



Canadian Residential Mortgage Markets: Boring but Effective?

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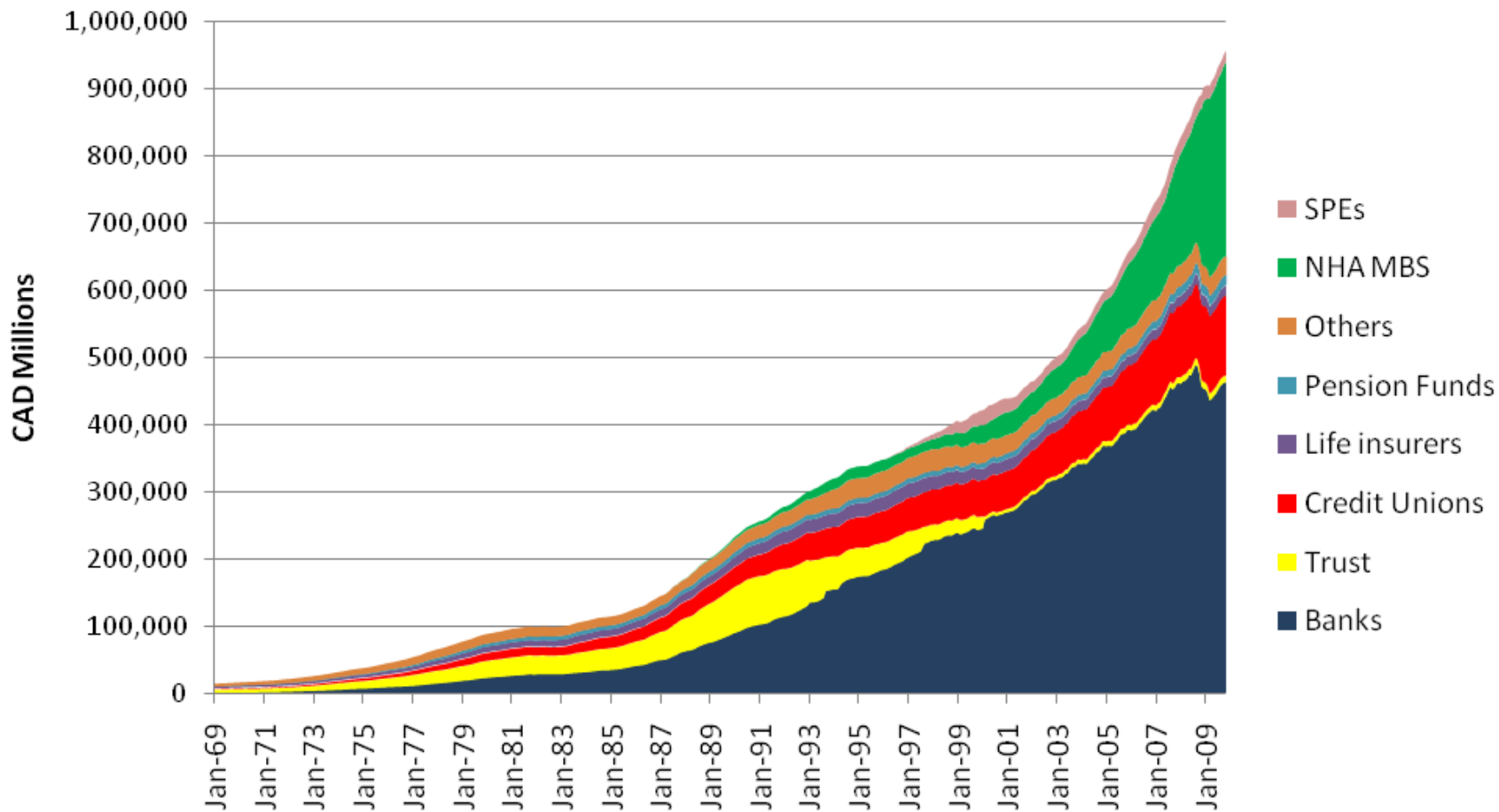
Monetary and Capital Markets Department

