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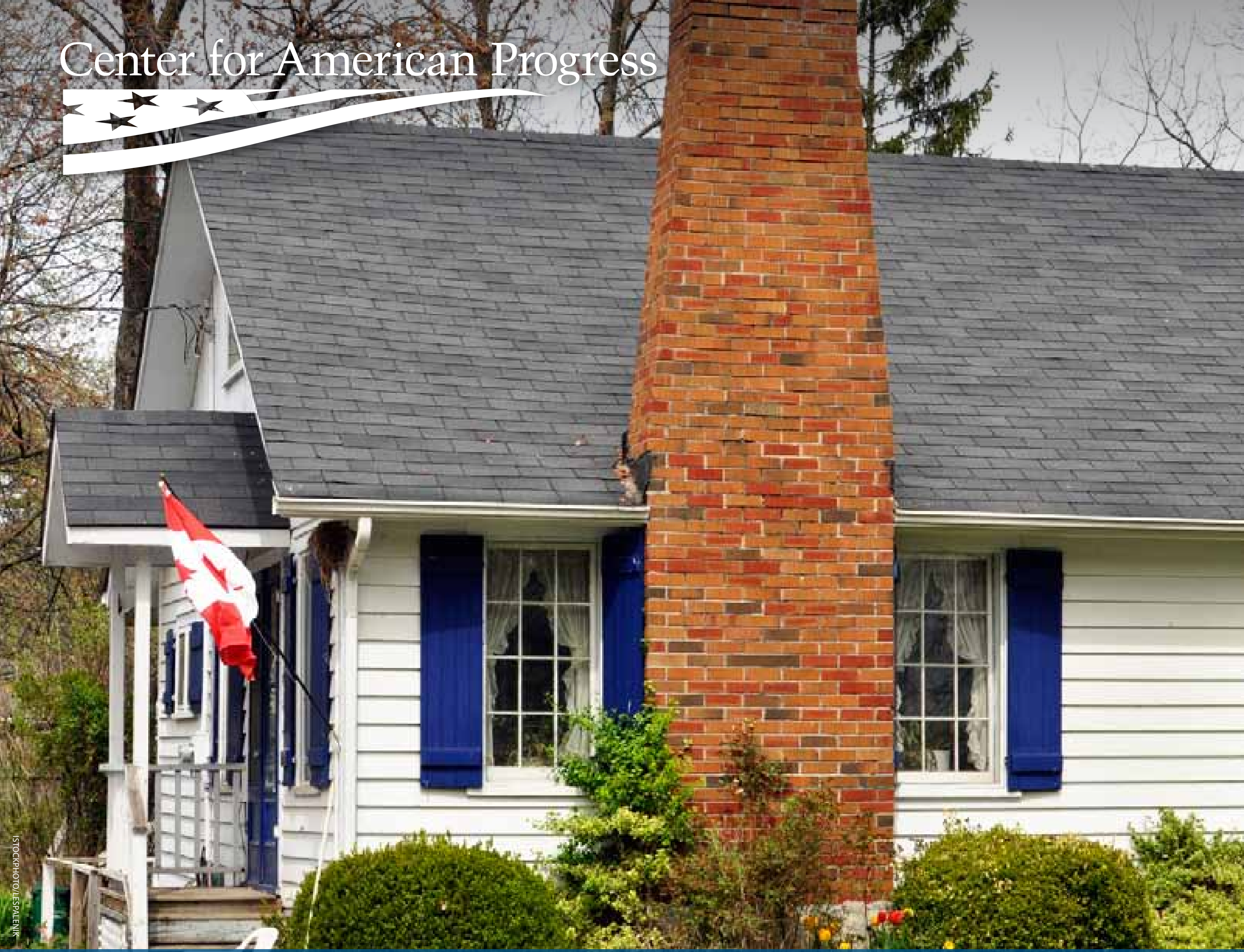

True North

The Facts about the Canadian Mortgage Banking System

David Min August 2010

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Introduction and summary

Given the relative stability of Canadian housing markets, many observers try to draw comparisons between the housing finance policies of Canada and the United States. Why is it that the United States suffered through such a painful housing bubble and bust in the last decade, while Canada did not? After all, the two countries enjoy relatively similar homeownership rates. And as American Enterprise Institute Senior Fellow Alex Pollock notes, the two countries share many other attributes as "[b]oth countries are rich, advanced, stable, have sophisticated financial systems and pioneer histories, and stretch from Atlantic to Pacific."

The answer, quite simply, is that Canada did not become enthralled with the *laissez faire* ideology that dominated U.S. economic policy making in the 2000s, and thus did not allow major gaps in its regulation of housing finance to develop.

Both the American and Canadian mortgage markets had long been dominated by government-backed mortgage lending. In America, this was primarily through the explicit government guarantees on mortgage-backed securities provided by Ginnie Mae or on the implicit government guarantee on the liabilities of Fannie Mae and Freddie Mac. In Canada, this was largely through guarantees on insured mortgages as well as significant levels of government-backed securitization. But from 2003-07, the United States experienced a sudden surge in the unregulated securitization of new, exotic mortgage products such as "2/28 ARMs," adjustable rate mortgages that reset after two years, with such features as "teaser rates" (a low introductory interest rate to attract borrowers) and "stated income" underwriting (where no documentation was required to show a borrower's income or assets). These exotic mortgages, which were often originated by unregulated nonbank lenders, were purchased by private-securitization conduits—typically sponsored by large financial institutions such as Merrill Lynch or Citigroup—and then packaged and sold as so called "private label" mortgage-backed securities. This mortgage financing channel grew tremendously, and in lockstep with the housing bubble, rising from roughly 10 percent of the U.S. mortgage market in 2003 to almost 40 percent in 2006.

