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Lesson 1

Introduction to Mortgage Finance and Market Participants

Learning Objectives

After completing this chapter, the student should be able to:

1. explain the advantages and disadvantages of relying on mortgage finance for purchasing real property;
2. describe and illustrate the concept of financial leverage;
3. discuss the history of the Canadian mortgage market, including the significance of CMHC and the role of the Bank of Canada;
4. identify the major participants in the Canadian mortgage market and comment on their respective roles: chartered banks, credit unions and caisses populaires, trust companies, mortgage loan companies, insurance companies, mortgage investors and dealers, pension funds, NHA mortgage-backed securities, private lenders, and mortgage brokers;
5. define mortgage-backed securities and discuss their introduction into the Canadian secondary mortgage market;
6. compare and contrast residential and non-residential mortgages in the Canadian financial market;
7. identify and discuss historic trends in mortgage interest rates and in the size of mortgage loans over time;
8. explain the role of the mortgage market within the larger financial marketplace;
9. explain the relevance of money markets and capital markets for mortgage finance;
10. discuss the components of mortgage interest rates and the relationship between mortgage interest rates, investment risk, and investment term;
11. describe the supply of and demand for mortgage funds; and
12. identify and explain the characteristics of mortgage loans as investments.

ASSIGNED READING

1. UBC Real Estate Division. 2016. *BUSI 221 Course Workbook*. Vancouver: UBC Real Estate Division.
Lesson 1: Introduction to Mortgage Finance and Market Participants
2. UBC Real Estate Division. 2016. *Real Estate Finance in a Canadian Context*. Vancouver: UBC Real Estate Division.
Chapter 1: Introduction to Mortgage Finance – Past and Present
Chapter 2: Mortgage Finance Market Participants

RECOMMENDED READING

1. Kirby, J. "The Insane Expectations Driving the Canadian Housing Market". *Maclean's*. March 8, 2016. www.macleans.ca
This article discusses the potential factors behind the rising average prices for single-family detached homes in Canada.
2. Allen, J. "Competition in the Canadian Mortgage Market". *Bank of Canada Review*. Winter 2010-2011. www.bankofcanada.ca
This report summarizes the research conducted by the Bank of Canada, which analyzed the Canadian mortgage market. In particular, this report seeks to understand how the interaction of market structure, product differentiation, and information frictions determines rates in the Canadian mortgage market.
3. Castaldo, J. "Prediction: The Canadian Housing Market Will Crash." *Canadian Business*. January 12, 2012. www.canadianbusiness.com
This article discusses the possible crash of the Canadian housing market through an analysis of the potential "bubble" that may be driving the Canadian market.
4. Dunning, W. "Confidence in the Canadian Mortgage Market". CAAMP. May 2012. www.caamp.org
This report has been prepared for the Canadian Association of Accredited Mortgage Professionals (CAAMP) by Will Dunning, Chief Economist of CAAMP. It provides an overview of the evolving state of the residential mortgage market in Canada.
5. Global Property Guide. 2015. "Canadian Two-Storey House Prices Rose 9.07% this Year. Too much, says the CMHC". www.globalpropertyguide.com
This article highlights the rising prices for two-storey homes across major Canadian cities.
6. Shufeit, T. 2013. "The Incredible Shrinking Mortgage Rate". *Canadian Business*. www.canadianbusiness.com
This article discusses the current state of interest rates and the level of household debt in Canada, and the impact these elements have on the Canadian housing market.
7. CAAMP. 2007. "Origination Standards for Fraud Avoidance". *Canadian Association of Accredited Mortgage Professionals*. January 2007. www.caamp.org
These standards are designed to reduce fraud within the Canadian mortgage industry by outlining the minimum standards of care and due diligence required for the acceptance, completion, and submission of mortgage loan applications.
8. Shumake, R. 2009. "Robert Shumake's 10 Tips to Protect Yourself from Mortgage Fraud". www.mortgagefraudalertmichigan.blogspot.ca
Robert Shumake, the CEO of a private equity real estate investment and development firm, outlines 10 helpful tips to protect oneself from mortgage fraud.
9. The Globe and Mail. 2016. "What to Know About Getting a US Mortgage". www.theglobeandmail.com
This article outlines the key differences that Canadian should consider when seeking a mortgage in the United States.
10. "The Downturn in Facts and Figures: US Sub-Prime". November 21, 2007. www.bbc.co.uk
This BBC article provides a graphical depiction of the rise and spread of sub-prime mortgages in the US, as well as the resulting bank losses and bond market collapse.
11. "Impacts of the US Mortgage Crisis". Desjardins Economic Studies. August 14, 2007. www.desjardins.com
This Desjardins article undertakes a comparative analysis exploring the impact of the US mortgage crisis in Canada as well as the US.
12. DiMartino, D. and Duca, J.V. 2007. "The Rise and Fall of Subprime Mortgages". *Economic Letter – Insights from the Federal Reserve Bank of Dallas*. www.dallasfed.org
This article chronicles the rise and fall of subprime mortgages in the United States and canvasses the impact it has had on the US housing market.

