CANADA'S VERY OWN MORTGAGE MESS: THE LAWS AND PROGRAMS BEHIND A NATIONAL DILEMMA

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Canadian house prices require explanation. Despite a deep global recession and persistent credit crisis, they remain near record highs while prices elsewhere have plummeted. This article offers an institutional account of that anomaly. The insurance and securitization programs of the Canada Mortgage and Housing Corporation have insulated the Canadian mortgage and housing markets from recent turbulence. These large, unfamiliar programs also distort and may ultimately destabilize the Canadian economy. Arguments about asset bubbles are unproductive. This article explains these programs, their effects and their legal framework so that we can better discuss what to do with them.

Comment expliquer le prix des maisons au Canada? En dépit d'une récession mondiale profondément enracinée et d'un grand resserrement du crédit qui perdure, le prix des maisons ne cesse de plafonner, tandis que les prix dans d'autres secteurs ont subi de fortes baisses. Le présent article offre une explication institutionnelle justifiant cette anomalie. Les programmes d'assurance et de titrisation de la Société canadienne d'hypothèques et de logement ont protégé le marché hypothécaire et le marché du logement canadiens contre les fluctuations récentes. Par contre, ces programmes vastes et mal connus donnent aussi une représentation fausse de l'économie canadienne et peuvent, à la longue, déstabiliser cette dernière. Les arguments relatifs aux bulles spéculatives ne règlent pas la question. L'article donne un aperçu de ces programmes, de leurs répercussions et du cadre législatif dans lequel ils s'inscrivent, dans le but de mieux éclairer le débat sur la gestion de ces programmes.

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The Canadian housing market has resisted the profound economic shocks of the past two years. Even as hundreds of thousands of Canadians have lost their jobs and the average price of a house in the United States (US) has declined by nearly thirty percent in three years, Canadian house prices have tested record highs.[1] That much is clear. Everything else about our economic predicament, however, remains ambiguous.

For some, high prices are a sign that our governments have charted a prudent course in turbulent times.[2] For others, they are an omen of impending financial disaster driven by irresponsible public policies and poor decisions by purchasers.[3] Government statistics do not avail for they, like all official pronouncements, invite both skepticism and interpretation. Predictions made by banks and realtor associations are somewhat less helpful.

To make sense of this anomaly – surging house prices during a savage recession – we must ignore the headlines and the press releases. If I were an economist, I might seek truth in "the fundamentals": conditions that determine aggregate supply and demand for residential real estate, such as wages, rents, interest rates, population growth and new construction. Unfortunately, I am a lawyer. I see the world in terms of rules and institutions, not buyers and sellers. My view of the Canadian housing market is sobering.

Many Canadians know that the federal government intervenes in the market for residential mortgage credit. The most prominent example of this practice is the insurance sold by the Canada Mortgage and Housing Corporation (CMHC) to protect mortgage lenders against the risk of borrower default. This insurance aims to encourage lenders to extend affordable credit to borrowers who make down payments that are small

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1 Tavia Grant, "Businesses face a new reality, Carney warns" *The Globe and Mail* (5 February 2010) B3; James Politi, "Housing data fail to fulfil recovery hope" *The Financial Times* (25 January 2010), online: Financial Times Ltd. <http://www.ft.com/cms/s/0/adf1f8e6-0932-11df-ba88-00144feabdc0.html> (accessed 6 May 2010); Steve Ladurantaye, "Real estate market bounces to highs" *The Globe and Mail* (15 January 2010), online: CTVglobemedia Publishing Inc. <http://www.theglobeandmail.com/report-on-business/real-estate-market-bounces-to-highs/article1433265/> (accessed 6 May 2010).

2 See e.g. Paul Krugman, "Good and Boring" *New York Times* (31 January 2010) A19; Chrystia Freeland, "Canada's great escape" *The Financial Times* (30 January 2010) Life & Arts 19.

3 See e.g. Garth Turner, *The Greater Fool: The Troubled Future of Real Estate* (Toronto: Key Porter, 2008).

by historical standards. Before its eligibility criteria were relaxed in 2006, this program was relatively uncontroversial.[4] More recently, it has drawn ire for its rapid growth.[5] In March 2009, Parliament raised the maximum aggregate amount of mortgages the CMHC may insure from $450 billion to $600 billion.[6] In February 2010, it had approximately $480 billion of insurance policies outstanding.[7] This is only the first of four layers of government intervention – the very large tip of a very large iceberg.

The three other programs by which the federal government has amplified the amount of residential mortgage credit available in Canada are less familiar, more complex and potentially more dangerous than CMHC mortgage insurance. Although they enabled the CMHC to guarantee over $134 billion of securities in 2009 alone, they have received very little attention.[8] Intricate and obscure, these programs resist simplification and their effects can be difficult to discern. Nonetheless, National Housing Act Mortgage-Backed Securities (NHA MBS), Canada Mortgage Bonds (CMB) and the Insured Mortgage Purchase Program (IMPP) have served as major pillars of the Canadian housing market.

In this article, I explain each stage of federal intervention in the residential mortgage market. I demonstrate how the four programs have combined to generate unprecedented amounts of mortgage credit and

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4 See e.g. Jacquie McNish and Greg McArthur, "Special investigation: How high-risk mortgages crept north" *The Globe and Mail* (12 December 2008), online: CTVglobemedia Publishing Inc. <http://www.theglobeandmail.com/report-on-business/article727831.ece> (accessed 6 May 2010).

5 See e.g. Boyd Erman and Tara Perkins, "CMHC's growth fuels worries over new risks" *The Globe and Mail* (17 October 2009) B1.

6 Bill C-21, *An Act for granting to Her Majesty certain sums of money for the federal public administration for the financial year ending March 31, 2009*, 2nd Sess., 40th Parl., 2009, Schedule 1, vote 16c (as passed by the House of Commons 24 March 2009) [*Appropriation Act No. 5. 2008-9*].

7 Boyd Erman and Tara Perkins, "Big Six banks urge Ottawa to tighten mortgage" *The Globe and Mail* (6 February 2010) A1, A11. The Canada Mortgage and Housing Corporation (CMHC) releases information about the total amount of mortgage insurance it has issued in its annual report. When this article was written, it had not yet published its annual report for 2009. At the end of 2008, it had insurance outstanding on $408 billion of mortgages. Canada Mortgage and Housing Corporation (CMHC), *2008 Annual Report* (2009) at 37, online: CMHC <http://www.cmhc-schl.gc.ca/en/corp/about/anrecopl/upload/Annual-Report-2008.pdf>.

8 CMHC, "NHA Mortgage-Backed Securities, Daily Status" (1 February 2010), online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/upload/r303a-eng.pdf>

thus unprecedented house prices. I also examine the legal basis for each program. I do so to diagnose the dilemma they pose to Canadians: reform and trigger large, unpredictable losses today; or refuse and risk worse results in the future. We need to debate the merits and alternatives to these programs. We need to clarify their costs to the persons affected by them. We also need to make difficult economic, political and legal decisions about how to minimize and allocate the harm they will cause. I hope this article can spark these vital conversations.

What I will not do is dwell on technical concerns. In particular, I will not criticize the CMHC's risk-management practices because they are irrelevant to my argument. Regardless of whether the CMHC is adequately capitalized to insulate the Canadian government from the risk of default on the mortgages it insures or the securities it guarantees, the operations of the CMHC pose serious threats to Canadian *homeowners* and the Canadian *economy*. To focus on risk-management matters like actuarial estimations and property audits is to miss the bigger picture.

These four government programs have promoted the formal status of home ownership at the expense of the substance such ownership traditionally embodied: financial autonomy. Although the strength of the Canadian housing market is not an illusion, it is poorly understood. It depends on the smooth flow of credit established by these programs, which have distorted the Canadian economy by encouraging investment in residential real estate instead of other assets and industries. High house prices may be a result of raging demand, but that demand is a product of extensive government intervention. These programs have not received the public scrutiny and political debate they deserve because we do not know enough about them; incomplete information about existing arrangements and uncertainty about the likely effects of reform diminish the incentives for public figures to risk their reputation by raising such concerns. This is the story I want to tell and the situation I hope we can remedy.

1. The Four Stages of Federal Intervention

The four programs were adopted as distinct responses to particular challenges, rather than as a single package. To help house veterans and expand the supply of rental and social housing, the predecessor to the CMHC was established in 1946. To foster the middle-class dream of suburban homeownership, the CMHC began selling mortgage insurance in 1954.[9] To assist Canadian lenders to access cheaper funds in the fixed-

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9 CMHC, "History of CMHC," online: CMHC <http://www.cmhc-schl.gc.ca/en /corp/about/hi/index.cfm>.

income market, it started guaranteeing mortgage-backed securities in 1986.[10] In 2001, to stimulate demand for those securities, which had been hampered by their unorthodox approach to payments, the CMHC introduced CMB, which offer regular coupon payments and other desirable terms.[11] Finally, to provide liquidity to Canadian banks and stabilize the supply of mortgage credit in the face of severe global shortages, the federal government introduced the IMPP in 2008.[12] Each program adds an order of complexity to its predecessors. This article seeks to convey this complexity clearly, for we cannot decide how to change these programs unless we know how they work.

