THE GLOBE AND MAIL

December 26, 2012

# Ottawa's $800-billion housing problem

By TARA PERKINS AND GRANT ROBERTSON

*The Canada Mortgage and Housing Corp. was formed to provide homes for soldiers after the Second World War. But rising home prices and tinkering by governments have transformed it into a dominant - some say dangerous - force in the housing market. Tara Perkins and Grant Robertson examine the causes and risks of the federal government's massive exposure to Canadians' mortgages*

*Home prices have doubled over the last decade, propelled by low rates and easy mortgage terms. But as the U.S. experience proved, soaring property values can come with an ugly downside. The Globe and Mail examines the foundation of Canada's historic real estate boom in a series.*

The governor of the Bank of Canada was getting angry.

It was a sweltering afternoon in July, 2006, and David Dodge was meeting with executives at Canada Mortgage and Housing Corp. in Ottawa, in search of the answer to a pressing question: Why were they lowering their standards in such a reckless fashion?

As Canada's largest mortgage insurer, federally-run CMHC is a gatekeeper to the housing market, influencing who gets to buy a home and who doesn't. For decades it has sought to make it easier for people to enter the housing market, but it has also enforced some strict rules, requiring home buyers to make minimum down payments and pay off their mortgages in 25 years.

Now CMHC was abandoning its old ways. It was starting to allow more exotic kinds of mortgages, similar to what lenders were offering in the United States – 35-year loans, and loans on which the buyers had to pay only the interest at first, giving them low monthly payments at first but saddling them with more debt down the road.

To Mr. Dodge, these were irresponsible moves that would encourage some people to borrow too much or jump into the market before they were ready, creating new risks for the economy. "This is a mistake," he told CMHC brass bluntly.

Lower mortgage standards were going to cause already-frothy house prices to inflate even more – an "excessive exuberance," the governor called it – as buyers rushed in, borrowing greater amounts of money and purchasing bigger homes than they could otherwise afford.

"This is absolutely not the appropriate thing to do," a frustrated Mr. Dodge told the meeting.

CMHC president Karen Kinsley defended the changes, arguing that the mortgage insurer wasn't getting lax, and that borrowers would be as closely scrutinized as ever. But she had other concerns. For months, competitive pressure had been mounting on the Crown corporation to bring in more business.

Created in 1946 to help returning Second World War veterans find homes, CMHC had morphed over the years into a multibillion-dollar goliath that fuels bank lending and housing demand by insuring riskier mortgages, especially those in which the buyer has only a small down payment. Without that insurance, many more people would be shut out of the real estate market, unable to get a mortgage from a chartered bank.

It has also been a lucrative venture for the government. But that business was now being eroded as a result of the arrival of aggressive U.S. insurers into Canada.

The American companies were willing to do things CMHC had never done. Some were even backing "zero-down" mortgages in which the buyer borrowed every dollar needed to pay for the home.

It was a race to the bottom, and CMHC was playing along. "We didn't lead it ... As we lost market share, we would follow what the American companies were doing," said former CMHC chairman Dino Chiesa. With money available and the economy booming, home buyers streamed into the market and prices soared.

Mr. Dodge's warnings didn't cause CMHC to change course. But later, convulsions in the U.S. economy would. The bursting of the American property bubble showed that a rapid rise in home prices and household debt, built on a foundation of low interest rates and easy mortgages, could be a toxic combination. When the boom ended, it left a legacy of failed banks, foreclosed homes, recession and government debt.

It is a path that Canada is trying to avoid after a period in which home prices have risen much faster than incomes – faster than any other decade since the 1950s. To afford those houses and condos, Canadians now hold nearly $1.2-trillion of mortgage debt, nearly three times what they had in 2000. Households have almost $1.65 in debt for every $1 in after-tax income, the highest since Statistics Canada began keeping the data in 1990.

And in the process, the federal government has been taking on bigger risks as well. The federal government now backstops some $800-billion in mortgages, mostly through CMHC, the equivalent of almost half of Canada's annual economic output.

Those are the reasons that Finance Minister Jim Flaherty has been trying to halt the rise in debt and engineer a soft landing in the real estate market. A crash in home prices wouldn't just cause untold financial pain for Canadian homeowners – it has the potential to expose the federal government to huge liabilities for their mortgages.

How we got to this place is not merely the story of a historic boom in real estate. It's also the story of an institution that has grown into something it was never intended to be.

**The evolution of CMHC**

CMHC was an idea of the postwar government of Mackenzie King, who saw a need for federal intervention to find a place to live for tens of thousands of soldiers who were coming home. It also built some of the first social-housing projects in Canada.

