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by Neil Mohindra

Uninsured Mortgage Regulation: From Corporate Governance to Prescription

Summary

- The Office of the Superintendent of Financial Institutions (OSFI) is proposing amendments to its guideline on residential mortgages including a requirement to stress test individual uninsured loans against a 200 basis point increase in interest rates.

- The guideline was originally introduced to meet an international standard of the Financial Stability Board. The international standard was a response to weak underwriting practices in the US that contributed to the global financial crisis.

- Arrears data indicate that underwriting standards in Canada have consistently remained strong. For uninsured mortgages, the homeowner's equity provides significant protection to the lender against loss.

- The proposed stress test risks negative impacts on the Canadian residential mortgage market including higher loan pricing and reduced loan access for some consumers. It could also lead to less competition and creates an incentive for riskier behaviour in some circumstances.

- The proposal to write a prescriptive requirement directly into the guideline is not necessary for OSFI to meet its regulatory objectives. Financial institutions currently have the flexibility to choose a mix of underwriting criteria to ensure mortgage loans are consistent with the board's appetite for risk. OSFI already has the regulatory tools to address any concerns it may have including the power to direct financial institutions to correct any deficiencies in underwriting practices.

Introduction

In July 2017, Canada's solvency supervisor, the Office of the Superintendent of Financial Institutions (OSFI), released proposed revisions to its guideline for residential mortgage underwriting (OSFI, 2017a). The proposals include a new stress test for uninsured mortgages, which are mortgages with a loan-to-value (LTV) ratio below 80 percent.[1] The proposed test would examine the impact of a 200 basis point increase in prevailing mortgage borrowing rates on a borrower's capacity to meet payments.

This research bulletin examines the existing regulatory framework and its adequacy for meeting regulatory objectives such as protecting depositors from loss, whether a prescribed standard for a stress test is necessary, and some likely adverse impacts of introducing the stress test. We find that given the existing regulatory regime, introducing the stress test will do more harm than good.

The existing regulatory framework

Canada's financial sector has generally received positive reviews from external assessments. For instance, in its most recent financial sector stability assessment the IMF noted:

> Canadian banks entered the global financial crisis with a solid funding base and high risk-based capital levels and recovered quickly from initial episodes of turbulence in funding markets… another important factor in the success of the Canadian financial system in avoiding the crisis has been the intensity and effectiveness of its supervisory framework and its positive influence on industry behavior. (IMF, 2014)

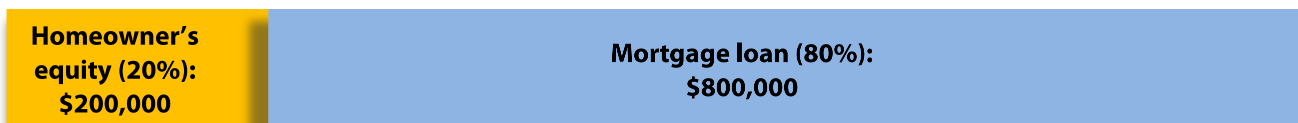
Legislation for federally regulated financial institutions restricts uninsured residential mortgages to 80 percent of a property's value. The borrower must have sufficient funds to cover the remaining 20 percent (the equity portion of the financing). In contrast, insured residential mortgages only require a down payment of 5 percent of the property's value up to $500,000 and 10 percent above $500,000 up to $1 million; above this price insurance is not available. OSFI notes in *Guideline B-20: Residential Mortgage Insurance Underwriting Practices and Procedures*, "Those residential mortgage loans with higher LTV ratios generally perform worse than those with a lower LTV ratio (i.e., higher proportion of equity)" (OSFI, 2014).

A core element of OSFI's regulatory framework is capital requirements. Capital serves as a buffer against unexpected losses.

