Why Canada needs a better mortgage backstop

THOR KOEPPL AND JAMES MACGEE, SPECIAL TO FINANCIAL POST | July 16, 2015 | Last Updated: Jul 16 1:25 PM ET
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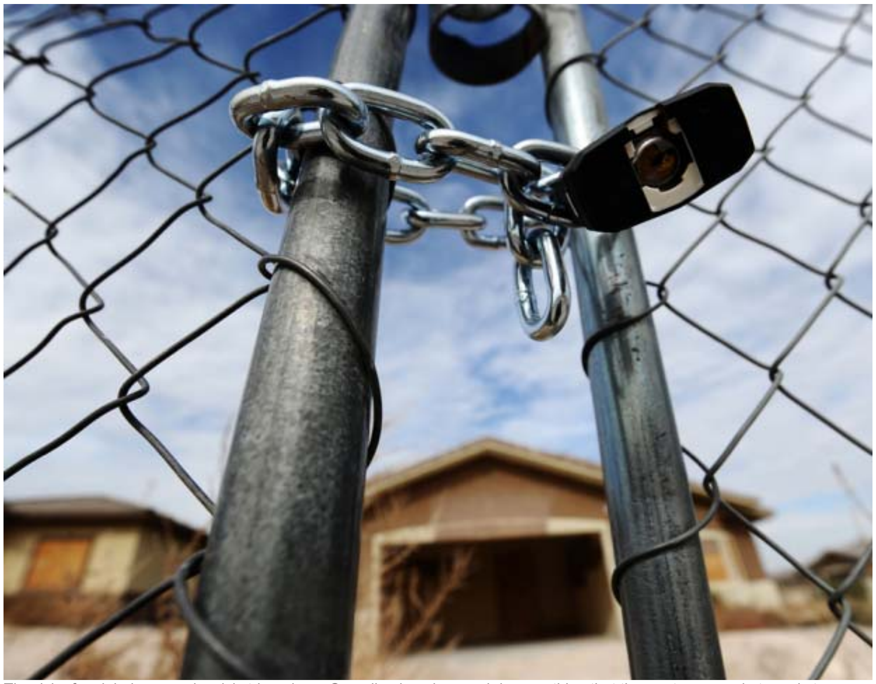

The risk of a global economic crisis triggering a Canadian housing crash is something that the mortgage market needs to prepare for. Getty Images

Global insecurity jeopardizes Canada's housing market if we don't protect against a major recession

Headlines about new record highs for housing prices in Toronto are a reminder that Canadian prices remain well above historical trends. Naturally, numerous economic commentators follow such news with warnings of the potential risks from high house prices and high household debt.

The good news is that a housing crash remains unlikely. Unlike the U.S. in the early 2000s, Canadian lenders have maintained prudent underwriting standards. As a result, most borrowers are currently able to manage their mortgage payments.

High house prices and debt do, however, leave the Canadian economy vulnerable to a severe recession. The worry here is that global shocks could result in a severe recession, and several years of high unemployment. In turn, this could trigger a large fall in housing prices and a dramatic rise in mortgage defaults.

The ongoing turmoil in Chinese stock prices, a looming Grexit, and depressed energy and commodity markets highlight the real concern of far-away events igniting another global crisis. This means that the risk of a global economic crisis triggering a Canadian housing crash is something that the mortgage market needs to prepare for.

A low-probability, but severe, housing crash could result in roughly $17 billion of losses on insured mortgages

The first line of defence against a housing crash is mortgage insurance. Mortgage insurers protect banks from losses should a borrower default, and insure all high-loan-to-value (with down payments of less than 20 %) mortgages issued by federal regulated lenders. With the objective of strengthening this line of defence, the federal government backstops, or partially guarantees, mortgage insurance policies.

In a recent C.D. Howe Institute Commentary, we find that a low-probability, but severe, housing crash could result in roughly $17 billion of losses on insured mortgages, or about 1 per cent of GDP. Although mortgage insurers' reserves currently exceed the minimum required, these losses would leave the federal government – or tax payers – with a bill of up to $9 billion to recapitalize mortgage insurers, should Ottawa choose to do so.

