MORTGAGE PROFESSIONALS CANADA | PROFESSIONNELS HYPOTHÉCAIRES DU CANADA

August 17, 2017

Ms. Carolyn Rogers
Assistant Superintendent, Regulation Sector
Office of the Superintendent of Financial Institutions of Canada
Email: b.20@osfi-bsif.gc.ca

Re: Mortgage Professionals Canada Responds to Proposed Changes to Guideline B-20

Dear Ms. Rogers,

Mortgage Professionals Canada is pleased to respond to the consultation paper requesting feedback on the proposed changes to the Guideline B-20 *Residential Mortgage Underwriting Practices and Procedures.* We would like to formally thank the Office of the Superintendent of Financial Institutions (OSFI) for conducting these public consultations and taking the views of Mortgage Professionals Canada into account when making these proposed changes.

Mortgage Professionals Canada is the national mortgage industry association representing 11,500 individuals and 1,000 companies, including mortgage brokerages, lenders, insurers and industry service providers. Our members make up the largest and most respected network of mortgage professionals in the country whose interests we represent to government, regulators, media and consumers. Together with our members, we are dedicated to maintaining a high standard of industry ethics, education and professionalism, consumer protection, and industry best practices.

Mortgage Professionals Canada's comments are provided for your review. Please do not hesitate to contact me if you have any questions.

Sincerely,

Paul Taylor
President and CEO
Mortgage Professionals Canada

Executive Summary

Mortgage Professionals Canada is the national mortgage industry association representing 11,500 individuals and 1,000 companies, including mortgage brokerages, lenders, insurers and industry service providers. Our members make up the largest and most respected network of mortgage professionals in the country whose interests we represent to government, regulators, media and consumers. Together with our members, we are dedicated to maintaining a high standard of industry ethics, education and professionalism, consumer protection, and industry best practices.

The mortgage broker channel originates more than 35% of all mortgages in Canada and 55% of mortgages for first-time homebuyers, representing approximately $80 billion dollars in annual economic activity. With this diverse and strong membership, we are uniquely positioned to speak to issues impacting all aspects of the mortgage origination process.

We are pleased to respond to the consultation paper eliciting feedback on the proposed changes to the Guideline B-20 *Residential Mortgage Underwriting Practices and Procedures (*hereby referred to as B-20) by the Office of the Superintendent of Financial Institutions (OSFI). We will focus our report on the key areas identified by OSFI in their consultation document:

- Imposing a 200 basis point qualifying stress test for all uninsured mortgages;
- Requiring that Loan-to-Value (LTV) measurements adjust for local market conditions where they are used as a risk control, such as for qualifying borrowers;
- Expressly prohibiting co-lending arrangements that are designed, or appear to be designed, to circumvent regulatory requirements.

These proposed changes follow up on the letter OSFI wrote to lenders in the summer of 2016; *Reinforcing Prudent Residential Mortgage Risk Management.* At that time, interest rates were at an all-time low and prices in Vancouver and Toronto were accelerating. This was also prior to the federal government's restrictions to mortgage insurance and eligibility announcements, the implementation of B.C. government's foreign buyers tax, and the Ontario government's introduction of its *Fair Housing Plan*.

It is our assertion that the cumulative impact of the above mentioned policies have created uncertainty in the Canadian housing market. We acknowledge that the cooling of certain markets was the objective and is showing signs of being achieved in the Greater Toronto Area (GTA), and to a lesser extent, the Greater Vancouver Area (GVA). However, we are seeing reductions in housing activity in the form of sales and housing starts, in areas of the country that were already moderate, flat, or even

declining. We are concerned that the combination of all of these changes, and the speed with which they have been cumulatively implemented, have created some adverse effects which could cause a further, and potentially significant, decline in housing activity nationally.

As such, while we support in principle the recommendations within the consultation, we recommend some technical adjustments that will improve prudential lending practices while mitigating potentially negative consequences.

