OPPORTUNITY
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Backgrounder

Economic Opportunity:

Making Housing Affordable and Helping Small Business

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Background

Squeezed by the increasing cost of living, high income taxes, sluggish wage growth and stubbornly high unemployment, Canadian families are finding it harder and harder to make ends meet.

Small- to medium sized enterprises (SMEs) are also finding it harder to get financing. Canada has low levels of business investment relative to many of our economic competitors. This low level of business investment is one reason for our low productivity growth rate. This low productivity growth rate is of particular concern since it is the only long-term determinant of wealth and prosperity.

These two challenges are interrelated. Governments need to take a hard look at macro-economic policies that make life less affordable, policies that are also making it difficult for SMEs to invest, grow and create jobs.

Statistics Canada has been tracking household expenditures since the 1960s. Currently, the top four household expenditures, in order of cost, are housing, income taxes, transportation and food.

The cost of transportation has remained relatively constant over the last 50 years, at about 14% of a household's gross income.

The cost of food has plummeted. Before the Second World War, the average Canadian household spent about a third of their gross household income on food. By the 1960s, this had dropped to about 20% of a household income. Since then, the cost of food has dropped even more. Today, the average Canadian household spends about 10% of their gross income on food. Until the 1960s, food was the single biggest expenditure for households; now it ranks third.[1,2] Never before in history has food been so inexpensive and affordable for Canadian families.

Clearly, the cost of transportation and food is not what is making life less affordable for Canadian families. Rather, it is the cost of housing and the level of income taxes that is driving unaffordability.

The level of taxation and the cost of housing have skyrocketed. Quite simply, income taxes are too high and houses are too expensive.

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[1] *Survey of Household Spending, Statistics Canada (2014)* <http://www.statcan.gc.ca/daily-quotidien/160212/dq160212a-eng.htm>

[2] *Spending Patterns in Canada: Analysis, Statistics Canada* <http://www.statcan.gc.ca/pub/62-202-x/2007000/part-partie1-eng.htm>

Income taxes have gone from about 12% of gross income in the 1960s to about 18% today – a 50% increase.[3,4]

Housing has gone from costing less than 15% of a household's gross income in the 1960s to 21% today, and two percentage points of that 6% increase has been in the last 10 years alone.[5,6]

This paper will propose measures to make housing more affordable, while at the same time help SMEs access financing.

The Plan

A Conservative Party led by Michael Chong will:

- Privatize Canada Mortgage and Housing Corporation's (CMHC's) mortgage insurance and securitization business; and
- Strengthen the Office of the Superintendent of Financial Institutions (OSFI) to ensure that Canada's banks do not take undue risk and undermine the stability of the Canadian financial system.

The Results

Privatizing CMHC's mortgage insurance and securitization business, and strengthening OSFI's oversight over the mortgage market will:

- Make housing more affordable for Canadian families;
- Increase financing available for small- and medium-sized enterprises;
- Lessen the risk to Canadian taxpayers; and
- Reduce federal debt and interest payments.

Making Housing More for Canadian Families

While many factors (land use planning, rapid population growth, foreign buyers, low interest rates, etc.) have contributed the rapid increase in housing prices, the single biggest factor has been the massive expansion of government-backed mortgage credit over the last 15 years. This

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[3] *Three Decades of Economic and Financial Change in Canada: 1969 to 1999* <http://publications.gc.ca/Collection-R/LoPBdP/BP/prb015-e.htm>

[4] *Survey of household spending (SHS), Statistics Canada* <http://www5.statcan.gc.ca/cansim/a26?lang=eng&retrLang=eng&id=2030021&&pattern=&stByVal=1&p1=1&p2=31&tabMode=dataTable&csid=>

[5] ibid.

[6] *Survey of Household Spending, Statistics Canada (2004)* <http://www.statcan.gc.ca/daily-quotidien/051212/dq051212a-eng.htm>

has contributed to what many argue is a housing bubble. It is this rapid increase in housing prices has made housing unaffordable for middle-class families in many of Canada's larger cities.

