Mortgage Default Insurance

What Is Mortgage Default Insurance

Mortgage default insurance is an insurance policy that compensates a mortgage lender for losses due to the default of a mortgage. A mortgage default means the borrower has not done everything the borrower is required to do under the mortgage agreement. The most common type of default is not making payments.

Under the Bank Act banks may lend up to 80% of the lower of the purchase price of a residential property or its appraised value (often called the loan to value ratio) without requiring the mortgage to be insured by a mortgage default insurer. This type of mortgage is generally referred to as a conventional mortgage. If the principal amount of a mortgage would result in a loan to value ratio greater than 80%, the mortgage must be insured by a mortgage default insurer. A bank may also ask for mortgage default insurance on conventional mortgages that have unique risks such as a property in a remote location with limited or poor marketability or in a community supported by a single industry, regardless of the loan to value ratio.

Mortgage default insurance allows homebuyers to buy a home with a down payment less than 20%, provided they meet the bank's lending qualifications and the underwriting standards of the mortgage insurer. Mortgage default insurance protects the bank only. It does not protect a borrower or the borrower's interest in the property. Mortgage default insurance is not a type of insurance that pays the mortgage payment if the borrower can't pay it or dies.

How Mortgage Default Insurance Works

If a borrower stops making mortgage payments or in another way breaches the mortgage contract, the bank may "enforce" its mortgage. The normal way a bank enforces its mortgage is to take legal action to sell the property to 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 bank does not recover the full amount owing to it, the mortgage default insurer will pay the bank the amount of the shortfall, subject to any limits put in place by the insurer. The mortgage default insurer may then take legal action to collect the shortfall from the borrower, if permitted under applicable law.

Mortgage Default Insurance Premium

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

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The insurance premium is paid by the bank; the bank is then reimbursed by the borrower. If the borrower does not have enough money to pay the insurance premium, the amount of the premium is added to the amount borrowed from the bank. 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 his/her lawyer/notary. If the insurance premium is added to the mortgage amount, the borrower will pay interest on the total amount borrowed, including the mortgage insurance premium.

If the borrower requests to add additional funds to the mortgage in the future, an additional insurance premium applies if the loan to value exceeds 80% of the appraised value of the property at the time the additional funds are advanced.

Who Are Mortgage Insurers

Banks can purchase mortgage default insurance from a private insurer approved by the Office of the Superintendent of Financial Institutions or from a federal Crown corporation authorized to provide this 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. The bank, not the borrower, selects the mortgage insurer. It is possible that a mortgage application may be approved by a bank, but the application for insurance may be declined by a mortgage insurer. If this happens, the bank will not be able to make the loan, unless another insurer is prepared to insure the mortgage.

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