INSTRUCTOR'S COMMENTS

Chapter 1 introduces the historical origins and contemporary development of Canadian mortgage lending practice. The significance of the mortgage market in the Canadian economy is documented in terms of both stock and flow of mortgage funds of the various market participants. This chapter also discusses the role that the Bank of Canada plays in the mortgage market. Mortgage interest rates are an integral component to any mortgage transaction. The relationship between rates and risk as well as the relationship between rates and mortgage term is discussed. This chapter also discusses the main characteristics of mortgage loans as investments.

Chapter 2 reviews the roles played by the major participants in the Canadian mortgage market: chartered banks, credit unions/caisses populaires, life companies, trust and mortgage loan companies, NHA mortgage backed securities, and private lenders. Other institutions such as pension funds and special purpose corporations are involved, but play a less significant role in terms of the magnitude of their flow of funds. Private individuals and governments tend to be residual lenders, either meeting the excess demands for funds or investing in markets where the various financial institutions do not or cannot lend. The latter part of Chapter 2 focuses on the role of mortgage brokers. Once a small player, working mainly with private lenders, mortgage brokers are becoming increasingly commonplace in the mortgage market. The final section of Chapter 2 introduces the concept of mortgage fraud.

REVIEW AND DISCUSSION QUESTIONS

Find suggested answers to select review questions under Online Readings on your Course Resource website.



1. Why is liquidity an important consideration for a potential real estate investor? Is real estate liquid? Briefly explain.
2. The degree to which chartered banks have participated in mortgage investment has fluctuated dramatically since the 1950s. Provide an explanation for this fluctuation. Explain the regulatory changes that have occurred.
3. Explain what "savers" and "borrowers" are in the context of the capital market. How would an increase in interest rates affect the actions of savers and those of borrowers?
4. Explain how changes in the business environment of life insurance companies have had an impact on the relative attractiveness of residential mortgages as an investment for insurance companies.
5. What is an interest rate? Explain why interest rates can vary depending on the type of loan and the characteristics of the borrower. Why might interest rates change over time? Why is the interest rate on conventional mortgage loans generally higher than that on government bonds?
6. What is the role of a mortgage broker? Some people elect to use a mortgage broker when arranging for a loan, and others do not. What are some of the pros and cons of using a mortgage broker?



Course Bulletins

Remember to check the BUSI 221 Course Resources website for course bulletins and note any changes in your workbook and manual.

ASSIGNMENT 1: Introduction To Mortgage Finance and Market Participants
Chapter 1: Introduction to Mortgage Finance – Past and Present
Chapter 2: Mortgage Finance Market Participants

Submit your answers to multiple choice assignments online using the Submit Multiple Choice Assignments link on your Course Resources webpage. As soon as you have submitted your assignment you can view the answer guide under Assignment History and Answer Guides.



