Finance announces more changes to mortgage lending rules (February 2011)

For the third time in the past two and a half years, the federal Department of Finance has moved to tighten the rules which apply to mortgages backed by the Canadian Mortgage and Housing Corporation (CMHC).

To understand who will be affected by the new rules, some background is necessary. Under federal law, home purchasers whose down payment is less than 20% of the cost of the property must obtain mortgage insurance through the CMHC. That insurance, the premiums for which are paid by the homeowner, guarantees the lender that in the event of default by the homeowner the federal government will make good on any deficiency.

Over the past several years the federal government has become increasingly concerned about the amount of debt being carried by Canadian families, and much of the recent increase in that debt has been secured by borrowers' home equity. Of equal concern were the terms on which mortgages were being provided, as the amount of required down payment decreased and the time period over which the funds could be repaid (the amortization period) got steadily longer. Canadian mortgage lending practices never approached the degree of recklessness which came to characterize American mortgage lending in the past decade. Nonetheless, the federal government became concerned that Canadians were taking on more and more debt related to home purchases and were carrying that debt for unprecedented lengths of time.

In October 2008, the federal government moved to raise its minimum standards for CMHC-insured mortgages, and implemented the following changes.

- **Fixing the maximum amortization period for new government-backed insured mortgages to 35 years.**
- **Requiring a minimum down payment of five per cent for new government-backed insured mortgages.**
- **Establishing a consistent minimum credit score requirement.**

- **Requiring the lender to make a reasonable effort to verify that the borrower could afford the loan payment.**
- **Introducing new loan documentation standards to ensure that there was evidence of reasonableness of property value and the borrower's sources and level of income.**

In April 2010, the federal government took additional steps to impose more stringent creditworthiness requirements on borrowers, to limit the extent to which homeowners could borrow against their equity when refinancing their homes and, finally, to require that purchasers of non-owner occupied homes put down at least a 20% down payment on purchase.

The most recent in this series of changes was released on January 17, 2011, as the Minister of Finance announced that new measures would be taken to further limit both the amount of borrowing which could be undertaken by home owners on refinancing and the time period over which home borrowings could be amortized.

Prior to the October 2008 changes, some financial institutions had been offering 40 year amortizations to prospective homeowners. The maximum amortization period was reduced to 35 years by the 2008 announcement and has now been reduced again to 30 years. While the government recognizes that a shorter amortization period will, of course, mean larger monthly payments, it is concerned that amortization periods longer than 30 years increase the likelihood that Canadians will carry a mortgage into retirement—a poor financial strategy by anyone's measure.

The second change announced will further limit the extent to which homeowners can borrow against the value of their homes when refinancing a mortgage. The April 2010 changes reduced the maximum borrowing in such circumstances to 90% (down from 95%) of the home's current value. The maximum borrowing on a refinancing has now been reduced to 85% of the home's value. In announcing that change, the Department of Finance indicated that part of the purpose of the measure was to limit the “repackaging” of consumer debt into mortgages guaranteed by the federal government. Reducing the loan-to-value ratio in this way will also reduce the likelihood that homeowners who have re-financed to the maximum extent possible will be faced with a situation in which their homes will, as the result of a drop in real estate values, be worth less than the amount they owe on them—an all-too-common situation in the United States over the past few years

Finally, the federal government will no longer provide CMHC insurance on lines of credit secured by homes, where such lines of credit do not have specific principal repayment requirements. Home equity lines of credit (HELOCs) have grown enormously in popularity over the past decade. While HELOCs are like conventional mortgages in that they are secured by the value of the property, they differ from such mortgages in two critical respects. First, homeowners are usually provided with a HELOC for a fixed maximum amount of up to 80% of the value of the home. However, the uses to which funds advanced through a HELOC can be put are not limited to home acquisition or housing-related costs. HELOCs can be (and have been) used for everything from paying off credit card balances to paying for vacations to buying big screen TVs. And, of course, every dollar borrowed through a HELOC reduces the homeowner's equity. The second major difference is that, in most cases, HELOC borrowers do not have fixed repayment obligations. While monthly payments are required, those payments can be as little as the interest amount accrued during the previous month. The homeowner can therefore continue to add to the debt represented by the HELOC while at the same time paying only the accrued interest and never reducing the principal amount owed.

It Is not hard to see how having access to large amounts of credit through a HELOC could easily lead to an unmanageable debt load for the undisciplined or unsophisticated borrower. It Is for that reason that financial institutions generally offer HELOCs only to borrowers who have a significant amount of equity in their homes and some history of being able to manage credit. Nonetheless, the fact that the federal government will no longer provide CMHC insurance for most HELOCs is a measure of its concern over the current extent (and purposes) of HELOC borrowing by Canadians.

Both the Minister of Finance and the Governor of the Bank of Canada have commented recently on the amount of debt carried by Canadian households and the impact that an increase in interest rates would have on the ability of many of those households to handle that debt load. Given that concern, it is likely that this latest round of changes restricting the ability of Canadians to tap into their home equity or to extend the period over which mortgage debt can be repaid will not be the last.