The federal government allowed CMHC to rapidly expand mortgage credit through the 2000s and 2010s, by increasing the limit on CMHC's guarantees-in-force. From $300 billion in 2005, CMHC's legislated limit now sits at $600 billion in 2016. It is no coincidence that the doubling of CMHC's annual legislated limit on guarantees-in-force during this period has also mirrored the doubling of mortgage debt held by Canadians during the same period, from about $650 billion to $1.3 trillion.[7]

A study by the International Monetary Fund (IMF) found that government intervention in housing finance exacerbated house price swings and amplified mortgage credit growth in advanced economies in the years before the global financial crisis. Moreover, the IMF's study also concluded that government participation did not provide a cushion against economic crisis, and countries with greater government involvement in mortgage financing experienced deeper house price declines. In a 2011 analysis, the IMF concluded that "…that rapid mortgage credit growth and strong house price increases go hand in hand …", and that "… government participation in housing finance exacerbated house price swings and amplified mortgage credit growth during the run-up to the recent [2008 financial] crisis, particularly in advanced economies." The IMF analysis also stated that "[c]ountries with more government involvement also experienced deeper house price declines."[8]

In the Vancouver area market, the average single detached house now costs $1.4 million[9] about 18 times the median household income of about $80,000 per year, well above the long term average. This year, the average single detached house in the Greater Toronto Area surpassed a million dollars.[10] Similarly high housing prices can be found in other Canadian cities. As a result, the average home price in Canada is now about 5.5 times household income, much higher than the historic average of about 3.5 times.[11]

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[7] *National Balance Sheet Accounts, Statistics Canada* <http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=3780122>

[8] *Global Financial Stability Report, International Monetary Fund, page 111 (April 2011)* <https://www.imf.org/external/pubs/ft/gfsr/2011/01/pdf/chap3.pdf>,

[9] *Housing Trends and Affordability, RBC (June 2016)* <http://www.rbc.com/economics/economic-reports/pdf/canadian-housing/house-jun2016.pdf>

[10] *"Average new GTA house tops $1M for first time," The Toronto Star (April 21, 2016)* <https://www.thestar.com/business/2016/04/21/average-new-gta-house-tops-1m-for-first-time.html>

[11] *"A house for three times your income? Think again" The Globe and Mail (November 8, 2015)* <http://www.theglobeandmail.com/real-estate/mortgages-and-rates/canadas-old-standards-of-housing-affordability-need-an-update/article27126408/>

Not only does government intervention lead to skyrocketing housing prices, in the long-term it also leads to lower ownership rates. According to the IMF, countries with government intervention in the mortgage market are more prone to housing crashes. In the US, government intervention in the mortgage housing finance precipitated the 2008 housing crash. Since the crash, US homeownership rates have plummeted to their lowest levels in decades.[12]

The huge increase in housing prices has also significantly increased household debt, putting Canadian families at risk in the event of a correction in housing prices. From June 2006 to June 2016, Canadian household debt skyrocketed from $1.04 trillion to $1.93 trillion, almost doubling over that decade.[13] The evidence is that this adverse build-up of unsustainable levels of household debt is largely due to the expansion of government-backed mortgage insurance and securitization.

While short-term measures (adjusting amortizations, down payments, risk sharing, etc.) can be taken to temper Canada's housing market, in the long-term, privatizing CMHC's mortgage insurance and securitization business is the most important measure that can be taken to increase housing affordability for Canadian families. Privatization of CMHC's mortgage insurance business was something proposed by former finance minister Jim Flaherty, when he suggested in October 2012 that CMHC be privatized in the following five to ten years.[14]

Research indicates that government-backed mortgage insurance is not necessary in order for the residential mortgage industry to operate successfully. In many advanced economies the mortgage insurance market operates well without government-backed mortgage insurance. In fact, private-sector insurers, like Genworth Canada and Canada Guaranty, currently operate in the Canadian mortgage insurance market.

