CANADA MORTGAGE AND HOUSING CORPORATION

August 2016

Research Insight

Risk Profile of Mortgage Investment Corporations

Main findings

Although our understanding of Mortgage Investment Corporations (MICs) is limited by a shortage of data, the available evidence suggests that these lenders presently play a relatively small role in the residential mortgage market. Their relatively small share of the mortgage market coupled with incentives to effectively manage risks suggests that the potential for MIC activity to create systemic risk is limited.

The research presented in this note is exploratory nature and pertains to just one group of unregulated lenders, MICs. The findings are drawn mainly from the research report "Growth and Risk Profile of the Unregulated Mortgage Lending Sector," based in part on a survey[1] of MICs.

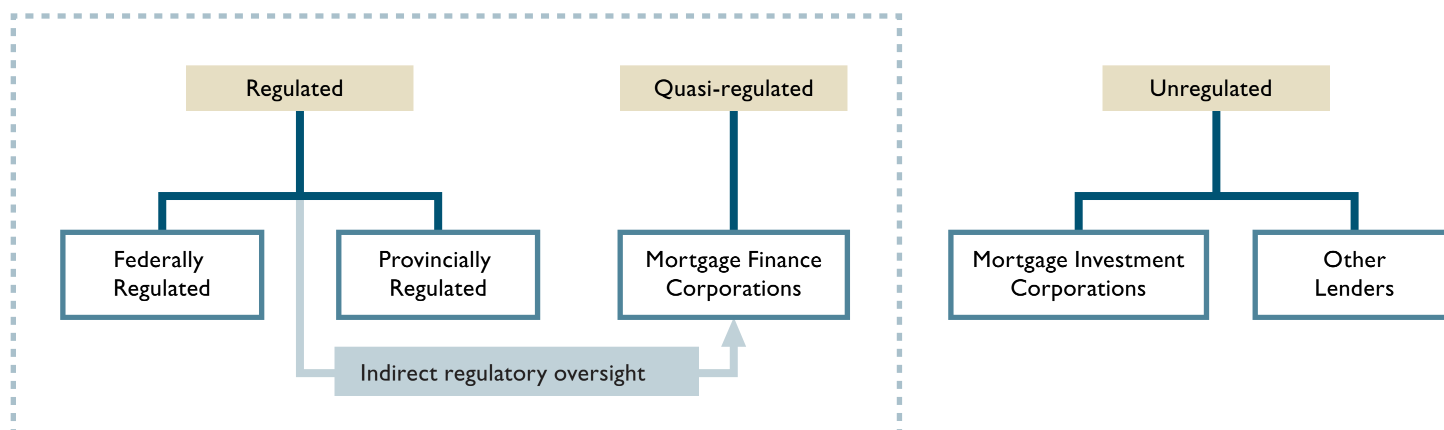
Three segments of lenders in the Canadian mortgage market

Canadian mortgage lenders can be divided into three broad segments corresponding to the degree of regulatory oversight of their lending practices: regulated lenders, quasi-regulated lenders and unregulated lenders (See Figure 1).

Regulated lenders

Regulated lenders comprise federally-regulated banks and trust companies[2] as well as provincially-regulated credit unions and caisse populaires. These lenders, which include the big six banks[3], are subject to direct regulatory oversight. Moreover, they provide the vast majority of residential mortgage lending in Canada.

Figure 1: Mortgage Lenders in Canada



[1] While the survey respondents were not drawn from a random sample of MICs, the firms included are believed to be representative of the MIC landscape.

[2] Trusts are financial institutions that, like banks, take deposits and make loans; they provide other services that banks are prohibited from providing, such as administering estates, trusts and pension plans. These firms are often subsidiaries of banks, and may be federally-regulated or provincially-regulated.

[3] Canada's big six banks are National Bank of Canada, Royal Bank, Bank of Montreal, Canadian Imperial Bank of Commerce, Bank of Nova Scotia and TD Canada Trust.

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Quasi-regulated lenders

Mortgage Finance Companies (MFCs) are large financial institutions that underwrite and service insured residential mortgages sourced from mortgage brokers. The mortgages underwritten by an MFC are typically sold to federally-regulated financial institutions (FRFIs) or securitized through CMHC's securitization program[4]. Since mortgages purchased by FRFIs must conform to federal government mortgage lending rules, MFCs are indirectly subject to these same rules. Similarly, to qualify for CMHC securitization, MFC mortgages must adhere to federal government guidelines for insured mortgages. These lenders are therefore described as quasi-regulated[5].

