

January 15, 2019

Subject: Pre-Budget Recommendations regarding Housing Affordability

Dear Minister Morneau,

In order to meet the government's goals regarding the middle class, housing affordability, retirement, jobs and more, we have two specific recommendations for you, refining them from our insights provided to the Budget 2019 process through our contributions to the Finance Committee in the Fall. We would be very happy to meet with you about these at your earliest convenience.

Canadians are extremely concerned about housing affordability and access to market for first-time home buyers. Actions can be taken that keep debt-to-income in check, do not destabilize the market, and do not artificially inflate house prices.

Our two key recommendations are detailed below, but in short, we recommend that the government:

- 1) return to 30-year amortization periods for first-time buyers with insured mortgages; and
- 2) adjust the mortgage stress tests to reflect the current economic conditions.

Implementing these recommendations will provide for:

Progress for Middle Class Families so that their hard work is enough to ensure success for themselves, and for their children, by being able to access homeownership. It will help Canadians to find and afford a good place to call home.

A Secure Retirement by enabling well-qualified Canadian families to buy their first home and build equity for retirement—a strong forced-savings plan, with StatsCan data showing that homeowners at all stages of life build more wealth than renters.

Standing up for the Middle Class by enabling Canadians to join it through access the dream of homeownership, which they directly associate with being middle class. Responsible homeownership will strengthen the economy, encourage job creation, increase wages and grow the middle class.

Better Jobs Today, and Tomorrow through the good, well-paying jobs, and opportunities in residential construction—a important part of the local economy in every Canadian community. Many local economies are currently suffering, and a down-turned residential sector is part of the problem.

Details for our recommendations and rationale are as follows.

Case and Details for 30-Year Insured Mortgages for First-time Homebuyers – It Just Makes Sense

Summary:

The reduction of maximum amortization for insured mortgages from 30 years to 25 years in June, 2012, has eliminated some 20,000 potential first-time home buyers from the market annually. While this demand reduction has slowed price escalation in the markets of Toronto and Vancouver, it has come at a high and disproportionate cost to younger and new Canadians working hard to be part of the middle-class who now find themselves locked out of homeownership.

Since 2011, the rate of home ownership within the prime first-time buyer cohort (age 34 and younger) has fallen by 4.3 percent, compared to a decline of only .9 percent for all other cohorts.

The insured mortgage market is dominated by first-time home buyers. Since 2010, the market share for insured mortgage originations has fallen from 40 percent to approximately 17 percent.

More recent mortgage insurance tightening, including the stress test, have further restricted first-time buyer access to mortgage financing. Compounding this, the Bank of Canada has raised its benchmark interest rate three times in 2018 alone, by 75 bps, and by 125 bps in just 18 months.

Currently, prospective first-time home buyers who do not receive significant financial assistance from family through gifting, in order to qualify for a conventional (uninsured) mortgage, are increasingly unable to participate in the market. This is resulting in a significant demographic inequality. Others are seeking alternate financing mechanisms from private lenders, at much higher rates, posing significant risks for themselves and the overall market.

While recent changes to mortgage rules were made to reduce risk and limit debt-to-income ratios, young Canadians in fact represent *the lowest* risk in terms of mortgage arrears rates, according to Equifax data.

The reintroduction of 30-year amortization for insured mortgages taken on by well-qualified first-time buyers represents a low-risk, smart policy adjustment that will address growing inequities in mortgage access that disproportionately impact younger first-time home buyers trying to achieve the Canadian dream of previous generations. In turn, this will deliver financial benefits to these younger Canadians through equity accumulation and result in long-term economic benefits to Canada as a whole. And, as first-time buyers typically purchase entry-level housing, it will not put undue pressure on house prices overall.

Policy Recommendation

It is strongly recommended that qualified first-time homebuyers¹ be provided access to mortgage amortization periods of up to 30 years for insured mortgages.

¹ The definition of a first-time home buyer should be consistent with that currently in place for the federal Home Buyers Plan, with additional provisions allowing qualification for those who have experienced a major life change (death of spouse, divorce or legal separation).