A) Mortgage Insurance

The CMHC introduced mortgage insurance to induce banks and other creditors to lend to individuals whose small down payments would otherwise have disqualified them or warranted onerous interest rates. Other countries use mortgage insurance to expand their housing markets, but private insurance companies play a relatively small role in Canada.[13] For each mortgage loan that meets the CMHC's eligibility criteria, a lender may purchase an insurance policy pursuant to which the CMHC agrees to pay the principal and interest due if the borrower defaults. Most lenders are required to insure a mortgage loan when the

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[10] *Ibid.*

[11] KPMG LLP, *Canada Mortgage Bonds Program Evaluation: Final Report* (June 2008) at 5 and 6, note 8, online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/in/camobo/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=178515>.

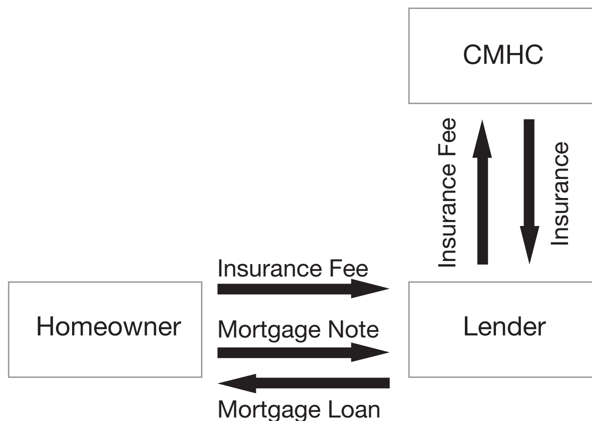
[12] Canada, Department of Finance, News Release 2008-075, "Government of Canada Responds to Global Financial Turmoil with Support for Canadian Credit Markets" (10 October 2008), online: Government of Canada, Department of Finance <http://www.fin.gc.ca/n08/08-075-eng.asp>.

[13] In March 2009, the President of the CMHC, Ms. Karen Kinsley, told the Senate finance committee that CMHC has a 67% share of the Canadian mortgage insurance market and that subsidiaries of AIG and Genworth split the remaining 33%; see Louise Egan, "Canada mortgage purchase plan may wind down – CMHC" *Reuters* (24 March 2009), online: Reuters, <http://www.reuters.com/article/idUSN2435051320090324>. In contrast, as of September 2009, the Federal Housing Administration insured just 17.98% of all homes in the United States of America, up sharply from 3.8% since that country's housing crisis began in 2007; see United States, Department of Housing and Urban Development, "FHA Single Family Activity in the Home Purchase Market Through September 2009" (8 December 2009), online: Department of Housing and Urban Development <http://www.hud.gov/offices/hsg/comp/rpts/fhamktsh/fhamkt0909.pdf>. Further, even private mortgage insurance companies enjoy substantial government support in Canada, as the Ministry of Finance is authorized to indemnify, guarantee and purchase replacements for up to $250 billion of mortgage insurance policies sold by private entities; see *Budget Implementation Act, 2006*, S.C. 2006, c. 4, s. 193.

down payment is twenty per cent or less of the purchase price.[14] In exchange for a premium paid at the outset of the loan, the CMHC assumes the credit risk posed by the borrower. Like other forms of insurance, this arrangement reduces the incentives lenders have to monitor borrower creditworthiness. The CMHC limits this moral hazard by imposing eligibility criteria on the loans it insures. The price of each policy is a percentage of the initial principal amount of the loan to which it applies. This percentage varies with the size of the down payment, from a 0.5% premium for a 35% down payment to a 2.75% premium for a down payment of 5%.[15] Lenders typically pass the entire cost onto the borrower. Figure 1 illustrates a standard transaction involving CMHC mortgage insurance.

CMHC mortgage insurance is generally viewed as a success. It has enabled many Canadians to access mortgage credit and buy their own homes. With $480 billion of mortgage insurance outstanding, CMHC insures nearly one half of all residential mortgage credit in Canada.[16] The program has grown rapidly: in December 2007, it had $345 billion of

Figure 1



[14] *Bank Act*, S.C. 1991, c. 46, ss. 418(1) and 418(2)(b). See also CMHC, "Who Needs Mortgage Loan Insurance?," online: CMHC <http://www.cmhc-schl.gc.ca/en/co/moloin/moloin_002.cfm>.

[15] CMHC, "How Much Does CMHC Mortgage Loan Insurance Cost?," online: CMHC <http://www.cmhc-schl.gc.ca/en/co/moloin/moloin_005.cfm>.

[16] Erman and Perkins, *supra* note 7 ($480 billion of mortgage insurance outstanding in February 2010) and Bank of Canada, *Credit Conditions – Household Credit* (16 February 2010), online: Bank of Canada <http://credit.bank-banque-canada.ca/householdcredit> ($963 billion of residential mortgage credit outstanding in December 2009) .

policies outstanding; in December 2004 it had only $244 billion.[17] Banks have even begun to purchase insurance on loans for which it is not mandatory.[18] This practice, known as mortgage portfolio insurance, seems driven less by credit risks than by accounting rules and financial considerations.

The legal basis for each program has two components: the authorization of the CMHC to perform the activities involved; and any constraints or conditions to which that authorization may be subject. The *Canada Mortgage and Housing Corporation Act* (*CMHC Act*) established the CMHC and granted it broad powers to enter into contracts and otherwise manage its financial affairs.[19] Section 8(1) of the *National Housing Act* (*NHA*) authorizes the CMHC to insure mortgage loans.[20] Section 11(a) of the same statute caps the total outstanding amount of CMHC mortgage insurance at $150 billion.[21] Section 11(b) provides the procedure by which this limit can be increased: "an appropriation Act or other Act of Parliament on or after April 1, 1997."[22] As noted above, Parliament set this limit at $600 billion on March 24, 2009.[23]

This is a huge sum. Even at its current size, CMHC mortgage insurance has a dramatic impact on the largest and most meaningful investment most Canadians ever make. It also directly benefits financial institutions by transferring the risk of default on hundreds of billions of dollars of debt to the federal government, with significant implications for the allocation of credit in this country. Such massive and persistent government intervention into this critical market warrants serious debate.

What purposes should a public mortgage insurance scheme serve? How should we measure its progress? What costs are we willing to tolerate in pursuit of these goals, from greater financial risks assumed by the federal government to increased debt borne by homeowners and untold amounts of credit diverted from industries that do not enjoy such government support? How, if at all, should we plan for the contraction and withdrawal of this program? These are practical questions with great normative significance. They concern basic characteristics of the economy

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17 CMHC, *supra* note 7 at 37 and CMHC, "FAQs: Mortgage Loan Insurance," online: CMHC <http://www.cmhc-schl.gc.ca/en/corp/faq/faq_006.cfm>.

18 CMHC, *supra* note 7 at 56.

19 R.S.C. 1985, c. C-7, ss. 3, 17-19, 21 and 26-28 [*CMHC Act*].

20 R.S.C. 1985, c. N-11, s. 8(1) [*NHA*].

21 *Ibid.*, s. 11(a).

22 *Ibid.*, s. 11(b).

23 *Supra* note 6.

we want and the responsibilities we are willing to assume to achieve it. The success of any deliberations will depend not only on the availability of independent research but also on the ability of politicians and other persons to explain that research to Canadian citizens.

Recent changes to the criteria that a mortgage loan must satisfy to qualify for CMHC insurance raise additional concerns. These criteria are set by government policy rather than legislation or regulation. They are often articulated by the Minister of Finance. No statute expressly empowers the Minister to fix the terms on which the CMHC may issue mortgage insurance, but the government does appoint, directly or indirectly, its management and directors.[24] In 2003, the CMHC eliminated the purchase price cap on its mortgage loan insurance; no policy sets a maximum principal amount for each mortgage it insures.[25] In 2006, Parliament expanded the Minister's authority to guarantee mortgage insurance policies issued by private companies.[26] In response to heightened competition from new market entrants, the CMHC relaxed its eligibility criteria. It began to insure mortgages obtained with no down payment at all, and to allow amortization periods of thirty, thirty-five and then forty years.[27] These new policies pleased banks and borrowers, but soon the American housing market imploded and lax lending practices took much of the blame. In July 2008, the Canadian government reversed course. The Minister announced that the CMHC would require a minimum five per cent down payment and a maximum thirty-five-year amortization period for each mortgage loan it insured. The government lauded these changes, which also included a mandatory minimum credit score and loan documentation standards, as a prudent means to promote home ownership.[28] However,

[24] Section 19(a) of the *NHA*, *supra* note 20, enables the CMHC to "set the terms and conditions" on which it provides mortgage insurance and performs other activities. The *CMHC Act*, *supra* note 19, ss. 6-13 empower its Board of Directors to establish by-laws that regulate the conduct of the CMHC's affairs and authorize its President to conduct the business of the CMHC in all matters not controlled by those by-laws or the *CMHC Act*.