In contrast, Canada's mortgage system did not experience such dramatic changes in its mortgage lending landscape, for reasons detailed below. As a result, while private-label mortgage securitization saw large market share increases in the United States in the last decade, this financing channel remained a negligible source of mortgage lending in Canada, remaining at less than 3 percent of the Canadian market during the 2000s.

These are telling differences between the two countries' housing finance markets, but at the outset it is important to urge caution in drawing overly strong conclusions from the Canadian experience, due to the relatively small size of the Canadian mortgage markets. Canada has a total population of about 34 million (larger than Texas but smaller than California), and total residential mortgage debt of slightly less than $1 trillion (as opposed to slightly more than $14 trillion in the United States). Nonetheless, there are some important lessons to be learned from Canada's experience, which boast implications for the future of housing finance in our country.

There are telling differences between the two countries' housing finance markets.

First, the many important similarities between our two countries' mortgage market policies undermine the various arguments that it was moral hazard caused by U.S. government guarantees on mortgage-backed securities and other debt securities issued by Fannie Mae and Freddie Mac, or their affordable housing goals, which caused the mortgage crisis. Indeed, central to Canada's mortgage finance system is the government-chartered and government-backed Canada Mortgage and Housing Corporation, which resembles in many important ways our own government-sponsored entities Fannie Mae and Freddie Mac.

CMHC has a public mission of helping "Canadians in all parts of the country to access a wide range of innovative and affordable financing choices." CMHC boasts affordable housing goals that are similar in many ways to those of Fannie and Freddie. Similarly, CMHC historically dominated the Canadian mortgage markets, leaving it open to the criticism that it distorts the efficient operations of the free markets. While CMHC historically focused on providing government-backed mortgage insurance, it also engages in significant levels of the government-backed securitization that is the core business of Fannie Mae and Freddie Mac, with this government-backed securitization reaching some 25 percent of all Canadian mortgage loans outstanding as of year end 2008.

The Canadian government further supports the mortgage market through its guarantee on mortgage insurance, which is required on all mortgages with down payments less than 20 percent.[1] Canadian mortgage insurance is heavily regulated, and issued by either one of two private firms or through CMHC. The Canadian government explicitly guarantees 90 percent of the mortgage insurance obligations of the two private insurers and stands 100 percent behind the obligations of the government agency CMHC. The government guarantee behind mortgage insurance, like the federally guaranteed securitization we have in the United States, effectively passes credit risk from the lender to the government, an appealing feature for lending institutions.[2]

Perhaps as a result of this transfer of risk, insured mortgages are very popular in Canada, accounting for roughly 45 percent of all outstanding mortgage debt in the country. Between the government guarantee on mortgage insurance and the government-guaranteed securitization, as much as 70 percent of all Canadian mortgages were guaranteed in one form or another by the Canadian government at the end of 2008.

This is not to say that all of the shared attributes that the Canadian and U.S. mortgage system have are laudable. Certainly there are legitimate criticisms to be made in both countries about the lack of "skin in the game" among mortgage market participants and the heavy reliance on government guarantees by the private mortgage industry. But given the relatively positive experience of Canada there would seem to be a compelling argument that elements of the U.S. system that also existed in Canada were not the driving cause of the U.S. mortgage market meltdown. Specifically:

- If it were affordable housing goals of Fannie and Freddie that caused the mortgage crisis, as some have claimed, then why didn't Canada, which has similar goals, experience the same problems?

- If it were government-backed securitization that caused the mortgage bubble, then why didn't Canada, which experienced tremendous growth in government-backed securitization during the 2000s, have a similar problem?

- If it were moral hazard caused by government interference in the ordinary functioning of the "free markets" that was instrumental in causing the credit crisis, then why didn't Canada, which had similar governmental intervention through its guarantee of mortgage insurance, experience a similar outcome?

While differences between the U.S. and Canadian mortgage systems may provide some important insights into why the United States experienced a mortgage crisis while Canada did not, many of the differences pointed out so far are relatively minor and it is hard to understand how these would be significant enough factors to explain the dramatically different experiences of the two countries. For instance, some observers highlight the fact that Canada allows prepayment penalties against borrowers and that it allows full recourse against defaulting borrowers as major reasons why Canada suffered through less housing market turmoil than the United States. Others note the predominance of the 5 year mortgage in Canada, as opposed to the 30-year standard mortgage in the United States. While these differences exist, they do not well explain why the United States had such a drastically different experience than Canada.

The most important difference between the U.S. and Canadian mortgage markets is in their relative exposure to unregulated lending channels and products—and it is this difference that best explains why Canada avoided the credit crisis that plagued the United States. During the 2000s, Canada experienced very limited amounts of lending financed by private securitization (and its alphabet soup of ABS, asset-backed securities; CMOs, collateralized mortgage obligations; CDS, credit default swaps; SIVs, structured investment vehicles, and the like), whereas that lending channel grew to immense heights in the United States, growing from around 10 percent at the beginning of the 2000s to nearly 40 percent at the height of the bubble.

The most important difference between the U.S. and Canadian mortgage markets is in their relative exposure to unregulated lending channels and products.

In the United States, this financing channel was notable for introducing mortgages with exotic features—such as negative amortization (in which the principal balance grew, rather than shrank, over time), interest-only payments, and so-called "no documentation" underwriting—into the mass market. So why did Canada experience so little private-label securitization, and thus the toxic loan products this mortgage finance practice introduced into the U.S. market?