Unregulated lenders

Unregulated residential mortgage lenders[6], the third and smallest group of mortgage lenders, are the subject of this note. In Canada, unregulated lenders include corporations, individuals, and other entities that offer mortgages but which are typically subject to neither federal nor provincial mortgage lending rules and guidelines. Unlike banks, trust companies, insurers, and credit unions, these firms' do not take deposits and are not subject to federal government mortgage lending rules and oversight. For example, they are not subject federal rules about the amount of funds they must keep in reserve for credit losses arising from mortgage loans.

Since unregulated lenders are not subject to the regulatory oversight (e.g., capital requirements, loan-to-value limits) of regulated lenders, some observers have expressed concerns about their growth and potential risk to the financial system.

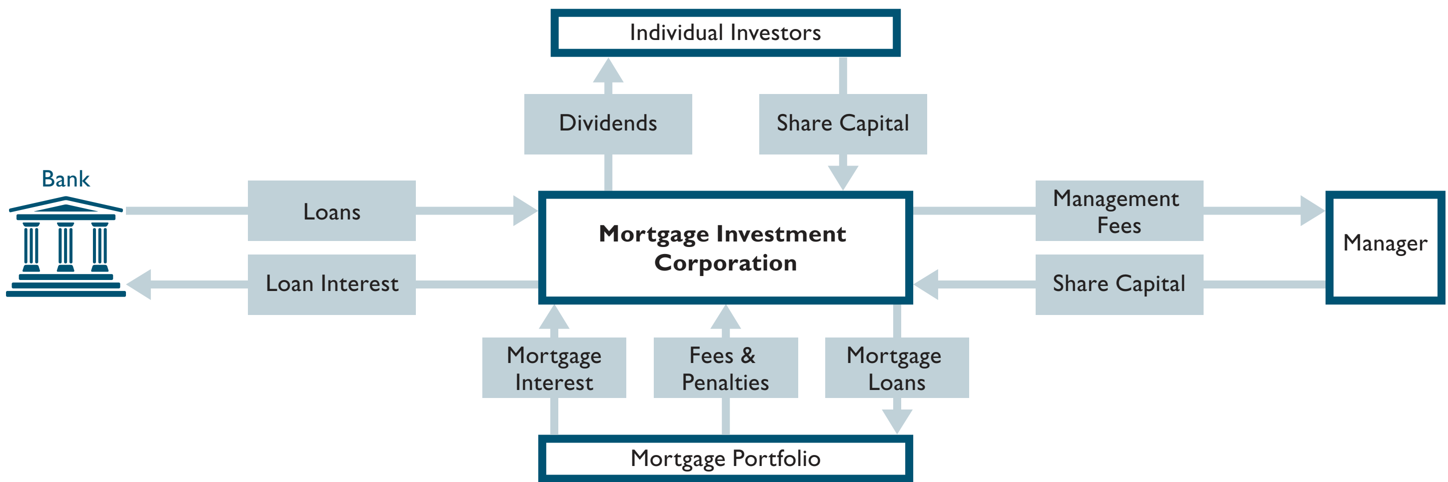
Mortgage Investment Corporations

The federal government introduced laws enabling the creation of MICs in 1973. MICs are unique corporations established mainly for the purpose of increasing the "flow of mortgage funds" and providing a channel for small investors to participate in the residential and real estate markets[7]. As unregulated entities, MICs do not take deposits and are not subject to federal or provincial mortgage lending rules[8].

The main activity of an MIC is residential mortgage lending. Indeed, under Canadian law, MIC lending is limited to the financing of real property in Canada, and at least 50% of their assets must be invested in residential mortgages or insured deposits.

MICs pay no corporate taxes when they remit all of their income as dividends to shareholders (See Figure 2 for an overview of the structure of an MIC). Moreover, share ownership in a MIC is eligible for government deferred and tax-sheltered plans[9], meaning that dividend income flowing into these registered plans incur no taxes. These features, coupled with the prospect of above-average returns, may provide an incentive for some Canadians to invest in MICs.

