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# CHBA Submission on Revised Guideline B-20 Residential Mortgage Insurance Underwriting Practices and Procedures

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## About the Canadian Home Builders' Association

Since 1943, the Canadian Home Builders' Association (CHBA) has been "the voice of Canada's residential construction industry" - one of the most vital and enterprising industries in Canada. Representing more than 8,500 member firms across Canada, CHBA members come from every part of Canada's housing industry - home builders, renovators, land developers, trade contractors, product and material manufacturers, building product suppliers, lending institutions, insurance providers, service professionals and others.

In 2016, the industry supported over 1 million jobs in new home construction, renovation and repair. It remains one of the largest employers in the country, with tens of thousands of business enterprises engaged. One of every 18 workers in Canada is working in residential construction, either directly on site or indirectly by supplying materials, technologies and services. Total wages paid in 2016 were estimated at \$59.4 billion. The construction-related value of new homes, renovations and repairs produced by the industry, including both on- and off-site activities in 2016 exceeded \$138 billion.

CHBA comments on proposed changes to OSFI Guideline B-20 recognize that the Office aims to align language throughout the revised Guideline with its July 2016 public letter. The revised Guideline also builds on a November, 2016 change to rules governing insured low-ratio loans. Its overall intent is to clarify and strengthen expectations in a number of specific areas. The latter include:

- Requiring a qualifying stress test for *all* uninsured mortgages;
- Requiring that Loan-to-Value (LTV) measurements remain dynamic and 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.

Implicit in the revised Guideline as well is increased OSFI attention to FRFI (federally-regulated financial institution) efforts to detect and prevent mortgage fraud. OSFI also advises FRFIs to use added caution when operating in markets experiencing rapid price increases, and at the other end of the spectrum, in relation to potentially illiquid properties.

CHBA concurs entirely with the first shift in regulatory priorities related to mortgage fraud. The Association also welcomes the opportunity to engage in dialogue with OSFI and other federal interlocutors about the nature of risks under current and foreseeable housing market conditions. Guidelines to FRFIs must, by their nature, be general in tone and cover a wide range of situations. Accordingly, risk management efforts will ideally be supplemented by intelligence gained through ongoing market tracking and analysis, and based on steadily improving indicators.

### **The Public Policy and Economic Context of Proposed Changes to Guideline B-20**

In this vein, and as context for CHBA comments, the Association notes the following key aspects of the current housing market situation across Canada:

- Current housing production rates are healthy for the country as a whole, but show ongoing weakness in several regional and local markets, including some of those hardest hit by the global commodity downturn. Recovery is underway in parts of Western and Atlantic Canada, but is uneven and is certainly not assured.
- Available data do not yet make it clear whether October 3, 2016 changes to mortgage insurance rules announced by the Minister of Finance have been fully absorbed in housing markets. Impacts on the markets with greatest price increases have been unpredictable, in part due to the combined effects of other measures at both federal and provincial levels, e.g., regarding foreign buyers.
- Following a long period of very low interest rates, the Bank of Canada has commenced to increase rates, in a step-by-step manner, recognizing the very low inflation environment that prevails.
- Mortgage borrower behaviour does not indicate rising delinquencies and defaults. Quite the opposite, according to Equifax tracking data, which show diligent debt management of both mortgages and HELOCs.
- Several knowledgeable observers of housing market dynamics are expressing deep concern about the *cumulative impacts* of all government policy and regulatory initiatives, given the uncertainty of the global economic situation, and of U.S. trade and economic policy positions in particular.

In that context, CHBA on behalf of the residential construction industry recommends *attention to the long-term fundamentals of Canada's housing system* as an essential backdrop to any further federal policy or regulatory actions by the ensemble of agencies reporting to or through the Minister of Finance, and by the Department itself.

These fundamentals include the following:

- That a *significant increase in demographic demand for family-oriented accommodation* is underway, which is unavoidable and likely to persist for the next ten years. This is putting pressure on the most attractive market regions for both immigration and internal migration, and on family-oriented units within those markets. All governments need to pay close attention to supply-related actions in this context.
- Both *municipal regulatory systems and lags in infrastructure investment* are creating *supply bottlenecks* in key markets which are having measurable impacts on prices of well-located family accommodation and are themselves an appropriate matter for ongoing federal policy concern on behalf of the economy as a whole.
- Increasingly important for young households entering the market is whether or not financial support is available from parents, relatives, or other external sources. While this may be a welcome development in the short term, it foreshadows *longer-term risks to Canada's housing system and to its economy and society as a whole*.
- Specifically, should home ownership become more and more restricted to the children of those who are already owners or who have significant accumulated wealth, inter-regional and upward mobility may both be reduced, retirement planning may be hampered, and social and economic divisions may be sharpened with a variety of negative societal consequences.
- CHBA itself expressed deep concern about potential negative and long-term impacts on first-time buyers when the original stress test was introduced in October of 2016. The Association remains alert to the possibility that too sharp a focus on shorter-term risks may drive longer-term and less transitory ones off the government's radar screen.