There are layers of regulatory capital that banks are required to meet (see OSFI, 2017b). The first layer is minimum capital requirements. The second layer is a "capital conservation buffer" to reduce the risk of a breach in minimum capital requirements. If this buffer is drawn down, a financial institution must submit a capital restoration plan to OSFI and may need to take actions such as reducing dividends. Banks can also be required to hold a "countercyclical buffer" if high aggregate credit growth is judged to be associated with a build-up of "system wide risk," which is risk to the financial system as a whole rather than just a specific institution. Financial institutions must meet a target capital ratio that is greater than total minimum capital requirements and buffers. OSFI has the discretion to set a higher target capital ratio for in-

[1] As of May 31, 2017, uninsured residential mortgages represented 11.7 percent of total bank assets. Some smaller institutions specialize in residential mortgages and would have a much higher percentage in their portfolio mix (OSFI, n.d.).

Exhibit 1: Bank ABC



dividual institutions. Canada's six largest banks are subject to an additional surcharge as they are considered systemically important in Canada (i.e., "too big to fail").

Exhibit 1 provides a hypothetical example of a bank that owns a single asset: a mortgage loan on a $1 million house. For simplicity, the example excludes transaction costs such as legal fees. It also assumes the lender cannot recoup losses through recourse[2] and the loan has just been originated so no payments have been made or missed.

With an insured residential mortgage, a homeowner's equity can be as low as $75,000. But a minimum of $200,000 is required for the uninsured mortgage. The value of the property would have to decline by 20 percent or $200,000 before Bank ABC would incur losses in the event of a default. For losses higher than 20 percent, there would be capital depletion starting with the target level of capital and buffers of capital in excess of minimum capital requirements. If bank capital deteriorates below minimum capital requirements Bank ABC could be considered at risk of insolvency and subject to regulatory actions including OSFI taking control.

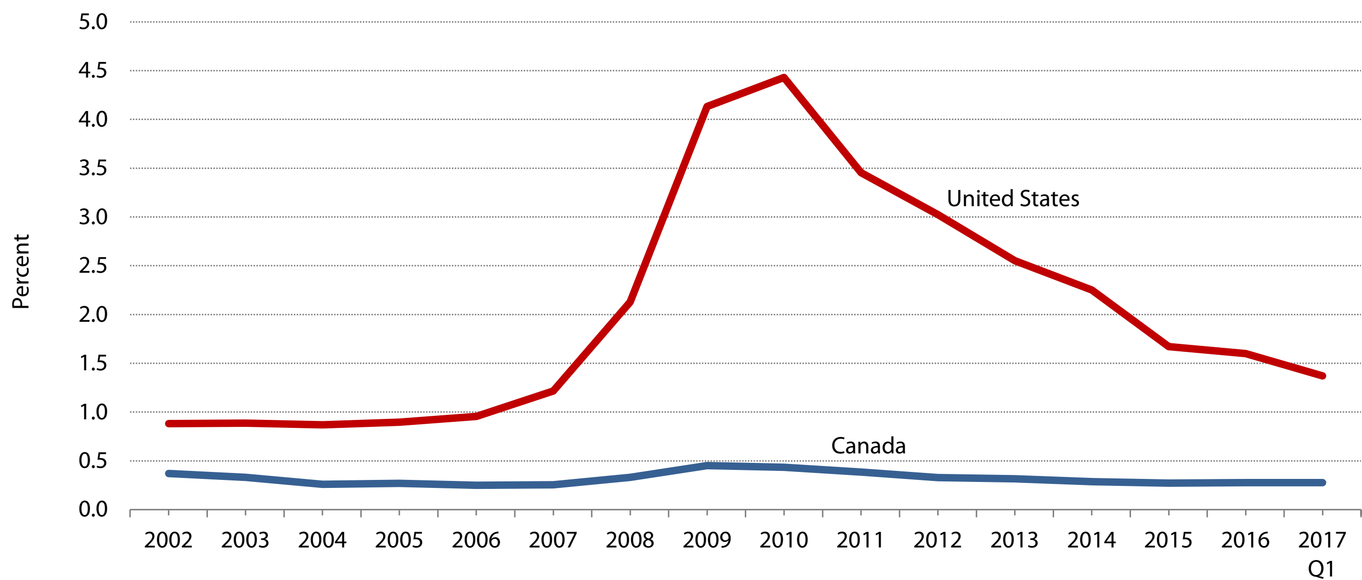
In addition to capital requirements, there are other OSFI guidelines that govern how financial institutions manage credit and other risks. A guideline on corporate governance sets out OSFI's expectations for the board in areas including risk appetite and internal controls (OSFI, 2013). Uninsured residential mortgages are also subject to the existing requirements in the current version of the underwriting guideline for residential mortgages (OSFI, 2014). As part of its supervisory process, OSFI will intervene at an early stage should it have concerns over an institution's financial condition or policies and procedures (OSFI, 2008).