Getting the government out of the business of providing mortgage insurance and securitization, and strengthening OSFI's oversight of the banking system, will ensure more sustainable mortgage credit growth rates, reducing the risk of housing asset bubbles and the associated steep declines. This is most important thing government can do to ensure that housing returns to more affordable levels for Canadian families.

CMHC currently plays a role in providing direct assistance to Canadians in housing need, such as low-income families, seniors, people with disabilities and aboriginal people. This direct

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[12] *The U.S. Homeownership Rate Falls Again, Nearing a 48-Year Low, The Wall Street Journal (April 28, 2016)*
[13] *National Balance Sheet Accounts, Statistics Canada* <http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=3780122>
[14] *"Flaherty eyes privatization of CMHC," The Globe and Mail (October 22, 2016)* <http://www.theglobeandmail.com/real-estate/the-market/flaherty-eyes-privatization-of-cmhc/article4627593/>

assistance should be continued by the federal government, and these functions could be transferred to an existing federal department.

Increasing Financing Available for SMEs

There is also evidence that CMHC's expansion of mortgage credit has also made it much more difficult for small- and medium-sized enterprises to access capital. This is because the banks have a government incentive to focus on mortgage lending and not on SME lending. This has resulted in the allocation of capital away from more productive uses such as business investment, reducing Canada's productivity rate and diminishing long-term prosperity.[15]

Robert Cardarelli, the IMF's mission chief to Canada, has called for the government to limit government-backed mortgage insurance in order to help increase financing available to SMEs. The IMF has concluded that Canada's government-backed insurance has distorted the allocation of capital by giving the banks an incentive to lend for mortgages rather than lend to SMEs.[16] This in turn has reduced the amount of capital for more productive uses, such as machinery and equipment. This is of particular concern, since Canada's low levels of business investment lags that of our major economic competitors and is one reason for our low productivity growth rates.[17] Productivity growth is the only long-term determinant of wealth and prosperity.

Privatizing CMHC's mortgage insurance and securitization business will take away the current disincentive for banks to loan to SMEs. This will make more capital available to SMEs, thereby increasing business investment, productivity and long-term prosperity.

Lessening the Risk to Canadian Taxpayers

CMHC's guarantees-in-force carry the full faith and credit of Canada, and they constitute direct, unconditional obligations of and by Canada. A paper released by the C.D. Howe Institute in February 2011 concluded that CMHC's mortgage insurance business "… subjects Canadian taxpayers to large, ill-defined risks."[18]

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[15] *Canada— 2013 Article IV Consultation Concluding Statement of the Mission, International Monetary Fund (November 26, 2013)* <https://www.imf.org/en/News/Articles/2015/09/28/04/52/mcs112613>

[16] *"IMF wants Ottawa to scale back CMHC's mortgage insurance" The Globe and Mail (November 27, 2013)* <http://www.theglobeandmail.com/report-on-business/economy/tenuous-european-economy-a-significant-risk-to-canadian-growth-conference-board/article15625943/>

[17] *Capital Needed: Canada Needs More Robust Business Investment, C.D. Howe Institute (July 2013)* <https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/e-brief_179.pdf>

[18] *What Governments Should Do in Mortgage Markets, C.D. Howe Institute (January 2011)* <https://financialinsights.files.wordpress.com/2011/02/commentary_318.pdf>

Privatization of the mortgage and securitization business, in a way that removes the full faith and credit of Canada, would limit the present and future liability of the federal government. This will ensure the federal government gets out of the business of "privatizing profit" and "socializing risk." It will reduce the risk to Canadian taxpayers – especially the third of households who do not own a home and are predominantly lower income – who are ultimately liable for CMHC's guarantees-in-force.

In parallel to the privatization of CMHC's mortgage insurance and securitization business, the Office of the Superintendent of Financial Institutions Canada (OFSI) should be strengthened to ensure sufficient oversight and supervision of Canada's housing finance sector. Mandated to contribute to public confidence in the Canadian financial system, OFSI has effectively demonstrated the ability to supervise, advance, advise and administer issues pertaining to Canada's financial system. Currently, oversight and supervision of housing sector finance is split among OSFI, the Department of Finance and CMHC. OFSI's mandate should be extended to include more comprehensive oversight of housing sector finance. This would also ensure that banks, especially systemically important ones, do not require a public bailout due to excessive risk taken in housing finance.