### **Specific CHBA Comments on the Proposed Guideline B-20 as Revised**

The main focus of the B-20 Guideline revisions is on borrowers with 20 percent or more equity submitted in applications to prospective lenders. At base, the revised Guideline can be viewed as a regulatory response to a situation in which a "perfect storm" occurs: a market-wide decline of residential values of greater than 20 percent, coupled with the actual equity stakes of borrowers not being as claimed in their loan applications.

While this has been a very rare occurrence in Canadian history, it is not a completely inconceivable scenario. *The challenge is to ensure that the very act of anticipating such a scenario does not itself generate serious negative market-wide impacts.*

In this context, CHBA comments will address each of the major proposed changes in turn.

### *Requiring a qualifying stress test for all uninsured mortgages*

In the context of current underwriting practices routinely applied by insurers and lenders, this can be regarded as a “belt-and-suspenders” approach. It is an alert to ensure that even in a worst-case situation of substantially-increased interest rates, borrowers can cope.

From a practitioner perspective, this is also the proposed measure with the largest potential for overblown market reaction and unintended consequences, depending on how it is introduced and what level of interest rates are applied as the test of borrower financial capability. At the same time, it certainly has some appeal to mortgage loan insurers as a step toward treating insured and uninsured mortgages in a similar way, even though the respective instruments differ in the amount of borrower and lender “skin in the game”.

CHBA recommends that:

- In contrast with the introduction of the stress test by the Minister of Finance for insured mortgages on October 3, 2016, a *stress test for conventional lending must be phased in over time, with impact monitoring at each step along the way*. Ideally, an across-the-board test would be at a lower rate, more in line with projected rate-increase scenarios, given the negative impacts it has on affordability for first-time buyers.

To implement whatever level of stress-testing is selected in one step would potentially signal government concern about an imminent decline in home values of over 20 percent. The OSFI public statement of July, 2016 may have been regarded as a “technical” matter within the mortgage insurance and lending community. A similar low-key response cannot be assured for this round, based on media comments already in the public domain, and the reality that the stress test will apply to a quantum increase in mortgage transactions affected.

Indeed, market impact projections prepared for CHBA (Annex “A”) indicate a potential risk of provoking a substantial downturn in both new production and home values, based on immediate introduction at the full proposed interest-rate stress-test level of 2% above the contractual mortgage rate.

- Rather than the approach to stress-testing envisaged by the draft Guideline B-20, *CHBA proposes that the stress-test method adopted be the same as for insured loans*. This method is now understood by the mortgage financing industry. It risks fewer of the potential unintended consequences in reducing effective buying power associated with the specific method proposed (set out in Annex “B”).

- It goes without saying, but is worth repeating, that *release of this revised OSFI Guideline must be accompanied by proactive evidence-based communication from all relevant authorities on their confidence in the long-term value of home ownership to Canadians*. A federal regulatory move based on a “worst-case” scenario of widespread residential property value decline is a delicate matter in the context that owning a home remains a very sound proposition, and that it represents the largest single investment of the majority of Canadian households. (Annex “C”.) An unfortunate impression has been created by some recent government policy statements at various levels implying that current and future generations of young Canadians and immigrants to Canada should be content with being renters all their lives, and that home ownership may be a poor investment.
- Because this proposed measure broadens application of stress testing to all mortgage borrowers applying to FRFIs (federally-regulated financial institutions), lower-risk mortgage borrowers may be pushed away from FRFIs, and towards provincially-regulated and non-regulated lenders, to escape federal policies that would alter (or even prevent) some housing and mortgage transactions. *Thus federal efforts to coordinate policy actions with provincial regulatory agencies will become even more urgent*. From the standpoint of Canada’s housing finance system as a whole, there is little gain in risk reduction from simply shifting risks from one level of government to another.
- Additionally, as currently proposed by OSFI, the terms of the stress test on conventional mortgages could have the effect of pushing borrowers towards shorter-duration fixed, or open, mortgage terms in order to reduce applicable interest rate and stress-test qualifying rate. This would likely increase market risk rather than reduce it.