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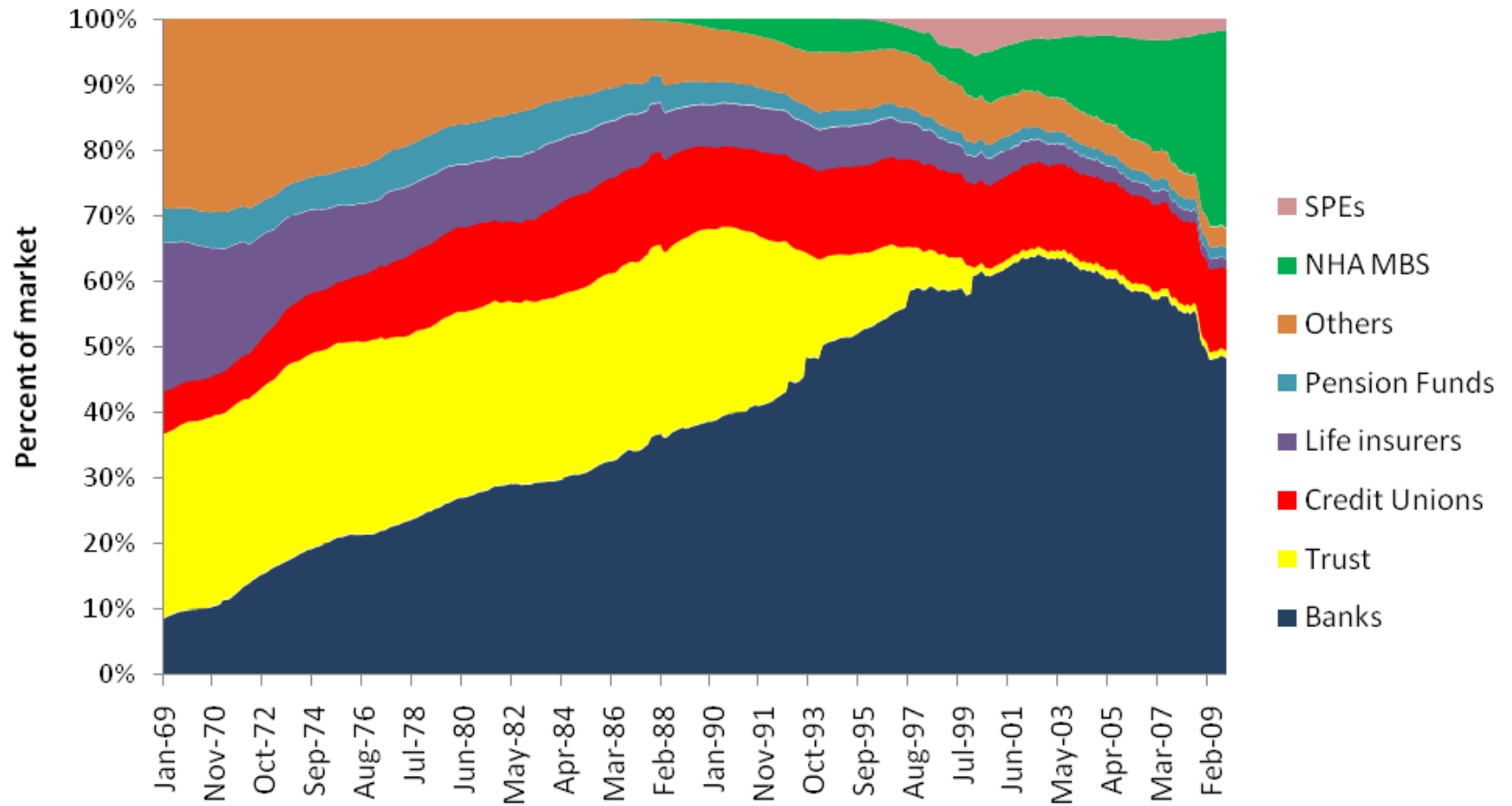
Overview of Presentation