At the time, home ownership was out of reach for many Canadians, even those in the burgeoning middle class. Lenders usually required a down payment of about 50 per cent, and the mortgage business was not very competitive, dominated by a small number of trust companies and insurers.

In the mid-1950s, Ottawa moved to change that, opening the doors to banks to grant mortgages and asking CMHC to begin offering mortgage insurance. The insurance kicks in if the homeowner fails to make payments on the loan, compensating the lender for any losses.

The creation of a federal guarantee knocked down one of the major barriers to entry in the housing market. Now it was possible to buy a home with a down payment of just 10 per cent; lenders would advance the money, knowing they were protected by Ottawa from bad borrowers and falling property markets. Home ownership rates went up; by the early 1970s, about six in 10 Canadians lived in a house they owned.

Still, the system had its limits. One was on length: CMHC would only guarantee mortgages of 25 years or less, to encourage people to pay off their homes in a reasonable time.

The length of a mortgage has a major impact on its cost to the borrower. Consider two homeowners taking out an identical $400,000 mortgage, at 4 per cent interest, making monthly payments.

The first pays off the loan in 25 years, shelling out $231,000 in interest over that time. The other takes 30 years, in order to enjoy lower payments along the way. But that extra five years adds more than $53,000 to his interest bill.

Mortgage insurance is also expensive, and in the past, most home buyers tried hard to scrape together the minimum down payment needed to avoid it. (Since 2007, that minimum has been 20 per cent of the purchase price; before that, it was 25 per cent.) In 1992, just one in five mortgages was insured.

CMHC quietly served this slice of the home-buying public and was largely ignored by its political masters. Canadians are reliable when it comes to repaying their mortgages, so insurance claims were minimal, and the company made money for the government.

Meanwhile, after an early-1990s correction in some regions, Canadian home prices began a long upward march. By the middle of the past decade, the country was in the middle of a virtuous circle. Higher home prices made a lot of consumers feel wealthier, fuelling consumer confidence, which in turn pushed up house prices even more. In 2006, the average price of a home in Canada had surpassed $250,000.

But prices were just about to really take off.

In 2006, the new Conservative government in Ottawa allowed CMHC to tinker with its tried-and-true formula. One of the key changes was in mortgage length: CMHC would insure mortgages 35 and 40 years in length.

The measures helped people like Sarah O'Brien, who bought her first home at the age of 26. She and her husband, Darryl Silva, purchased a condo three years ago in Etobicoke, on the western side of Toronto, with a down payment of just 5 per cent. Mortgage rates were low, which helped. But so did the bank's willingness to give them a CMHC-insured 35-year mortgage. The longer amortization held their biweekly payments to about $700.

"We're young to be getting into the real estate market, so if the monthly amounts were significantly higher, we probably wouldn't have," Ms. O'Brien said. "We probably would have waited."

The arrival of buyers like Ms. O'Brien and Mr. Silva has changed the market, however. Home buyers have responded to low rates and easy mortgage rules "by bidding up the price of houses," said bank analyst Peter Routledge at National Bank Financial. Since 2000, the price of houses across Canada has risen 127 per cent; they've gone up nearly 50 per cent since 2006.

"You can never really provide cheap housing," argues Moin Yahya, associate professor of law at the University of Alberta. "All you can really do is provide cheap cash, which of course then drives up the price of housing. You're only distorting the market."

How much did the mortgage rule changes contribute to the steep rise in home prices? That's not clear. Low rates and rising incomes have been significant factors, as has a perception that real estate is a more stable place to invest than, say, the stock market.

What is beyond dispute is that CMHC's rules have enabled a change in behaviour among home buyers like Ashleigh Egerton. When she and her boyfriend bought a townhouse in Brampton, Ont., in May, 2008, they could have made a 5 per cent down payment – but opted to put nothing down instead.

"Instead of putting that money into the house, we felt like we'd be off to a better start if we had some money to furnish the house," Ms. Egerton says. "I wasn't under the impression that I would be paying this house off. This wasn't the house that we would be staying in forever, it was just about getting into the market, getting a place."

But the zero-down mortgages created a new problem in the housing market: Buyers who weren't building any equity in their properties, since the payments were primarily covering the interest in the early stages of the loan. When Ms. Egerton moved out about two years later after splitting up with her boyfriend, the pair still didn't have any equity in the home.

**The market starts to unravel**

As CMHC was making it easier than ever to get a mortgage in Canada, it was also profiting from the boom. Its profits soared, rising from $376-million in 2000 to $1.03-billion in 2006.

Its balance sheet swelled. In 1996, CMHC was the insurer on $131-billion worth of mortgages; a decade later, it had more than doubled, to $291-billion. (It has since almost doubled again, to $576-billion by the end of September.)

