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Potentially flawed data used by banks and lenders bump up house prices

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Fears of a falling market have some worried residential property owners could be left exposed

Flaws in a national databank that helps determine the value of houses across Canada have helped fuel inflation in home prices, putting mortgage lenders and borrowers at greater risk, key players in the housing sector have warned.

Documents obtained by The Globe and Mail detailing confidential statements from banks, appraisers and mortgage insurers show rising worry over the use of a database operated by the Canada Mortgage and Housing Corporation (CMHC). The documents suggest the data are flawed and help push home prices up.

Introduced in 1996 as a way for the CMHC, banks and other lenders to quickly and inexpensively determine how much money can be lent against a residential property, the database known as Emili is relied upon too heavily by lenders, the documents suggest.

Emili is an automated system that uses figures such as recent sales of nearby homes to gauge values, without sending an actual appraiser to the address. However, the potential margin of error in calculations may pose significant problems. For home buyers, or homeowners with home-equity lines of credit, an inaccurate valuation by the database could allow them to overpay or borrow much too heavily for the home, industry members argue.

For banks, it could mean the collateral they have against the mortgage is not worth as much as believed.

"Although it provides very rapid responses, this automated approval system has significant shortcomings," says one industry respondent in the documents, which were obtained by The Globe and Mail through access to information requests.

Because the database does not evaluate a specific property, but uses generalities to determine the risk level of a mortgage, "CMHC insured loans are often granted without truly taking into account the property's market value," the respondent says. "This poses a real danger of altering housing market data."

CMHC is the largest mortgage insurer in the country. The documents, from May, were part of a process by the federal banking regulator, the Office of the Superintendent of Financial Institutions (OSFI), to determine whether Canada's mortgage lending rules needed to be tightened.

Though it is not possible to know who is responsible for each comment, since the names of each industry player are redacted to comply with privacy laws, numerous parties flagged concerns about the accuracy of Emili data in gauging home values. Groups who responded to the call for comments include the country's major banks, real estate associations, representatives of the appraisal industry, mortgage insurers, and mortgage brokers.

OSFI advised banks this summer to take a closer look at how they determine housing values, and to make more effort to do more in-person appraisals. However, when those new guidelines were announced, there was no indication of the extent of the concerns raised in private by industry, and the heightened level of concern over the accuracy of Emili data.

Known as an automated value model (AVM), Emili is used to estimate whether a mortgage or a refinancing is risky or not. When financial players, including CMHC, use Emili, they submit a proposed value to the database, which then responds by saying whether the value fits within the range for that community or not. However, the database can not tell whether the actual property is worth that much.

"It allows people to pay too much for a property," Rick Sieb, president of Intercity Appraisals Ltd. in Vancouver, said in an interview. "If the property is worth $300, and somebody comes through and the realtor has convinced him to pay $330, so he's 10 per cent out, and they submit it through Emili or another AVM, it will just say 'yeah, that's fine for that area," Mr. Sieb said. "So the lender still lends the money, the guy still buys it, and the only person hurt in the whole deal is the person who paid too much."

The Canadian housing market has been on a tear for much of the past decade but is now showing signs of petering out. During that time, consumers took on record-high levels of mortgage debt, a situation that has troubled Finance Minister Jim Flaherty, who sought to cool the housing market to prevent it from overheating any more and ultimately crashing. His goal has been to steer it towards a so-called soft landing. The latest market data suggest house sales have been falling since he tightened the rules.

During a hot housing market, a wider margin of error on estimated values was less of a concern, since there is smaller likelihood a mortgage or loan refinancing will end up under water. But if the market starts to fall, as some economists expect, the accuracy of appraisals becomes paramount. When a lender is forced to liquidate a home in the event of a default, it could incur a loss. In the case of CMHC, the federal government would be left picking up the tab.

Automated systems such as CMHC's Emili emerged because they are a fast and inexpensive way to gauge the value of a property, instead of paying for an appraiser. When CMHC launched Emili, it said the move would move "application approval times from days to seconds." Emili is also used by banks on mortgages where the down payment is over 20 per cent.

Asked about the documents, a spokesperson for the CMHC said in an e-mailed statement on Wednesday that the corporation uses appraisals "where appropriate." The spokesperson added that Emili "relies on a number of different factors and models beyond home resale data" to determine risk, but did not elaborate.

The documents also suggest blunt estimates on home valuations may have resulted in higher CMHC premiums paid by consumers on insured mortgages.