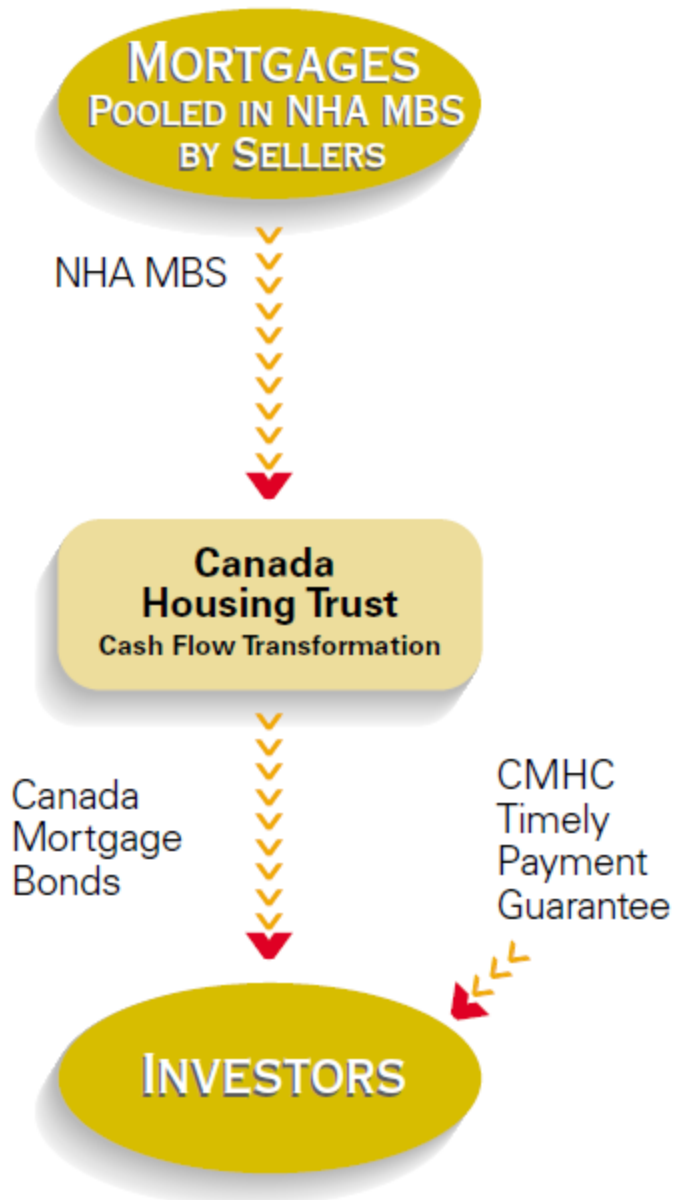
- Key features of the Canadian (versus U.S.) residential housing finance system
- Comparison of Canadian and U.S. mortgage offerings
 - Scarcity of longer (> five-year) fixed-rate mortgages in Canada (versus 30 year+ in the U.S.)
 - Apparent costliness of prepayment in Canada
- Comparison of prime borrower accessibility
- Summary and policy suggestions