Our position

We suggest that instead of implementing a stress test as described in the consultation paper, the stress test should be aligned with the insured mortgage stress test requirement of the Bank of Canada's posted benchmark five-year rate. There should be allowance for qualification at the contract rate for mortgage contracts issued above the posted benchmark rate. Mortgage Professionals Canada also suggests that the current method for setting the benchmark rate requires a technical adjustment (a concern we will be directly addressing with the Bank of Canada and the Department of Finance), however, for ease of consumers' communication and understanding, the benchmark rate is a known mechanism and will be easily understood. Our contention is that the benchmark rate should provide an approximate 75 basis points increase over commonly available marketplace five-year term rates.

We are supportive of the proposals to ensure dynamic loan-to-value ratios are improved and strengthened. Our members are confident their underwriting methodologies already contain provisions that address the concern OSFI has highlighted in the consultation paper, and they are aligned with the sentiment that these risks must be considered by prudent lenders.

Finally, we understand OSFI's proposed restriction on certain co-lending activities; however, we do not believe a complete prohibition on co-lending is warranted.

Stress Test Considerations

Since the announcement of the changes to mortgage insurance and eligibility last October, Mortgage Professionals Canada has been advocating to the Department of Finance and the Bank of Canada for a change in the way the benchmark rate is calculated. The current method typically provides a rate that is approximately 200 basis points above commonly available market rates for a five-year term. This methodology should be amended for two reasons.

First, 200 basis points is too high a number. It is not based on an empirical market expectation of how rates and household incomes will change over a five-year term. It is also causing significant reductions in purchasing power for many Canadians. This

results in fewer potential purchasers at each price point, causing overall reductions in housing values across Canada.

Secondly, the Bank of Canada should use a method of setting the benchmark that is agnostic of the business decisions of FRFIs and look to bond markets or other independent financial indices. We believe a 75 basis point stress test is more reasonable and provides some additional safeguard above the current GDS and TDS maximums without disqualifying too many middle class Canadians from their dream of attaining home ownership.

However, in the absence of this adjustment, it is important to harmonize the stress test requirements across the entire marketplace. We understand that OSFI is proposing the new stress test because conventional mortgage portfolios of many lenders are becoming riskier. Since the implementation of the stress test for insured mortgages, the data indicates that more consumers are finding a way to raise a 20% down payment and avoid mortgage insurance.

The concern is that many may be taking personal loans from friends or family that they are not disclosing during the application process and that loans are being issued to purchasers who are more highly leveraged than they appear. This may be adding additional strain and default risk to the uninsured portfolios of FRFIs. This is why a harmonized test between the insured and uninsured market is so important – it removes the incentive for consumers to take on more debt to avoid mortgage insurance by removing the discrepancy in qualification.

Furthermore, having a differing or floating benchmark will create additional problems: competitive advantages for some lenders over others; educating consumers about the differences between insured and uninsured qualifications will be significantly more difficult; and borrowers in the riskiest segments, those who are leveraged the most, will be incented to seek the shortest mortgage terms possible for qualification purposes, thereby exposing the most vulnerable to the greatest risk of a short term interest rate spike.

The large majority of individuals borrowing above the benchmark rate do so on a short term basis while they rehabilitate their credit or change their life circumstances and, at the end of the term, obtain a renewal at a significantly better rate. For those borrowers whose situation indicates they will likely continue to require higher interest rate products, we believe the introduction of the other measures contained within the consultation (the changes to co-lending and more regional sensitivity to loan-to-value calculations), in addition to the already stringent underwriting practices of lenders, will ensure prudent but fair and accessible lending practices are supported throughout the industry.

We also recommend consideration be given to individuals who currently hold mortgages. If a 200 basis point stress test is implemented above contract rate, and rates do in fact rise over their term, many may no longer qualify for a renewal. They will

see an artificial 200 basis point increase over their actual interest rate increase. We recommend that mortgage renewals be permitted to qualify at their contract rate without an additional stress test. Similarly, an exception to the qualification should be made for individuals who port their mortgage because they move mid-term and do not increase, or reduce, the outstanding loan amount.

Why do we think 75 basis points is the right number?