The answer is complex, but appears to be related to two key factors. First, the Canadian mortgage system is well regulated for risk and product safety. Second, the Canadian system encourages lenders to become and remain regulated through the benefits it provides them, most importantly in the form of government-guaranteed mortgage insurance. In other words, Canada did not allow regulated lenders to deal in unsafe products or banking practices, and Canadian mortgage lenders and bankers had little incentive to be unregulated. The combination of the two ensured that Canada had little of the problematic unregulated lending that characterized the U.S. mortgage bubble.

If you believe the critics of the U.S. mortgage finance model, then Canada should have been a poster child for a mortgage crisis. Canada's mortgage market is supported by the government to a degree even greater than that of the United States (prior to the credit crisis), and is rife with the "market distortions" and "moral hazard" that many critics of the U.S. system blame for the U.S. bubble. Canada relies heavily on CMHC, a government-backed institution, to provide a significant proportion of its housing finance needs. Canada actively promotes policies meant to promote the availability of affordable housing and affordable mortgage finance among low-income and minority communities, both among CMHC and private lenders. And CMHC engaged in significant levels of government-backed securitization, the core business of the U.S. government-sponsored enterprises Fannie Mae and Freddie Mac.

Given all of these factors, Canada's mortgage markets should have experienced the same mortgage crisis that the United States did, according to these critics. Instead, Canada has been relatively calm throughout the global credit bubble and ensuing bust.

Background on the U.S. mortgage market

Up until the implosion of the nonbank financial sector in 2008, there were four main mortgage lending channels in the United States:

- Loans originated by depository institutions held to maturity, financed by bank or thrift deposits
- Loans originated by qualified lenders, insured by the Federal Housing Administration or the Veterans Administration and packaged into mortgage-backed securities carrying the "wrap" or guarantee of the government agency Ginnie Mae, which in turn is explicitly backed by the full faith and credit of the U.S. Treasury
- Loans originated by qualified lenders, resold to one of the government-sponsored entities Fannie Mae or Freddie Mac, and financed by the sale of mortgage-backed securities guaranteed by Fannie or Freddie, which in turn were thought to carry the implied backing of the U.S. Treasury
- Loans originated by anyone (including mortgage brokers, nonbank lenders, and depository institutions), resold to a private-securitization conduit (typically an off-balance sheet special purpose vehicle sponsored by a major Wall Street financial institution), and financed by the sale of mortgage-backed securities that carried credit ratings issued by the rating agencies.

Beginning in the late 1980s, the U.S. mortgage market became increasingly dominated by securitization, as Ginnie Mae securitization, GSE securitization, and private-label securitization grew to capture a majority of the U.S. mortgage market. Conversely, the share of mortgages financed by bank deposits plummeted, from 75 percent in 1970 to just under 20 percent at the end of 2008.

One theory as to why securitization grew so much in the United States is that it allows regulated lenders to reduce their regulatory capital requirements. Under the international bank capital standards recommended by the Basel Committee, banks and other regulated lenders must hold capital against the loans they hold, on a risk-weighted basis. While capital requirements increase the safety and soundness of the banking system, this capital is relatively expensive to raise, and holding more capital effectively reduces the "return on equity" that a financial institution can earn.

One alternative to raising capital is to reduce the amount of loans held on an institution's books, and one way to do this is by selling these loans to third parties. Securitization, which pools mortgages and other types of loans, and then issues securities based on the cash flows (such as monthly mortgage payments) in the pools, provides a ready outlet for lenders seeking to offload their loans and thus reduce their capital requirements. Selling loans to securitization outlets such as the GSEs or private-securitization conduits allows lenders to use the proceeds to then make further loans and earn fees and other income from the lucrative origination and servicing of mortgages, effectively allowing them to further increase their leverage while shifting the credit and prepayment risks associated with these loans elsewhere.

Private securitization was unique among the major U.S. mortgage financing channels as there was effectively no regulatory oversight on it.

Within the trend towards securitization, it is important to understand the differences between the different types of securitization. As the Congressionally created Financial Crisis Inquiry Commission recently noted, there are important distinctions between government-backed securitization performed by Ginnie Mae or the government-sponsored entities Fannie Mae and Freddie Mac, and private-label securitization. The former relies on a government guarantee behind the securities being issued to ensure investor confidence; the latter relies on subordination and a structure of tranching (where the higher tranches are shielded from losses by lower tranched securities that bear first losses), as well as credit ratings provided by the credit rating agencies, to achieve the same purpose.

Until the recent Dodd-Frank financial regulatory reform legislation was passed, private securitization was unique among the major U.S. mortgage financing channels as there was effectively no regulatory oversight on it. Private securitization was typically performed by off-balance sheet special purpose legal entities sponsored by (and ostensibly independent of) financial institutions such as Goldman Sachs Group Inc. or Merrill Lynch & Co. (now part of Bank of America Corp.). While Fannie Mae, Freddie Mac, and other regulated lenders such as banks and thrifts were overseen for safety and soundness, with regulatory supervision for capital adequacy and for the types and quality of the mortgages they purchased, private-securitization conduits had no such regulatory oversight.

The lack of regulation of private securitization was compounded by the fact that most of the mortgages securitized by private-securitization conduits were originated by unregulated nonbank lenders, such as the subprime lenders New Century Financial Corporation or Ameriquest Mortgage—both of which are now out of business. Regulated lenders such as banks and thrifts had some oversight of their lending practices, but nonbank lenders who did not rely on deposits to fund their loans effectively had no regulatory oversight of their practices.