Canadian Residential Mortgages Outstanding



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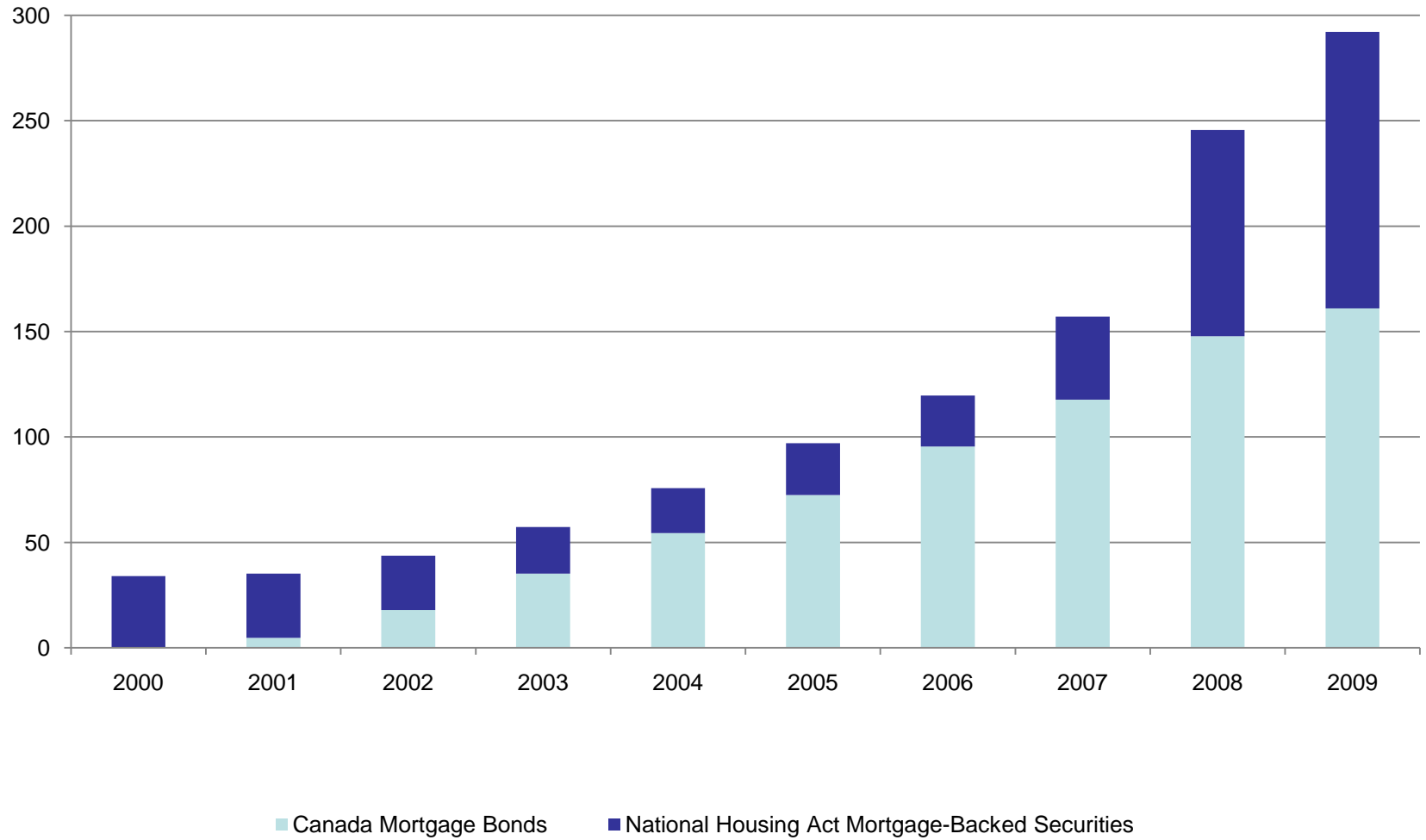




NHA MBS are backed by pools of amortizing residential mortgages insured by CMHC or private mortgage insurers

CMBs are backed by pools of NHA MBS and fully guaranteed by CMHC. They convert the monthly and amortizing NHA MBS cash flows into typical bond-like payments.