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Perhaps more importantly, the collapse scenario would trigger the 10 per cent deductible on the government guarantee of the mortgage insurance policies issued by insolvent private insurers. The issue is that the deductible kicks in if the insurer is unable to meet its payments – in which case the deductible results in a loss for whoever owns the underlying mortgage.

Anticipation of deductible losses could trigger a "run," where lenders avoid dealing with private insurers. This could restrict access to finance for home buyers, at a time when it is urgently needed, further destabilizing the housing market.

The good news is that there are ways to reform our current mortgage insurance architecture to better deal with these risks.

First, the government backstop for mortgage insurance should become a standalone fund that accumulates reserves. This would help protect government deficits from additional demands during a crisis.

It would also increase transparency over the costs of guaranteeing mortgage insurance. Furthermore, the backstop should only guarantee mortgage insurance policies if a severe housing crash were to occur. This could be done by making it depend on a large fall (say at least 25 per cent) in house prices.

Second, the Financial Institutions Supervisory Committee (FISC) – comprised of the Department of Finance, the Bank of Canada and OSFI – should oversee the pricing of guarantees offered by the backstop fund, as well as the target level for reserves. A careful review of the current premium charged by the government to backstop mortgage insurance is needed, since our calculations suggest that current premiums are too low to cover potential losses.

This reform would also provide policy makers with a tool to "lean against the wind" and smooth out rapid movements in house prices. If FISC felt that house prices were increasing too rapidly, it could raise the fee charged to backstop mortgage insurance. By making the purchase of a home with a small down payment more expensive, this could act to lower demand and help cool overheated markets.

By increasing the resiliency of private insurers in a crisis, these reforms would help level the competitive playing field between private insurers and CMHC. In addition, by restricting the government backstop to supporting insurers in systemic crisis, it would leave the private capital of insurance companies to handle the costs of regular business cycles fluctuations in default rates. This would strengthen incentives of insurers to carefully assess the risks presented by prospective home buyers.

Canada is fortunate to have a strong mortgage insurance system to build on. The success of the Canadian housing finance system in avoiding a house crash, however, is not cause for complacency about the risks associated with high and rising household debt.

Instead, it calls for well thought out reform of government support for mortgage insurance to help manage the risk of a future housing crisis.

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Topics: **FP Comment**, **Housing Market**

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carlingford2 • 16 hours ago

Of course no one wants to read this dose of reality.

Hell no.

Exactly what I have been predicting for several years. Only now, the damage will be several times worse because the party continued using debt.

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carlingford2 • 18 hours ago

"Unlike the U.S. in the early 2000s, Canadian lenders have maintained prudent underwriting standards."

Total rubbish.

Canadians for the longest time could buy a house with zero down and get CMHC insurance. CMHC now require 5% down, which is a pitiful amount when there is a downdraft. Any first time buyer in the last 5 years will be underwater. Some of the more recent new buyers will be underwater for as much as $200K. They will declare bankruptcy and walk.

Also, zero down mortgages are still widely available. Google " Canada zero down mortgages".

You will find plenty of offerings.

Canadians are obsessed with how they are always better than the US, in most cases that claim is totally baseless.

But that is the first thing to come out of a Canadian mouth when things deteriorate in Canada.

It is mostly a lie, and it is arrogant and narcissistic.

And that will come back to bite Canadians in the rear. It currently does when Canadian companies try to sell their products in the global marketplace.

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Brunnenburg → carlingford2 • 13 hours ago

Spot on. You also nailed the part about BB and Bombardier. While Apple was busy innovating and investing in R & R, Balsillie was busy dreaming up a hockey team to buy, like a bored schoolboy with too much $ for baseball cards. BBD.B has been an unmitigated disaster for investors for poor management and nepotism.

Canada, where innovation goes to die.

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LoneWarrior • 21 hours ago

Our housing market is a fortress. We should bring back 0 down 40 years amortization. Let's keep building and buying!

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