Up until about 2003, government-backed securitization was dominant, accounting for the great majority of mortgage lending in the United States. But beginning in 2003, private-label securitization saw an enormous increase in market share, growing from about 10 percent to nearly 40 percent in 2006. This growth came almost exclusively at the expense of Fannie Mae and Freddie Mac, which saw an equivalent drop in market share over the same period.

Much of this dramatic market share shift occurred because AAA-rated private-label securities appeared to be just as safe as equivalently rated securities issued by Fannie or Freddie, while offering higher returns to investors. In retrospect, given the sharply higher default rates of the mortgages securitized by private-securitization conduits, it is clear that private-label securities were not as safe as once thought.

The rise of unregulated private securitization and fall of regulated government-backed securitization from 2003-07 roughly corresponds with the U.S. housing bubble.

Background on the Canadian mortgage market

The major distinguishing feature of the Canadian mortgage market is its unique system of federally backed mortgage insurance. Canada requires that all mortgages with a loan-to-value ratio of more than 80 percent (referred to as "high-ratio loans"), which are provided by federally regulated financial institutions, be insured against the possibility of default. This mortgage insurance can only be issued by approved insurers, which are strictly regulated for safety and soundness.

Until recently, only two entities were allowed to issue mortgage insurance—the Canada Mortgage and Housing Corporation, or CMHC, a government corporation wholly owned by the Canadian government, and Genworth Financial Canada, a private corporation that entered the Canadian mortgage insurance market in 1995. In 2006, the Canadian government allowed another private firm, the Canada Guaranty Mortgage Insurance Company (formerly AIG Canada until the Ontario Teachers' Pension Plan purchased the entity earlier this year), to enter the market.

The requirement that high-ratio loans be accompanied by insurance purchased from one of several large, strictly regulated mortgage insurers is offset by the Canadian government's explicit guarantee on all mortgage insurance obligations, which serves to drive down the costs of these types of mortgages. Furthermore, unlike in the United States, where private mortgage insurance typically only covers 20 percent or less of the loan (the amount in excess of 80 percent of the value of the property), Canadian mortgage insurance covers 100 percent of the loan, with essentially all of this guaranteed by the Canadian federal government. The guarantee covers 100 percent of CMHC's obligations, and 90 percent of the obligations of the two private mortgage insurers.

From the perspective of Canadian lenders, then, the explicit Canadian government guarantee on mortgage insurance essentially serves a similar function to government-backed securitization in the United States, transferring credit risk to the government. Yet in the United States lenders seeking to offload the risk associated with a particular loan—and the capital they would need to hold against that loan—must actually sell that loan. In Canada, lenders can hold onto government insured loans without raising additional capital against those loans. This is because, to the extent that insured mortgages in Canada have an explicit government guarantee standing behind them, they are considered as good as Canadian sovereign debt. As such, banks and other lenders in Canada who hold insured mortgages do not have to hold regulatory capital against the insured portion of those loans.[3]

Thus, for regulated Canadian lenders who are part of the mortgage insurance system, securitization of high-ratio loans is far less attractive than it is for U.S. lenders. As far as regulatory capital requirements go, securitization is essentially the same as holding an insured mortgage backstopped by the Canadian government. In part because of the regulatory capital benefits of government-backed mortgage insurance, mortgage insurance (which is predominantly but not entirely used for high-ratio loans) is prevalent throughout Canada, representing some 45 percent of all outstanding mortgage debt as of 2009.

Banks and other lenders in Canada who hold insured mortgages do not have to hold regulatory capital against the insured portion of those loans.

On the other hand, securitization—especially private-label securitization—plays a much smaller role in the Canadian mortgage system. While the securitization of mortgages has grown in importance in Canada, particularly in the last decade, total mortgage securitization in Canada is far less pervasive than in the United States. As of year-end 2008, approximately $267 billion in mortgages—29 percent of total outstanding mortgages—had been securitized, as compared to over 60 percent of U.S. mortgages.

Notably, almost all of this securitization is backed by the Canadian federal government, with approximately $245 billion securitized through the government-owned CMHC. Conversely, private-mortgage securitization accounts for very little of Canadian lending, accounting for less than 3 percent of all mortgages. In short, with 45 percent of outstanding home loans covered by mortgage insurance and 25 percent of mortgage debt securitized with a backing from CMHC, as much as 70 percent of the mortgage financing in Canada is ultimately guaranteed by the federal government.

Contrary to the United States, where an explosion in unregulated lending occurred through nonbank lenders, Canada experienced virtually no unregulated lending over the same period as essentially all lending was done through institutions overseen for safety and soundness. This regulation was buttressed by the presence of the Financial Consumer Agency of Canada, which is similar to the Consumer Financial Protection Bureau that was just created as part of the Dodd-

Frank financial regulatory reform bill, and oversees lending practices to protect consumers from deceptive lending practices.

Canada has a minimum mortgage down payment requirement of 5 percent, but this need not be cash and can be borrowed, effectively allowing for zero down payment products. The dominant mortgage product in Canada—analogous to the 30-year prepayable fixed-rate mortgage here— is a five-year mortgage.[4]

Comparing the U.S. and Canadian mortgage systems

In an effort to advance the argument that it was excessive government intervention, primarily through the moral hazard and market distortions created by the government-sponsored entities Fannie Mae and Freddie Mac, that caused the mortgage crisis, a number of observers, including the American Enterprise Institute, *The Washington Post*, *The Wall Street Journal*, Marketwatch, and others have relied on incorrect or misleading claims to try to make the case that Canada's relative stability during the global credit bubble was due to the "free market" or private nature of its mortgage system.