Outstanding NHS MBS and CMBs (CAD Billions)



Key Role of Mortgage Insurance

- Loans backing NHA MBS must be insured, and
- Federally-regulated deposit-taking institutions can only hold “high ratio” (LTV>80%!) if insured.
- About half of bank-held loans are insured
- CMHC is dominant insurer (70%), with AIG and Genworth taking up rest
- Guarantee covers full amount of loan, borrower pays full amount upfront
- Federal government provides backstop guarantee to the private insurers (90%)

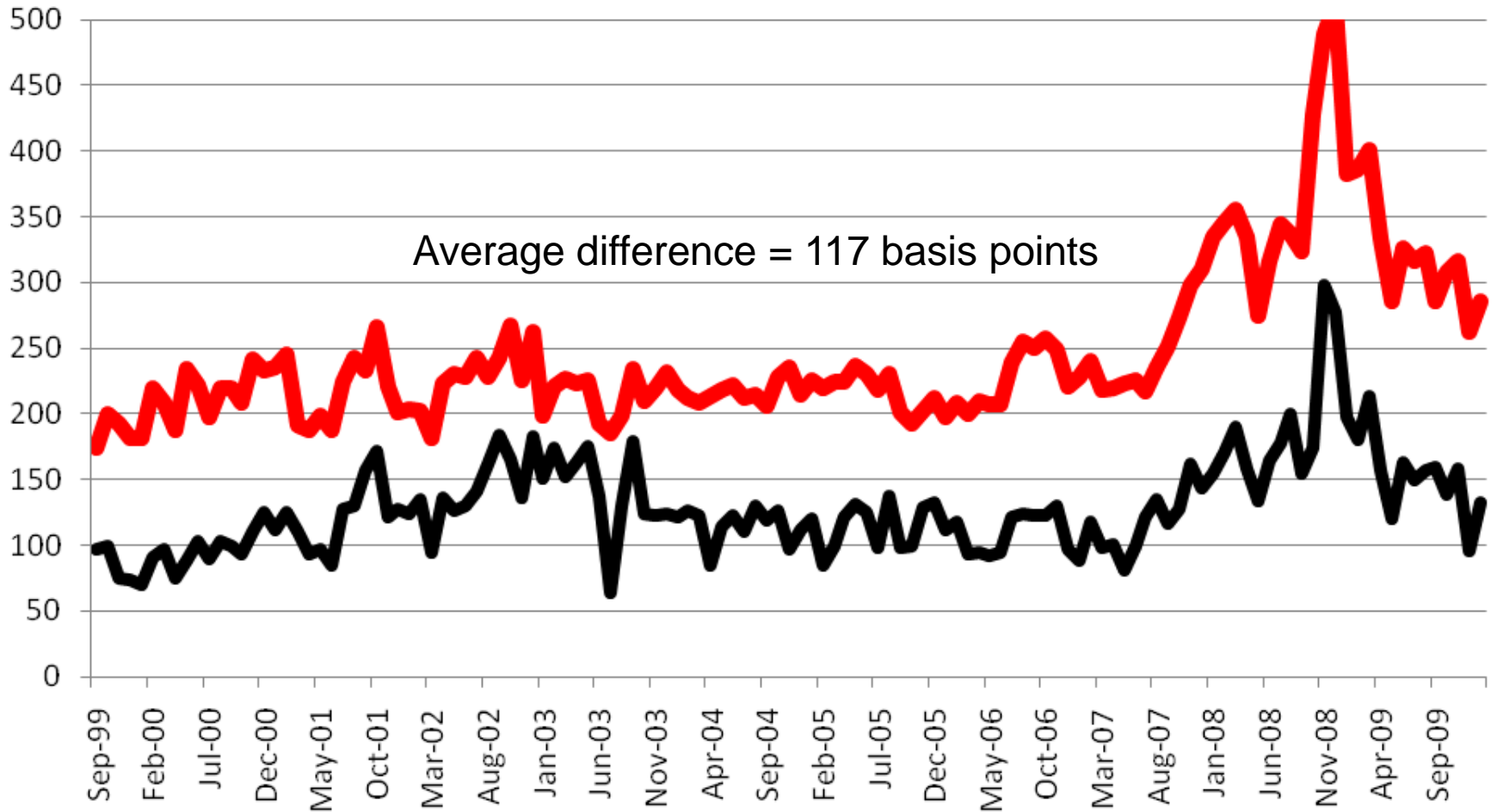
Government Uses MI to Set Lending Standards

