JUST THE FACTS

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Comparing Canada and U.S. Housing Finance Systems

CANADA AND U.S. HOUSING POLICY

The *National Housing Act* and the *Protection of Residential Mortgage or Hypothecary Insurance Act* (PRMHIA) play an important role in defining Canadian housing and housing finance policy. The government acts to implement public policy through its government-backed mortgage insurance framework, and through Canada Mortgage and Housing Corporation (CMHC), a Crown corporation. CMHC delivers federal investments in housing; facilitates access to and competition and efficiency in the provision of housing finance; protects the availability of adequate funding for housing; and contributes to the stability of the financial system. CMHC's public mortgage insurance and securitization programs are available to qualified Canadians and qualified lenders and remained stable throughout the recent global financial crisis.

Canada, unlike the U.S., does not have a policy goal of increasing the rate of homeownership. Rather, we encourage the availability of housing across a variety of tenure types – homeownership, rental housing, supportive housing and transitional housing. The housing needs of low-income Canadians are addressed through government assistance programs.

U.S. housing finance policy relies on a number of public sector entities. Fannie Mae and Freddie Mac provide guarantees on mortgage-backed securities (MBS) and have public mandates to support mortgage funding and stability. Prior to the crisis they were privately owned, but were considered to have an "implicit" government guarantee. Since 2008, they have been under direct government ownership. Other government entities, such as the Federal Housing Administration (FHA) and the U.S. Department of Veterans Affairs and Ginnie Mae (a government-sponsored entity like Fannie and Freddie), were traditionally targeted at low- and moderate-income households. All of these entities have expanded their role in the housing sector since the crisis; the last three are taking steps to resume their traditional focus, while reforms are being considered for Fannie Mae and Freddie Mac.

In Canada, the primary regulator of federally regulated financial institutions is the Office of the Superintendent of Financial Institutions (OSFI), which has responsibility for the prudential oversight of banks, federal insurance companies, federal trust and loan companies, and federally regulated pension funds, as well as mortgage insurance companies. Almost all credit unions and *caisses populaires* are provincially regulated; mortgage broker activities are also regulated by provincial legislation.

The U.S. financial regulatory system is complex, with many overlapping responsibilities. Among others, it includes three prudential bank regulators; the Consumer Finance Protection Bureau (governing mortgage origination regulations); the Federal Housing Finance Agency (supervisor of Fannie Mae and Freddie Mac); and the Department of Housing and Urban Development (supervisor of FHA).

Canada's housing policy encourages access to housing through a variety of tenure types; its policy does not explicitly favour homeownership. In the U.S., federal policy actively encourages homeownership. Consistent with this policy, Fannie Mae and Freddie Mac, before the recent economic downturn, were required to support mortgages to low-income borrowers in specific neighbourhoods and geographic areas, as well as to other high-risk groups.

MORTGAGE INSURANCE IN CANADA AND THE U.S.

In Canada, legislation prohibits federally regulated banks from providing residential mortgages without mortgage loan insurance if the loan is greater than 80 per cent of the purchase price or value of the home. This insurance, which can be purchased from CMHC or private insurers governed under PRMHIA, covers the entire amount of the loan and is for the entire life of the mortgage.

The insurance remains in place at term renewal and can be transferred if the borrower decides to switch lenders or even switch homes. Mortgage insurance premiums are typically paid by the borrower, either up front in a lump sum, or added to the mortgage principal and blended with the regular mortgage payment. There is no annual fee.

In the U.S., banks will often require mortgage loan insurance for loans where the borrower makes a down payment of less than 20 per cent, even though there is no legal requirement to do so. This is because for these mortgage loans, Fannie Mae and Freddie Mac are prohibited from purchasing mortgages without a credit enhancement such as mortgage insurance.

Insurance for loans purchased by Fannie Mae and Freddie Mac is provided by private mortgage insurers and typically paid through monthly premiums billed to the borrower (rather than a lump-sum amount). The coverage provided by private mortgage insurance is "partial," meaning that the insurance covers only a portion of the total loan amount, typically about 20 to 30 per cent. Private mortgage insurance for most borrowers is cancelled when the value of the loan falls below 78 per cent of the home's purchase price.

