Intelligence MEMOS

From: Thorsten Koeppl

To: The Hon. Bill Morneau, Minister of Finance

Date: August 25, 2016

Re: HOW TINKERING WITH MORTGAGE INSURANCE RULES – JUST PRICE IT RIGHT

Last week news emerged that Finance Canada is floating the idea of a deductible on mortgage insurance. This will be another attempt by the Federal Government to rein in the hot Canadian housing market. Unfortunately, tinkering with mortgage rules has shown little effect in cooling off the market, and introducing a deductible on mortgage insurance for lenders runs counter to the idea that such insurance is arguably the most important pillar for the macroprudential regulation of housing finance.

While mortgage insurance is required for high risk mortgages, lenders can also purchase insurance against the risk that borrowers default on other mortgages. This allows the banks to reduce their capital cost and gives smaller lenders access to funds via securitization. On the surface then, it seems that a deductible on the losses from mortgage defaults is a good idea. Funding costs for the banks will increase, and lenders will have skin in the game forcing them to consider default risk on the mortgages they finance.

What has been forgotten is that a well-designed mortgage insurance framework goes a long way in addressing a housing crisis when it happens. In a recent commentary that I wrote with James MacGee for the C.D. Howe Institute, we point out that mortgage insurance is the first line of defence against a housing crisis with widespread mortgage defaults and a sustained fall in house prices. Insurers insulate the financial sector from losses and allow banks and other lenders to continue lending.

A deductible runs counter to this reasoning. Lenders will bear the losses and have no incentive to continue lending when the crisis occurs. Worse, the big players are aware of this situation and, in case of a crisis, will argue collectively that losses need to be absorbed in part by the government.

The better way to use mortgage insurance is to use the existing system, but price the risks appropriately. There is currently no deductible on mortgage default losses, but the pricing of insurance does not fully consider the idiosyncratic default risk of the mortgage either. Risk-based premiums would increase the cost of the mortgages that add more risk to the housing system, since insurance costs for high risk mortgages are passed on by lenders to borrowers. Moreover, the government backstops mortgage insurers. A step in the right direction is to start charging a premium for this backstop to mortgage insurers up front, in order to pass on the potential cost of an extreme housing crisis to the mortgage industry. Notwithstanding, the premiums that are currently charged seem to grossly underestimate these costs.

The mortgage insurance framework in Canada seems to be rather well-designed and tinkering with it by introducing a deductible seems to undermine its strengths. More effort should be undertaken by regulators and the industry to price risks in mortgage lending appropriately. With a low interest rate environment continuing to fuel the housing market, such risk-based pricing would at least align the cost of borrowing with the risks involved for the financial system.

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