[25] See e.g. CMHC, "FAQs: Mortgage Loan Insurance" at question 7, online: CMHC <http://www.cmhc-schl.gc.ca/en/corp/faq/faq_006.cfm>; CMHC, "CMHC Purchase: Helping to Make Dreams of Homeownership Come True" at 2, online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/moloin/hopr/upload/OPIMS65606-CMHC-Purchase-03-27-09.pdf>.

[26] *Budget Implementation Act, 2006*, *supra* note 13, ss. 192-95; PMI Canada, "Submission to Competition Policy Review Panel" (11 January 2008) at 10, online: PMI Canada <http://www.pmicanada.ca/pdf/pmi_submission1034fh_0108.pdf>.

[27] McNish and McArthur, *supra* note 4.

[28] Canada, Department of Finance, News Release 2008-051, "Government of

these new rules have not dampened the enthusiasm of Canadian homeowners. In light of their ongoing borrowing spree, the Minister recently introduced even more restrictive criteria to temper the risks of rising mortgage debt.[29]

By making it easier for buyers to get into debt, recent measures also have made it more difficult for them to get out. The CMHC claims that the expanded mortgage insurance program has improved housing affordability by reducing the share of income required to make mortgage payments on a house with an average price.[30] An abnormally long run of low interest rates has made this claim plausible, but it is clear that such "savings" may present false economies. Borrowers can reduce the size of their mortgage payments by amortizing their debt over a longer period.[31] However, a longer amortization period entails more payments and thus can greatly increase the overall cost of a mortgage.[32]

By emphasizing "affordability" and defining it as lower mortgage payments, the CMHC and the government offer an incomplete account of mortgage insurance and other CMHC programs. They emphasize convenience over sustainability. They do not ask the difficult questions, such as the extent to which these programs inflate house prices by expanding both supply and demand for mortgage credit, the degree to which they promote an inefficient concentration of investment in houses and the construction industry, and the amount of wealth they transfer from homeowners to financial institutions. The impact of these programs depends on a number of factors that cannot be determined in the abstract, such as the elasticity of housing supply and competition among financial institutions. Again, to answer these important questions, we need critical

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Canada Moves to Protect, Strengthen Canadian Housing Market" (9 July 2008), online: Government of Canada, Department of Finance <http://www.fin.gc.ca/n08/08-051-eng .asp>.

[29] Canada, Department of Finance, News Release 2010-011, "Government of Canada Takes Action to Strengthen Housing Market" (16 February 2010), online: Government of Canada, Department of Finance <http://www.fin.gc.ca/n10/10-011-eng .asp>.

[30] Erman and Perkins, *supra* note 5.

[31] According to the Canadian Association of Accredited Mortgage Professionals, 47% of mortgage loans made in 2009 have an amortization period of more than 25 years; see Will Dunning, *Annual State of the Residential Mortgage Market in Canada* (2009) at 6, online: Canadian Association of Accredited Mortgage Professionals <http://www.caamp .org/meloncms/media/Fall%20Report%20FINAL%20ENG.pdf>.

[32] For an illustration of this effect, see Bank of Canada, "Impact of Amortization Period on Mortgage Payments" (23 June 2008), online: Bank of Canada <http://www .bankofcanada.ca/en/speeches/2008/slide7_230608.pdf>.

and independent analysis, not more reports from the CMHC, its consultants, the banks or the real estate associations.[33]

B) National Housing Act Mortgage-Backed Securities

In 1987, the CMHC established the NHA MBS program to help Canadian lenders raise money to finance mortgage loans. Mortgage insurance expands the primary market for mortgage loans (that is, the supply of residential mortgage credit) by reducing the credit risk borne by lenders. In contrast, the NHA MBS program seeks to expand the secondary market for those loans (that is, the supply of money available for use as mortgage credit) by reducing the risks faced by investors who buy securities backed by those loans.[34] Securitization enables lenders to loan more because they can supplement deposits with money raised on the capital markets. The NHA MBS program aimed to enhance the effect of securitization by adding what is effectively a government guarantee. While its initial market impact was limited by an unpopular approach to payments, the NHA MBS program immediately added a layer of legal and administrative complexity to Canada's system of mortgage finance.

A National Housing Act Mortgage-Backed Security is a debt security (1) issued by a CMHC-approved lender, (2) composed of the payments collected from a pool of residential mortgages originated by the lender, (3) secured by the lender's interest in the underlying mortgages and (4) guaranteed by the CMHC. Figure 2 demonstrates the basic structure of an NHA MBS transaction.

The mortgages, issuer and securities involved in an NHA MBS transaction must each meet criteria established by the CMHC. For example, the mortgages must be insured against borrower default (either by the CMHC or a private company), must entail amortized payments of both principal and interest, and must fall within a category (or "pool") of loans authorized for securitization by the CMHC.[35] An issuer must have a certain minimum net worth and, unless it qualifies for a narrow

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33 See e.g. KPMG LLP, *supra* note 11; CIBC World Markets, Inc., "Household Credit Analysis" (6 October 2009), online: CIBC World Markets, Inc. <http://research.cibcwm.com/economic_public/download/hca-091006.pdf>; The Canadian Real Estate Association, News Release, "2009 resale housing market ends on a high note" (15 January 2010), online: The Canadian Real Estate Association <http://www.crea.ca/public/news_stats/pdfs/media_dec09.pdf>.

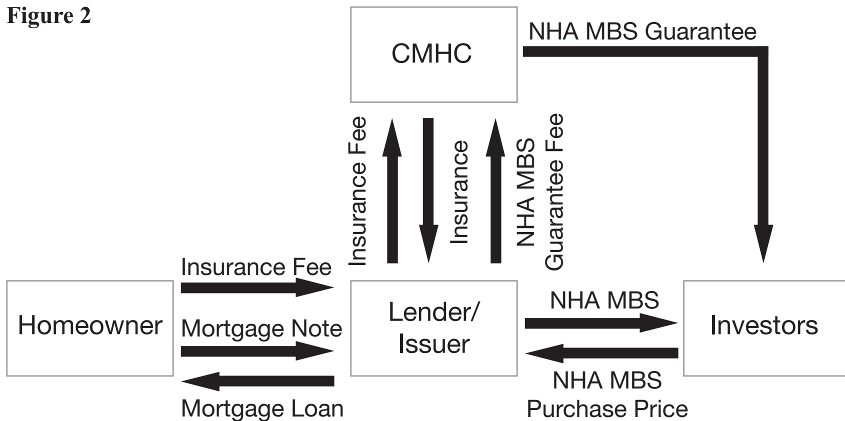
34 CMHC, *The NHA Mortgage Backed Securities Guide 2006* at 1-1, online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/upload/NHA-MBS-Guide.pdf>.

35 *Ibid*. at 1-3, 3-4 and 3-5 (insurance), 5-2 (amortization) and 5-3 to 5-5 (pools, which offer different combinations of property type, interest rate and prepayment options).

exception, must be a financial institution regulated under federal or provincial law.[36] Thirty-seven issuers have NHA MBS outstanding.[37] Finally, the securities must be documented, registered, marketed and delivered in accordance with CMHC guidelines and other regulations.[38] For example, the CMHC requires that the lowest mortgage rate collected from the loans used for an NHA MBS exceed the interest rate paid on that NHA MBS by at least 50 basis points (0.50%) to ensure that the loans will generate sufficient cash to pay amounts owing on the securities and all fees involved in the securitization process.[39]

The definitive element of an NHA MBS, however, is the CMHC's guarantee of timely payment of principal and interest, which the issuer purchases for the benefit of investors. This guarantee is expected to quell fears of issuer default and induce investors to purchase NHA MBS at a discount. Since each mortgage included in an NHA MBS is insured, investors enjoy two layers of protection against borrower default. Mortgage insurance protects the issuer directly and investors indirectly. However, some risk remains because, in the event a borrower fails to make a mortgage payment, the issuer remains obligated to make all NHA MBS payments in full and on time. It cannot wait to be reimbursed by

Figure 2



36 *Ibid.* at 3-1 and Appendix 5. For the exception and the applicable supplementary criteria, see CMHC, "Changes to NHA MBS Approved Issuer Qualification Criteria" (23 December 2008), online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/upload/changesDec23.pdf>.

37 CMHC, "NHA Mortgage-Backed Securities, Volumes by Issuer" (8 February 2010), online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/upload/r120-eng.pdf>.

