

Summary of Genworth Canada's Submission on

"Balancing the Distribution of Risk on Canada's Housing Finance System"

March 8, 2017

Genworth Canada is Canada's largest private sector provider of mortgage default insurance, with approximately 30% market share. Genworth has been operating in Canada since 1995, and has helped millions of Canadians achieve homeownership. As such, we are pleased to have this opportunity to respond to the Department of Finance's Consultation entitled "Balancing the Distribution of Risk on Canada's Housing Finance System" ("Consultation Document").

In addition to the perspectives provided in our response, we have included a paper we commissioned from Susan Wachter, Sussman Professor, Professor of Real Estate and Finance, The Wharton School, University of Pennsylvania and Co-Director of the Penn Institute for Urban Research and Andrey Pavlov, Professor of Finance, Beedie School of Business at Simon Fraser University, entitled "When Risk Sharing Increases Risk: Analysis of the Government of Canada Mortgage Risk-Sharing Proposal".

In considering change of any sort – especially the sweeping, structural changes that are implied through the proposed risk-sharing model – decision-makers in the housing sector must ask this simple question: Will the stability and efficiency of the market be strengthened? Unless the answer is a resounding yes, the contemplated actions should not be undertaken.

In this respect, we are reminded that when Minister Morneau introduced changes to the insurable mortgages criteria on October 3rd last year he stated, *"…The federal government plays an important role in ensuring that housing markets are stable and function efficiently…"*

As discussed in our submission, we do not believe Minister Morneau's 'stability and efficiency' test can be met by the current proposals. In our view, changing the allocation of risk between government-backed mortgage insurers and lenders as outlined in the Consultation Document will make the Canadian housing finance system less stable and less efficient. While the potential benefits of the proposed risk sharing models are only hypothetical and difficult to achieve, the costs and new risks they will create are direct, immediate, and potentially significant in size. This view is supported by research from Wachter and Pavlov who concluded that:

> *"The proposal would neither reduce the risk in the housing finance system nor mitigate the potential taxpayer exposure. On the contrary, particularly during downturns, taxpayer losses will increase due to decreases in lending that worsen and prolong housing recessions. More generally, the proposed changes are likely to worsen taxpayer exposure to risk and stimulate the spread of pro-cyclical lending practices, worsening region based risks, and ultimately increase the exposure of all participants to extreme real estate market events and create systemic risk that is currently not present*."

Why Risk Sharing Should Not Be Implemented

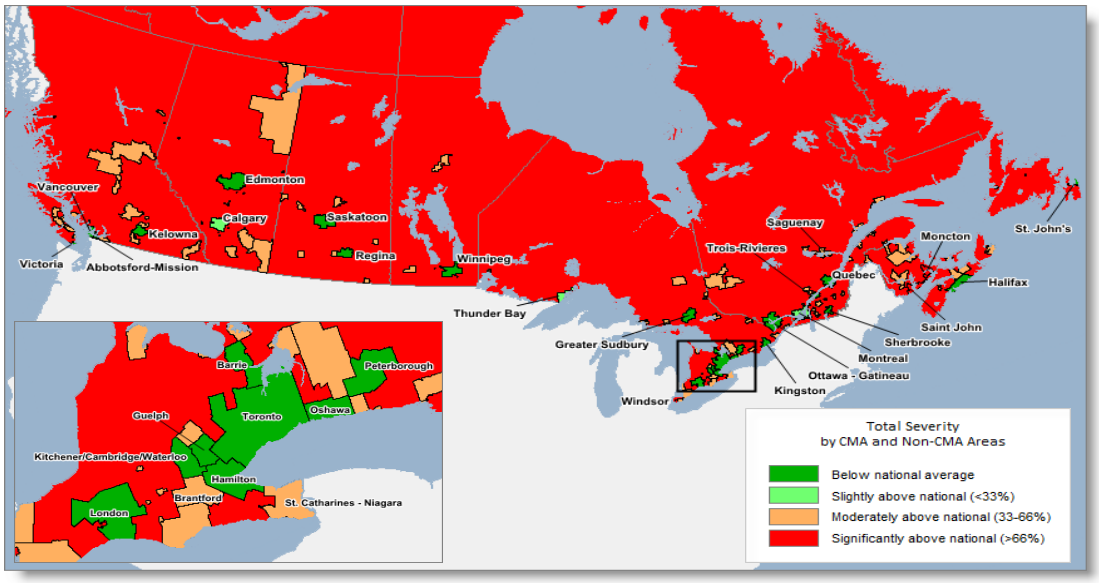
1. **Market stability, underwriting quality, and taxpayer interests are well protected in the current system:** Given the six rounds of "Sandbox" changes and additional regulatory intervention (e.g. OSFI's Residential Mortgage Underwriting Practices and Procedures - Guidelines B20/B21) over the past eight years, Canadians are well protected by the current system.