- For example this week's announcement:
 - Affordability of insured mortgages to be based on 5y fixed-term rates
 - LTV ratio on cash-out refinancing reduced from 95% to 90%
 - Increased down payment requirement on investment properties from 5% to 20%
- Back in 2008 maximum term reduced from 40 to 30y

Basic Attributes of Canadian Residential Mortgages

- Most loans amortize over 25+ years but roll over every six months to five years (18% longer than 25 years)
- Most (68%) are fixed-rate and closed (limited prepay)
- Rollover terms: 10% < 1Y, 62% 5Y, 12% > 5Y
- Much narrower choice than in the U.S., but Canadians satisfied...
- Only 9% have home equity less than 10%
- 80% have more than 80% home equity

Residential Mortgage versus Interest Rate Swap Rates

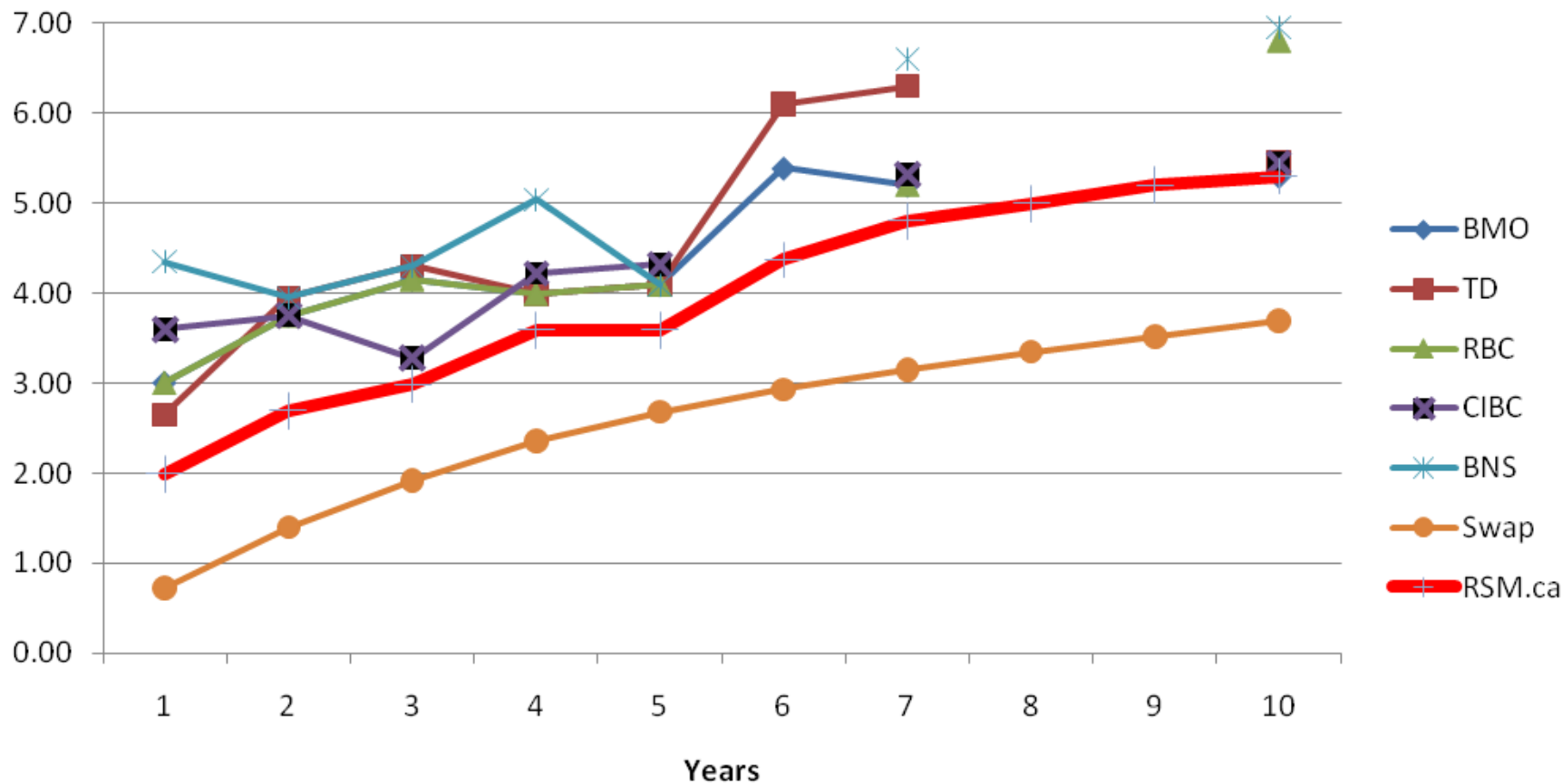


Canadian 5Y Conventional v 5Y Swaps **U.S. 30Y Conforming v 10Y Swaps**

Problems with Rate Comparisons

- Long-term in Canada is 5 years, and 30 years or more in the United States
- Upfront points embedded in US rates (February 11 official 30y US rate was 4.97% with 0.7 points, equivalent to 5.27% (30 bps) with zero points).
