Mortgage Default Insurance

What is mortgage default insurance?

Mortgage default insurance ("mortgage insurance") is an insurance policy that compensates a mortgage lender (a bank) for losses caused by a mortgage default. Under the Bank Act, banks may lend up to 80% of the purchase price of a residential property or its appraised value (often called the loan to value ratio), whichever is lower, without requiring the mortgage to be insured by a mortgage default insurance company ("mortgage insurer"). This type of mortgage is generally referred to as a conventional mortgage. If the principal amount of a mortgage results in a loan to value ratio that is greater than 80%, the mortgage must be insured by a mortgage insurer. Mortgage default means the borrower has not done everything the borrower is required to do under the mortgage agreement. The most common reason for a default is not making payments.

Mortgage insurance allows homebuyers to buy a home with a down payment of less than 20%, provided they meet the bank's lending qualifications and the mortgage insurer's underwriting standards. A bank may also require mortgage insurance on conventional mortgages that have unique risks, regardless of the loan to value ratio. These can include properties in remote locations with limited or poor marketability and properties in communities supported by a single industry. Mortgage insurance protects the bank only. It does not protect a borrower or the borrower's interest in the property. Mortgage insurance is not a type of insurance that pays the mortgage payment if the borrower can't pay it or if the borrower dies.

Who are mortgage insurers?

Banks can purchase mortgage insurance from a private mortgage insurer approved by the Office of the Superintendent of Financial Institutions or from a federal Crown corporation authorized to provide mortgage insurance. The decision as to whether a mortgage can be insured is not made by the bank. Each mortgage insurer has its own criteria for evaluating the borrower and the property, and it decides whether or not a mortgage can be insured. As part of the mortgage insurer's evaluation process, a borrower's credit reports are obtained from credit reporting agencies. The bank, not the borrower, selects the mortgage insurer. A bank may approve a mortgage application, but the application for mortgage insurance may be declined by the mortgage insurer. If this happens, the bank will not be able to make the loan unless another mortgage insurer is prepared to insure the mortgage.

How mortgage insurance works

If a borrower stops making mortgage payments or breaches the mortgage contract in some other way, the bank may "enforce" its mortgage. Normally this means taking legal action to sell the property and recover what the borrower owes under the mortgage. The lender will attempt to recover the balance of the amount borrowed, unpaid interest and legal fees. If the lender does not recover the full amount owing to it, the mortgage insurer will pay the lender the amount of the shortfall, subject to any limits put in place by the insurer. The mortgage insurer may then take legal action to collect the shortfall from the borrower, if permitted under applicable law.

Mortgage insurance premium

The mortgage insurance premium ("insurance premium") is calculated as a percentage of the amount borrowed. The insurance premium amount is dependent on a number of factors, including the size of the down payment. The higher the loan to value ratio is, the higher the insurance premium will be. Other factors, such as the mortgage amortization period (how long it will take to pay off the entire amount borrowed), the property value, the type of occupancy (whether it is owner-occupied or rented) and the owner's employment status, influence the premium's calculation. The mortgage insurer determines the factors that are used in the calculation and the amount of the insurance premium.

For additional information about the mortgage default insurance premiums and rates, please visit these websites:

CMHC:
www.cmhc-schl.gc.ca/en/co/moloin/index.cfm

Genworth:
www.genworth.ca/en/index.aspx

Canada Guaranty:
www.canadaguaranty.ca/

The bank collects the insurance premium from the borrower, and it is paid to the mortgage insurer. If the borrower doesn't have enough money to pay the insurance premium, it is added to the mortgage amount. Once the mortgage is funded, the bank sends the insurance premium to the mortgage insurer, and the remaining mortgage funds are given to the borrower or the borrower's lawyer/notary. If the insurance premium is added to the mortgage amount, the borrower will pay interest on the total amount borrowed, including the insurance premium.

Example: Insurance premium calculation

The purchase of a property with a selling price of $200,000 and a down payment of $10,000 will result in a loan to value ratio of 95%. With an amortization of 25 years and assuming the default insurance premium rate is 4.00%, the insurance premium is calculated as follows:

Insurance premium* = $190,000 x 4.00% = $7,600

* The example assumes a default insurance premium rate of 4.00%. Example is strictly for illustrative purposes only and the actual client default insurance premium rate may differ.

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