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From: Jim MacGee

To: Bill Morneau, Minister of Finance

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Re: **Limit the Buildup of Risk, not Competition, in Mortgage Lending**

Last month saw another move to limit the buildup of risk in housing markets, with the Office of the Superintendent of Financial Institutions updating guideline B-20 on residential mortgage underwriting practices and procedures. A key reform is the introduction of an interest rate stress test for uninsured mortgages, which requires lenders to assess whether a prospective borrower's debt service ratio remains below a maximum level even if interest rates were two percentage points higher.

The case for tightening underwriting standards to head off the buildup of risky borrowers is clear. High and rising house prices – especially in the GTA and Vancouver – have left too many buyers with high debt to income ratios. This is even more concerning as short-term rates look set to rise as the Bank of Canada retreats from its extended low-interest hibernation. Although rate increases are projected to be gradual, highly indebted borrowers risk facing very high debt service payments when they renew their mortgages.

An interest rate stress test on new mortgage originations should help mitigate the risks. Requiring new borrowers to have sufficient income to manage their mortgage payments at the current loan rate plus two percentage points adds a needed measure of prudence to underwriting standards.

While a stress test for new mortgage originations makes sense, imposing a stress test on existing borrowers looking to renew their mortgage does not. Unlike in the US where 30-year fixed rate mortgages are common, most Canadian mortgages have five year terms. This means that – until the mortgage is fully paid off – Canadian home buyers periodically need to renew their mortgage and negotiate a new interest rate.

The B-20 guideline revision (partially) recognizes this by exempting borrowers renewing a mortgage with their existing lender from the stress test.

The problem is this approach unnecessarily limits competition. By imposing an interest rate stress test on a borrower if they switch lenders, borrowers with high debt-to-income ratios may find that they can only qualify for a renewal with their existing lender. This removes the option to shop for a better rate, and limits borrowers' bargaining power on renewal. This is likely to result in higher rates for borrowers who already face high debt payments relative to their income.

The proposed stress test for new borrowers also unduly limits competition. In response to concerns that simply adding two percentage points to the quoted mortgage rate would encourage borrowers to shift from five-year fixed mortgages to shorter term mortgages with variable rates, OSFI requires lenders to use the higher of the rate offered by the lender plus two percent or the average five-year fixed rate posted by the six largest banks. This lowers the incentives for a lender to offer a low interest rate to help a borrower qualify for a mortgage.

Fortunately, there is an easy tweak to the details of the stress test to address these concerns. First, remove the stress test on borrowers looking to renew an existing mortgage. Second, revise the stress test on new mortgages so that the rate for a five-year fixed mortgage is the quoted interest rate plus two percent. These modest revisions can alleviate the impact of the stress test on competition, while maintaining a (needed) degree of prudence as we enter a period of rising interest rates.

With well-designed policy, limiting the buildup of risks needn't also limit competition in mortgage markets.

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