In fact, Canada's mortgage market experience shows quite the opposite. Canada's mortgage markets contain essentially all of the elements that critics of the U.S. system have blamed for its mortgage crisis—including, contrary to the claims of many of the above, large levels of government backing for the mortgage system—and yet Canada did not experience the same bubble-bust cycle as its southern neighbor.

Similarities abound, but differences matter

Comparison of the significant elements of the U.S. and Canadian mortgage markets

	United States	Canada
Similarities		
High levels of government support for home mortgage markets	Yes	Yes
Markets dominated by government-backed entities	Yes	Yes
Substantial levels of government-backed securitization	Yes	Yes
Affordable housing and fair lending policies	Yes	Yes
Private institutions with government guarantees	Yes	Yes
Differences		
Large market share for firms unregulated for safety and soundness	Yes	No
High number of mortgages originated by unregulated nonbank lenders	Yes	No
Dominant product is a long-term, fixed-rate, prepayable mortgage[1]	Yes	No

1 The dominant mortgage product in the United States is the 30 year, fixed-rate mortgage, although notably, this product lost significant market share in favor of shorter-duration products during the 2000s bubble. The dominant product in Canada is a 5-year mortgage, amortized over a 25 year schedule, that must be refinanced at term.

Source: Center for American Progress. For details on the similarities and differences, see paper.

While some critics of the American system have seized on certain, relatively less significant differences between the U.S. and Canadian mortgage markets, such as the fact that Canada does not have any laws restricting the ability of lenders to seek recourse against defaulting borrowers beyond the value of the home, or the Canadian practice of having prepayment penalties for borrower who seek to refinance, these differences are greatly overstated. They do not explain the enormous differences in the experiences of the two countries: the United States suffered its worst mortgage crisis in nearly a century while Canada remained relatively unscathed. These various arguments are addressed below.

Unfortunately, these same analysts have almost universally ignored the elephant in the room—the absence of unregulated lending channels in Canada, either in the secondary markets or at the origination level. Simply stated, Canada has negligible exposure to private securitization and to unregulated lending origination. Compare this to the United States, where unregulated private-securitization conduits, acquiring loans purchased mainly from unregulated nonbank lenders, accounted for nearly 40 percent of the mortgage market at the height of the credit bubble.

It is this difference that is the most obvious explanation as to why Canada's mortgage market escaped the fate that befell ours. Why did Canada avoid an influx of unregulated financing and lending? One potential answer for this appears to be that Canada's government-guaranteed mortgage insurance provides substantial benefits (in the form of capital relief) for the regulated financial institutions that have access to it. In other words, Canada tilts the playing field in favor of regulated lenders. As a result, there is far less incentive to be unregulated in that country's mortgage system.

Canada's government-guaranteed mortgage insurance provides substantial benefits (in the form of capital relief) for the regulated financial institutions that have access to it.

Similarities between the U.S. and Canadian mortgage systems shows it was not excessive government intervention that caused the U.S. crisis

In the wake of the U.S mortgage crisis, many commentators argued that it was excessive government intervention in the private mortgage markets that caused both the mortgage and housing bubbles and their consequent busts, claiming that the government guarantees on liabilities issued by the government-sponsored entities Fannie Mae and Freddie Mac and the government agency Ginnie Mae created moral hazard that distorted the mortgage market. Many of these same critics have also argued that government policies, including the affordable housing goals of Fannie and Freddie and the Community Reinvestment Act's requirement that regulated banks and thrifts provide nondiscriminatory access to credit, caused private institutions and the GSEs to take on bad credit risks, creating a mortgage bubble in the process.

These arguments are, however, undermined by the experiences of Canada, which did not undergo a housing or financial crisis, maintains similar homeownership rates as the United States, but which has policies and institutions similar to the ones that have been so heavily criticized in the United States. In particular, many of these similarities tend to contradict the claims that it was the government-sponsored entities Fannie Mae and Freddie Mac, or their affordable housing goals, that drove the financial crisis. Canada's mortgage system has elements that closely resemble the aspects of Fannie and Freddie that critics of the U.S. system have blamed for causing the American mortgage bubble, and yet Canada has so far avoided the bubble-bust cycle that the U.S. experienced. Among the similarities:

Government-backed entities with mandates to promote public policy goals

Some observers note that Canada does not have mortgage-related "government sponsored entities" such as Fannie Mae and Freddie Mac. While this claim is technically true, it is highly misleading. The Canada Mortgage and Housing Corporation is a government *owned* (not *sponsored*) corporation that looks much like Fannie and Freddie.

Similar to Fannie and Freddie, CMHC has a legislative mandate to "promote the construction of new houses, the repair and modernization of existing houses, and the improvement of housing and living conditions," which it strives to meet by "improv[ing] access to affordable, high quality housing for all Canadians" and "ensuring a stable, low-cost supply of funds for mortgage lending."

CMHC also has numerous mandates to subsidize affordable housing and ensure the availability of affordable mortgage finance, particularly to low-income and minority communities. In addition to its "Affordable Housing Initiative," which is meant to increase the supply of affordable housing in conjunction with Canadian states and provinces, CMHC has an explicit duty to provide housing finance to all geographic areas and to support affordable rental housing.

CMHC also supports a broad array of other programs meant to increase homeownership and the supply of affordable housing finance, particularly among minority and low income populations.