According to calculations conducted by our chief economist, Will Dunning, a 75 basis point stress test achieves an appropriate protection to consumers in the event that rates rise, while not unduly pricing too many consumers out of the market place. It is important that a market-based rate be used to calculate the stress test to ensure that the appropriate balance between stability and affordability can be found for Canadians. As discussed below, the use of a 75 basis point test rate at initiation simulates the effect of a 200 basis point rise five years in the future.

The stress test addresses events that might occur in the future but the calculations rely on current parameters. As such, the test will over-estimate the impact of a future rise in mortgage interest rates on borrowers' costs.

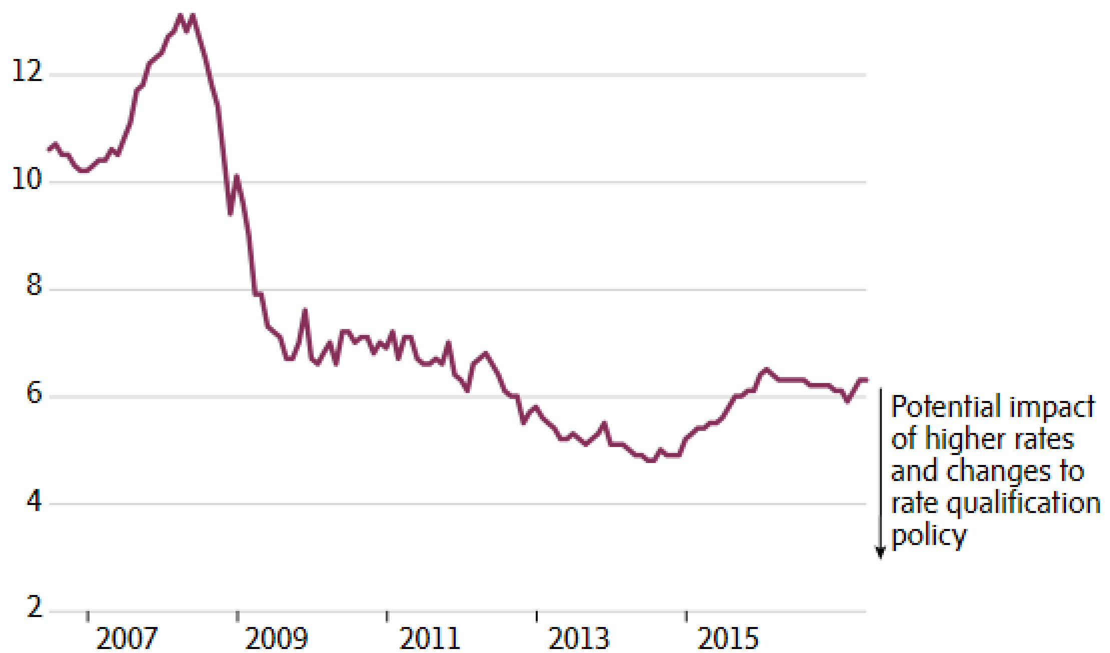
The stress test does not consider that at the time of a future mortgage renewal, the borrower's income will likely have also increased and the outstanding principle will have been reduced. Therefore, the future rise in the payment will be less than estimated and a natural buffer is created to absorb a rise in rates (in an initial five-year term, on average, 15% of the principle is repaid as of the renewal). In addition, if interest rates have increased by a substantial amount on a sustained basis, we would expect that the economy would have strengthened and that this would most likely be resulting in more rapid growth of income than is presently occurring.

The stress test aims to simulate the impacts on ability-to-pay if rates rise to ensure that Canadians are protected from taking on too much debt. Based on current parameters, the effects of a rise in interest rates of 200 basis points five years in the future (assuming that incomes rise at the same rate of the past five years) could be adequately simulated by a test that assumes an interest rate that is 0.43 points to 0.78 points higher than the actual contracted interest rate. Therefore, the effects of a 200 basis point rise in rates over a five-year term could be achieved by using a 75 basis point stress test at initiation, while mitigating the negative impacts on consumers and the economy.

