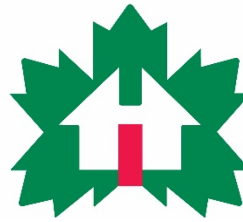


**CHBA Submission to the Office of the Superintendent of Financial Institutions on the Public consultation on guideline B-20: Residential Mortgage Underwriting**

**Introduction**

On behalf of the Canadian Home Builders' Association (CHBA) and its more than 8,500 member companies across Canada, I am writing today regarding the the Office of the Superintendent of Financial Institutions (OSFI) consultation on guideline B-20 – Residential Mortgage Underwriting.

Residential construction and renovation are a massive part of the Canadian economy and provide jobs in every community. In 2021, the sector accounted for 1.44 million jobs across Canada, representing $95.6 billion in wages and $182.7 billion in economic activity. However, the industry is not without its serious challenges. Increasing interest rates have led to a slowdown in sales – which will result in reduced housing starts in the months ahead.

CHBA does of course recognize the Canadian and international efforts to get inflation under control through higher interest rates, with the intent of easing off rate hikes once inflation is abated. CHBA also recognizes that assessing when that point is reached is challenging. However, measures over and above these high interest rates that risk reducing the job-creating engine of renovation and new home construction could have a negative impact on the economic stability of communities large and small across the country.

The latest CHBA Housing Market Index (HMI), which is a leading indicator about the current and future health of the residential construction industry in Canada, shows the extreme effect that interest rate hikes are having on reducing housing starts for 2023. This translates to less housing supply when so much more is needed in order to address affordability challenges. The 2022 Q4 HMI results showed industry sentiment dropped yet again to staggering lows, reflecting lower sales and buyer traffic that will translate into less housing starts in the months ahead. The HMI, which is on a scale of 0 to 100, was at 26.2 for single-family builders, while the multi-family builder HMI dropped to 26.0, both all time lows. For contrast, the HMI peaked in Q1 2022 at 89.4 for single-family builders and 88.8 for multi-family builders. It has been rapidly declining ever since due to rising interest rates. These HMI results suggest that starts could drop as much as 30% in the months ahead. This trend is the exact opposite of the doubling of housing starts that is needed, and has been stated as a target by the Federal government.

The vast majority of Canadians still strive to achieve the dream of homeownership, which remains a sound path to financial wellbeing. However, affordability challenges brought on by lack of supply and other factors are very discouraging, especially for first-time buyers. Indeed, the federal government also understands and supports the importance of homeownership and affordability challenges. The 2022 federal budget stated that "*Everyone should have a safe and affordable place to call home. But that goal—one that was taken as a given for previous generations—is increasingly out of reach for far too many*

*Canadians. Young people cannot imagine being able to afford the house they grew up in*." However, there are some aspects of the current OSFI B-20 concepts in the consultation document that would run counter to the goal of achieving the dream of homeownership.

**Key Messages**

While rising interest rates target curbing overall inflation in the economy, the effect on slowing housing starts, which is compounded by the stress test and would be further compounded my more underwriting tightening, excessively runs the risk of starting a recession and is at odds with the need to get more supply online to address Canada's housing supply shortage and the chronic housing affordability issues that come with demand continually outstripping supply. It is at odds with the federal government's stated goal of needing 3.5 million homes over the next decade. In order to achieve this goal, there needs to be a doubling of housing starts to about 400,000 units per year. Increasing interest rates and further tightening of mortgage rules affect first-time home buyers the most, knocking more and more well qualified buyers out of the market, keeping those would-be buyers in rental units and causing further shortages in the rental stock as well. And there is already an extreme shortage of rental units in Canada.

Canadians, particularly first-time buyers, are feeling the effects of rising interest rates. While the market may be seeing a softening of housing prices as a result of increasing rates, it does not mean affordability is improving as the cost of financing has increased. Increased interest rates mean even with slightly lower prices, it is less affordable to purchase a home. And of course, on top of that, the stress test has meant still fewer well qualified people can qualify for a mortgage.

With the current interest rate environment, there needs to be policy to counter the impacts on new construction as well as locking out more first-time homebuyers**.** Therefore, in order to support well-qualified homebuyers access homeownership without increasing risk to the financial system, OSFI can and should modify the stress test for uninsured mortgages to reduce the test rate on a declining basis for 7- and 10-year mortgage terms, given the reduction in risk with longer mortgage terms for both Canadians and the financial system. The stress test reduces the buying power of those at the margins of qualifying by is a significant barrier to the purchase of homes – longer term mortgages can both increase access to home ownership while lowering risk to the financial system.