While these affordable housing obligations differ in some important ways from those of Fannie Mae and Freddie Mac, their existence tends to undermine the argument that it was affordable housing and fair lending policies, per se, that caused the U.S. crisis.[5]

CMHC also is used as a public policy vehicle to provide countercyclical mortgage liquidity. In response to the recent drop in other sources of mortgage liquidity, for example, the Canadian government raised CMHC's insurance cap by 33 percent to allow it to fill that gap—similar to the role played by Fannie and Freddie in the United States.

Much like Fannie and Freddie, CMHC has been criticized for enjoying benefits and subsidies that give it an advantage over its private competitors, including lower capital requirements, cheaper access to capital, exemption from many forms of regulation, lessened financial and reporting requirements, and an exemption from provincial income taxes.

Government guarantees for private shareholders

Another major criticism of the Fannie and Freddie is that they enjoy a public backing while being private entities with private shareholders. But Canada has a similar situation in its mortgage markets, as it provides government guarantees to the mortgage insurance obligations of two approved private mortgage insurers with private shareholders (Genworth Financial and Canada Guaranty). These mortgage insurers, which account for roughly 30 percent of all mortgage insurance (with the rest of the mortgage insurance market being served by CMHC), enjoy a government backing on their insurance liabilities.[6]

Government-backed securitization

While Canada does not have nearly the level of government-backed securitization as in the United States, it does have a significant amount of such securitization, which is responsible for financing about a quarter of all mortgage debt. Of

During the credit and housing bubble that hit the United States but not Canada, U.S. government-backed securitization was declining while Canadian government-backed securitization was soaring.

particular interest is the fact that much of the growth in this public securitization, which is either issued by CHMC or guaranteed by CMHC, occurred in the 2000s (even as the United States saw major declines in the market shares of Fannie and Freddie securitization). In other words, during the credit and housing bubble that hit the United States but not Canada, U.S. government-backed securitization was declining while Canadian government-backed securitization was soaring. If it was the core securitization activities of Fannie and Freddie that had caused the U.S. mortgage crisis, one would have expected to see an even worse crisis in Canada.

Public guarantees of credit risk

The U.S. mortgage system is heavily criticized for creating "moral hazard" because it guarantees so much of the credit risk in the U.S. mortgage markets through its explicit guarantee on the obligations of Ginnie Mae and its implied guarantee on debt and securities issued by Fannie Mae and Freddie Mac. But the Canadian government has similar and even more expansive governmental backing for its mortgage market, both in the form of guarantees on mortgage-backed securities issued or guaranteed by CMHC, which now comprise some 25 percent of the total market, and the government guarantee on all mortgage insurance, which accounts for roughly 45 percent of all Canadian mortgage debt. In total, the Canadian government guarantees up to 70 percent of all outstanding mortgage debt in that country.

High concentration among financial intermediaries

Many observers have criticized the U.S. banking system for being too concentrated, both at the origination level, where a handful of financial institutions (and their subsidiaries) dominate the origination and servicing of mortgage loans, and at the secondary markets level, where Fannie and Freddie and a few private firms dominated the securitization of lending. Canada has a similar concentration of risk. At the origination level, the five largest national chartered banks account for about 85 percent of all lending in the Canadian banking system. These lenders are backstopped by a mortgage insurance structure that is similarly concentrated. Canadian mortgage insurance is entirely provided by CMHC—which has about 70 percent market share—and the two private entities, Genworth Financial and Canada Guaranty Mortgage Insurance Company, which benefit from the explicit government guarantee on their insurance obligations.[7]

Low down payment lending

Many observers argue that the Canadian mortgage system is more stable than the United States because it has higher down payment requirements than the United States. This claim is somewhat incorrect. Canada technically has a 5 percent minimum down payment requirement, but this down payment does not need to be cash, and can be borrowed from other sources, effectively allowing for zero down payment mortgage products.

Differences between Canada and the U.S. that are less important

There are, of course, many differences between the U.S. and Canadian mortgage systems, and many leading commentators note a few of them as ones that should be considered in understanding why the United States experienced a mortgage crisis while Canada did not. These differences are certainly important ones, but their impacts have generally been overstated, and it seems implausible that these relatively minor policy distinctions could explain the major differences between the experiences of the two countries. Among these differences:

Canada allows prepayment penalties

Some observers point out that Canada allows prepayment penalties as one reason why that mortgage market is more stable. But the consequences of this do not seem particularly likely to be great, and at least one study has found that they are essentially negligible. A 2009 working paper by the International Monetary Fund found that Canada's prepayment penalties are about the same as the extra origination fees paid by U.S. borrowers. When upfront points and lock-in fees (which do not exist in Canada) are factored in, U.S. consumers pay similar or even greater amounts to refinance their mortgages than the 3 month interest penalty paid by Canadian borrowers. As a result, it seems unlikely that prepayment penalties in Canada have had much effect on homeowner behavior, and certainly do not explain the dramatic differences in performance between the two systems.

Canada allows full recourse against borrowers

Another aspect of Canada's mortgage system cited as a reason for their relative stability is their legal structure, which allows full recourse against defaulting mortgage borrowers beyond the value of the home. In conjunction with a July 2009 study from the Federal Reserve Board of Richmond, which found a correlation between laws limiting full recourse and the use of "strategic foreclosures" by borrowers who owed more on their mortgages than the home was worth, this claim has been used to argue that limitations on full recourse in the United States is an important factor in understanding why the U.S. housing and finance sectors experienced a mortgage crisis while Canada did not.

There are, however, some serious issues with this argument. First, as has been outlined in a research note from the Federal Reserve Board of Atlanta, the Richmond Fed research was highly skewed by the fact that only 11 U.S. states have any limitations on recourse, and California and Arizona—both of which have experienced extraordinarily high foreclosure rates—are among these states.