*Requiring that Loan-to-Value (LTV) measurements remain dynamic and adjust for local market conditions*

This element of the Guideline is confirmation of the soundness of typical insurer and lender best practices. At the same time, assigning it more OSFI attention may give rise to unintended consequences via FRFI lending and insurance practices if not carefully explained and then monitored. For example, there are several references in the Guideline to exercising increased caution in relation to loans for “illiquid properties”.

To select one major example, there is the situation those living in rural properties and/or wishing to do so. The latest Census of Canada indicates that people living in the country’s rural areas still account for some 18.7% of the total population, and their number approaches 6.6 million people. There was measurable population growth between 2011 and 2016 at an average annual rate of 49,000. According to CMHC data,

rural properties composed 8.7% of all new housing production in 2016, with the total number of starts rising by 23.9% from 2015.

It is important that this proposed guideline not be read by FRFIs – several of which are already reducing their services in many rural areas and smaller communities -- as an opportunity to increase barriers to obtaining mortgage financing or mortgage insurance for rural properties as a whole.

*Expressly prohibiting co-lending arrangements designed to circumvent regulatory requirements*

In general terms, this proposal appears to be intended to help forestall mortgage fraud and excessive debt unsupported by adequate income or collateral. It is a necessary element of federal and financial system-wide regulation. Given the still-vivid example of the American experience over the period 2002 to 2008, CHBA supports this proposal, as well as the proposed requirement that the intended use of funds be documented.

The desire of some borrowers to work around the requirement for mortgage insurance at less than 20% equity offers the best rationale for the federal government to extend the stress-testing regime already in place for insured loans to all mortgage lending by FRFIs, and indeed by the whole financial services industry. Indeed, it would obviously be a much more apt explanation for expanding the current stress-testing regime than a fear of imminent and substantial property value decline.

However, the Association wishes to comment on related elements of the Guideline from the standpoint of both current market conditions and evolving innovation in home financing arrangements.

In Canada, declining affordability means that it now takes young Canadians 2 to 3 times longer to save for a down payment compared to a generation ago (according to Generation Squeeze). Numerous surveys over the past year report that approximately 40%-50% of first-time homebuyers get financial help from the “Bank of Mom and Dad”. This is a reaction to rising house prices in some markets, but is also part of a purposeful intergenerational wealth transfer from Baby Boomers with large equity positions to their children.

Given both demographic trends and urban market dynamics, CHBA believes this kind of gifting and lending activity is likely to continue to expand. In this context, there is a possibility of increasing resistance to the OSFI requirement for a letter confirming “no recourse” for gifts from parents or others. CHBA would urge OSFI to recognize that the overwhelming desire of parents is for success of their children whatever gifting details may be.

It would also be a good idea to ensure that barriers are not erected to new shared-borrowing and shared-equity arrangements among unrelated households that are emerging, especially in markets like Vancouver.

These should not be hampered by the Guideline if they are approved by lenders and insurers based on financial capabilities of all borrowers, and proper legal arrangements for risk-sharing and mediation in the event of changed circumstances.

Finally, CHBA urges that OSFI go beyond the characterization of equity down payments offered by “Affordable Housing Programs” as being merely “incentive and rebate payments” funded by governments. CHBA would hope to see such techniques and programs more widely encouraged in the future, with both non-profit and private sector providers engaged. In this context, CHBA proposes that the exception made for these programs for government-funded programs should be extended to recognized private sector companies with a track record in the field of “entry-level” housing production as well, subject to suitable risk mitigation measures being on place.

#### **Conclusion and Recommendations in Brief:**

Revised Guideline B-20 recognizes several key risks arising from recent housing market trends, and could play an essential role in mitigating those risks. At the same time, it has some potential to convey market-destabilizing messages simply by what it implies about anticipated residential property value scenarios. That may not be the OSFI intent, but it is certainly a possibility that should be addressed in the contents of the revised Guideline, in its implementation, and in the manner of its announcement.