By 2006, the year Stephen Harper's Conservatives took office, Department of Finance officials started to think about how to take some of that risk off the government's books. They mooted the idea of privatization. CMHC was a large, healthy corporation, already competing with private sector rivals. It looked strong enough to go out on its own.

A source close to the CMHC told The Globe and Mail that the discussions were serious. Had the global economy stayed robust, it's likely the Tories would have proceeded with selling the business.

That, of course, is not what happened.

By the summer of 2007, two things had become obvious. First, the U.S. real estate market was in trouble, with serious implications for its economy; second, problems in "subprime" mortgages – those given to riskier borrowers – were beginning to choke the credit markets.

Within a year, Fannie Mae and Freddie Mac – two U.S. financial institutions whose mandate, like CMHC's, is to promote home ownership by greasing the wheels of the home lending market – were nearing collapse and Washington started planning their nationalization.

The risks of easy money were now clear, and Mr. Flaherty was forced to respond. In July, 2008, he announced that government-backed mortgage insurance would no longer be eligible on 40-year mortgages. The new maximum was 35, and a down payment of at least 5 per cent would be required. The rules were scheduled to kick in Oct. 15.

By the time that date arrived, though, bad mortgage debt had tipped the world into a full-blown financial crisis; a global recession soon followed. Oil prices plunged, Canada's manufacturing sector seized up, and companies began laying off thousands of workers.

Ottawa had a few levers to try to cushion the drop. The real estate market was one of them. Mr. Flaherty and his mandarins realized that CMHC could play a useful role. By using its balance sheet, it could ensure that banks had the money so they would keep lending during the crisis.

So in early October – the week before his new mortgage rules took effect – Mr. Flaherty placed a call to a high-ranking CMHC official to deliver a command. The Crown corporation would need to start buying tens of billions of dollars in mortgages from Canada's banks, giving those banks cash to make new loans.

Under those orders, CMHC bought $69-billion worth of mortgages. It was a strategic move by the government: The banks continued to lend, Canadians continued to borrow, and after a short downturn, housing prices began to snap back in early 2009, helping to lead the country out of recession.

**Fears of a housing bubble**

Ottawa's plan worked – too well. By early 2010, home prices were rising so quickly that a number of bank CEOs had become concerned.

Mr. Flaherty asked officials in the Finance Department to get him more information on real estate speculation, according to 773 pages of government documents that were released to The Globe and Mail on Dec. 24, nearly seven months after they were requested under the Access to Information Act.

The minister's officials responded with a memo marked ``Secret`` on Feb 5, 2010, which included a section on mortgage insurance products.

Most of the memo has been redacted, and it is unclear what influence the memo had on Mr. Flaherty's next move. On Feb. 16, he announced new restrictions on CMHC insurance covering investment properties. He also cut the amount of equity that people were allowed to take out of their homes when refinancing.

The moves were made so quickly that Finance had yet to work out the details. In fact, the documents show that 10 days after Mr. Flaherty`s announcement, he received another memo that was labelled "secret" about how the changes would be implemented. "We plan to define an owner-occupied property as one where the borrower, or an immediate family member, occupies the premise," it said.

Yet questions about the housing market persisted. In April, 2010, Mr. Flaherty's department sent him an analysis of household debt, which noted that some analysts were raising concerns about a potential bubble.

"While the broad conclusion of this presentation is that there is no clear evidence that a housing bubble exists this is not to suggest that a housing bubble could not develop overtime [sic] in Canada," the internal memo said.

The economic risks associated with a bubble were significant, the memo said. "A house is most likely to be the single most important asset that Canadian consumers own. Housing is also the largest asset class in the economy. Changes in home prices, therefore, affect directly the wealth position of consumers and impact their spending patterns."

### The mortgage insurance 'sandbox'

Mr. Flaherty's swipe at CMHC did little to dampen enthusiasm for real estate. Vancouver`s runaway housing market, which saw prices rise by 19 per cent in the year leading up to April, 2010, was poised for further increases and had economists worrying that the situation was out of control.

By December of that year, Finance Department policy makers were plotting further changes to the mortgage insurance "sandbox," as they now called it, according to internal documents obtained by The Globe. They wrote a memo seeking a decision from Mr. Flaherty on possible new rules, under the subject line ``Sandbox Options: Housing Finance Changes."

The next moves came in January, 2011. Thirty-five year mortgages like Sarah O'Brien's were banned from the sandbox. The government further reduced the amount of equity that could be taken out, and said it would no longer guarantee insurance on home equity lines of credit.

In normal times, those steps might have been enough to cool the market. But as Europe tumbled into a severe economic and political crisis in 2010 and 2011 and the global economic recovery got weaker, interest rates stayed low, making mortgages cheap.