Marks: 1 mark per question

1. Consider the following statements regarding capital markets:
- A. Financial markets exist as a result of borrowers' and savers' interactions.
 - B. If the demand for funds decreases, the resulting competition forces interest rates to increase.
 - C. Interest rates can be considered the reward for saving money.
 - D. Peoples' expectations can affect interest rates in financial markets.
 - E. Bonds, being equity investments, are not a part of the capital market.

Which of the above statements are TRUE?

- (1) Only A and D
 - (2) Only B, C, and E
 - (3) Only A, C, and D
 - (4) Only B and E
2. Which of the following is characteristic of a mortgage **as an investment**?
- (1) Mortgages are not "unique", which makes them easy to trade.
 - (2) Requires a high degree of administrative work.
 - (3) Requires a small initial outlay of capital.
 - (4) All of the above are characteristic of a mortgage as an investment.

THE NEXT TWO (2) QUESTIONS ARE BASED ON THE FOLLOWING INFORMATION:

A property produces an income (before tax and before debt financing) of \$20,000 per year, and costs \$120,000.

3. The annual yield on this investment is:
- (1) 15%
 - (2) 16.67%
 - (3) 6%
 - (4) 10%
4. The possible increase in yield due to the presence of debt financing is called:
- (1) diversification.
 - (2) trading on the equity.
 - (3) financial leverage.
 - (4) both (2) and (3).

ASSIGNMENT 1, continued

5. Which of the following statements are valid reasons why investors choose to utilize mortgage financing?
- A. The use of fixed cost debt always provides a higher rate of return on invested equity capital as the amount of debt increases.
 - B. Investors can reduce overall portfolio risk by diversification.
 - C. In an inflationary environment, the investor may anticipate a rise in the value of the real property.
 - D. A merchandising company may choose to use available funds for inventory rather than invest it in land and buildings.
- (1) All of the above
 - (2) Only A, B, and C
 - (3) Only B, C, and D
 - (4) None of the above
6. As a result of the economic collapse during the 1930s' Great Depression, lenders switched from:
- (1) interest only loans to fully amortized loans.
 - (2) fully amortized loans to interest only loans.
 - (3) partially amortized loans to fully amortized loans.
 - (4) interest only loans to straight line principal reduction loans.
7. Mortgage default insurance was:
- (1) developed by financial institutions.
 - (2) designed to increase the supply of and demand for housing.
 - (3) originally available only for non-residential mortgage loans.
 - (4) created to protect borrowers from rapidly rising mortgage interest rates.
8. Rapid inflation during the late 1960s led to the creation of:
- (1) fully amortized mortgage loans.
 - (2) partially amortized mortgage loans.
 - (3) zero amortized mortgage loans.
 - (4) graduated payment mortgage loans.
9. The capital market:
- (1) is a national market for buying and selling of short-term credit.
 - (2) includes Government of Canada short-term bonds and treasury bills, day-to-day loans through banks, and commercial paper.
 - (3) includes debentures, long-term bonds, equity, preferred shares, and mortgages.
 - (4) includes equity, mortgages, treasury bills, and GICs.