38 See e.g. CMHC, *supra* note 34 at 9-1 to 9-4 and Appendix 1.

39 *Ibid.* at 5-6; CMHC, *supra* note 7 at 89.

the company that insured the delinquent mortgage.[40] The CMHC guarantee, which under section 4 of the *NHA* is an obligation of the Crown, addresses the risk of issuer insolvency.[41]

The NHA MBS program should lower the average cost of the money with which approved lenders make mortgage loans. To participate, an institution with a mortgage portfolio obtains CMHC authorization, purchases the CMHC guarantee and sells NHA MBS backed by those mortgages. The issuer also transfers its interest in the mortgages to the CMHC on behalf of investors.[42] A custodian maintains the documents and data relating to the mortgages.[43] The issuer's only remaining responsibility is to service the mortgages – to transfer the payments it receives to a trust account for investors and to pursue any delinquencies – and many of these administrative tasks can be performed by a third-party servicer.[44] Investors enjoy not only the lender's pledge of its interest in the underlying loans but also the CMHC's guarantee of timely payment. In theory, insulated against default by both borrowers and issuers, they should buy more NHA MBS and pay less for them than they would absent this guarantee.

In practice, the advantages conveyed by the CMHC guarantee are compromised by an anachronistic approach to payments. NHA MBS are part of the first generation of securitization schemes because they pass the payments made on the underlying mortgages, minus fees collected by the issuers and the CMHC, through to investors.[45] As a result, NHA MBS payments consist of both principal and interest.[46] Investors in asset-backed securities generally prefer to receive coupon payments comprised solely of interest and the entire principal amount at maturity. Newer versions of mortgage-backed securities, such as CMBs, provide these features. NHA MBS do not, so they attract less demand.[47] At the end of 2000, the year before CMBs were introduced, there were only $34

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40 CMHC, *supra* note 34 at 1-1 to 1-3.

41 *Ibid.* at 1-2 to 1-3; *NHA*, *supra* note 20, s. 4.

42 CMHC, *supra* note 34 at 1-3.

43 *Ibid.* at 8-1.

44 *Ibid.* at 2-1 to 2-3.

45 See e.g. Statement of Cameron L. Cowan on behalf of the American Securitization Forum, before the Subcommittee on Housing and Community Development and the Subcommittee on Financial Institutions and Consumer Credit of the US House of Representatives (5 November 2003) at 2-3, online: <http://financialservices.house.gov/media/pdf/110503cc.pdf>.

46 See e.g. CMHC, *supra* note 34 at 1-1; and CMHC, "What is MBS?," online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/mobase/mobase_001.cfm>.

47 See e.g. KPMG LLP, *supra* note 11 at 9-11.

billion of NHA MBS outstanding.[48] By December 2009, there were $293 billion, $176 billion of which had been repackaged as CMBs.[49]

Regardless, unrefined NHA MBS remain more attractive than residential mortgage-backed securities that lack a CMHC guarantee. As of December 2009, there were just $16 billion of the latter outstanding: a decline of $4.6 billion (twenty-two percent) from twelve months prior.[50] Absent the government guarantee, demand for Canadian mortgage-backed securities would be weaker, the supply of financing for mortgage loans would be lower and the cost of such financing would be higher. For all of these reasons, the NHA MBS program may be seen as a success.[51] These narrow considerations, however, ignore other effects of this expansion in mortgage credit: higher house prices, increased total mortgage costs and less money available for more productive industries.

The CMHC has the authority to guarantee NHA MBS and is operating within applicable constraints. Section 14 of the *NHA* authorizes it to guarantee mortgage-backed securities.[52] Section 15 incorporates by reference the section 11 cap on mortgage insurance as the cap on total guarantees.[53] So, when Parliament increased the amount of mortgage loans the CMHC may insure to $600 billion, it also increased the amount of mortgage-backed securities the CMHC may guarantee.

Again, this massive government intervention warrants more scrutiny than it has received. It has provided Canadian lenders with a huge amount of money to finance residential mortgage loans. According to Statistics Canada and the Bank of Canada, as of December 2009, NHA MBS contributed thirty per cent of all outstanding mortgage credit,

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48 Statistics Canada, *Table 176-0069, Residential mortgage credit, outstanding balances of major private institutional lenders, monthly (dollars)*, online: Statistics Canada <http://cansim2.statcan.ca/cgi-win/cnsmcgi.pgm?Lang=E&ArrayId=1760069&Array_Pick=1&Detail=1&ResultTemplate=CII/CII___&RootDir=CII/>.

49 *Ibid*. (NHA MBS); CMHC, "Canada Mortgage Bonds, Outstanding Debt Securities as of January 19, 2010" (19 January 2010), online: CMHC <http://www.cmhc-schl.gc.ca/en/hoficlincl/in/camobo/camobo_002.cfm?renderforprint=1> (CMBs); Canada, Department of Finance, *Canada's Economic Action Plan: A Fourth Report to Canadians* (2009) at 156, online: Government of Canada, Department of Finance <http://www.fin.gc.ca/pub/report-rapport/2009-4/pdf/CAPDEC2009_eng.pdf> (IMPP).

50 Bank of Canada, *supra* note 16.

51 See e.g. CMHC, "Mortgage Backed Securities Frequently Asked Questions" at question 27, online: CMHC <http://www.cmhc-schl.gc.ca/en/corp/faq/faq_001.cfm>. See also CMHC, *supra* note 7 at 56 and 61.

52 *National Housing Act*, *supra* note 20, s. 14.

53 *Ibid.*, s. 15.

$293 billion of $963 billion. It is the second-largest source of residential mortgage credit and in recent years it has expanded much more rapidly than other sources.[54] The $134 billion of NHA MBS issued in 2009 was equal to seventy-two per cent of the $186 billion total mortgage principal forecast to have been loaned in 2009.[55] By essentially assuming the risk of default, the CMHC guarantee has attracted substantial sums that otherwise would not be invested in residential mortgage-backed securities at prevailing rates.

While the NHA MBS program helps to maintain lofty home prices by attracting a stable supply of mortgage finance, it also sharpens the three problems presented by mortgage insurance. First, it compounds false economies. The CMHC guarantee increases demand for NHA MBS so that issuers can raise more funds for mortgage loans without offering to pay higher interest rates. In theory, they can then lend homeowners more money without having to charge higher interest rates. As a result, more homeowners can borrow more money and pay more for houses without necessarily facing larger mortgage payments. But, as noted above, long amortization periods and low interest rates can yield small mortgage payments, notwithstanding a large principal amount. Also, the larger their loans, the longer their amortization periods and the more their lenders rely on the bond market to finance mortgage lending, the more exposed Canadian borrowers become to fluctuations in that market.

Second, the NHA MBS program distorts the Canadian economy. The CMHC guarantee at the heart of the NHA MBS program expands supply and demand for residential mortgage credit; it attracts financing dedicated to that purpose in the bond market and it enables borrowers to take advantage of relaxed mortgage insurance eligibility criteria. Even if the market for residential mortgage credit is able to avoid shocks to the price of credit (that is, a rapid rise in interest rates), it is out of balance with other credit markets that cannot rely upon a government guarantee to ensure cheap and abundant financing. Absent the CMHC guarantee,

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[54] In the 12 months to December 2009, the amount of NHA MBS outstanding grew by $47 billion or 18.9%. In contrast, the largest source of residential mortgage credit – chartered banks – grew by only $13 billion or 3.0%. Bank of Canada, *supra* note 16; Statistics Canada, *supra* note 48. For a graphic representation of recent trends, see John Kiff, *Canadian Residential Mortgage Markets: Boring But Effective?* (International Monetary Fund Working Paper WP/09/130, June 2009) at 15, online: International Monetary Fund <http://www.imf.org/external/pubs/ft/wp/2009/wp09130.pdf>.

[55] See CMHC, *supra* note 8 ($134 billion NHA MBS issued in 2009); and Dunning, *supra* note 31 ($186 billion in mortgage loans forecast to be approved in 2009). The latter amount remains a forecast because final 2009 figures for total new mortgage loans were not available when this article was written.

investors likely would insist on a higher return from these securities and allocate more of their funds to assets that offer a better mix of risk and return. The market share of non-guaranteed residential mortgage-backed securities is just 1.7%, in contrast to the 30% possessed by NHA MBS.[56] Similarly, securities backed by short-term and long-term business loans do not enjoy a government guarantee and comprise just 2.4% and 2.9% of their respective markets.[57]

The CMHC guarantee promotes investment, innovations and efficiencies of scale in industries related to housing. It encourages residents to purchase homes, realtors to develop sales networks, lenders to invest in retail and administrative facilities, developers to expand their companies and students to study trades. Participants in other industries, from hospitality to high technology, do not receive such government support. They and their customers must suffer higher interest rates and other terms that are more onerous than if they were comparably endowed. Their growth also could be enhanced by a government guarantee that reduces the cost, increases the supply and stabilizes the flow of credit.

Decisions about whether government should support industry, which industries it should support and how it should do so cannot be made without detailed information about the relevant markets, strategic concerns and voter preferences. Such decisions should be treated as real choices between real alternatives with real consequences. Neither Parliament nor the government seem to regard the existence and expansion of the NHA MBS program and other CMHC activities in these terms. They remain focused on reacting to economic emergencies but must begin to consider the lasting harm to growth and stability from these shortsighted policies, which deploy public resources to foster investment in residential real estate and may weaken the broader economy by reinforcing its reliance on housing and finance.