Reducing the Federal Debt and Interest Payments

In August 2016, AIG sold its mortgage insurance unit, United Guaranty Corporation (UGC), for $3.4 billion USD.[19] UGC has about $186 billion USD mortgage insurance in force as of 2016.[20]

With total insurance-in-force of $520 billion as at March 31, 2016,[21] CMHC's mortgage insurance and securitization could fetch billions of dollars. This money should be used to pay down the national debt.

In addition to reducing the federal debt, privatizing CMHC's mortgage insurance and securitization would have generate two other benefits. First, for every $1 billion in proceeds from the privatization, federal interest charges on the debt would be reduced by $12 million annually, based on the current 10-year Government of Canada benchmark bond yield of 1.2%. Second, removing CMHC's debt obligations from the government would reduce the cost of capital for the remaining debt obligations of the Government of Canada. For example, a 10 basis point reduction in the cost of capital would result in annual savings of $100 million for every $100

[19] *"AIG Reaches Deal to Sell Mortgage-Insurance Unit to Arch Capital for about $3.4 Billion," The Wall Street Journal (August 15, 2016)* <http://www.wsj.com/articles/aig-nears-deal-to-sell-mortgage-insurance-unit-to-arch-capital-for-about-3-4-billion-1471280311>

[20] *"AIG reaches agreement to sell United Guaranty Corporation to Arch Capital for US$3.4 billion," Canadian Underwriter (August 17, 2016)* <http://www.canadianunderwriter.ca/insurance/aig-agrees-sell-united-guaranty-corporation-arch-capital-us3-4-billion-1004098340/>

[21] *CMHC Releases 2016 First Quarter Results, Canada Mortgage and Housing Corporation* <https://www.cmhc-schl.gc.ca/en/corp/nero/nere/2016/2016-05-30-0900.cfm>

billion in interest bearing federal debt. While these two benefits are not significant in the current low-interest rate environment, they will become significant should interest rates go up.

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Appendix 1 – A Brief History of CMHC

1954: Introduction of government-backed mortgage insurance: Minimum down payment of 25%
1984: Mortgage Insurance Fund has a deficit of $1.7 billion (2016 dollars), largely due to the Assisted Homeownership Program (AHOP) and the Assisted Rental Program (ARP)
1999: Introduction of a 5% down payment (pilot in 1992, permanent in 1999)
2003: Elimination of $250,000 house price ceiling for mortgage insurance
2007: Maximum amortization increased from 25 years up to 40 years; minimum down payment reduced from 5 to 0%
2008: Maximum amortization period reduced from 40 to 35 years; minimum down payment increased from 0 to 5%
2010: Maximum mortgage refinancing is cut from 95 to 90%; minimum down payment increased to 20% for second properties
2011: Maximum amortization period is reduced again from 35 to 30 years; maximum mortgage refinancing is cut from 90 to 85%
2011: No more mortgage insurance on home equity lines of credit (HELOCs)
2012: The maximum amortization drops from 30 to 25 years; maximum mortgage refinancing is cut from 85 to 80%; re-introduction of house price ceiling for mortgage insurance, set at $1 million
2016: The minimum down payment increases from 5 to 10% for the portion of house price over $500,000.

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Appendix 2 - History of CMHC's Annual Legislated Limits on Guarantees-in-Force

2016 - $600 billion
2015 - $600 billion
2014 - $600 billion
2013 - $600 billion
2012 - $600 billion
2011 - $600 billion
2010 - $600 billion
2009 - $600 billion
2008 - $450 billion
2007 - $350 billion
2006 - $350 billion
2005 - $300 billion
2004 - $300 billion
2003 - $250 billion
2002 - $250 billion