For changes to the stress test for uninsured mortgages, CHBA undertook a brief analysis to confirm the impact on the buying power a model buyer. Now that the contract rates for fixed 5-year term mortgages are well above 3.25%, the stress test is the contract rate plus two percentage points. Based on a buyer wishing to purchase a $400,000 home at the Bank of Canada's conventional 5-year fixed rate of 6.49% with a 20% down payment, the stress test of 8.49% would result in a 15.8% decline in buying power for this particular buyer, holding all else equal. This 15.8% reduction in buying power is prevalent across other home price scenarios as well. Similarly, using the average prevailing posted rates from the big five banks of 5.2% and a 20% down payment, buying power declines by 16.8%.

An OSFI press release from December 2022 stated that OSFI does not consider the Minimum Qualifying Rate (MQR) to be a tool to manage the demand for housing. However, the stress test (and further attempts to tighten it) does directly impact housing demand (or it at least suppresses demand). A proper balance must be struck, and it would be advisable for OSFI to return to its mandate of taking a balanced approach. The OSFI mandate states that it "acts to protect the rights and interests of depositors, policyholders, financial institution creditors and pension plan beneficiaries while having due regard for

the need to allow financial institutions to compete effectively and take reasonable risks." The mandate also states, "OSFI recognizes that management, boards of directors and pension plan administrators are ultimately responsible for risk decisions…" Reaching beyond this approach is indeed impacting the housing market and those who would like to enter that market.

Supporting first-time buyers will not adversely stoke the housing market, nor will it create undue risk. According to the Canada Mortgage and Housing Corporation (CMHC), using data from Equifax, the age cohort under the age of 35 is shown to be the lowest risk cohort of buyers in terms of mortgage arrears. Nationally, the % of arrears (3 or more months) to total mortgages from Banks have remained near their all time low at the end of 2022 (0.15%) and well below the long-term average rate of 0.35%. More broadly, total consumer insolvencies remain well below pre-pandemic levels, despite a moderate upward trend. Outright consumer bankruptcies have remained low since the start of the pandemic, with the upward trend being driven by insolvency proposals. Average insolvencies in January and February of 2023 were still 11.4% below the pre-pandemic average insolvencies in January and February 2019. All of this demonstrates that now is not the time to further tighten mortgage lending rules; indeed, creative means to support first-time homebuyers are what is required now.

## CHBA Responses to B-20 Consultation Proposals

## Loan-to-income and debt-to-income restrictions

### How should an LTI threshold be determined?

CHBA does not support the introduction of a formal high loan-to-income threshold. The definition of income used in the LTI calculation, as it currently stands, is not balanced. As noted in the latest setting of the minimum qualifying rate (MQR) in December 2022, OSFI's focus of underwriting practices is to guard against a future reduction of a borrower's income or increased expense. However, the definition of income within LTI is static at the time of origination or renewal of a mortgage. LTI does not account for the more probable outcome that a borrower's income rises over time, due to cost-of-living adjustments, career progression, capital gains income, etc. The determination of high LTI ratios and thresholds should be left to residential mortgage underwriting policies (RMUPs) of federally regulated financial institutions (FRFIs).

CHBA also calls for OSFI to provide a transparent quantitative rationale for the proposed 450% ratio as the threshold for a high loan-to-income (LTI). For example, the Bank of Canada's staff analytical note from Bilyk et al. (*2021)*, found that a 100-percentage point increase in the LTI ratio on an uninsured mortgage increased the probability of falling two months behind on *any* debt payment within the first three years from origination by just 0.13-percentage point. Although statistically significant, its shows that the LTI ratio is not a sensitive empirical predictor of financial stress. The authors also noted their sample was limited to mortgage originations from oil producing provinces after the oil price decline in 2014 and cautioned that the findings should not be applied to other economic scenarios. Therefore, the need for a formal high LTI threshold is not broadly supported by available empirical research.

**What reasonable exemptions should OSFI consider (e.g., for smaller or less complex lenders, lenders with low mortgage volumes)?**

CHBA calls for no additional restrictions to mortgage lending and approvals within guideline B20 rather than designing exemptions for the proposed new measures. OSFI must consider the vast number of non-

federally regulated lenders that have already seen their market share increase due to the stress test, which has *decreased* financial system stability. CHBA again recommends avoiding more restrictions on FRFI lending practices that will send potential homebuyers to alternate lenders. Put another way, additional restrictions transfer financial risk away from where OSFI can effectively manage it, with FRFIs, while still exposing what OFSI views as risky borrowers to the broader financial system.