The recommended reintroduction of 30-year amortization for insured mortgages will not mark a return to lending conditions in place prior to the 2012 restriction. Since that time, a number of additional measures have been put into place, including more stringent GDS and TDS caps, a \$1 million cap on purchase price², a 10 percent down payment requirement on the portion of an insured mortgage over \$500,000, OSFI B20 and B21 guidelines, a restriction on mortgage refinancing and the current Stress Test.

Background and Policy Context

In most urban centers across Canada there is a growing crisis in the affordability of owning a home. This crisis is particularly acute for first-time homebuyers – a group dominated by younger Canadians, new Canadians and those with young families.

In recent years, house prices have risen far faster than incomes. At the same time, federal rules on home mortgages and mortgage insurance have also become much more restrictive. In combination, this is locking out a growing number of younger Canadians who have been working hard to achieve the dream of home ownership.

Recent surveys have found that housing affordability is the top issue of concern for Millennials. *“Over 6 in 10 millennials rated housing affordability as a top or very high priority. It’s the top issue of those we tested and six points higher than government spending, cutting taxes, prescription drug prices, and fighting climate change³.”*

CHBA polls also show Canadians believe governments are doing a very poor job on this issue and that changes are needed to address affordability and to help would-be first-time homebuyers⁴.

A recent report by the International Monetary Fund (IMF) highlighted the emerging risks associated with declining affordability, noting that *“worsening housing affordability poses a major problem to some of Canada’s most dynamic metropolitan regions⁵”*. The increasing difficulty faced by employers in these regions in attracting younger, highly skilled workers has also been noted by other commentators.

The underlying causes of high house prices are complex, including a persistent shortage of new homes in some of our largest cities, and a serious mismatch between the type of houses that are available and the needs of young families looking for an entry-level home. Governments at all levels will need to work together to address underlying causes of the affordability crisis.

At the federal level, there are simple, low-risk measures that the government can take today that will help.

² More granular and regionally responsive caps for insured mortgages would also be possible, recognizing the spectrum of market conditions across the country.

³ Abacus Data for the Canadian Real Estate Association - <http://abacusdata.ca/housing-affordability-is-the-top-issue-for-millennials-who-are-looking-to-achieve-the-dream-of-homeownership/>

⁴ Earncliffe Strategy Group for franc, April 2018

⁵ International Monetary Fund, IMF Country Report No. 18/221

One of these is to allow 30-year mortgage amortization for well-qualified first-time homebuyers. Affordability is determined by house prices, mortgage rules, and income. This targeted low-risk measure will innovatively address the key mortgage challenges young Canadians now face and will make homeownership more affordable for many⁶.

Based on current mortgage interest rates, extending the mortgage amortization period from 25 to 30 years can increase the purchasing power of qualified first-time home buyers by approximately 20 percent, potentially allowing an additional 15,000 to 20,000 first-time home buyers to achieve home ownership each year. The vast majority of these additional buyers will come from the Millennial cohort, in their 20s and 30s.

Policy Rationale

The federal government has a central role and responsibility in ensuring that lending practices do not pose unacceptable risks to Canada's financial system, to the government's fiscal position, or to Canadians. With proper conditions and lender guidelines, increased mortgage amortization flexibility for first-time homebuyers should deliver broad economic benefits and involve little or no material risk.

- Available data on mortgage arrears shows that younger homeowners already pose the lowest risk of mortgage default of any age group.
- For the most part, younger first-time homebuyers are at the beginning of their working careers and data show that their incomes trend sharply upward from their mid-20s through their late 30s. Their Gross Debt Service Ratio drops as incomes grow, and this also supports the accelerated mortgage repayment typical of this age cohort. These buyers are in the best position to take on long-term financial obligations and manage these effectively.
- Typically, first-time home buyers purchase more modest and entry-level housing. The current mortgage insurance cap restricts purchases of luxury homes. Greater market participation by first-time buyers will not unduly cause house price increases.
- Lenders should, or course, remain prudent in their lending practices to ensure that all mortgage borrowers have the capacity to service their mortgage and other debt.
- Inability to purchase a home is keeping many would-be first-time homebuyers in rental units, restricting the availability of rental units and putting upward pressure on rental rates, negatively affecting many lower income Canadians. Typically, some 80 percent of rental units that become available each year result from first-time buyers vacating them. 30-year amortization periods would enable the housing continuum to function better again, and restore this natural progression through the housing continuum.