FSB standard and the US sub-prime saga

The impetus for OSFI's original B20 Guideline on residential mortgage underwriting was a standard introduced by the international Financial Stability Board (FSB). Modern financial regulation is largely shaped by global standards. In the case of bank regulation, most standards are set by the Basel Committee on Banking Supervision whose membership consists of bank supervisors from several jurisdictions including Canada. For example, this committee has es-

[2] Outside of Alberta and Saskatchewan, uninsured mortgages are predominantly "recourse" meaning the borrower cannot simply walk away from a house if its value declines to the extent that the borrower's equity is eliminated. The lender can seek the borrower's other assets to help pay for the losses (Marr, 2015, May 4).

Figure 1: Residential Mortgage Arrears in Canada and the Unites States



Source: Canada Mortgage and Housing Corporation (n.d.).

tablished the Basel Accord, upon which OSFI's capital requirements are largely based. However, some international standards are set by the FSB, which addresses issues related to global financial stability on behalf of the G20.

In April 2012, the FSB released *Principles for Sound Residential Mortgage Underwriting Practices*. The principles cover:

- the verification of income and other financial information;
- the debt service coverage;
- the loan-to-value ratios;
- the collateral management; and
- the use of mortgage insurance.

The FSB standard was a reaction to the role that US subprime residential mortgages played in the global financial crisis. The FSB press release for the standard stated:

> Problems arising from poorly underwritten residential mortgages contributed significantly to the global financial crisis. As the global crisis demonstrated, the consequences of weak residential mortgage underwriting practices in one country can be transferred globally through securitisation of mortgages underwritten to weak standards. As such, it is important to have sound underwriting practices at the point at which a mortgage loan is originally made. (Financial Stability Board, 2012a)

Subprime mortgages are US loans that do not meet the repayment standards of government sponsored entities such as Freddie Mac. One of the most infamous segments of these loans was described as "NINJA," which stood for "no income, no job, and no assets." Originators financed sub-prime loans through securitization

structures in which pools of mortgages were used to create packages of securities that were sold to investors, including financial institutions in other countries.

Was there any reason for the FSB principles to be implemented in Canada other than compliance with the international standard? The problems that emerged in the US subprime market were practically non-existent in Canada—and continue to be non-existent. This is evident from the arrears data in figure 1. A mortgage is in arrears if the borrower is more than 90 days behind on their mortgage payments. The figure shows that the arrears rate during the global financial crisis never exceeded 0.45 percent in Canada. Arrears in the US have been consistently higher and spiked during the financial crisis. The arrears data suggest that underwriting standards in Canada are high and did not deteriorate over the course of the global financial crisis.

Canada has a very different market than the US for mortgage backed securities. The Canadian market is dominated by Canada Mortgage and Housing Corporation (CMHC) securitizations in which repayment of interest and principal is government guaranteed. New issuance of residential mortgage backed securities has been close to nonexistent in Canada in recent years (Mordel and Stephens, 2015). Hence, the possibility of mortgage risk being transferred to other countries is a non-issue.