In summary, CHBA recommends as follows:

1. Both phased-in implementation of a stress test for low-ratio loans and effective communication by all federal officials and agencies concerned on the long-term value of home ownership are essential. (CHBA notes that the current level of the stress test is substantially higher than that required by the projected level of interest rate increases.)
2. The stress test method adopted for uninsured mortgages should be the same as that for insured mortgages, and should be explained as a way of bringing regulation of insured and uninsured loans into line with one another, rather than as a response to a clear and present danger of market decline.
3. Increased FRFI attention to local market conditions and to borrower characteristics should be placed in the context of ongoing concern to facilitate housing activity in rural areas, and of the federal mandate under the *National Housing Act* to offer mortgage lending services to Canadian residents not fully served by private lenders and insurers.
4. CHBA supports FRFIs being compelled to document the end use of funds. However, rather than just stressing prohibition of co-lending activities, OSFI and other federal

agencies should work to bring all lenders under a similar regulatory umbrella, and to welcome co-borrowing and equity-sharing with proper legal protections and risk mitigation. Bringing all FRFI loans into the stress-testing regime substantially reduces the motivations in any case.

5. The current exemption made for government-sponsored equity-sharing arrangements (redefined from the current reference to “incentive and rebate payments” should be extended to private sector companies with proven track records in offering entry-level housing products to first-time buyers.

## **ANNEX “A”: ECONOMIC PROJECTIONS OF POTENTIAL STRESS-TESTING IMPACTS IF INTRODUCED IMMEDIATELY AND AT THE PROPOSED FULL 2% RATE**

Combining the proposed revisions to B-20 with recently-introduced federal, provincial and municipal housing interventions, and increased interest rates, it is projected that housing market activity could be reduced by 10% to as much as 15%.<sup>1</sup> This would have significant economic impacts that need to be factored into consideration of these guidelines by federal policy-makers:

- Resale transactions could be reduced by 50,000 to 75,000 units per year, resulting in the loss of 18,500 to 27,700 jobs.<sup>2</sup>
- Housing starts could be reduced by 20,000 to 30,000. A 10% (20,000) reduction in housing starts would result in 42,500 fewer jobs and a 15% (30,000) drop in starts would reduce employment by 63,800 jobs.<sup>3</sup>
- In combination, employment in Canada could be reduced by 61,000 to 91,500.

Combining the proposed revisions to B-20 with recently-introduced federal, provincial and municipal housing interventions, and increased interest rates, it is projected that housing market activity could be reduced by at least 10% to as much as 15%.

Furthermore, reduced sales activity would impair price growth (causing slower growth in some communities and price reductions in others). This would assuredly reduce the “housing wealth effect”, an important driver of consumer confidence and spending, and thus an important factor for job creation.

While the direct economic effects of resale market activity occur quite rapidly, the impacts from housing starts occur more gradually, and the impacts of the wealth effect are even more prolonged.

Through the combined direct and indirect economic effects, a 10% to 15% reduction in housing activity would likely cause employment in Canada, in three years, to be about 100,000 to 150,000 lower than it would otherwise be.

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<sup>1</sup> According to a review of potential economic impacts of amendments to OSFI Guideline B-20, completed by Will Dunning Inc. for CHBA in August, 2017 and presented here.

<sup>2</sup> The CREA research report can be found here: [http://www.crea.ca/wp-content/uploads/2016/02/Altus-Report-Economic-Impact\\_OS\\_En.pdf](http://www.crea.ca/wp-content/uploads/2016/02/Altus-Report-Economic-Impact_OS_En.pdf). Research conducted for the Canadian Real Estate Association indicates that an average sales rate of 464,363 sales per year during 2012 to 2014 resulted in 171,650 jobs per year, or 0.37 jobs per sale.

<sup>3</sup> Economic analysis for CHBA estimates that in 2016, 198,463 housing starts resulted in 421,942 jobs, or 2.13 jobs per unit.

## **ANNEX “B”: DETAILED COMMENTS ON LIMITATIONS OF THE STRESS-TESTING METHOD CURRENTLY PROPOSED**

Potential limitations of the proposed stress test should be reconsidered by OSFI, and the current stress-test methodology should be adopted instead. As proposed, it does not appear to take into account changes in factors that will occur by the time of renewal – for most Canadians, after five years have passed:

- First, the calculation does not take account of the considerable amounts of principal that will have been repaid by the future renewal date.
- Second, the proposed stress test overstates the amount by which payments would actually increase.
- Third, it does not appear to consider the income growth of the borrower.
- Finally, the stress test may exert an undue influence on borrowers’ mortgage choices in favour of shorter-term loans.

