

SPECIAL REPORT

Backgrounder Residential Mortgage Insurance

**As your
mortgage broker;
my only job
is looking out for
your best interest.**



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Strength of the Canadian Housing and Mortgage Markets

Canadian housing and mortgage markets are performing well:

- Current Canadian house prices are in line with economic factors such as low interest rates, rising incomes and a growing population, a view supported by the International Monetary Fund.
- Demand for residential housing continues to be strong. For example, housing starts are expected to remain above the 200,000 mark for the seventh consecutive year.
- The percentage of bank mortgages in arrears¹ is stable at 0.27 per cent, near the lowest levels experienced since 1990 and well below the highs of 0.65 per cent experienced in each of 1992 and 1997.

The historically prudent and cautious approach taken by Canadian financial institutions to mortgage lending, combined with a sound supervisory regime, has allowed Canada to maintain strong and secure housing and mortgage markets. Sub-prime² mortgage origination has been low in Canada, comprising less than 5 per cent of the market in recent years. As a result of the conservative approach taken by domestic lenders, and the resulting relative strength of the domestic housing and mortgage markets, Canadians have benefited from broad access to world-class mortgage finance products at competitive prices.

Recent Developments in the Mortgage Market

Since the fall of 2006, the mortgage markets have experienced a period of accelerated financial innovation. The marketplace has been quick to adopt these innovations, which permit such features as:

- Longer amortization periods (from 25 years up to 40 years).
- Higher loan-to-value ratio loans (up to 100 per cent).
- Niche products for near-prime³ borrowers.
- Streamlined loan documentation requirements with respect to borrowers' income and employment.

What is Mortgage Insurance?

Many Canadians generally understand how mortgage insurance works. We are not talking about mortgage life and critical illness insurance, we are talking about mortgage default insurance.

Mortgage insurance (which is sometimes called mortgage default insurance) is a credit risk management tool that protects mortgage lenders from losses on mortgage loans. If a borrower defaults on a mortgage, and the proceeds from the foreclosure of the property are insufficient to cover the resulting loss, the lender will submit a claim to the mortgage insurer to recover its losses.

Role of Mortgage Insurance

The law requires federally regulated lenders to obtain mortgage insurance on loans where homebuyers make down payments of less than 20 per cent of the purchase price of the home (i.e., high loan-to-value ratio loans). Lenders generally require high-ratio borrowers to pay for the premium for the mortgage insurance, which can be added to the mortgage balance.

Mortgages are sometimes insured after origination through what is often called “portfolio insurance.” High- and low-ratio⁴ mortgages are often combined to create a portfolio that is sold to investors (i.e., securitized). The government guarantee is also a criterion for high ratio loans to be sold into the Canada Mortgage Bond program, which is a relatively new cost-effective funding source for banks and mortgage lending companies. These Bonds are bought up by investors all around the world due to their higher yield than Government of Canada Bonds combined with their “government guarantee”.

How is the Government Involved in Mortgage Insurance?

Mortgage insurance is available to regulated and unregulated lenders in Canada from Canada Mortgage and Housing Corporation (CMHC) and from private mortgage insurers. Since CMHC is a Crown corporation, the Government is ultimately responsible for all of CMHC’s obligations including its mortgage insurance claims.

To make it possible for private insurers to compete effectively with CMHC, the Government also backs private mortgage insurers’ obligations to lenders through guarantee agreements that protect lenders in the event of default by the insurer. The Government’s backing of private insurers’ business that is eligible for the guarantee is subject to a deductible equal to 10 per cent of the original principal amount of the mortgage loan.

The New Mortgage Insurance Guarantee Framework

The new mortgage insurance guarantee framework will establish a boundary on the risk characteristics of the mortgage and of the borrower that are acceptable when the

Government guarantees the mortgage insurance policy. These requirements will apply to all government-backed mortgage insurance policies (whether issued by CMHC or private insurers) for high-ratio mortgages⁵ on residential properties with up to four units.

The Key Amendments to the Mortgage Insurance Guarantee Framework

There are four mortgage and borrower characteristics that define the key parameters of the new mortgage insurance guarantee framework:

A) Loan-to-Value Ratio

Government-backed insurance is currently available on mortgages where the loan-to-value ratio is up to 100 per cent. This limit will be reduced to 95 per cent. Borrowers may borrow the 5 per cent down payment, but it will not be insured under the new guarantee framework.

B) Amortization Period

Amortization is the period or length of time it will take to pay off the entire mortgage loan. The amortization period should not be confused with the “term” of the mortgage, which sets out the period over which a fixed interest rate or variable rate option will apply. A typical mortgage has a term of five years but an amortization period that is usually much longer.

