ROSS GENTLEMAN

206 – 3530 Cambie Street
Vancouver BC V5Z 2X1

778-237-0813
ross.gentleman@shaw.ca

Capital Markets Section
Financial Sector Policy Branch
Department of Finance Canada

email: risksharing-partagedesrisques@canada.ca

Dear Policy Analysts:

I am providing comments in response to the paper and invitation published by Finance Canada on the subject of 'Lender Risk Sharing' for insured mortgages. Until last year I served as CEO and GM for CCEC Credit Union and earlier in my work life I served in several roles with provincial regulatory authorities.

CONTEXT

I will first observe that the consultation paper chooses to frame the discussion very narrowly on default risk sharing. However, the introduction the paper references the National Housing Act and the larger purposes of the government program under the Act. The following comments are offered in this context.

The policy framework is well set out. However, the principal reasons for IMF and OECD concerns was less than well stated. The objective is to enable market forces to more effectively determine risks, allocate resources, and set prices. The government's exceptional 'guarantee', its monopoly power as 'the' mortgage insurer, and its potentially conflicting interest in stimulating real-estate markets distort lending markets.

The Finance paper does not distinguish between insurance programs and proposes changes that appear to be 'across the board'. There appear to be at least three sub-categories used in CMHC reporting; high-ratio homeowners, low ratio portfolios, and multi-unit residential complexes. It may be that rationales for each of these insurance program interventions is independent, which would then lead to independent assessments of each with respect to the need for government mortgage insurance, the extent, the products, and the risk sharing model.

The paper does stress government's role in 'stabilizing' housing markets, and the paper asserts that "...the housing market is stable..." That may not be the case. There is considerable volatility in the prices of homes in two major centres and housing costs (including rentals) are increasing far faster than other costs for most households. (see CanSim tables) There is a housing affordability crisis which is under represented.

1. To the extent that government's intention is to “promote housing affordability” the mortgage insurance program may be counter-productive. The program has induced a substantial number of households into the home ownership market, expanding the demand in that market which drives up purchase prices. Price inflation for homes has been high and sustained for more than a decade, averaging @12% annually. Income growth has not approached anything close to this level. And the extent of government intervention – CMHC insured high-ratio mortgages total 1/3 of all mortgage debt nation-wide in 2015 (@$500B of @!,400B) – suggests that government mortgage insurance plays a very big role in defining the market and price levels. In this respect, government interventions do not seem to have given us 'stable' or 'affordable' housing markets as was the objective.
2. The mortgage insurance program is not just helping a small number of purchasers who are a little short on a down-payment; it is inducing large numbers of 'sub-prime' purchasers into home ownership and high levels of debt. The CMHC role is not always apparent in statements made by the Bank of Canada but it is implicit. The highly indebted households identified, with concern, by the Bank fit the CMHC client profile, “...highly indebted borrowers tend to be younger, have lower incomes and wealth and are less likely to have pursued post-secondary studies or training.”
3. The extent of the government intervention has 'stimulated' the real estate industry (and banking) and burdened an array of modest income households and future generations with debts and high housing costs.
4. The mortgage insurance program should be more tightly targeted to serve a small number of households who come close to meeting conventional financing qualifications and who are more able to assume the high debt loads. By doing so, government may assist in 'deflating' Canadian shelter costs.
5. The volume of CMHC insured mortgages is now so large that banks and other lenders have come to rely on it heavily. Any change will be resisted by the mortgage lending industry as mortgage insurance has been a windfall for these players. Banks transfer the default risk, with costs borne by borrowers, while retaining the conventional yields on the loans; most beneficial.

RISK SHARING

The paper outlines a solid argument in favour of 'aligning' the interests of the lender and the insurer. The transfer of 100% of the risk, save for some collection costs, is exceptional.

1. The paper`s references to the 'lender' often appear to presume that the lender will continue to administer the loan; that the lender will not assign their interest or transfer administrative responsibilities. If this is assumed by government, this should be made explicit. Indeed, in the US the disconnect between the loan originator and the final owner of 'sub-prime' mortgage loans proved to be a major failure.
2. Two insurance models are set out. A third, stop-loss excess insurance, might also be evaluated. If it has been discounted the reasons should be provided.
3. The paper's discussion of pricing, costs and competition obscures the larger question of consolidation or concentration. In 2016 Canada's bank oligopoly held @75% of all outstanding residential mortgages in Canada. As is noted, the larger banks may have competitive advantages (over smaller and provincially regulated players) and the federal government has an obligation to ensure that the broader public interest is

served – not to foster a more dominant role for the big banks.

4. Credit unions (and mortgage investment companies) offer a dis-inter-mediated model for loan and mortgage funding. Most credit unions do not securitize loans or seek funding through bond or other markets. The policy approach should not be premised on (or biased in favour of) the use of capital markets used by large banks and institutional investors.

TRANSITIONAL ISSUES

The paper highlights concerns related both to capital requirements for prudentially regulated institutions, and to "procyclical" economic effects.

1. Credit unions will be affected by increased capital requirements to reflect added default risks under provincial legislation. The nature of the risk weightings for these loans is subject to discussion. Unlike banks, credit unions do not go to the markets to solicit additional capital. Credit union capital is provided directly by member owners (consumers) and, in large measure, through retained earnings. Member shareholding requirements are usually low and consequently capital for growth (and new risks) is principally derived from earnings, which takes time. This reality will constrain some credit unions from 'sharing' too much additional risk.
2. Most credit unions have a long-term commitment to a locality or region. They do not, as national lenders may, allocate loans based on regional economic risks, potentially exacerbating or extending booms or busts. Credit unions are not as inclined to alter residential lending practices dramatically over an economic cycle, and consequently they are not "procyclical".

Overall, government has a role to play in building a diverse, innovative and competitive market for residential finance. Over the last few decades there has been consolidation and commodification. Some providers, such as trust companies and mortgage loan companies, have been marginalized. Government mortgage insurance and securitization has grown. There is an illusion that financing is more 'efficient'. At the same time the cost of housing has gone up. This does not mean that Canadians are being well served.

Sincerely

Ross Gentleman

Ross Gentleman