Seven Considerations for the Stress Test's Impact on the Economy and Consumers

A new stress test of 200 basis points has the potential to significantly disrupt and diminish mortgage growth in Canada and have a negative impact on consumers ability to qualify for a mortgage in seven ways:

1. **Reduction in mortgage originations**. This policy will have a significant economic impact, by reducing economic activity and employment. CIBC has estimated that this policy alone could reduce the growth in mortgage originations by 50% over two years.[1] This policy could compound the effects of rising rates and slowing prices on Canadian consumers, initially negatively impacting many Canadians' ability to afford or maintain homeownership, and eventually eroding the value of the homes of the Canadians fortunate enough to own.



2. **Riskier marketplace**. The new stress test will shift consumers away from the stability of five-year fixed rates and into shorter one and two year term mortgages, or variable rate mortgages, as they are easier to qualify for than the stability and security of five-year fixed terms. Shifting borrowers to shorter term mortgages could dramatically shift the composition of the uninsured mortgage rate market and create an additional level of vulnerability for consumers. Renewing after one or two years makes the borrower more susceptible to interest rate increases than renewing at the end of a five year term, when borrowers will have accumulated equity in the home and have likely seen an increase in their income. In extreme cases, borrowers completing a five-year

[1] CIBC: *Assessing Household Debt's Sensitivity to Higher Interest Rates*: https://economics.cibccm.com/economicsweb/cds?ID=3421&TYPE=EC_PDF

term who have accumulated equity in their properties can extend their amortization period, reducing their monthly payments and making it easier to absorb additional interest rate increases. Those in shorter terms will not likely have this option.

3. **Increase in unregulated lending**. An additional unintended impact could be to push these vulnerable borrowers away from the highly regulated alt-a space into the much less regulated private mortgage space, where rates are often much higher and the same quality of underwriting is not always followed. We are concerned that new Canadians, first-time homebuyers and self-employed individuals, who are considered more vulnerable borrowers, will be pushed into this space. Removing these borrowers from the highly regulated alt-a space could create a risk to the entire market. If the goal is to ensure stability in the financial system, creating uncertainty for a vulnerable group of borrowers could have the opposite effect.

4. **Economic impacts**. Within the regions that already have balanced, stable, or declining housing markets, the further suppression of demand that will result from a combination of policies and rising interest rates creates a risk of falling house prices. This in turn elevates economic risks for those communities. If a 200 basis point stress test is applied on top of the current situation in these communities, there is a concern that declining home prices will cause knock-on economic declines. It could also alter the structure of the lending environment, should a smaller community be hit with economic disruption resulting in job losses. These communities are often economically weaker to begin with, as it is well known that job creation and housing activity are directly correlated. We understand the concerns regarding affordability in the Greater Toronto Area and Vancouver markets but caution that the proposed stress test could create risk, uncertainty, and price depreciation in markets that were not in need of demand being suppressed. We reiterate that the timing for implementation of any of these proposed changes be carefully considered, and their implementation not be introduced too hastily.

5. **Job losses**. According to Mr. Dunning, it should be expected that the result of a 200 basis point stress test combined with other recently implemented policy measures and the recent increases in mortgage interest rates, would be a housing market activity reduction of at least 10%, and possibly as much as 15%. Mr. Dunning's calculations further indicate that this would result in a reduction of 50,000 to 75,000 units per year. Research by the Canadian Real Estate

Association indicates that each resale transaction results in about 0.37 jobs.[2] Additionally, Mr. Dunning's own analysis for the Canadian Home Builders Association estimates that each housing start results in 2.13 jobs. Combining this finding with an estimated 10% to 15% decline in housing starts, we could see a reduction in employment figures in Canada by 61,000 to 91,500.

6. **Self-employed and new Canadians**. The biggest constituency of Canadians that will be negatively impacted by the proposed stress test are the non-prime consumers who are often new Canadians or self-employed individuals. As we welcome record numbers of new Canadians to our country every year, we should not make it harder for them to qualify for homeownership simply because they do not have a credit history in Canada. These potentially vulnerable individuals, the majority of which migrate to a prime rate within five years, may have to obtain a one or two year term, or may not qualify at all if subject to the additional qualification of a 200 basis point stress test.