This unfortunate scenario clarifies the third problem presented by the government's intervention in the mortgage market: it has no exit strategy. Neither the government nor the CMHC has released realistic plans to reduce or terminate this program, which has nearly tripled in size in just four years.[58] In its 2009-13 corporate plan, the CMHC envisioned cutting new NHA MBS guarantees from an anticipated $167 billion in 2009 to

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[56] Bank of Canada, *supra* note 16.

[57] Bank of Canada, *Credit Conditions – Business Credit* (16 February 2010), online: Bank of Canada <http://credit.bank-banque-canada.ca/businesscredit>.

[58] Statistics Canada, *supra* note 48 ($100 billion in December 2005, $293 billion in December 2009).

just $67 billion in 2010 and each year thereafter.[59] It did not explain this decision. It simply presented the figures without providing their rationale or considering their likely effect.

The actual amount of NHA MBS guarantees issued in 2009 was $134 billion.[60] To cut this program in half would significantly reduce the supply of residential mortgage credit in this country. It would return the NHA MBS program to levels last seen in 2006 ($58 billion) and 2007 ($86 billion).[61] Other sources of credit seem unlikely to fill that gap in the short term: the recent growth of NHA MBS has far exceeded that of other sources; the market for non-guaranteed mortgage-backed securities is too small; and even the chartered banks and other lenders may struggle to accommodate so much new credit on their balance sheets. Absent adequate public preparation, such a deliberate contraction would likely prove both economically disruptive and politically unpopular.

From these details, our dilemma begins to emerge. These programs "support" Canada's housing market by piling debt atop debt. They produce high prices but render those prices increasingly vulnerable to fluctuations in the credit supply. Any policy changes that seek seriously to reduce dependence on mortgage debt threaten to accelerate the damage they aim to avoid. The longer NHA MBS and other CMHC programs remain in place, the harder they will be to remove. These programs create their own constituency; many homeowners and large businesses, such as banks and property developers, have a strong economic interest in their survival and expansion. All Canadians, however, have an interest in sustainable economic growth. The question is not whether reform poses risks. It does, but so does our current path. The question is whether the risks of reform exceed the risks of choosing not to reform.

Refusing to discuss these issues does not delay the day of reckoning, when bond investors demand an interest rate from NHA MBS that sends mortgage rates above what highly-leveraged homeowners can afford. Dithering today is a sensible political strategy only if our representatives believe they will be able to escape blame tomorrow. A more sophisticated public debate may change this calculus and enable political entrepreneurs to address these problems. By connecting institutional nuances with

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59 CMHC, *2009-13 Summary of the Corporate Plan* (2009) at 46, online: CMHC <http://www.cmhc-schl.gc.ca/en/corp/about/anrecopl/upload/CPS_2009-2013_EN-W.pdf>.

60 CMHC, *supra* note 8.

61 *Ibid*.

familiar experiences, we can identify the parties responsible for these policies, shift attention from unproductive questions – whether the low target rates set by independent central banks have fueled an asset bubble, for example – and explore possible solutions to our mounting debt dilemma. But before we can do so, we must consider the final two stages of federal intervention in the mortgage market.

C) Canada Mortgage Bonds

As noted above, the CMHC introduced CMBs in 2001 to supplement the NHA MBS program and increase the supply of financing for residential mortgage loans. To attract investor interest, CMBs convert the pass-through payments of NHA MBS into coupon payments of pure interest and a single payment of the entire principal amount upon maturity. They employ the NHA MBS structure with one major modification: Canada Housing Trust™ No.1 (CHT) is inserted between NHA MBS issuers and investors. CHT transforms NHA MBS into CMBs in three steps. First, it purchases NHA MBS from issuers. Second, it enters into financial contracts with third parties in order to substitute the unpopular payments generated by those NHA MBS for the payments preferred by bond-market investors. Third, it sells CMBs with the new payment profile and the standard CMHC guarantee of interest and principal to satisfied investors. As before, the issuer of the NHA MBS pays a fee to the CMHC, but in this case it pays for three distinct services: a guarantee of timely payment on the NHA MBS sold to CHT; a similar guarantee on the CMBs sold by CHT to investors; and the purchase of replacement NHA MBS to re-invest the principal amounts received by CHT that cannot be passed on to CMB investors.[62] Figure 3 illustrates a standard CMB transaction.

The contracts by which CHT turns the NHA MBS payments it receives into the CMB payments it makes are essential to this program because they make CMBs much more marketable. These agreements are based on standard market documents that enable parties to hedge their risks or otherwise manage their cash flows by agreeing to "swap" payments that are calculated by reference to a notional (that is, stipulated) amount. They are often used to trade a floating interest rate for a fixed one, or payments in one currency for payments in another, depending on each party's needs and expectations. The parties do not transfer the notional amount, which is used solely to derive the amounts owed under the swap agreement. In this case, CHT agrees to exchange the payments it receives from the NHA MBS it has bought for the payments it must make on the

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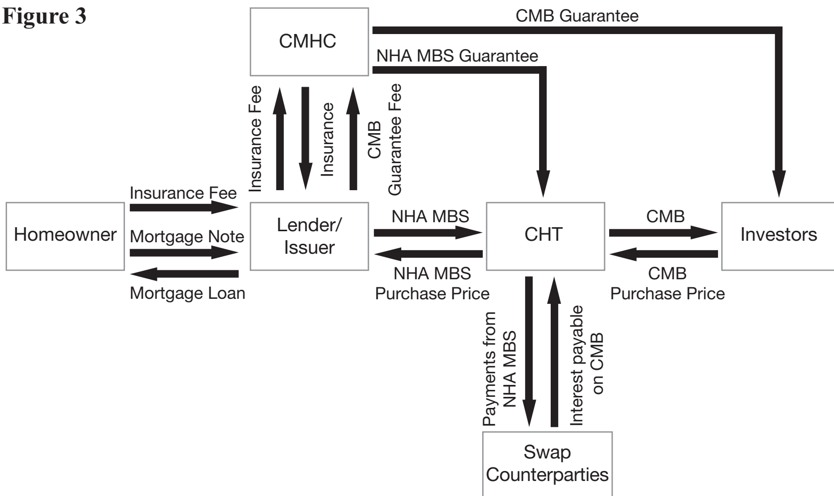
[62] CMHC, *supra* note 34 at 1-6.

CMBs it has sold. As a result, the swap counterparties, which must be financial institutions that meet certain criteria and may even be issuers of NHA MBS, can obtain the payments generated by NHA MBS without assuming the risk of borrower defaults or retaining the underlying assets.[63]

The CMHC is authorized to participate in the CMB program and its participation complies with current constraints. Amendments to the NHA in 1999 empowered the CMHC to review and revise its insurance and guarantee programs in order to enhance their commercial appeal.[64] Representatives of the mortgage finance industry helped it develop the CMB program, which was approved by the Minister responsible for the CMHC and authorized by the Minister of Finance in October 2000.[65] CHT was established under the laws of Ontario in April 2001.[66] It is a trust for the benefit of certain charitable organizations and it is authorized to issue CMBs.[67] Its accounts are consolidated with those of the CMHC for the purpose of annual financial reports.[68] The CMHC relies on the same statutory provisions for the guarantees it provides under the CMB

Figure 3



63 KPMG LLP, *supra* note 11 at 6, note 9, and 11.

64 *Ibid.* at 15.

65 *Ibid.* at 1.

66 *Ibid.* at 4-5.

67 CMHC, *supra* note 7 at 102; KPMG LLP, *supra* note 11 at 5; see also Canada Housing Trust™ No. 1, Offering Circular C$8,000,000,000 Aggregate Principal Amount 3.150% Canada Mortgage Bonds™, Series 28, to mature June 15, 2014, 16 June 2009 at 1.

68 CMHC, *ibid.* at 103.

program as it does for the NHA MBS program: the aggregate principal value of guarantees made under the two programs is capped at $600 billion.[69]

The CMB program has clearly succeeded in attracting investor interest and, more importantly, capital. It has enjoyed spectacular growth. CHT did not exist in 2000. By the end of 2006 it had $95 billion of CMBs outstanding, and by the end of 2009 it had $176 billion.[70] Equally important, demand for CMBs has survived the recent economic turmoil: CHT sold $43 billion in 2008 and $39 billion in 2009.[71] It has driven a similarly rapid expansion of the NHA MBS program, which has surged from $35 billion outstanding at the end of 2001 to $124 billion at the end of 2006 and $293 billion at the end of 2009.[72] CMBs have proven so popular that the CMHC is considering further innovations, from greater flexibility in the assets that underlie NHA MBS and CMBs to new securities with multiple tranches and CMBs issued in foreign currencies.[73] Since the CMHC and its activities are supposed to help homeowners, the success of the CMB program cannot be assessed on its size alone. We must also consider its effects on the Canadian mortgage market.