⁶ Measures that would incent first-time home buyers to select longer-term, fixed-rate mortgages, ideally five-year fixed rate, could also be pursued as this would provide additional shelter in cost stability and serve as a buffer to shorter-term rate fluctuations.

Case and Details for Updating the Mortgage Stress Test – The Time is Now

Summary:

Over the past decade, the federal government has implemented seven sets of policy changes aimed at reducing mortgage borrowing. Over the last year, conditions in both housing and financial markets have continued to evolve. Of significance, interest rates have risen while housing affordability has continued to deteriorate. Housing finance policy should reflect such changing circumstances.

The most recent change, made by the Office of the Superintendent of Financial Institutions (OSFI), came into effect in January 2018. This requires that all conventional residential mortgages issued by federally-regulated mortgage lenders be subjected to a “stress test” using the greater of two percentage points above the contracted interest rate, or the Bank of Canada’s 5-year posted rate.

This measure was in addition to a requirement for somewhat different stress testing for all insured mortgages introduced a year earlier. In combination, these two policies subject somewhere around 80% of all home purchases to a stress test.

Of all the government’s policy interventions, the January 2018 stress test requirement has had the greatest impact, as new mortgage originations have fallen sharply through 2018. To ensure that mortgage policy remains responsive to changing conditions, there is now a need to update the current mortgage stress test for non-insured mortgages.

Specifically, the reference interest rate required by the stress test should be modified based on the duration and rate basis of specific mortgages. The updated stress test would apply a higher stress rate to open and short-duration mortgages and a lower reference rate for mortgages of longer duration with locked-in rates. This approach would better reflect the actual risk posed by future mortgage rate increases in these different borrowing scenarios.

Policy Recommendation

As financial and market conditions evolve, the current stress test is resulting in perverse impacts. To address these, some modifications to the stress test are clearly required. Specifically, in place of the current ‘blanket’ stress test that applies equally to all mortgages, the stress test rate should be varied based on the mortgage term and conditions.

In simple terms, the longer locked-in period, the lower the stress test should be. The stress test would remain unchanged for mortgages with open terms and variable rates but be reduced for fixed-rate, locked-in mortgages, with the greatest reduction applying to terms of five years or longer. (See *Chart One*)⁷.

⁷ Based on available rates in place as of December 1, 2018

Chart One: Proposed Updates to the OSFI Stress Test

Term	Mortgage Interest Rate	Revised Stress Test Interest Factor	Revised Stress Test Qualifying Rate	Current Stress Test Qualifying Rate
open/variable	3.05	2.0	5.05	5.34
1 year fixed	3.35	1.6	4.95	5.35
2 year fixed	3.45	1.4	4.85	5.45
3 year fixed	3.60	1.2	4.80	5.60
4 year fixed	3.65	1.00	4.65	5.65
5 year fixed	3.70	0.75	4.45	5.70

Note: For reference, as of November 2017, 72 percent of mortgages were at a fixed-rate and 24 percent had variable or adjustable rates. The remaining 4 percent were combination mortgages.

Background and Policy Context

New data emerging monthly shows that current mortgage policies, and the stress test in particular, are having a substantial depressive effect on housing markets, and that this effect is cumulative and increasing.

At this point the OSFI stress test appears to be overshooting its policy objectives as economic and financial conditions continue to evolve. Since the introduction of the stress test, the Bank of Canada’s (BoC) overnight rate has increased by 75 basis points. Most economic forecasters believe that the BoC is at or beyond the mid-point in the current tightening cycle and that economic growth in the next number of years will slow from its current rate.

The impact of the stress test is also uneven across markets and among age cohorts.

In particular, younger Canadians without housing equity who are seeking to become home owners are more significantly impacted by the current regulatory environment. This cohort was already seeing declining ownership rates before the latest regulatory measures came into effect (Chart One), and the new stress test has only served to accelerate this harmful trajectory. Data also shows, perversely, that this cohort – that is impacted the most by the new rules – is in fact one of the least risky, given their extremely low arrears rates (per Equifax).