2. **Risk sharing will weaken the financial stability of the housing finance sector by introducing pro-cyclical risk:** A direct result of risk sharing will be less available and/ or more expensive mortgages in regions more susceptible to economic downturns, deepening and lengthening the impact of regional housing stress events. As Wachter and Pavlov point out:

   > *"…the incentive to adopt loan-level pricing would have minimal effect on rates in rising real estate markets where observed loan losses are limited. In fact, lending is likely to increase to those markets which regulators are most concerned about due to their low current level of observed loan losses. However, risk premiums would increase in weaker markets and weaker market sectors, with higher levels of observed loan losses and loss severities."*

   In fact Pavlov and Wachter note that, contrary to recent efforts by the government, risk sharing , *"…may also concentrate lending into currently low loan loss markets, such as Toronto and Vancouver,"* which could further exacerbate house price appreciation in those regions.

3. **Borrowers in rural parts of Canada will have less access to mortgage financing:** As Pavlov and Wachter point out, borrowers in rural parts of the country, such as Atlantic Canada, will face a reduction in access to affordable loans, and many may have to turn to higher cost loans offered by private or less regulated lenders. To illustrate this point, the map below shows in red the parts of the country which have elevated loss severity and in a risk sharing environment would find it more difficult and more expensive to find mortgage financing.



4. **Risk sharing will increase financing costs for borrowers:** Risk sharing will increase borrower costs by increasing the capital requirement for lenders, especially credit unions and regional lenders, which have limited access to capital and less diverse portfolios. These additional costs will be passed onto borrowers as higher interest rates, compounding challenges for rural homebuyers.

5. **Heightened risk of growth in shadow banking sector**: To the extent that regulated lenders withdraw from higher risk markets, the void may be filled by more non-regulated lenders such as mortgage investment companies and private lenders.

6. **Less efficient mortgage underwriting:** As lenders would bear part of the risk associated with a mortgage going into default they will likely change the way in which they interact with insurers as they try to protect themselves from potential risk in the mortgage insurer's process. This may lead to increased underwriting costs, a slower and less efficient process, and ultimately, higher costs for homebuyers.

7. **Less help available for distressed borrowers:** Today, mortgage insurers look for opportunities to work with lenders to avoid foreclosures by helping borrowers through temporary hardships. Risk Sharing would put these arrangements at risk as lenders may be unwilling to expose themselves to the potential risk associated with borrower "work out" solutions.

8. **Risk sharing puts depositors at greater risk**: By transferring mortgage default risk to lenders, it reduces the protection provided by mortgage insurers to financial institutions in times of stress. This reduction in the protection provided by mortgage insurance increases the risk to depositors and corresponding deposit insurance companies, especially in tail events.

9. **Requiring mortgage insurers to pay 100% of claim obligations to securitization vehicles creates new risks:** Making mortgage insurers responsible for paying 100% of claims on mortgages securitized into CMHC sponsored vehicles introduces counterparty risk to mortgage insurers and generally negates any potential reduction of mortgage insurance premiums as mortgage insurers will have to maintain full capital to survive tail events.