**Should OSFI explore broader restrictions on indebtedness (i.e., DTI) that capture additional, non-mortgage debt?**

CHBA does not support the inclusion of broader restrictions on indebtedness within guideline B20. It is the role of the individual FRFI lenders to assess the suitability and serviceability of a borrower's non-mortgage debt during a mortgage application and approval process. OSFI already acknowledges the heterogeneity of loan characteristics that exists between FRFIs, with some taking on "riskier" borrowers. Broader restrictions on indebtedness will lead to marginal buyers to private lending practises (outside of OSFI's regulatory reach) and lead to greater homogeneity of loan book characteristics across FRFI lenders—which reduces incentives to innovate and compete. CHBA firmly believes a measure like DTI should not be implemented.

**To what extent do you believe that a new LTI restriction will meet OSFI's policy objective**?

The CHBA believes that a new LTI restriction would off load risk of deteriorating mortgage quality from FRFIs and into the private lending space—outside of OFSI's regulatory reach. Disqualifying high LTI mortgage applications will not address the undersupply of homes, which is widely accepted as the root cause of rising household indebtedness. Complete job loss is the most likely scenario that would impact a borrower's ability to pay, which is supported with research findings by the Federal Reserve and other authorities. A LTI ratio is not predictor of job stability. FRFI assessment of a borrower's employment situation and prospects should be encouraged but this process should be left to FRFI's own RMUPs.

OSFI's policy objective of "enhancing the credit quality of residential mortgages" oversteps its broader mandate of "taking a balanced approach" and allowing FRFIs to be responsible for their own risk decisions and the losses that come with it. Furthermore, guideline B-20 was designed and implemented to address the risk of a period when interest rates rise, which we are currently seeing. OSFI must better explain its specific concerns with the current state of credit quality. and why the current state of guideline B-20 is inadequate—despite reaffirming the current MQR in December 2022—and justify any changes against its mission to take a balanced approach to risk. This is particularly true given that broader credit enhancement would be at the cost of forcing more buyers at the margin to higher cost options and at the cost of putting downward pressure on the long-term trend of the number of new homes constructed.

CHBA is also concerned by the suggestion in the consultation's preamble that "high" LTI thresholds could change with different macroeconomic conditions and through-the-cycle dynamics. This policy requires speculation on the mortgage rate cycle. CHBA advocates for a regulatory environment that is predicable and limited in uncertainty for homebuilders to plan and operate in. This is particularly true for large urban areas where affordability has been a persistent issue. Modulating the high LTI threshold over time would have outsized fluctuations on the proportion of would-be homebuyers that can pass guideline B-20 restrictions in Canada's largest cities.

## Debt service coverage restrictions

**Are the formulas and definitions for insured mortgage GDS and TDS appropriate for uninsured mortgages? What alternatives should OSFI consider?**

CHBA does not support the application of formal GDS and TDS ratio definitions for uninsured mortgages. OSFI must first establish why the current residential mortgage underwriting practices, currently left up to individual FRFIs' residential mortgage underwriting polices, are inadequate. By applying additional regulations across the entire industry, OSFI further homogenizes the characteristics of borrowers on the books of all FRFIs, which leads to lower competition and can also lower incentives to innovate new mortgage offerings.

**Should OSFI introduce an explicit amortization limit in Guideline B-20 that is used only for qualification?**

During a period of heightened unaffordability, creating options for longer amortization periods would help lower barriers to homeownership for many borrowers. Like the high-LTI threshold proposal, there should be a transparent analysis to justify the introduction of an amortization limit. An amortization limit at the time of qualifying does not consider the income growth of the borrower, which is highly likely among young first-time buyers, nor does it consider the inflationary impact that reduces the burden of monthly principal payments in 10- or 20-years' time. CHBA does not support the use of an explicit amortization limit for qualification.

**To what extent do you believe that a new restriction on high debt service lending will meet OSFI's policy objective?**

OSFI's policy objective of "enhancing the credit quality of residential mortgages" oversteps its broader mandate of "taking a balanced approach" and allowing FRFIs to be responsible for their own risk decisions and the losses that come with it. Furthermore, guideline B-20 was designed and implemented to address the risk of a period when interest rates rise, which we are currently seeing. OSFI must better explain its specific concerns with the current state of credit quality. OFSI should also explain why the current state of guideline B-20 is inadequate—despite reaffirming the current MQR in December 2022—and justify any changes against its mandate to take a balanced approach to risk. This is particularly true given that mortgage credit enhancement would be at the cost of forcing more buyers at the margin to higher cost options and at the cost of putting downward pressure on the long-term trend of the number of new homes constructed.