In 2008, KPMG LLP claimed to do just that. The CMHC hired KPMG and five other consulting firms to evaluate "the relevance, impacts and cost-effectiveness" of the CMB program during its first five years of operation, 2001 through 2006.[74] KPMG prepared the final report. Unfortunately, the terms of this evaluation were very narrow, so it does not provide a critical discussion of either the CMB program or the CMHC.

Pursuant to its instructions, KPMG examined whether CMBs have "contributed to lower mortgage costs for Canadian borrowers."[75] It did not do so, however, by measuring the average mortgage payment, whether as an absolute amount or as a proportion of average household income, or by considering the total payments made on the average mortgage over its amortization period. Rather, KPMG determined whether CMBs had reduced mortgage costs for *borrowers* by analyzing whether

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69 *NHA*, *supra* note 20, ss. 11, 14 and 15; *Appropriations Act No. 5, 2008-09*, *supra* note 6.

70 See KPMG LLP, *supra* note 11 at 4 (2006 figure); CMHC, *supra* note 49 (2009 figure).

71 CMHC, *ibid.*

72 *Ibid.* (2009 figures); Statistics Canada, *supra* note 48 (2001 and 2006 figures).

73 CMHC, *supra* note 59 at 14.

74 KPMG LLP, *supra* note 11 at i and 1.

75 *Ibid*. at 1.

they had reduced the cost of funds for mortgage *lenders*.[76] The analysis employed two assumptions shared by the CMHC. First, CMHC and its consultants assumed that "lower mortgage costs" meant lower interest rates on mortgage loans.[77] They ignored any effect the CMB program may have had on the principal amounts of such loans and thus the total payments required to satisfy mortgage debt. Second, they assumed that lenders would pass all of their savings from the CMB program to their customers, the borrowers.[78] They maintained this belief despite KPMG's observation that it was not supported by American experience and the absence of clear evidence of this practice among Canadian lenders.[79] KPMG concluded that, given the proportion of the mortgage market funded by CMBs (15%), an average savings of 18 basis points (0.18%) for lenders likely translated into savings of three basis points (0.03%) for borrowers.[80] As a result, the KPMG report could support the CMHC's belief that this program promotes housing affordability without actually determining how CMBs affect one's ability to afford a house.[81]

KPMG did not consider whether these hypothetical three basis points could be yet another example of false economy. The marginal savings provided by such a small reduction in mortgage rates could easily have been offset by any increase in outstanding mortgage principal caused by the injection of $95 billion of mortgage credit between April 2001 and December 2006, not to mention the net $81 billion added by CMBs issued since then. Such a blinkered analysis does not contribute to meaningful debate, by which I mean an informed discussion of alternative policies, and it is not intended to do so. This narrow emphasis on the savings generated for lenders does not attempt to capture the complete costs and benefits of this program.

Without a more comprehensive and rigorous review of all of these CMHC programs, we will not be able to determine the extent to which

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76 *Ibid.* at ii-iii and 33-40.

77 See e.g. *ibid*. at 5 (CMHC) and 40 (consultants).

78 See e.g. *ibid*. at 15 (CMHC) and 40 (consultants).

79 See *ibid*. at 35, note 46 and 34-40.

80 *Ibid.* at ii-iii (18 basis points * 15% = 2.7 basis points).

81 See e.g. *ibid*. at 15-18 (CMHC assumed that CMBs would lower the cost of funds for lenders, which would lower mortgage rates for borrowers, which would by definition improve housing affordability) and ii-iii (KPMG confirms that CMBs lowered the cost of funds for lenders and mortgage costs for borrowers). See also CMHC, "Canada Mortgage Bonds Program Description," online: CMHC <http://www.cmhc.ca /en/hoficlincl/in/camobo/upload/Introduction-to-the-CMB-Borrowing-Program.pdf>, and CMHC, "Canada Mortgage Bonds," online: CMHC <http://www.cmhc-schl.gc.ca/en /hoficlincl/in/camobo/index.cfm>.

CMBs, combined with NHA MBS and mortgage insurance, have distorted the Canadian economy. Nor will we be able to craft a responsible exit plan, because we will not know which data to monitor and which reforms to prioritize. Once we have considered the fourth and final stage of federal intervention, the Insured Mortgage Purchase Program, we will have a better sense of how to proceed with these practical tasks.

D) The Insured Mortgage Purchase Program

The minority Conservative government introduced the IMPP in response to the financial crisis that gripped global markets in 2008.[82] As credit contracted worldwide and the prices of asset-backed securities plummeted, it sought to minimize the damage to Canadian markets. Designed to complement other emergency actions taken in Canada and abroad, the IMPP was intended to accomplish two objectives: to provide Canadian financial institutions with long-term funding; and to ensure a stable supply of financing for residential mortgage credit.[83] By linking these two goals, the government aimed to avert the cascade of defaults and devaluations that could have resulted from a sharp reduction in mortgage credit.

The initial plan was for the Department of Finance to loan the CMHC up to $25 billion to purchase NHA MBS from Canadian financial institutions.[84] The federal government would fund the IMPP by issuing ordinary government bonds.[85] It increased the size of this program twice:

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[82] For accessible accounts of the credit crisis, see Gillian Tett, *Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe* (New York: Free Press, 2009); Andrew Ross Sorkin, *Too Big to Fail* (New York: Viking, 2009); and Joseph E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* (New York: W. W. Norton & Co., 2010).

[83] Canada, Department of Finance, *supra* note 12.

[84] Canada, Department of Finance, "Government of Canada Announces Additional Support for Canadian Credit Markets" (21 November 2008), online: Government of Canada, Department of Finance <http://www.fin.gc.ca/n08/08-090-eng .asp>. See also CMHC, "Canada Mortgage and Housing Corporation Supports Canadian Credit Markets" (10 October 2008), online: CMHC <http://www.cmhc-schl.gc.ca/en /corp/nero/nere/2008/2008-10-10-1700.cfm>.

[85] These borrowings do not increase the federal debt or accumulated deficit because "they are offset by interest-bearing financial assets," namely the NHA MBS whose purchase they finance. Canada, Treasury Board of Canada Secretariat, *Supplementary Estimates (A) 2009-10* at 14, online: Treasury Board of Canada Secretariat <http://www.tbs-sct.gc.ca/est-pre/20092010/sups/A/docs/index-eng.pdf>. See also Canada, Department of Finance, *Debt Management Report 2009-2009* (8 December 2009) at 17, online: Government of Canada, Department of Finance

to $75 billion in November 2008 and to $125 billion in January 2009.[86] As of December 2, 2009, the CMHC had purchased a total of $66 billion of NHA MBS.[87] Amid improved financial conditions and diminished demand from issuers, the government decided to cease new purchases under the IMPP at the end of March 2010.[88] According to statements from both the CMHC and the Department of Finance, the investments made under the IMPP are expected to generate a modest profit and the CMHC intends to hold them until maturity.[89]

A purchase under the IMPP resembles an ordinary NHA MBS transaction, except the CMHC not only guarantees but also buys the NHA MBS with money borrowed from the federal government.[90] Like CHT, the CMHC enters into swap agreements with financial institutions to ensure that the interest it receives from the NHA MBS will be sufficient to pay the interest on those loans.[91] These transactions resemble the contracts used by the CHT to transform NHA MBS payments into CMB payments. Figure 4 illustrates the IMPP.

The legal basis for this program is more complicated than for the other three. The Minister of Finance has the authority to borrow the requisite funds. Pursuant to section 43.1 of the *Financial Administration Act*, the Governor in Council may authorize the Minister to borrow funds

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http://www.fin.gc.ca/dtman/2008-2009/DMRe08-09.pdf; and Canada, Receiver General for Canada, *Public Accounts of Canada 2008-09*, vol. I (Ottawa: Public Works and Government Services Canada, 2009) at 1.11, online: Public Works and Government Services Canada <http://www.tpsgc-pwgsc.gc.ca/recgen/pdf/49-eng.pdf>.

86 See Department of Finance, *ibid.* at 17; and Receiver General for Canada, *ibid.* at 2.14.

87 Department of Finance, *supra* note 49 at 168.

88 Canada, Department of Finance, *Budget 2010* (4 March 2010) at 265, online: Government of Canada, Department of Finance <http://www.budget.gc.ca/2010/pdf /budget-planbudgetaire-eng.pdf> (accessed 4 March 2010).