Chart Two: Home Ownership Rate by Age Cohort

Age Group	2011	2016	Change (percentage)
Under 25 years	23.8%	19.7%	-4.1%
25 to 29 years	44.1%	39.6%	-4.6%
30 to 34 years	59.2%	55.0%	-4.2%
35 to 39 years	67.1%	63.5%	-3.6%
40 to 44 years	71.0%	69.0%	-2.0%
45 to 49 years	73.8%	71.8%	-1.9%
50 to 54 years	75.7%	74.5%	-1.2%
55 to 59 years	76.9%	75.8%	-1.1%
60 to 64 years	77.2%	76.8%	-0.4%
65 to 69 years	76.7%	76.6%	-0.1%
70 to 74 years	75.5%	75.8%	0.4%
75 years and over	70.5%	72.3%	1.7%
Total – All Age Groups	69.0%	67.8%	-1.2%

Source: Will Dunning from Statistics Canada Census Data

Perversely, as access to mortgages becomes increasingly restricted, some in the younger first-time buyer cohort are pushed towards open, variable rate mortgages to reduce the stress test impact (see Chart One), while others are seeking mortgage financing in the unregulated market, often at much higher interest rates.

In addition, elements of the revised B-20 Guidelines that require application of the stress test if an existing mortgage is moved to a new lender act to limit Canadians' ability to negotiate the lowest possible interest rate when renewing their existing mortgages, reducing market competition and causing existing homeowners looking to renew unnecessary financial harm. Changes to this requirement should also be considered.

Available data and market trends indicate that the federal government needs to update specific aspects of the OSFI stress test to better align it with current market conditions and to address emerging inequities impacting younger, first-time home buyers.

Policy Rationale

The current stress test for non-insured mortgages does not differentiate between mortgages of different durations and terms. As a result, it fails to account for the significantly different risk horizons that apply, and in fact pushes buyers into riskier mortgages.

Open variable rate mortgages will be immediately impacted by any interest rate increase. In contrast, a newly originated mortgage with a five-year term and locked rate will not be impacted for five years. Fixed-rate mortgages of shorter duration will fall between these two examples.

Applying a single stress test factor to all of these scenarios has the effect of 'over-stressing' longer duration mortgages with locked-in rates by as much as 1.25 percent. As other market

observers have also pointed out, the current stress test regime overlooks a number of important factors:

- In the current rate environment, a new mortgage borrower will repay between 14 and 15 percent of the mortgage principal during the first five years (based on a 25-year amortization and five-year fixed term). Upon renewal – the first time the borrower will be subject to any rate increase – interest charges will apply on this reduced principal amount, not on the original mortgage value.
- In any scenario where interest rates rise by an additional 2 percent over current rates, economic growth would need to be reasonably robust, and some inflation at or above the BoC target level would need to be assumed. In such a scenario, wages would be expected to increase at, or near, the rate of inflation. Wage growth averaging just 2 percent per year would see the borrowers' income grow 10 percent prior to renewal and rate reset in the case of a five-year mortgage term.

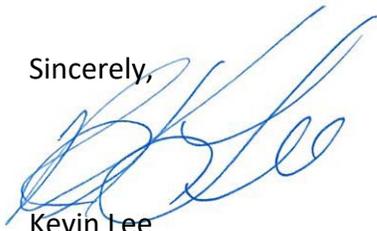
The current stress test uses principal and income values in place at the time of origination. As a result, it over-estimates the degree to which mortgage costs will increase and under-estimates the borrower's ability to pay, to varying degrees depending on the mortgage duration.

Using the current posted mortgage interest rate for stress testing of mortgages of longer durations is excessively stringent and increasingly prevents large numbers of Canadians from achieving responsible housing goals. Indeed, data indicates it is currently sending borrowers into more risky mortgage options. It is also particularly unfair to younger, first-time home buyers who are at or near the beginning of their careers.

Current market conditions suggest strongly that adjustments to the stress test are both justified, necessary, and will directly address current shortcomings without creating additional risk to either mortgage borrowers or lending institutions.

Thank you, very much for your attention on these matters. We would be very happy to meet to discuss these recommendations at your earliest convenience.

Sincerely,



Kevin Lee
CEO, Canadian Home Builders' Association