ASSIGNMENT 1, continued

10. Which of the following statements are TRUE?
- A. Government bonds are generally regarded as a particularly safe, risk-free security.
 - B. Generally, the rate on a well-secured first mortgage will be lower than the yield on government bonds redeemable at the end of a time period similar to that of the term of the mortgage.
 - C. A mortgage is a more liquid investment than a government bond and may require significantly greater management effort.
 - D. The risks of a federal government bond are from general price fluctuations before the date of redemption and the possibility of a fall in the value of money.
- (1) All of the above
 (2) Only A and D
(3) Only B, C, and D
(4) Only A, B, and C
11. Which financial institution was a dominant participant (in terms of loan approvals) in the mortgage market during the 1960s?
- (1) Chartered banks
 - (2) Credit unions
 - (3) Trust companies
 - (4) Life insurance companies
12. Which of the following statements regarding chartered banks is FALSE?
- (1) Prior to 1954, banks were permitted to make mortgage loans under the Farm Improvements Loan Act.
 - (2) Up to 1967, chartered banks were permitted to have only 10% of their total assets in conventional residential mortgages.
 - (3) In 1959, when mortgage rates increased to a rate that exceeded 6%, banks withdrew from the mortgage market.
 - (4) In 1967, chartered banks were permitted to enter the conventional mortgage market.
13. Consider the following statements about interest rates.
- A. Generally, the longer the term of an investment, the higher the interest rate on the locked-in investment funds.
 - B. When determining an interest rate on a mortgage loan, the lender will consider only the value of the underlying property.
 - C. Lenders consider interest rates to be a return on the invested capital, a reward for the risk undertaken, and a payment for the costs of mortgage lending activities.
 - D. On floating rate development loans, the LIBOR is often used as a benchmark rate.

Which of the above statements is/are FALSE?

- (1) None of the above
- (2) Only A and C
- (3) Only B
- (4) Only C and D

ASSIGNMENT 1, continued

14. Which of the following statements regarding the bank rate are TRUE?
- A. It is set by the Bank of Canada.
 - B. It is the rate used on long-term loans to financial institutions.
 - C. It can be used as a signal for money supply.
 - D. It is the maximum rate commercial banks can charge their business clients.
- (1) All of the above
(2) Only A, B, and C
(3) Only A and C
(4) Only B and D
15. Which of the following statements about credit unions and caisses populaires are FALSE?
- A. Credit unions and caisses populaires exist only in Quebec.
 - B. Many credit unions and caisses populaires offer a broad range of financial services.
 - C. All credit unions and caisses populaires are provincially incorporated.
 - D. The federal government has no role in the credit union and caisses populaires movement.
- (1) Only A and D
(2) Only A, B, and C
(3) Only A, C, and D
(4) Only C and D
16. Which of the following statements are TRUE?
- A. The presence of independent trust companies in Canadian mortgage markets has been decreasing.
 - B. MICs can qualify for special status under the Income Tax Act.
 - C. Between 1968 and 1978, trust companies were the largest single source of mortgage funds in Canada.
 - D. The presence of life insurance companies in the mortgage market has decreased since the 1980s.
- (1) All of the above
(2) Only A, C, and D
(3) Only B, C, and D
(4) Only A and B
17. Mutual funds:
- (1) have not played a significant role in the financial market since the 1940s.
 - (2) are not available to the public.
 - (3) have shares which are sold only through stockbrokers.
 - (4) are open-ended funds.

ASSIGNMENT 1, continued

18. Which of the following statements regarding mortgage brokers are TRUE?
- A. Mortgage brokers may lend their own funds to borrowers.
 - B. Mortgage brokers typically play an intermediary role in the mortgage market.
 - C. All mortgage transactions require the use of a mortgage broker.
 - D. Licensing and registration of mortgage brokers is a federal matter.
- (1) All of the above
(2) Only A and B
(3) Only A and C
(4) Only C and D
19. The main types of mortgage fraud include which of the following:
- A. Identity fraud
 - B. Counterfeit fraud
 - C. Brokerage fraud
 - D. Value fraud
- (1) All of the above
(2) A and B only
(3) B and C only
(4) A and D only
20. Which of the following statements are TRUE?
- A. The Canadian subprime market is subject to less risk than its American counterpart because all high-ratio Canadian mortgages from federally regulated institutions must be secured with mortgage insurance and Canadian financial institutions do not lend more than 100% of the purchase price.
 - B. The market share of Canadian subprime mortgages is much smaller than in the US.
 - C. One of the problems in the US subprime market arose because it was easier to obtain loans with little or no proof of income and little or no down payment requirements.
 - D. Subprime lenders account for risk by charging increased interest rates and incorporating higher administration and processing fees compared to prime lenders.
- (1) All of the above
(2) Only A and B
(3) Only B, C, and D
(4) None of the above