7. **Reduced competition**. Lenders source capital to fund mortgages in a variety of different ways. We are concerned that the stress test, as proposed, could create competitive disadvantages for some lenders. We have seen the competitive landscape shift since the introduction of the Department of Finance measures in 2016 and we would expect this new stress test, if implemented as OSFI proposes, to compound the impact on some lenders.

Therefore, we recommend that instead of proceeding with a 200 basis point stress test for uninsured mortgages that OSFI consider using the same stress test for conventional mortgages as those required for insured mortgages. We also strongly suggest that OSFI consult with the department of finance and the Bank of Canada to amend the benchmark rate to an independent mechanism that creates an approximate 75 basis point premium over commonly available five-year term rates.

Income Verification

We appreciate and support the enhanced emphasis on income verification and with a specific focus on the language regarding the expectations for enhanced rigour. We endorse all additional measures that can help to reduce misrepresentation, fraud or criminal activity, which can put additional risk into the marketplace. However, we recommend that the new "rigour" include additional guidance to ensure clarity of OSFI's expectations and define it based off of industry best practices.

[2] The research report can be found here: http://www.crea.ca/wp-content/uploads/2016/02/Altus-Report-Economic-Impact_OS_En.pdf.

Dynamic Loan-to-Value ratios

We are supportive of OSFI's proposals to strengthen the guidelines around loan-to-value ratios and we are confident that our lender members are already taking into consideration local labour market and inflationary conditions when underwriting mortgage loans.

Co-lending

We recommend additional clarity in the language used to define "co-lending". Following discussions with staff members at OSFI, it is our understanding that the concern refers to when more than one lender issues a mortgage product on the same property; one lender issues a primary mortgage and other lenders issue mortgage products with subordinate rights to the property title to the primary loan issuer. When the combined loan-to-value ratios of these mortgage products exceed 80% of the property value, it may appear that this lending arrangement was used to circumvent the legally required mortgage insurance. For ease of reading, we have referred to this structure as "co-lending" but for many in the industry, co-lending actually refers to a number of lenders or investors collectively funding a single mortgage with the group collectively sharing the same right to title of the property providing the security.

With regards to OSFI's proposal to "expressly prohibiting co-lending arrangements that are designed, or appear to be designed to circumvent regulatory requirements", we are supportive of these efforts but we do not believe that there should be a complete prohibition on co-lending activities. For loan-to-value ratio's below 80%, co-lending is used by lenders as risk-mitigation tool and reflects sound underwriting practices.

Not all lenders or their investors have the same risk tolerance for loans and co-lending is a useful tool to diversify risk among different lenders or investors. We are concerned about the unintended impacts of a complete prohibition on co-lending, potentially pushing borrowers to less regulated and riskier lenders. This could result in higher rates for borrowers, less oversight from the regulator on these loans and ultimately more risk in the marketplace. It is our view that a complete prohibition will create more risk within the marketplace.

Conclusion

Given the Department of Finance's changes to mortgage insurance, the Ontario government's *Fair Housing Plan*, the B.C. foreign buyers tax, and the recent decision by the Bank of Canada to increase rates, we believe that now is not the most appropriate time to add further changes to the marketplace. Time is needed for the market to adjust to new measures already in place and for evidence to be gathered on their impacts before the implementation of a new stress test to the uninsured marketplace.

We do not believe that the market can currently support a floating 200 basis point stress test, and believe there will be negative economic consequences if it is implemented. We would recommend that OSFI consider unifying requirements for uninsured mortgages with those of insured mortgages, and to enter discussions with the Bank of Canada and the Department of Finance regarding an independent mechanism that would see the benchmark set at approximately 75 basis points higher than commonly available market rates.

We are supportive of the efforts to strengthen the loan-to-value guidelines and recommend that an industry working group be established to harmonize lenders' policies and procedures based on industry best practices. We would be happy to assist these efforts in any way we can.

Finally, we understand OSFI's proposed restriction on certain co-lending activities; however, we do not believe a complete prohibition on co-lending is warranted.

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