## Interest rate affordability stress tests

**Should the MQR, or a similar interest rate affordability stress test, be applied to a borrower's total debt service (i.e., for other existing mortgages and non-mortgage debt obligations), in addition to gross debt service?**

CHBA does not support an expansion of the debt subject to the MQR. Not all debts are sensitive to overnight policy rates. Most installment loans are fully amortized at a contract rate. Credit card debts, which are roughly 12% of non-mortgage loans, are also not affected by interest rates. Furthermore, outstanding debt levels for lines of credit, home equity lines of credit (HELOCs), or originations from credit unions are down or remain stable. OSFI should explain why current underwriting practices are not

adequately assessing a potential borrower's broader debt obligations and what risks have changed during the foreseen rise in the overnight policy rate.

**To what extent do you believe that the potential adaptations to the MQR would meet OSFI's policy objective?**

Since the MQR for uninsured mortgages was introduced in 2018, it has been asserted that this stress test helped cool overheated markets. However, instead of reducing demand for existing and new homes, it simply reduced the number of transactions by pricing many out of the market. The fact that housing is a basic need means that demand destruction is not possible, housing demands simply shift between purchasing and renting based on affordability conditions. The MQR has distorted this by raising the demand for rental properties, which in turn makes rental units and other properties more attractive to own from investors who are able to pass the stress test. It is the introduction of the MQR which has inhibited owner-occupied home purchases. By further raising the MQR, by including non-mortgage debts, OSFI is placing further pressure on an overstretched rental market relied upon by a diverse and large set of Canadians.

As stated previously, imposing additional restrictions like the adaptation to the MQR could potentially achieve OSFI's policy objective by simply moving the risk to other areas of Canada's economy. CHBA believes that the OFSI's policy objective is misguided and the proposed regulatory changes to achieve its policy objective have not been sufficiently justified. If the current state of guideline B-20 was prudent, there would be little reason to introduce additional restrictive regulations during a period guideline B-20 was designed to insulate mortgage credit quality from. Additional restrictive mortgage regulations will not sustainably achieve OSFI's policy objective.

**Question 4**

**Are there alternative options that OSFI should consider that would better achieve its policy objective?**

CHBA firmly believes that OSFI's policy objective ignores and exacerbates the underlying problem with credit quality of residential mortgage assets, which is the persistent shortage of new dwellings being constructed. Greater leverage is required as more buyers compete for an inadequate supply of new and existing homes. Put simply, homebuilders do not have incentive to increase their rate of home construction to accommodate potential buyers who are not able to qualify for a mortgage. Furthermore, homebuilders' decisions to invest in the capital to increase their capacity to produce homes requires certainty in future regulations that impact the demand for homes. This means that further mortgage underwriting restrictions make capital investment decisions more difficult for homebuilders due to increased limitation of buyers who can still qualify for a mortgage. Amending guideline B20 with greater restrictions that apply to all FRFI RUMPs will continue to contribute to the undersupply of new homes in Canada. In order to sustainably improve mortgage credit quality, OSFI must assess the direct and significant impact its policies have on access to homeownership, the production of more housing supply, the construction industry, and the financial opportunities for Canadians with regards to homeownership. As an agency of the federal government, such considerations should be acknowledged and considered part of the balanced approach to OSFI's regulations.

The proposed policy changes have focused on the downside risks of underwriting practices and are not balanced with upside risk. Applying the same risk management practices across all mortgages, which pose

different levels of financial risk, is not prudent policy and goes against OFSI's mandate of allowing FRFIs to compete and take reasonable risks. These proposed changes to guideline B-20 also remove much of the of risk decision responsibilities from FRFIs and present significant adverse impacts on Canadians' prospects of homeownership.

CHBA advocates for reducing MQR requirements, on a declining basis, for fixed 7- and 10-year term mortgages. OSFI acknowledges that fixed rate longer-term mortgages, those with terms longer than 5-years, can carry less payment and renewal risk. Steps to encourage greater diversification of mortgage terms, through lower renewal risk long-term mortgages, is the primary alternative approach to achieving OSFI's policy objective of "enhance the credit quality of residential mortgage assets and underwriting practices of federally regulated lenders" without adversely impacting the path to homeownership for Canadians.

CHBA also calls for a more dynamic application of the MQR stress test across all uninsured mortgage offerings for mortgage by incorporating borrower's potential income growth into the stress test. Under this stress test regime, the stress test above the contract rate should be lowest for longer term mortgages, for example 0.75 percentage point above the contract rate for a 5-year mortgage. The proposed stress test increment would increase by 0.25 percentage points for every year the term shortens. A variable rate mortgage would be subject to the full 2 percentage point stress test rate. The rational is that the longer the term at a fixed rate, the borrower would have greater time to increase their income to meet the servicing cost of a higher contract rate at renewal time, even with modest assumption surrounding wage growth. CHBA implores OSFI to consider reasonable upside risk to outcomes within mortgage lending when assessing future MQR designs.