Another important criticism of this research made in the Atlanta Fed note is that limitations on recourse are only meaningful to the extent that they prevent recovery by lenders. Two other important factors may be far more relevant than recourse laws. First, the bankruptcy laws in place in the borrower's jurisdiction may prevent recovery far more than limitations on recourse. Second, to the extent that borrowers have limited assets (and most borrowers who face foreclosure would presumably fall into this category) there is little for a lender to recover, with or without any limitations on recourse. The right of lenders to seek recourse may be valuable in theory, but when this right comes up against the reality of generous bankruptcy laws or judgment-proof borrowers, it may be seen as far more worthless.

Canada does not allow mortgage interest to be deducted

Another claim is that Canada did not suffer because it does not allow mortgage interest to be deducted, while the United States does for principal residences. While there is certainly great merit to the argument that the U.S. mortgage interest deduction tends to drive resources toward homeownership, inflating the housing market and driving speculation, this claim about Canada is highly misleading. Canada has a slew of tax and other policies that encourage home purchases in their own right, which is one major explanation of why Canada historically had a similar homeownership rate as the United States.

While Canada does not have a mortgage interest deduction for owner-occupied homes, it does have such a deduction for rental homes, which arguably encourages speculation even more so than a deduction for owner-occupied homes. Canada also exempts the sale of owner-occupied property from any capital gains taxes (as opposed to in the United States, where capital gains are exempt from taxes up to $500,000 if the property has been the principal residence for 5 years), and provides a tax rebate on the purchase price of a new or substantially renovated house. First-time home buyers are allowed to use up to $25,000 from their tax-free retirement savings account (similar to U.S. 401k defined contribution pension plan accounts), without penalty, to purchase a home.

In the aggregate, then, Canadian tax policies seem to be comparable to those in the United States in encouraging and subsidizing home buying.

Canada has a standard 5-year mortgage, rather than a 30-year, fixed-rate mortgage

Some critics of the American system point out that Canada's standard mortgage is a 5-year mortgage, and suggest that the 30 year fixed-rate prepayable mortgage that is the U.S. standard tends to destabilize the financial system by leaving excessive interest rate risk with financial intermediaries (or the government). It is worth noting that this argument does not bear on the recent mortgage crisis, in which troubled financial institutions bore losses on their credit risk, and not on interest rate risk. Moreover, this argument ignores some important benefits of the 30-year fixed-rate mortgage as well as some key deficiencies with shorter-duration mortgages.

First, longer duration mortgages are more sustainable. In the United States, since 1998 (when statistics are readily available), prime adjustable-rate mortgages (such as a 5-year or 7-year ARMs, which most closely resembles the Canadian 5-year mortgage) have been 2.72 times more likely to go into foreclosure than prime long-term fixed rate mortgages (such as the 30 year mortgage), according to the Mortgage Bankers Association's National Delinquency Survey.

Second, while it is true that the 30-year fixed-rate mortgage (or other long-duration mortgage products) puts interest rate risk onto financial institutions, it is equally true that a 5-year mortgage (or other short-duration mortgage) moves this interest rate risk onto households. One reason why foreclosure rates are so much higher for shorter-duration products is the relative inability of households to deal with interest rate risk. Unlike financial institutions, households typically cannot hire experts to analyze interest rate trends, and they cannot purchase complex financial interests to hedge against interest rate risk. Transaction costs are also much higher for households because it is relatively far more expensive to move to another home than it is to switch investment portfolio allocations.

Third, short-duration mortgages constrain the ability of central banks to conduct monetary policy, one of the key findings of the "Miles Report," the landmark 2004 report on reforming the British mortgage system. The Miles Report found that in countries where short-term mortgages (such as the Canadian 5-year mortgage) were predominant, interest rate changes had far greater impacts on housing prices. As a result, central banks in these countries must be much more careful about implementing interest rate changes because such action can more easily drive housing bubbles and downturns. Given how much interest rate risk is borne by households in these countries, and the heightened sensitivity of house prices to interest rate changes, it is reasonable to assume an implicit obligation on central banks in these countries to maintain low interest rates with low volatility.

The real difference: Canada's absence of private securitization and unsupervised lending

Remarkably, the difference between Canada and the United States that seems most relevant to the question of why Canada's mortgage markets have been so relatively stable has gone largely under the radar, to date. The unregulated "private-label securitization" financing channel that grew to such great heights in the United States financed very little Canadian lending, and at the origination level, Canada has almost no unregulated lenders.

While Canada had significant amounts of government-backed securitization, insured or guaranteed by CMHC, it had very little private securitization funding its mortgage lending. At the height of the U.S. bubble in 2006, private securitization accounted for only $22 billion of Canadian mortgages—less than 3 percent of all Canadian mortgage debt outstanding. This compares to a 38 percent market share in the United States.

At the mortgage origination level, almost all Canadian mortgage lending was done by entities that were regulated by the federal government. Canada did not experience much lending from nonbank mortgage lenders like New Century, Argent, and Ameriquest, which dominated the U.S. subprime mortgage market during the 2000s bubble. Furthermore, lending standards were buttressed by strong consumer protections, in the form of the Financial Consumer Agency of Canada, which is analogous to the Consumer Financial Protection Bureau that was just signed into law as part of the Dodd-Frank financial regulatory reform bill.