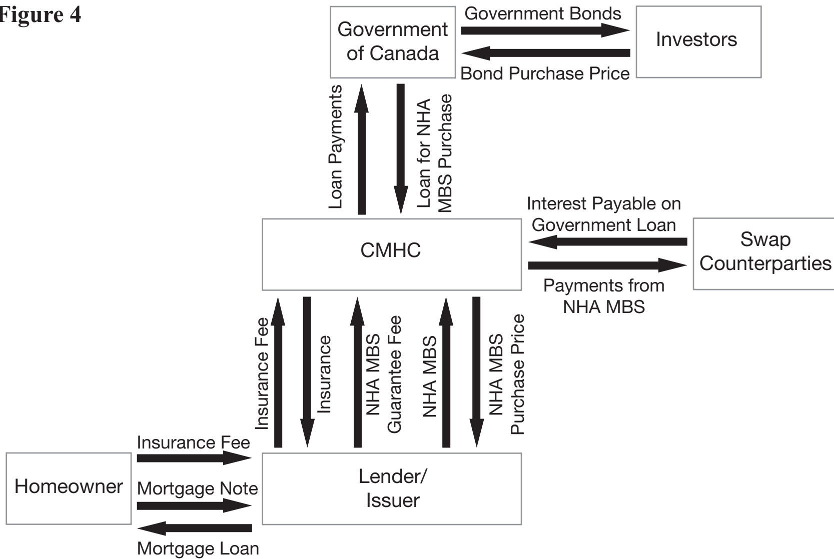
89 See e.g. Canada, Department of Finance, *2008 Economic and Fiscal Statement* at chapter 3, online: Government of Canada, Department of Finance <http://www.fin.gc .ca/ec2008/Ec/ecc3-eng.html>.

90 See e.g. CMHC, *supra* note 7 at 17, 38 and 143.

91 *Ibid.* at 131. For a more detailed description of these agreements and other technical aspects of the IMPP, see Jean-François Nadeau, *The Insured Mortgage Purchase Program* (13 March 2009), online: Library of Parliament <http://www2.parl.gc .ca/Content/LOP/ResearchPublications/prb0856-e.pdf>. This paper claims *ibid.* at 5-8 that the IMPP poses no risk to taxpayers because the government has already guaranteed the NHA MBS involved and insured the underlying mortgages; it does not consider the risks posed by making the Canadian housing and mortgage markets more dependent on debt and government intervention.

on behalf of the Crown in right of Canada.[92] According to section 44(2) of the same statute, the Governor in Council limits the "aggregate principle (sic) amount of money borrowed by the Minister" in each fiscal year.[93] In November 2008, the Minister obtained a $90 billion increase in the amount authorized for the fiscal year 2008-09 to fund the first $75 billion of the IMPP.[94] The additional $50 billion announced for the IMPP in January 2009 appears to have been factored into the $370 billion of borrowing the Governor in Council authorized for 2009-10.[95] The Minister also has authority to transfer funds to the CMHC in the form of a loan.[96] The Budget Implementation Act 2007 amended the *CMHC Act* to enable the Minister of Finance to lend money to the CMHC on such terms as he sees fit.[97] Finally, the CMHC has the authority to borrow that money, purchase securities with it and enter into contracts to manage the

Figure 4



[92] *Financial Administration Act*, R.S.C. 1985, c. F-11, s. 43.1.

[93] *Ibid*., s. 44(2).

[94] P.C. 2008-1738.

[95] P.C. 2009-0373.

[96] See e.g. Canada, Department of Finance, *Annual Fiscal Report of the Government of Canada to Canadians* (16 October 2009), online: Government of Canada, Department of Finance Canada <http://www.fin.gc.ca/afr-rfa/2009/afr-rfa09_1-eng.asp>. The CMHC obtained the approval of the Governor in Council for amendments to its 2009-13 Corporate Plan that allow for this unanticipated borrowing; see P.C. 2009-0316.

[97] *Budget Implementation Act 2007*, S.C., c.29, s. 90(1), amending *CMHC Act*, *supra* note 19, *s*. 21(1).

risks presented by those investments.[98] The IMPP relies entirely upon existing statutory authority. Parliament has not acted to limit or otherwise regulate the CMHC's investments in these securities.

The IMPP appears to have shielded Canadian homeowners and financial institutions from the worst of the credit crisis, but at what cost? After a slump in late 2008, Canadian house prices have rebounded to near record heights. Canadian banks have rallied from large losses to deliver rude profits in the fourth quarter of 2009 and amass their largest annual bonus pools ever.[99] However, Canadian household debt has also reached a new peak, both in absolute terms ($96,100/person) and as a percentage of gross household income (145%).[100] Total residential mortgage debt is now a staggering $963 billion; total household debt is $1,411 billion.[101]

The IMPP did not stabilize faltering demand for NHA MBS, because that demand never really faltered. The amount of NHA MBS outstanding actually increased by $34 billion from January to September 2008 and by nearly $15 billion from August to September alone.[102] Rather, this program was necessary to offset the drop in residential mortgage loans held by chartered banks, which cut their exposure sharply from an August 2008 peak.[103] Their confidence and holdings have since recovered, and total outstanding residential mortgage credit has increased by $73 billion since the IMPP was introduced.[104]

By enabling Canadian homeowners to borrow throughout the credit crisis, the IMPP preserved high house prices. It also reinforced a structural role for the CMHC programs that had cultivated those prices. In recent years, house prices have been propelled by growing debt rather than rising income. Total residential mortgage credit increased by 9.7%

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98 *CMHC Act*, *ibid.* at ss. 21(1) and 28(1)(c).

99 Tara Perkins, "Bank profits back on the fast track" *The Globe and Mail* (4 December 2009) B1; Tara Perkins and Andrew Willis, "Bankers to reap record bonus haul" *The Globe and Mail* (10 December 2009) B1.

100 Roger Sauvé, The Vanier Institute of the Family, *The Current State of Canadian Family Finances: 2009 Report* (2010) at 13, online: The Vanier Institute of the Family <http://www.vifamily.ca/library/cft/famfin09.pdf>.

101 Bank of Canada, *supra* note 16.

102 Statistics Canada, *supra* note 48.

103 Bank of Canada, *Banking and Financial Statistics, January 2010* (2010) at S17, online: Bank of Canada <http://www.bankofcanada.ca/pdf/bfs.pdf>.

104 *Ibid*. at S55 (total residential mortgage credit in October 2008 was $890 billion), and Bank of Canada, *supra* note 16 (total residential mortgage credit in December 2009 was $963 billion).

in 2004, 9.9% in 2005, 10.7% in 2006, 11.3% in 2007 and 11.8% in 2008.[105] These figures far outpace any conceivable income growth in those years. Absent radical wage hikes, future buyers will need to borrow similar amounts to maintain current prices, let alone push them higher. CMHC mortgage insurance and securitization activities support so much of the residential mortgage market that they cannot be easily, quickly or cheaply replaced. The IMPP – a temporary measure – increased the likelihood that CMHC mortgage insurance, NHA MBS and CMBs will become permanent features of our financial and political landscape. It acted as a buffer against shocks that might have spurred a more thorough review of these programs and their effects on the Canadian economy.

Homeowners have spent another eighteen months chasing false economies. They borrow more than ever and increasingly rely on extended amortization periods. Even if interest rates and payments remain low for some time, many homeowners will require more payments to retire their mortgage debts and thus may pay much larger total amounts for their homes. They also assume greater exposure to interest rate risk; longer amortization periods give rates more opportunities to rise, while larger debts magnify the effect of any such rise. Further, prevailing trends may be generating systemic risk in the Canadian housing market.

Individual borrowers are increasingly sensitive not only to interest rates but also to credit supply. In general, the more they borrow now the more principal will remain outstanding when their mortgages mature. The vast majority of Canadian mortgages have a term of five years or less, and relatively low short-term rates led many borrowers to refinance and adopt a shorter term in 2009.[106] The larger the loan and the shorter the term, the more exposed a borrower becomes to fluctuations in credit supply; in the event of a significant contraction, such a borrower may not be able to obtain a new loan sufficient to cover the principal owed on his maturing loan. Short mortgage terms operate as a crude mark-to-market device; if credit is expanding (and prices are rising), then borrowers have more opportunities to take profits; if not, they have more opportunities to lose equity.

These individual risks threaten to become systemic for three reasons. First, most homeowners have a mortgage and are directly exposed to these risks.[107] Second, few houses are unique. From a buyer's perspective, substitutes exist for almost every house. As a result, house prices are

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105 Bank of Canada, *supra* note 103 at S6.