The maximum amortization period for mortgages insured with government backing will be reduced from 40 years to 35 years.⁶

So what has changed?

Well, the Finance Minister looked to our southerly neighbours as well as across the pond and noticed some pretty dire scenarios which begged the question: Are we guaranteeing mortgages that are a little too risky? After an analysis of the mortgages that fall within their guarantee, recent trends, and industry consultations, the Minister of Finance **decided to cease guaranteeing** high ratio mortgages with the following characteristics:

- LTV ratios in excess of 95%
- **Amortizations** in excess of 35 years
- Non-amortizing mortgages (**Interest-Only Mortgages**).
- Applications where the **beacon** score of both borrowers is less than 620.

C) Credit Score

A credit score is a numerical value that measures a borrower’s credit risk at a given point in time based on a statistical evaluation of information in the individual's credit file. It has been proven to be predictive of loan performance and is considered by some mortgage insurers and lenders to be the single best determinant of default risk. Credit scores are well-established industry tools and are generated in Canada by three private firms.

Canadian lenders have not originated many government-backed mortgages for borrowers with low credit scores. To ensure this practice continues, the new framework will establish a credit score floor of 620. There will also be a limited “basket” to provide for exceptions to this rule, recognizing that there are some

borrowers with credit scores below 620 that otherwise represent low credit risks.

D) Loan Documentation

The initiative also includes minimum loan documentation standards to ensure that there is evidence of reasonableness of property value and of the borrower's sources and level of income.

E) Other Parameters

The new guarantee framework also includes other parameters that are required to give full effect to the initiative. These include:

- Excluding high-ratio mortgages where no amortization is required in the first few years from the government guarantee.⁷
- Setting a maximum of 45 per cent on borrowers' total debt service ratio.⁸

Moving to the New Framework

The new mortgage insurance guarantee framework is planned to take effect October 15, 2008. This would allow existing mortgage pre-approvals with the common 90-day duration to be used or expire. Exceptions would be allowed after October 15 where they are needed to satisfy a binding purchase and sale, financing, or refinancing agreement entered into before October 15, 2008.

Consultations with the Mortgage Industry

During the transition period, the Department of Finance will consult with industry stakeholders about the implementation of the new mortgage insurance guarantee framework.

How Does This Affect The Consumer?

If you are a current homeowner, who is happy in your home and have no intentions of moving in the near future then this probably does not affect you. However if you are a prospective homebuyer, looking for 100% financing and a 40 year amortization then your financing options are becoming a little more limited. Most of the big chartered Banks and many lenders have already pulled the above products. Other lenders are offering these products until October 13, 2008 (a CBM mortgage professional can discuss questions concerning rules around this deadline).

Looking Ahead...

If the decision to take 40 year amortizations is based on cashflow, then we'd suggest \$41 per month on its own will not cause any major disruptions in the housing market (see note 6). The reality is that new mortgagors will have to spend a little more in their monthly mortgage obligations but the impact to the housing market will be isolated to those who needed the 40 year amortizations and 100% financing to qualify for their mortgage. As a replacement for 100% financing, we may see the increase in popularity of Cashback mortgages once again. The 100% financing programs have all but made CashBack offers obsolete, however they may be a decent option for some people once again - even if the interest rate is higher.

In the short term, we may see a small spike in homebuying and refinance activity as people try to accelerate their timelines in order to take advantage of these fleeting offers. This may keep the market relatively strong through 2008. In the medium to long term, we don't expect these changes to have much of an impact to the housing market. 35 year amortizations are still available and for that matter 40 year amortizations will still be available by some lenders, such as MERIX, for those customers who have the minimum 20% down payment for conventional financing.



¹ Most lenders generally consider a mortgage to be in arrears after three missed monthly payments.

² A "sub-prime" borrower is one whose record of managing credit is weaker than the industry standard for mortgage lending.

³ The "near-prime" market is made up of borrowers whose record of managing credit is close to the industry standard for mortgage lending, but still below that standard.

⁴ "Low-ratio" mortgages are loans with a loan-to-value ratio of less than 80 per cent at the time of origination.

⁵ Less stringent requirements will also apply to low-ratio mortgages that are insured as portfolios.

⁶ Reducing amortization from 40 years to 35 years on a mortgage loan of \$200,000 with a 6 per cent interest rate results in a \$41 increase in a borrower's monthly payment, but the borrower will save \$49,000 in interest payments.

⁷ This includes high-ratio mortgages that begin with "interest-only" payments and home equity lines of credit (HELOCs).

⁸ Total debt service ratio is the proportion of gross income that is spent on debt service and housing-related fixed or essential payments.

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