- Canadian “posted” rates overstate actual transacted rates (February 13 official 5y rate was 5.39% but four banks were offering “specials” at 4.09% (-130 bps) and one was at 3.89% (ING))
- Term differential (5 vs 30 years) impacts prepayment s and “effective” term

Canadian Bank Fixed-Term Mortgage Rates (February 13, 2010)



Interest Act and the Paucity / **Cost of 5Y+ Terms**

- Conventional wisdom - retail depositor preferences drive mortgage terms, perhaps driven by a 5 year cap on CDIC retail deposit guarantees
- But *Interest Act* caps prepay penalties at three months of interest after 5Y
- However, prepay rights are a put option, with price an increasing function of term
- Hence lenders build premium into rates

Much Cheaper to Originate and Refinance in Canada

	\$240,000 Mortgage Origination Costs		
	Canada: New Mortgage	Canada Refinancing	United States New & Refi
Origination fees	n/a	n/a	\$1,000 - \$3,000
Settlement & closing costs	\$850	\$150	\$1,000
State & local recordation	\$100	\$100	\$1,000
<i>Prepayment penalty</i>	<i>n/a</i>	<i>≈\$2,500 + 500 (3M interest+)</i>	<i>n/a</i>
Total	\$950	\$3,250	\$3,000 – 5,000

Plus upfront points in US, by which borrowers “sell” away part of their prepayment option.

