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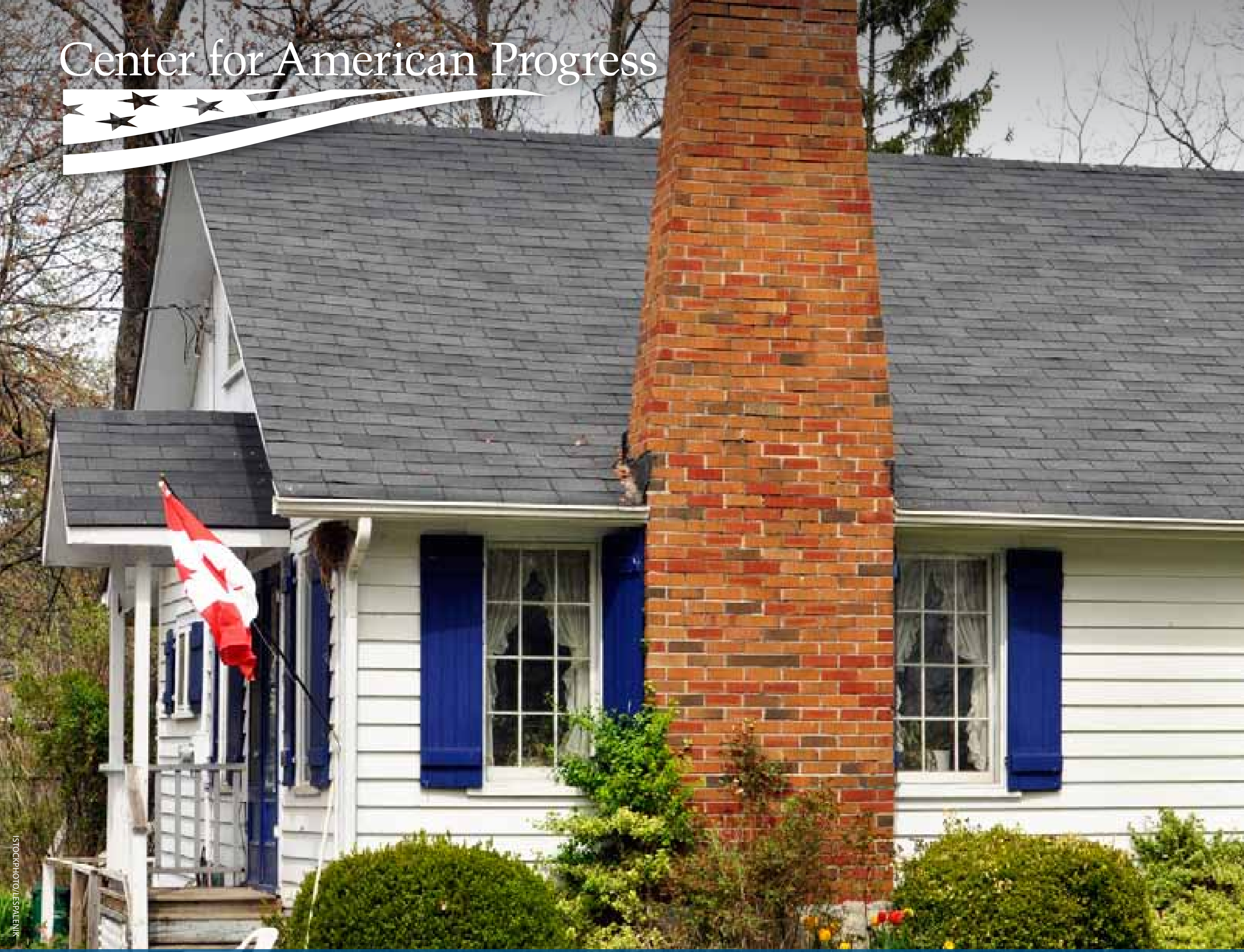

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True North

The Facts about the Canadian Mortgage Banking System

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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.

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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.

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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.

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