The proposed stress test relies on current parameters. Consequently, the test will likely over-estimate the future impact on borrowers’ costs of a future rise in mortgage interest rates. A scenario using current parameters illustrates this:

- Assuming an initial mortgage principal of \$300,000, at a 2.8% mortgage interest rate for a 5-year fixed rate mortgage and a contracted amortization period of 25 years
- The required monthly payment would be \$1,389.13.
- At a test rate of 4.80%, the payment for the purpose of the stress test would be \$1,710.82.
- Assuming that the borrower makes only the required minimum payments, at the end of the initial 5-year term the remaining principal would be about \$255,430.
- If the remaining mortgage was renewed at the stress test rate of 4.8%, for the remaining 20-year amortization period, the payment would be \$1,651.03. The stress test will have over-estimated that future payment by \$59.79 (3.6%) per month.
- In order for the future payment to be at the same level as was assumed by the stress test (\$1,710.82 in this example), the actual mortgage interest rate at renewal would need to be 5.23%, or 0.43 points higher than the 4.8% rate used in the stress test and 2.43 points higher than the initial mortgage interest rate.

In this scenario, at the renewal in five years at a rate that is two percentage points higher than the initial rate, the borrower’s actual monthly mortgage cost would increase by 18.9%. The stress test would assume a larger rise of 23.2%. By over-estimating

future costs, the stress test will overstate the impacts of potential future interest rate increases on borrowers' future mortgage costs.

The proposed stress test also does not consider that at the time of a future mortgage renewal, the borrower's income is very likely to have increased. If, over time, interest rates increase 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 currently occurring.

Substantially higher interest rates in future would be associated with a stronger economy and more rapid growth of household incomes.

The results of running scenarios would conclude that five years hence, even if mortgage rates were to rise by 2 percentage points, borrowers' mortgage cost burdens as a share of income would not be substantially changed compared to the initial levels.

At any point in time, the interest rate used in the uninsured stress test would vary for different borrowers:

- For the majority of borrowers who take a 5-year fixed rate mortgage, the rate for the OSFI stress test might, under present conditions, be slightly above the posted rate. On the date this analysis was completed, a typical actual interest rate for such a mortgage would be 2.8%, resulting in a stress test at a 4.8% interest rate, versus the 4.64% rate for an insured mortgage.
- Some borrowers might negotiate rates as low as 2.25% for 5-year fixed rate mortgages, resulting in an OSFI test rate of 4.25%, that is, well below the posted rate.
- In addition, for the minority of borrowers who make other mortgage choices (such as a variable rate mortgage as low as 2.0% or a 1-year fixed rate mortgage at 2.1% or a 2-year fixed rate at 2.2%; one lender is currently offering a 1.5-year fixed rate mortgage for 1.50%), available choices may result in stress test interest rates well below the rates used in the mortgage insurance stress test.

The proposed OSFI stress testing has the potential to affect borrower choices concerning types and terms of mortgages. In particular, since a borrower would qualify for a larger mortgage by selecting a shorter term or variable rate mortgage, the OSFI test may encourage some borrowers to make those choices even though they might otherwise prefer the security of a fixed-rate mortgage with a longer term. Thus, the proposed stress test has the potential to increase the riskiness of mortgage lending by FRFIs, undermining the market stability objective. This change could also have a significant effect on the ability to obtain either a mortgage and/or mortgage insurance for a property, especially as FRFIs significantly reduce their presence in rural Canada.

**ANNEX "C": INVESTMENT IN HOME OWNERSHIP BY CANADIANS AS MEASURED BY RESIDENTIAL PROPERTY VALUES IN MILLIONS OF DOLLARS, 2011 TO 2013**

<b>Geography</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
Canada	3841481	4060637	4228737
Newfoundland and Labrador	36090.5	39516.6	42627.9
Prince Edward Island	6038.1	6425.5	6539.1
Nova Scotia	68180.3	70591.4	72524.8
New Brunswick	35349.1	37408.4	39057.1
Quebec	658282.1	702861.4	731595.3
Ontario	1547639	1665349	1750370
Manitoba	87720.2	94234.9	100351.3
Saskatchewan	88661.2	97351.1	105544.8
Alberta	482599.1	505121.7	534974.9
British Columbia	824506.2	835011.9	838144.5
Yukon	1938.1	2108.7	2222.4
Northwest Territories	3369	3505.7	3536.4
Nunavut	1108.2	1151	1248.7
Census Metropolitan Areas	2916429	3100775	3244801

Source: Statistics Canada. Table 026-0018 - Residential property values, by province, territory and census metropolitan areas.