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In short, Canada appears to have avoided the fate of its neighbor to the south for two reasons. First, Canada's regulated lenders and financing channels were supervised fairly well, and were not allowed to jump into the exotic mortgage products that proved so disastrous in other countries (such as interest-only mortgages, negative-amortization mortgages, or "liar loans"). Second, Canada did not experience a massive influx of unregulated mortgage financing or lending.

But why did Canada not experience an influx of unregulated mortgage lenders and financing vehicles? At least one important reason appears to be the relative benefits provided to regulated Canadian lenders. Regulated lenders in the United States seeking to reduce their capital levels and raise their return on equity had strong incentives to avoid regulation and to sell their loans to securitization conduits.

In contrast, Canadian lenders benefited from government-backed mortgage insurance, which was only available to regulated entities. Because Canadian mortgage insurance provided capital relief, there was significant incentive for lenders to be regulated, and among these regulated lenders, there was little attraction offered by private-securitization conduits. As a result, Canadian lending was almost entirely well regulated, and so did not experience the deterioration in underwriting and risk analysis that characterized U.S. lending over the same period.

In short, there are many important differences between the mortgage systems of the United States and Canada, and given the relative stability of our northern neighbor we would do well to heed the obvious lessons its experience teaches. But such lessons should be based on a firm grasp of the facts about Canadian housing finance, and not upon false or misleading claims. The key lesson Canada appears to teach us is that regulated, government-supported mortgage finance leads to greater sustainability and stability than its unregulated, purely private counterpart.

Endnotes

1 Mortgage insurance is available, but optional for loans with down payments of 20 percent or more.

2 The government explicitly guarantees the mortgage securitization obligations of the government agency Ginnie Mae, and was thought to provide an implicit guarantee to the debt- and securitization-related obligations of the government-sponsored entities Fannie Mae and Freddie Mac.

3 Loans insured by CMHC enjoy a 100 percent government guarantee, while privately insured loans enjoy a 90 percent government guarantee. Under the Basel accords on capital standards, loans insured by CMHC are essentially treated like Canadian sovereign debt, and regulated lenders do not have to hold any capital against them. With respect to privately insured loans, regulated lenders do not have to hold any capital against the 90 percent portion that is guaranteed by the Canadian government; they must hold capital against the remaining 10 percent portion in accordance with Basel's risk-weighting guidelines for insured residential mortgages. See, e.g., "Residential Mortgages and Securitization in Canada: Overview of the Mortgage Market," DBRS Industry Study, p. 22, May 2007, available at http://www.dbrs.com/research/211674 ("The primary incentive for a mortgage lender to purchase bulk insurance is to obtain capital relief. Capital risk weighting for uninsured mortgages is 50% (further reduced to 35% when the Basel II banking regulations are implemented) while insured mortgages do not attract any capital requirements" (emphasis added)).

4 This product is typically amortized over a 25 year period, such that the borrower's monthly payments pay down principal and interest as if the mortgage was a 25 year fixed-rate loan. Of course, with a 5-year loan amortized over 25 years, the borrower must pay the balance of the principal owed after the 5-year loan expires, or find a new loan.

5 The argument that U.S. affordable housing policies triggered the mortgage crisis is also belied by a number of key facts and trends as well. As the FCIC depicts in its preliminary staff report, "Securitization and the Mortgage Crisis," the market share of private-securitization conduits, which are essentially exempt from affordable housing or fair lending requirements, soared during the housing bubble, while the market share of depository institutions and the GSEs, which are subject to such requirements, dropped correspondingly. [*See* Financial Crisis Inquiry Commission, "Securitization and the Mortgage Crisis" p. 10 , available at http://www.fcic.gov/reports/pdfs/2010-0407-Preliminary_Staff_Report_-_Securitization_and_the_Mortgage_Crisis.pdf.] Furthermore, the bubble-bust cycle that characterized the mortgage crisis was also seen in other credit markets, which were not subject to any affordable housing policies but which had high exposure to financing provided by unregulated private securitization. For example, commercial real estate experienced comparable price inflation during the credit bubble and has subsequently experienced similar delinquency rates. A clear pictorial indication of this phenomenon is provided by Adam Ashcraft, an economist with the Federal Reserve Board of New York, who charts the high rate of increase in asset-backed securitization issues during the years 2003-07, followed by a precipitous drop. [*See* Adam Ashcraft, "Do Global Banks Spread Global Imbalances," (International Monetary Fund, p. 7), available at http://imf.org/external/np/res/seminars/2009/arc/pdf/ashcraft1.pdf.] In fact, as a McKinsey Global Institute report from January 2010 noted, the largest increases in credit accumulation occurred among households in the 60-90 percentiles of income, not typically the targets of affordable housing policies. [*See* "Debt and deleveraging: The global credit bubble and its economic consequences," McKinsey Global Institute, January 2010, available at http://www.mckinsey.com/mgi/publications/debt_and_deleveraging/index.asp.] It is also worth noting that loans originated under affordable housing policies have actually performed significantly better than other loans, when made to the same borrowers. [*See* David Abromowitz and Janneke Ratcliffe, "Homeownership Done Right: What Experience and Research Teaches Us," Center for American Progress, April 2010, available at http://www.americanprogress.org/issues/2010/04/homeownership_right.html.]

6 It is worth noting that the guarantee enjoyed by private Canadian mortgage insurers is explicit and narrowly tailored, whereas the guarantee enjoyed by Fannie and Freddie was implicit and thus construed more broadly.

7 Given the high concentration and large asset bases of these institutions, it is not unreasonable to believe they may be "too big to fail" and thus enjoy an implied government guarantee behind some of their obligations, much like the largest U.S. financial institutions.

About the author

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