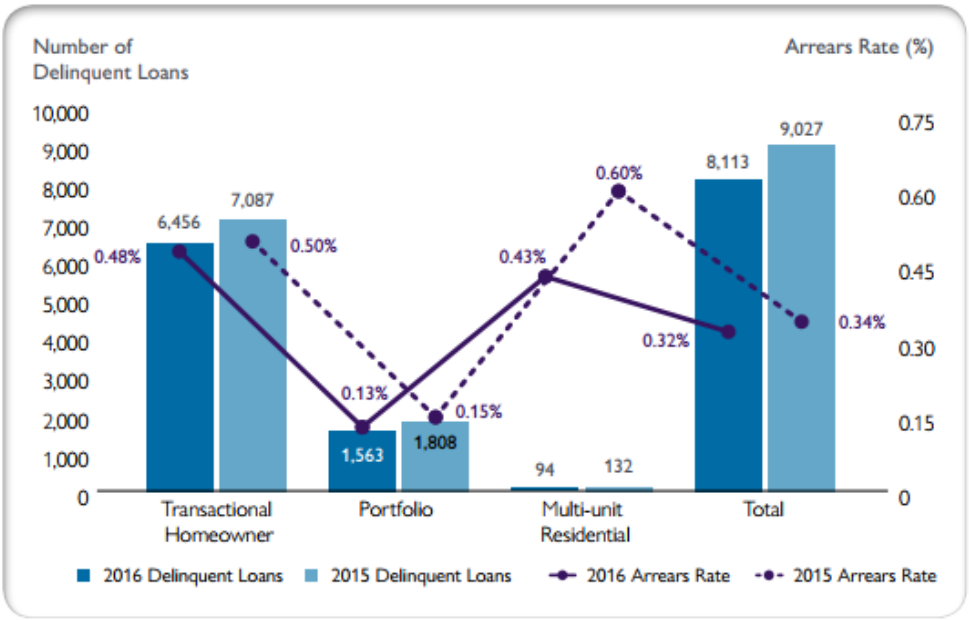
- CMHC Premiums and Fees received (2016) $1.5 billion.
  (2015 - $1.4B, 2014 - $1.3B, 2013 - $1.3B, 2012 - $1.4B)

- CMHC total insured volumes (2016) 84,275.
  (2015 - 80,447, 2014 - 75,376, 2013 - 91,518, 2012 - 98,987)

- CMHC claims paid (2016) 377.
  (2015 - 353, 2014 - 390, 2013 - 423, 2012 - 562)

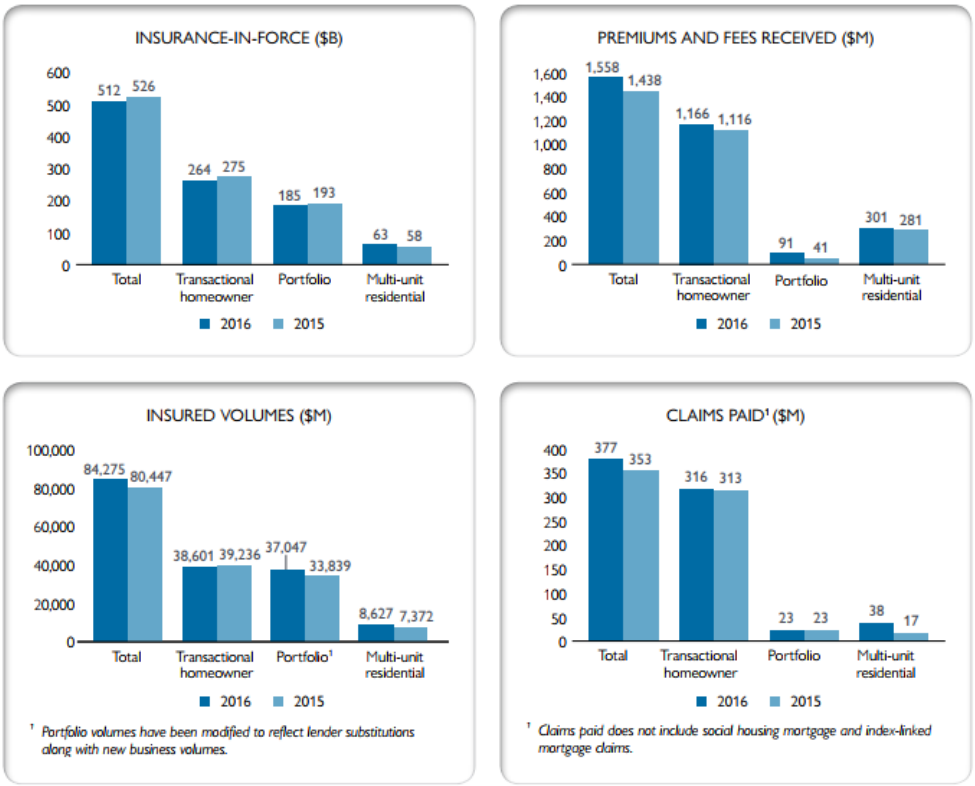
- CMHC Loss Ratio (2016) 22.2%.
  (2015 - 18.2%, 2014 - 19.4%, 2013 - 17.6%, 2012 - 27.0%)

Figure 1. Number of Delinquent Loans and Arrears Rate (CMHC)



Source: https://www.cmhc-schl.gc.ca/en/corp/about/core/upload/cmhc-annual-report-2016.pdf, pg 54.

Figure 2. CMHC Metrics



ENDNOTES

[1] MDI is not exclusive to Canada Mortgage and Housing Corporation other companies such as Genworth MI Canada and Canada Guaranty offer MDI.

[2] Ratehub. "Mortgage Default Insurance or CMHC Insurance". https://www.ratehub.ca/cmhc-mortgage-insurance.

[3] Canada Mortgage and Housing Corporation. "What are the General Requirements to Qualify for Homeowner Mortgage Loan Insurance?". https://www.cmhc-schl.gc.ca/en/co/moloin/moloin_003.cfm.

[4] Portability is a loan feature which allows you to transfer your original mortgage to a new property while preserving a low interest rate and saving the cost of setting up a new mortgage.

[5] Loan-to-Value (LTV) = Mortgage Amount / Appraised Value of the Property

[6] Canada Mortgage and Housing Corporation. "HIstory of CMHC". https://www.cmhc-schl.gc.ca/en/corp/about/hi/index.cfm

[7] Government of Canada. Department of Finance. "Technical Backgrounder: Mortgage Insurance Rules and Income Tax Proposals (revised October 14, 2016). http://www.fin.gc.ca/n16/data/16-117_2-eng.asp.

[8] A type of bulk insurance that lenders would use to insure mortgages with down payments of 20 percent or more.

[9] Low ratio mortgages - the borrower has a down payment of more than 20%.

[10] High ratio mortgages - the borrower has a down payment of less than 20%.

[11] A number assigned to a person that indicates to lenders their capacity to repay a loan.

[12] Canada Mortgage and Housing Corporation. 2016 Annual Report. March 22, 2017. https://www.cmhc-schl.gc.ca/en/corp/about/core/upload/cmhc-annual-report-2016.pdf

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