Adverse impacts of the proposed changes

Introducing a prescriptive stress test will have some impacts on the Canadian residential mortgage market. The impacts likely include:

Accessibility

Potential homebuyers will find their access to mortgages more limited, especially in higher priced markets as their buying power is reduced. Because of that, they will only be able to afford a less desirable home or may have to postpone their purchase.

Alternative lending channels

Many borrowers could turn to lenders that are not subject to solvency supervision, such as mortgage finance companies that are funded by private investors. These borrowers will likely find they must pay significantly higher interest rates to these lenders. When borrowers turn to alternative providers, the providers accept higher risk in return for higher pricing. Payday lenders are an example of this. In addition, the consumer protection framework for regulated financial institutions would not apply. This framework consists of the regulatory standards under the auspices of the Federal Consumer Agency of Canada in areas such as disclosure as well as access to an independent redress mechanism. Because these channels are more opaque, policymakers would find available data on the mortgage market less complete.

The Bank of Canada recently flagged this issue noting, “Borrowers affected by any of the new rules may seek out less-regulated, higher-cost lenders, such as mortgage investment corporations and private mortgage lenders. Since these lenders are not subject to OSFI regulations and, unlike mortgage finance companies, do not use mortgage insurance, they are not constrained by the new rules. Careful attention from authorities will be needed to monitor any increase in vulnerabilities resulting from greater use of alternative lending channels” (Bank of Canada, 2016).

Business strategies

Financial institutions will find their flexibility to pursue niche strategies more limited. An institution might target segments based on different combinations of pricing, down payments, terms and conditions, and income history. For example, a 200 basis point standard for stress testing may be excessive when a borrower has other assets (i.e., an investment portfolio) that could be sold off to meet higher payments or seized by the lender in the event of default.

The mandatory standard for stress testing could result in a less competitive and more concentrated mortgage market. Some financial institutions that are niche players in the residential mortgage market may find their ability to pursue their business strategies (such as focusing on segments such as self-employed individuals) impaired. This runs counter to the federal government's objective of promoting more competition by smaller banks (Canada, 2017b).

Perverse incentives

Some borrowers may find they can increase their buying power by securing shorter term variable loans. For example, a mortgage with a short-term variable rate might be selected over a longer term fixed rate. This leaves the borrower more vulnerable to fluctuations in interest rates.

Conclusion

OSFI describes its primary goal as safeguarding depositors and policyholders from loss (OSFI, 2010). Its mandate as set out in the OSFI Act is to ensure that institutions are regulated to contribute to public confidence in the financial system (Canada, 2017a). The Act states that OSFI's role is to monitor and evaluate system-wide issues. OSFI is not responsible for "cooling" overheated markets.

Is there is a rationale for treating uninsured mortgage loans differently from other assets such as commercial mortgages or credit card receivables? OSFI introduced the existing guideline on residential mortgage underwriting for compliance with the FSB standard rather than historical experience in Canada. The FSB standard was inspired by problems unique to one country.

The FSB standard states that supervisors may wish to consider requiring lenders to adopt more conservative underwriting standards in situations where underlying risks are higher, such as asset price bubbles in specific geographical areas (FSB, 2012b). This could be why OSFI has proposed the stress test. But the FSB standard also states compensatory tightening in one dimension may offset another.

Rather than insist on a prescriptive test in its guideline, OSFI could use its existing powers, such as its ability to direct an institution, to correct what it believes are deficiencies in policies and procedures. Doing so would address any concerns OSFI may have over losses to depositors. At the same time, it would minimize disruptions to the residential mortgage market because financial institutions would continue to have the flexibility to choose a mix of underwriting criteria that ensure mortgage loans are consistent with the board's risk appetite.

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***Neil Mohindra** is a public policy consultant and freelance writer. He is a former director of the Fraser's Institute's Centre for Financial Policy Studies. He has also held various positions with industry and regulators both in Canada and overseas. Mr. Mohindra authored a Fraser Institute study in 2010 that showed the growth in taxpayer exposure to the residential mortgage market through mortgage insurance.*

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