SM/10/305
Correction 3

December 17, 2010

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Canada—Selected Issues**

The attached corrections to SM/10/305 (11/29/10) have been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 49, footnote 7, line 1: for "For borrowers with lower credit scores (below 680 on the FICO scale), the debt service cost limit is 42 percent of gross income."
read "For borrowers with lower credit scores (below 680 on the FICO scale), the CMHC and private mortgage insurers set a debt service cost limit at 42 percent of gross income."

Typographical Error

Page 50, line 4: for "was lowered from 95 per cent to 90 per cent of"
read "was lowered from 95 percent to 90 percent"

Questions may be referred to Mr. Kramer, WHD (ext. 38491).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

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Department Heads

Canada Housing Trust. In the United States, Ginnie Mae guarantees the FHA and VA insured loans that it securitizes, and Fannie Mae and Freddie Mac guarantee the "conforming" loans that they securitize. Conforming loans are those that meet underwriting guidelines that are set by the Office of Federal Housing Enterprise Oversight, in terms of loan size, documentation, debt-to-income ratios, loan-to-value ratios, and so on.

5. **However, government-controlled mortage insurance (MI) plays a bigger role in housing finance in Canada than in the United States**. The *Bank Act* prohibits Canadian federally-regulated lending institutions from providing mortgages without MI issued by approved insurers for loan amounts that exceed 80 percent of the value of the home. Also, MI is required on mortgages securitized through CMHC's securitization program.[5] In the United States, MI is only required on FHA/VA loans securitized by Ginnie Mae, and high loan-to-value (greater than 80 percent) loans securitized by Fannie Mae and Freddie Mac. Also, Canadian MI covers 100 percent of the loan, whereas in the United States, private MI typically only covers the amount in excess of 80 percent of the home value.

6. **Due to the regulatory capital reductions provided by MI, banks and other deposit-taking lenders insure their low loan-to-value ratio mortgages**. Mortgages insured by government-owned and –backed CMHC, are assigned a zero risk weight for regulatory capital requirement purposes. Mortgages covered by approved private insurers are assigned a slightly higher weight, but one that is lower than 35 percent on uninsured mortgages. CMHC accounts for about 70 percent of all outstanding MI in Canada, and two private insurers, operating in accordance with rules set out by Canada's Department of Finance, account for almost all of the rest. The private insurers agree to abide by these rules in order to meet the government's eligibility standards, and in return for a 90 percent government backstop on their MI business.[6]

7. **The Canadian government uses its control over MI terms and conditions to influence mortgage loan availability**. For example, since 2008 the maximum loan-to-value ratio on insured loans has been 95 percent, amortization terms have been limited to 35 years, and debt service costs have not been allowed to exceed 44 percent of gross income.[7] As an

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[5] Due to the regulatory capital reductions provided by MI, the majority of Canadian mortgages are insured, even those with loan-to-value ratios below the required threshold.

[6] The government guarantees that lenders will receive the benefits payable by approved private mortgage insurers, less 10 percent of the original principal amount of the loan, in the event that the insurer is bankrupt or insolvent. This public-private model is close to that advocated in Joyce and Molesky (2009). However, they advocate a full guarantee to provide a level playing field between private insurers and CMHC. They also recommend removing the insurer insolvency condition, saying that it may introduce inadvertent procyclicality.

[7] For borrowers with lower credit scores (below 680 on the FICO scale), the CMHC and private mortgage insurers set a debt service cost limit ~~is~~ at 42 percent of gross income. The CMHC definition of debt service costs include mortgage principal and interest payments, property taxes, and heating expenses, plus other debt

(continued…)

example of this control in action, the rules were tightened in February 2010 to reinforce the long-term stability of Canada’s housing market. For example, the maximum amount that could be withdrawn during mortgage refinancings was lowered from 95 per-cent to 90 per cent of the home value. Also, a minimum down payment of 20 percent became required on non-owner-occupied properties purchased for speculation.

payments. For U.S. “conforming” mortgages debt service costs do not include heating costs, and they are limited to 28 percent of gross income. The maximum LTV on “conforming” loans is 80 percent.