Canada`s banks added to that problem by getting caught up in a mortgage price war. Even so, Mr. Flaherty took no action.

Then, this past June, he and central bank governor Mark Carney flew off to G20 meetings in Los Cabos, Mexico.

By that point, Mr. Flaherty had already been contemplating yet another tightening of mortgage rules for at least a month, according to the documents obtained by The Globe. The Mexico summit reinforced one crucial point for the two men: The euro zone disaster will take years to repair. That meant central bankers like Mr. Carney would be unable to raise interest rates for fear of discouraging business activity.

But those same historically low rates were stoking the housing market. So Mr. Flaherty and Mr. Carney plotted one more move on mortgage insurance, a topic they stewed over on the six-hour flight home from Mexico.

The surprise announcement came the morning of June 21. The government cut the maximum length of an insured mortgage back to 25 years, effectively ending much of the experimentation of the past six years. CMHC would only back mortgages on homes bought for less than $1-million, and refinancing rules were changed for a third time.

Only a few years earlier, in the depths of the crisis, government policy encouraged consumers to borrow. Now the message has changed. First-time buyers are particularly affected by the new regime. People such as Ms. O'Brien and Ms. Egerton, who benefited from the easing of government policies before, would no longer be able to buy homes on those same terms today.

### CMHC's future role

Six months after Mr. Flaherty's latest crackdown, the "excessive exuberance" that once defined Canada's housing market has disappeared.

Home prices have not fallen much, but sales activity has, particularly in Greater Vancouver. Some who earn their living in the real estate business now blame the government for overcompensating in response to the heated housing market, and that Ottawa should not have meddled a fourth time in CMHC's rules.

But it will take much longer to answer the really big questions. Has the government managed to engineer a healthy correction in home prices – or something much worse? If prices do fall sharply, what will that mean for CMHC and its competitors, who now backstop nearly three out of four mortgages?

CMHC, which dominates the market by a wide margin, had about $286-billion of insurance outstanding, as of the end of 2011, on mortgages where the homeowner had a down payment of less than 20 per cent. It has a large cushion to absorb potential losses, but how steep would those losses be if the property market were to suffer a hard landing? "What's immediately at risk in the event of a significant downturn is the capital of CMHC, which is about $12-billion, so once they blow through that, then they start turning to the public purse," says Finn Poschmann, vice-president of research at the C.D. Howe Institute.

"To blow through that, you need unemployment that stays high for a little while and a significant increase in the number of mortgage defaults. That's not farfetched – it has happened before. We like to think that it won't happen, and that we're better at managing those risks, but good things happen and bad things happen and they're very difficult to predict."

Ms. Kinsley, CMHC's CEO, declined several interview requests from The Globe and would not comment for this article.

Whatever happens in the housing market, former central bank governor David Dodge thinks there's a bigger issue at stake. The rules that shape the housing market should not be subject to the whims of politicians, he says. Finance ministers should not be allowed to make them up on the fly, in the manner that Ottawa has over the past several years.

Mr. Dodge believes a system should be devised to measure house prices against other benchmarks, to determine when mortgage insurance rules need to be tightened or loosened, regardless of political considerations.

"There are different ways one can go at that, but you don't want it all in the hands of the Minister of Finance. Because generally, the pressures on the Minister of Finance are to do the wrong thing," he said.

Mr. Dodge also believes that the mortgage insurance system places too much emphasis on keeping banks healthy by protecting them from mortgage losses, rather than keeping the economy healthy by ensuring that housing supply is in line with demand.

Looking back on that angry meeting with CMHC executives in 2006, and with the benefit of seeing what has happened to the housing market, he stands by his criticism. "I have no reason to revise what I said at the time at all. I think [loosening the rules] was a mistake," Mr. Dodge said.

Even some former CMHC insiders are now calling for a radical rethinking of what the institution does.

Gary Mooney, a former director on CMHC's board, says "it is now time for root and branch reform," including "an honest evaluation of CMHC's relationship with our major financial institutions." Private competitors – of which there are currently only two – could play a bigger role in providing mortgage insurance, he suggests.

Mr. Flaherty has gone even further, asking whether the federal government should be in the business of guaranteeing loans for the benefit of banks. In a recent interview with The Globe, he said he wants Ottawa to look at privatizing CMHC in the next five to 10 years. Proponents of that idea say one of the main benefits would be to reduce the taxpayer's exposure to mortgages – and to a housing slump.

But Mr. Dodge argues that's not really the case. Ottawa is already in too deep.

"The system as a whole is too big to fail," he says.

"And when something is too big to fail, the government will come in."