Mortgage insurance is also offered by the federal government in the U.S. through the FHA. FHA insurance coverage is similar to that offered by Canadian mortgage insurers, protecting lenders for the entire amount of the loan and the entire life of the mortgage. While FHA coverage is comparable to Canadian coverage, the premium structure is different; most FHA-insured loans have a one-time up-front payment, as well as annual fees. For lower-ratio loans (under 90 per cent loan-to-value) the annual fees may be cancelled when certain conditions are met.

MORTGAGES IN CANADA AND THE U.S.

In Canada, the most common mortgage is the five-year fixed-rate closed mortgage. Historically in the U.S., the most common mortgage has been the 30-year fixed-rate open mortgage.

Many mortgage borrowers in Canada have the option of transferring their mortgage within the same lender (including the mortgage insurance) if they decide to sell one property and purchase another. This

can be of particular benefit to borrowers if mortgage rates have risen since they obtained or last renewed their mortgage. Mortgage borrowers in the U.S. do not have this option.

In Canada, mortgages are typically "full-recourse" loans, which means the borrower continues to be responsible for repaying the loan even in the case of foreclosure. Lenders can take legal action to recoup money from the homeowner if a foreclosed home is sold for less than the amount owing on the mortgage. In some U.S. jurisdictions, mortgages are "non-recourse," which means that borrowers can often walk away from their homes and the associated mortgage debt, leaving lenders with no recourse beyond the property.

Mortgage interest on a principal residence can be deducted from taxable income in the U.S.: the larger the mortgage, the more interest that can be deducted. Homeowner mortgage interest is not tax deductible in Canada, so there is no tax incentive for borrowers to prefer a mortgage over rental or maintain higher mortgage balances over the life of a mortgage.

The rate of 90 days mortgage arrears in Canada was 0.29 per cent in the second quarter of 2014, according to the Canadian Bankers Association, in line with the average since 2000 of 0.35 per cent. This compares to 1.13 per cent for prime fixed-rate mortgages in the U.S. (which are most comparable to the overall Canadian mortgage market) for the second quarter of 2014 (average of 0.82 per cent since 2000), according to the U.S. Mortgage Bankers Association. The arrears rate for the total U.S. residential mortgage market was 2.31 per cent in the second quarter of 2014.

SUB-PRIME MORTGAGES IN CANADA AND THE U.S.

Sub-prime mortgages are those that are made to riskier borrowers, such as those with a weaker credit history or a lack of documentation on income or assets (e.g., self-employed). In the U.S., before the recent housing crisis, the sub-prime market became quite large, peaking at 23.5 per cent of mortgage originations in 2006.[1] Many factors contributed to this, including the prevalent mortgage funding model in the U.S., where mortgages were originated by third party lenders to be quickly packaged and sold to investors. The lenders, thus, often had limited incentives to apply prudent underwriting, while the investors often did not understand the associated risk.

> New types of "exotic" mortgages became popular in the U.S. in the years leading up to the economic crisis. These mortgages often featured "teaser rates" that kept initial monthly payments artificially low, only to have them increase significantly later in the mortgage without properly disclosing this to the borrowers or ensuring that they could afford them. Such products and poor practices were never popular in Canada.

In Canada, the sub-prime market did not take hold to the extent that it did in the U.S.; estimates place it at less than 5 per cent of the Canadian market at its peak. Most mortgages in Canada are originated and retained by institutions whose goal is to maintain a long-term, broad relationship with their customers, also offering credit cards, car loans and investments. Lenders thus have a financial interest in ensuring that borrowers do not take on unmanageable debt, which reinforces their motivation to prudently underwrite mortgages.

[1] The Financial Crisis Inquiry Commission, January 2011, "The Financial Crisis Inquiry Report", http://www.gpo.gov/fdsys/pkg/gpo-fcic/pdf/gpo-fcic.pdf.

The Canadian banking system is dominated by six large banks that together hold the majority of domestic banking assets. The large banks are in turn diversified geographically and across product lines, while the non-traditional, or shadow, banking system is relatively limited in scope compared with that of the U.S.

Rigorous supervision and prudent regulation on the part of OSFI have contributed to conservative practices in mortgage lending and risk management by the lenders. CMHC does not insure or guarantee MBS backed by subprime mortgages, nor does it purchase and hold a significant portfolio of mortgages (including subprime) for investment.