Figure 2: Structure of a Mortgage Investment Corporation



4 To qualify for CMHC securitization, an MFC's mortgages must be insured against borrower default. Insurance can be obtained from any Canadian mortgage insurer.

5 Some of Canada's top MFCs include First National, MCAP, Street Capital, Paradigm Quest, Investors Group.

6 In this note, we use the terms *unregulated lenders* and *unregulated residential mortgage lenders* interchangeably.

7 The motive for establishing MICs is described in a 1973 speech by Honourable Stanley Ronald Basford, then Minister of State for Urban Affairs. See http://parl.canadiana.ca/view/oop.debates_HOC2901_05/84?r=0&s=3.

8 One exception is MCAN Mortgage Corporation, one of the largest MICs in the country. MCAN is a publicly-listed financial institution that accepts certain types of deposits and which is subject to federal mortgage lending rules.

9 Eligible plans include Registered Retirement Savings Plans, Registered Education Savings Plans, registered retirement income funds, tax free savings accounts, life investment funds, locked-in retirement accounts, individual pension plans, and registered disability savings plans.

Some of the largest MICs include MCAN, Rompsen, Timbercreek, Atrium, Firm Capital and Antrim (See Figure 3).

MICs typically lend to borrowers less served by traditional lenders

MICs provide mortgages to borrowers who, due to their credit history and credit risk profile, would typically not qualify for a loan with a regulated financial institution. Such borrowers, who fall outside the underwriting rules and guidelines followed by regulated lenders, may include self-employed individuals whose incomes are more difficult to verify, real estate investors and recent immigrants.

The loans advanced by MICs typically have a lower LTV ratio, usually less than 80% of the value of the residential property. Still, a number of these firms offer second and even third mortgages[10], meaning that a portfolio of loans with relatively low LTVs may not always provide an accurate picture of the risk profile of an MIC.

MICs normally charge higher mortgage rates compared to regulated and quasi-regulated lenders. Since the interest rate charged is risk-based, it tends to vary across borrowers, reflecting their respective credit risk. Available evidence suggests that these lenders account for the majority of unregulated lenders and, in terms of value, the bulk of sub-prime lending in Canada.

MICs typically provide short-term mortgages, with terms lasting six to 24 months. MICs market themselves as a more flexible alternative to traditional mortgage lenders. This flexibility has to do with their lending terms and ability to structure loans to meet the specific requirements of a borrower. Of course, flexibility also arises from the fact that their lending activities are less constrained by government regulatory oversight.

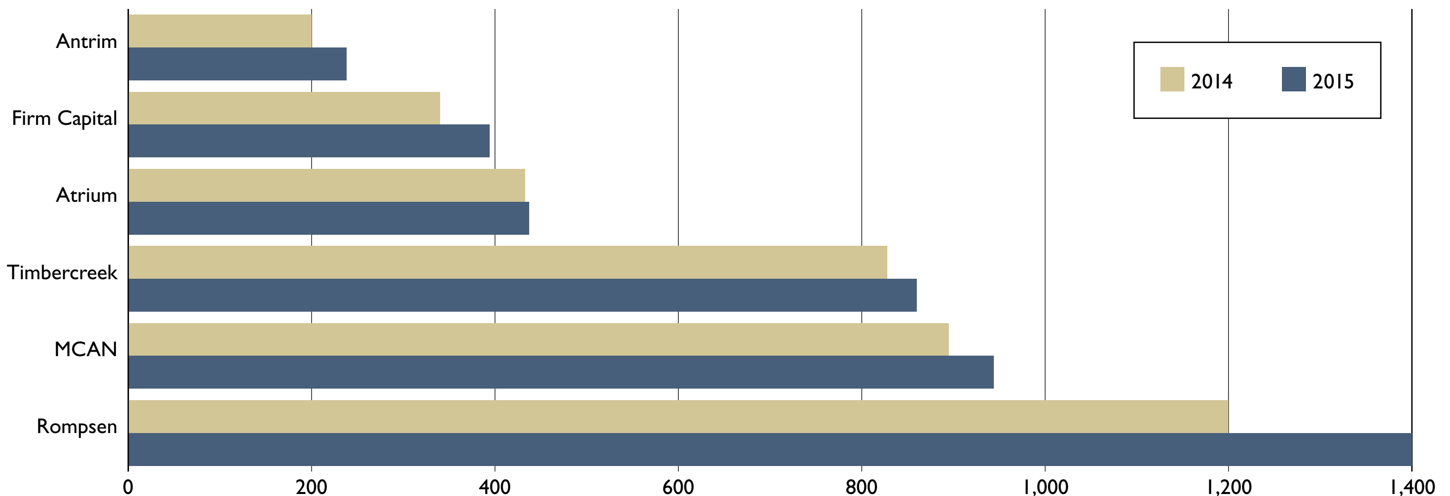
MICs account for a small and growing share of the mortgage market