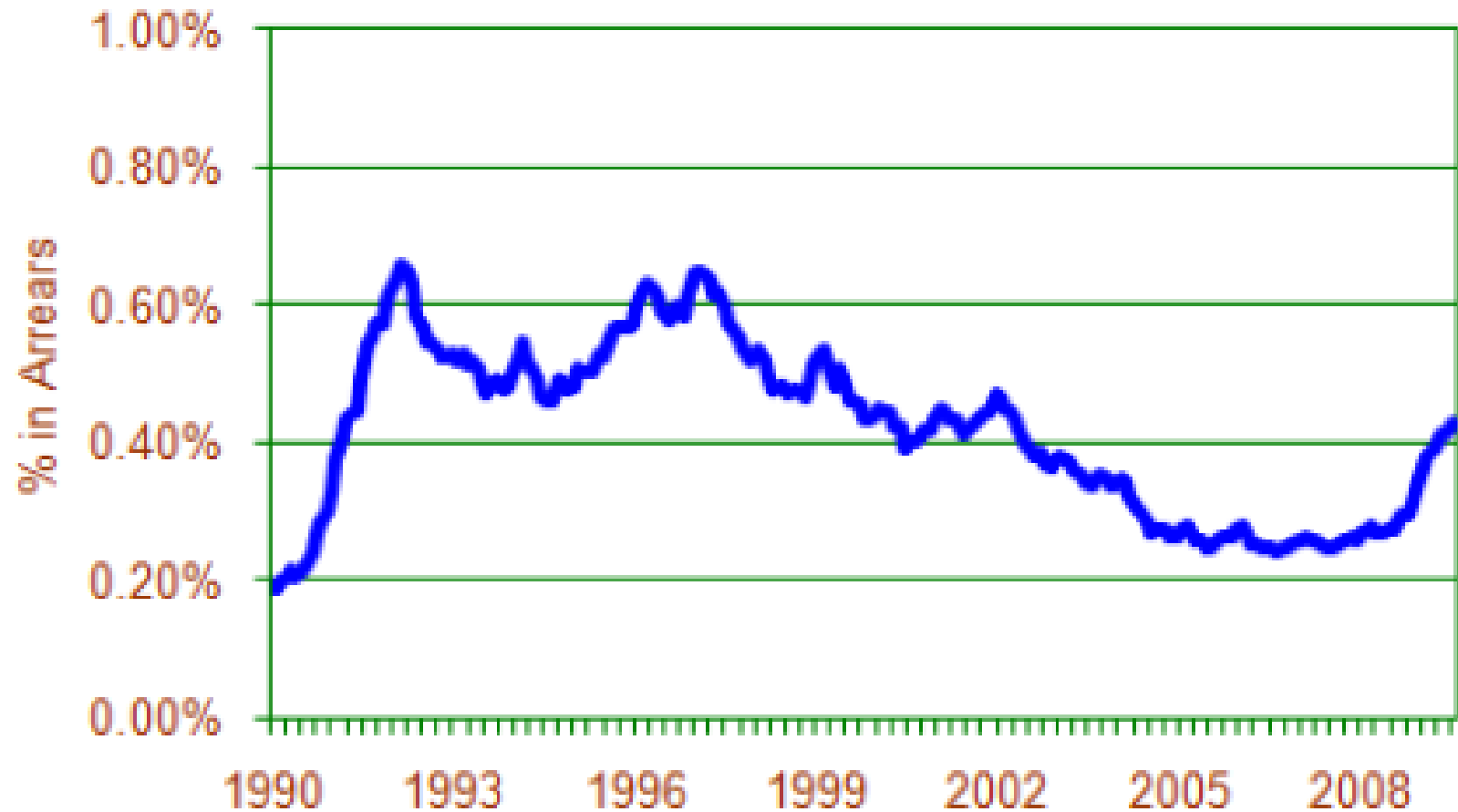
Prime borrower access broadly similar in Canada and the U.S.

	Canada (conventional)	U.S. (conforming)
Maximum loan-to-value	95%	95%
Maximum payment	32% of income	28% of income
Adjustable-rate payment basis	Highest fixed rate inside of 5-year term	Current adjustable rate index
Maximum loan size	?	Varies up to \$417,000*

Other key differences between Canadian and U.S. Markets

- Canadian market not “atomized”
 - Fewer loans originated by brokers (35% v 70%), and only act as middlemen.
 - Banks service their own portfolios
 - Almost all payments made by auto debit
 - Borrowers can opt for more frequent payments
 - Full recourse (versus non-recourse in some US states)

Increasing Rate of Mortgage Arrears in Canada



Source: Canadian Bankers Association

Summary

- Canadian mortgage markets less complex than U.S. markets, but
- Still provide cost-effective and flexible enough funding options to homeowners
- And government mandated mortgage insurance gives authorities another set of housing policy levers
- But effective five-year term barrier could be removed from the *Interest Act* and deposit insurance.