106 Dunning, *supra* note 31 at 6 and 22.

107 *Ibid*. at 19.

correlated; the price at which one house sells informs the prices at which comparable houses will sell. Homeowners cannot rely on their own financial prudence to insulate themselves from this effect. Third, house prices and mortgage credit have a circular relationship; house prices are influenced by the amount of mortgage credit available to borrowers, and the amount of mortgage credit available to borrowers is influenced by house prices. Mortgage lenders will lend no more than what they expect to obtain from the sale of the house that secures a mortgage loan. In recent years, this cycle has been virtuous, as rising Canadian house prices and mortgage credit have spurred each other to new heights. As recent American experience has shown, however, it can quickly turn vicious.[108]

CMHC mortgage insurance and securitization activities distort this relationship, since lenders do not retain all of the risks associated with loans placed in those programs. However, lenders continue to hold hundreds of billions of dollars of uninsured mortgage loans, so they remain sensitive to the market price of the assets that secure those loans.[109] They also hold other consumer loans worth hundreds of billions of dollars, and both the price of those assets and the revenue they generate would be jeopardized by the uncertainty and reduced liquidity caused by a significant contraction in mortgage credit.[110] Canada's largest banks demonstrated their concern over volatile house prices and credit conditions when they told both the Bank of Canada and the leading national

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[108] See e.g. Suzanne Kapner, "US banks take hit to clear home loan books" *The Financial Times* (17 February 2010) online: Financial Times Ltd. <http://www.ft.com /cms/s/0/5fc11c56-1b39-11df-953f-00144feab49a.html> (accessed 6 May 2010); David Streitfeld, "Interest Rates Are Low, but Banks Balk at Refinancing" *New York Times* (13 December 2009) A1.

[109] The CMHC has $480 billion of mortgage insurance outstanding; see Erman and Perkins, *supra* note 7. Assuming the President of the CMHC accurately characterized its market share, this represents 67% of all mortgage insurance policies in Canada, which means that private mortgage insurance companies have about $236 billion of mortgage insurance outstanding ($480 billion / 0.67 = $716 billion; $716 billion - $480 billion = $236 billion); see Egan, *supra* note 13. See also PMI Canada, *supra* note 26 at 9 (estimating CMHC share of mortgage insurance market in 2008 at approximately 70%). Of this total $716 billion of mortgage insurance policies, at least $293 billion concerns mortgages packaged in NHA MBS; see Statistics Canada, *supra* note 48. This leaves around $423 billion of CMHC and private insurance for the $655 billion of unpackaged mortgage loans held by chartered banks, trust and mortgage loan companies, credit unions, life insurance companies and other institutions; see Bank of Canada, *supra* note 16. This means that about $232 billion of those loans are uninsured. This is clearly a very rough estimate, based on approximate figures from multiple sources. However, no single, precise calculation is readily available.

[110] Bank of Canada*, ibid*.

newspaper that they welcome more stringent requirements for CMHC mortgage insurance, even if that meant they would collect fewer fees.[111] The government proved sympathetic: the Minister of Finance soon announced new rules that would heighten scrutiny of borrower creditworthiness and deter speculative purchases.[112] In addition to political considerations, the government shares at least some of their concern because irresponsible lending can generate losses for the CMHC if enough borrowers default on insured mortgage loans. Aside from other negative implications, if these losses exceed the CMHC's reserve fund, the government would have to finance and account for them as actual liabilities.[113] Such losses would increase the cost of operating the CMHC and, if large enough, could increase the government's borrowing costs. This result may seem unlikely today, but the financial and political constraints on CMHC policies are real.

Falling house prices could reduce the amount of mortgage credit available in Canada, notwithstanding extensive CMHC intervention. A shock of sufficient depth and duration to either credit supply or interest rates could destabilize prices and trigger a disorderly decline in the housing market. The government appears motivated by similar concerns when it emphasizes the importance of smooth credit flow.[114] The IMPP protected the housing market and the government from the economic and political pressures of the credit crisis, but it also rendered them more vulnerable to future shocks by enabling Canadian homeowners to acquire more mortgage debt.

The IMPP also has exacerbated the economic distortions introduced by the three other CMHC programs. It ensured easy access to mortgage loans, and the more resources we dedicate to mortgages, the less we have for other purchases and investments. Chartered banks are beginning to return to the residential mortgage market, but other forms of credit, such as short-term business loans, remain scarce.[115] The Canadian Secured Credit Facility (CSCF), pursuant to which the federal government offered to fund the purchase of up to $12 billion of asset-backed loans by the Business Development Bank of Canada, was a pale imitation of the IMPP. The CSCF, which also was scheduled to run until the end of March 2010, aimed to ensure that financing remained available for the production and sale of vehicles and equipment while credit conditions were tight.[116] The

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[111] Erman and Perkins, *supra* note 7.

[112] Department of Finance, *supra* note 29.

[113] Receiver General for Canada, *supra* note 85 at 2.30 and 11.25.

[114] See, e.g. Department of Finance, *supra* note 12.

[115] Bank of Canada, *supra* notes 16 and 57.

[116] Department of Finance, *supra* note 88 at 266.

impact of this program was constrained by three factors: it was limited to auto and equipment manufacturers; the minimum transaction size for "small" businesses was $100 million; and it was less than one-tenth the size of the IMPP.[117] Absent a comprehensive strategy, the piecemeal accumulation and expansion of CMHC programs risks undermining economic recovery by using consumer debt to fuel unsustainable gains in housing and finance, which can render those sectors and the broader economy less stable.[118]

The IMPP was a short-term response to a long-term problem. Instead of weaning lenders and borrowers off cheap, ample credit, the government provided that credit when it feared no one else would. By protecting high house prices, the IMPP preserved the intellectual and institutional edifice of the CMHC. In Canada, rather than an imperative to revisit the role of government in the housing market and the function of the housing and financial industries in the national economy, the credit crisis has served as an opportunity to reinforce bad ideas and dangerous practices. Just two months after the government expanded the IMPP to $125 billion, Parliament raised the cap on CMHC insurance and guarantees from $450 billion to $600 billion. The IMPP may have relieved financial pressure on the Canadian mortgage market and thus forestalled political demands for a new approach to mortgage finance, but it also compounded the harmful effects of the other three programs and made the need for such a strategy even more urgent.

2. Seeking Solutions in New Mortgage Math

The solution to the massive mortgage debt that inflates our housing market and distorts our economy is unlikely to be even more debt. We face the familiar problem of the devil we know: as risky as it may be to continue to rely on CMHC insurance and guarantees, there is almost no serious discussion about how to reform or replace them, in part because the economic effects (and thus the political benefits) of meaningful change remain so uncertain. Since any significant reduction in government support may trigger the collapse of mortgage credit and house prices that

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[117] Canada, Department of Finance, News Release 2009-044, "Ministers Welcome Rollout of the Canadian Secured Credit Facility" (8 May 2009), online: Government of Canada, Department of Finance <http://www.fin.gc.ca/n08/09-044-eng.asp>; Canada, Business Development Bank of Canada, "Canadian Secured Credit Facility – Updates," online: Business Development Bank of Canada <http://www.bdc.ca/en/about/federal_budget_2009/cscf/update_cscf.htm>.

[118] See e.g. Mark Carney, "Current Issues in Household Finance" (Address to The National Forum, 16 December 2009), online: Bank of Canada <http://www.bank-banque-canada.ca/en/speeches/2009/sp161209.html>.

reform seeks to contain, bold action seems unlikely. We need to change this equation. We need some new mortgage math.

This is not a call for more "financial innovation" – the proliferation of acronyms and formulae that gave a false air of sophistication to speculation on American and Canadian housing markets. Rather, we need to change the incentives our politicians face in order to influence the calculations they make. So long as we remain ignorant of the nature and extent of federal interventions in the housing market, members of Parliament have little reason to inquire or act; the economic and political benefits of high, stable house prices seem clear because the costs and risks of these CMHC programs are obscure. The more we learn about the four programs, the more expensive political inaction will become.

To begin, we must clarify the costs of our current path. We do not know the CMHC, its activities and its effects as well as we think we do or as well as we should. The preceding discussion of the four stages of federal intervention is part of this exercise. The empirical relationships between these programs, mortgage rates, house prices and total mortgage costs require thorough analysis and straightforward explanation. We also need to compare more carefully the legal architecture and commercial practice of mortgage finance in Canada and the United States. Instead of trying to convince ourselves and others that what is happening there could not possibly happen here, we should be trying to identify and anticipate our own problems.

Once we understand the flaws in our arrangements, we can discuss whether and how to address them. We will need to design viable alternative means to finance affordable housing in Canada. Perhaps the federal government's recent proposal to enact legislation that helps financial institutions issue "covered bonds," which are bonds secured by assets such as residential mortgage loans that remain on the issuer's books but are protected from other creditors in the event of default, will succeed and suffice to wean lenders off existing CMHC securitization programs.[119] Perhaps we will opt for a more drastic measure, such as the contraction of some or all CMHC activities. Or perhaps we will adopt an incremental approach and begin with a relatively modest proposal, such as re-introducing a reasonable cap on the principal amount of each mortgage insured by the CMHC. Unless we choose to do nothing, we also will need to plan the transition from the incumbent mortgage finance regime to any proposed successor. These are more difficult tasks than the one performed by this article. To succeed, we will need to make a series

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119 Department of Finance, *supra* note 88 at 113.

of economic, political and legal decisions. Each will present a variation on two basic questions: how to minimize the damage caused by the four CMHC programs and how to allocate the losses that do arise. If we opt not to answer these questions, the bond market may do so for us, and only in the most abstract and paternalistic sense can it be said to have our best interests in mind.