The number of MICs is estimated to be between 200 and 300 firms. In 2015 the estimated value of MIC mortgage credit outstanding was less than 1% of total mortgage credit outstanding, suggesting that these lenders play a marginal role in the housing finance system. With at least 36 MICs formed since 2007, it appears that there has been significant growth in this class of lenders in recent years.

MICs concentrated in British Columbia

MICs tend to be headquartered primarily in Ontario and Western Canada, with the majority of their head offices (about 61%) located in the West. Of the MICs studied in this research, just over one-half are headquartered in British Columbia.

Figure 3: Top Mortgage Investment Corporations
Mortgage Portfolio ($millions)



Source: Company annual reports, and adapted from Fundamental Research Corporation

[10] When a mortgage goes into default and foreclosure, the lender holding the first mortgage is first in line to recover monies outstanding. Any remaining funds from the sale of the property would then go to the holder(s) of any second or third mortgage(s). For some MICs, such as Ginkgo Mortgage Investment Corporation, the business model is based primarily on second mortgages, which charge a significantly higher interest rate. Ginkgo's web site notes a rate of 12%-16% for second mortgages.

Mortgage Investment Corporations Risk Profile

Business model creates incentives for MIC risk management

Unlike MFCs, who securitize their mortgage loans or sell them to banks, MICs tend to hold their mortgages on their books. This, plus the fact that they operate in the higher risk, uninsured part of the market, suggests that MICs have a strong incentive to effectively manage credit risk.

Moreover, the *Income Tax Act* sets some limits on MIC leverage. For a lender to retain its MIC status it must maintain a certain debt-to-equity ratio, with the ratio ranging from three-to-one to five-to-one, depending on the amount of assets invested in residential mortgages or insured deposits.

The study's findings suggest that MICs do have measures in place to control credit risk. The loans advanced to borrowers typically have LTVs ranging from 50% to 85%, potentially providing them with some protection against the risk of significant house price declines. The short duration of their loans means that they may be less exposed to large fluctuations in interest rates and house prices. Larger MICs tend to hold more geographically diverse mortgage portfolios, which could likewise help to reduce their risk exposure. Smaller MICs hold more concentrated portfolios.

Some of the larger MICs are publicly-traded companies[11]. Like other publicly-traded firms, they are likely to be more transparent about their activities and have a more diverse funding base.

At least 40% of the MICs use bank lines of credit as a source of capital, suggesting that banks' lending requirements could positively influence their risk-taking and risk management practices. Still, the use of bank funding also exposes these lenders to the risk of a sudden withdrawal of that funding.

MICs unlikely a major source of risk to the housing finance system

While there remain gaps in our understanding of MIC mortgage lending practices and business models, available evidence suggests that these lenders presently play a relatively small role in the residential mortgage market. This means that the potential for this segment of the mortgage market to create systemic risk is limited.

[11] These include MCAN Mortgage Corporation, Timbercreek Mortgage Investment Corporation, and Atrium Mortgage Investment Corporation.

Further reading:

FULL REPORT

Growth and Risk Profile of the Unregulated Mortgage Lending Sector

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Printed in Canada
Produced by CMHC 26-08-16

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Alternative text and data for figures

Figure 3: Top Mortgage Investment Corporations Mortgage Portfolio ($millions)

	2014	2015
Antrim	200	238
Firm Capital	340	394
Atrium	433	437
Timbercreek	828	860
MCAN	895	944
Rompsen	1200	1400

Source: Company annual reports, and adapted from Fundamental Research Corporation