10. **Other countries have looked at risk sharing and decided to use other tools:** While the global usage of risk retention notionally applies to securitization as a way to align incentives and reduce information asymmetries, it does not apply to the relationship between lenders and mortgage insurers. As a result, there is no international precedent for the approach that is being put forward in the Consultation Document. Australia, after studying this issue, concluded that a risk retention scheme would be counter to its desire for a simplified framework and that Australian banks already have linkages such as servicing rights and residual income that strengthened incentives to maintain lending standards.[1]

[1] APRA 2015 Australian Prudential Regulation Authority. (2015, November 26). Press Release "APRA proposes revisions to prudential framework for securitization". Sydney: Australian Prudential Regulation Authority. http://apra.gov.au/MediaReleases/Pages/15_34.aspx

There Are Better Options the Government Should Examine to Strengthen the Current Housing Finance System

1. **Update the National Housing Act Mortgage Backed Securities Requirements:** The NHA MBS structure is overdue for a review. The Government should conduct this review to ensure the program is effectively meeting its policy goals.

2. **Explicitly reduce the amount of risk CMHC takes:** As the taxpayer has direct exposure to the risk that CMHC writes, it can reduce this risk by reducing the amount of business CMHC takes and allow the private sector mortgage insurers to assume this risk. This provides greater protection to the taxpayer through the private sector capital and the 10% deductible in the Protection of Residential Mortgages and Hypothecary Insurance Act (PRMHIA).

3. **Expand OSFI's B-20 and B-21 Residential Mortgage Underwriting Guidelines**: These guidelines can be modified to allow OSFI to specifically target risks in the market.

4. **Enable all mortgage insurers to use reinsurance**: By allowing mortgage insurers to access international pools of capital through reinsurance the government can, in times of stress, take advantage of this capital source to support the Canadian Housing Finance System.

5. **Follow through on the commitment to study and tackle mortgage fraud**: As set out in Minister Duclos' Mandate letter, the government should follow through with its commitment to address mortgage related fraud.

Should the Government Still Choose to Proceed With Risk Sharing, Genworth Believes It Should:

1. **Do nothing until the Fall 2018 and then reassess the state of the market:** As the Government has recently introduced a number of changes to the insured mortgage market, it should wait until the market has had a chance to rebalance itself, and then at that point reassess the need for any risk sharing and determine its potential impact.

2. **Favour the first loss model over the proportional model:** While the general impact of the two models is similar, the first loss model offers greater clarity of exposure for all parties involved, and therefore should be easier to implement. In particular, the first loss model typically results in a lower overall risk to lenders in severe stress scenarios and this helps smaller lenders. It also maintains most of the current incentives for lenders to collaborate with insurers on workouts and other loss mitigation strategies.

3. **Move cautiously, starting with a first loss deductible of 3%:** As stated by the International Monetary Fund (IMF) and Organization for Economic Cooperation and Development (OECD), the Government should move slowly if it proceeds. Starting small reduces downside risk and gives the Government an opportunity to study the impact of risk sharing. Specifically, it might mitigate some of the negative consequences of pro-cyclicality.

4. **Do not force insurers to pay 100% of claims on mortgages securitized into CMHC sponsored vehicles:** This opens insurers, and thus taxpayers, to counterparty risk as insurers have to pay the entire claim amount and then try to collect from lenders. In a severe stress event some lenders may face financial difficulties, thus increasing overall risk to the financial system. In the short term this means that mortgage insurers would not be able to materially reduce their premiums as they would have to maintain the same level of capital to reflect their 100% claim obligation.

5. **Eliminate the 10% deductible for private mortgage insurers under PRMHIA:** The proposed risk sharing structure would exacerbate the competitive disadvantage that the private sector has as a result of the different level of guarantee provided under PRMHIA and CMHC's 100% guarantee. As the chart below shows lenders already have an additional layer of risk exposure to private mortgage insurers through the PRMHIA deductible. To enable competition the PRMHIA deductible should be reduced to the extent that an upfront claims deductible is introduced through risk sharing. This would allow the private sector to compete on a more level playing field with CMHC and put private sector capital ahead of the taxpayer.

