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E-BRIEF

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One More Case for Longer-term Mortgages: Financial Stability

by

Michael K. Feldman

- Beyond the benefit of greater consumer choice, increasing the availability and take-up of longer-term mortgages in Canada could have another positive effect: enhancing financial stability.
- However, the custom in Canada for residential mortgages to have a legal maturity of five years is too well-entrenched to be overcome organically without incentives or changes to laws or government policies and programs to encourage this development.
- I examine why Canada does not have a market for longer-term mortgages and the steps that can be taken to encourage them.

The Canadian residential mortgage market has an unusual characteristic – while residential mortgages are usually amortized over periods of between 25 and 40 years, they typically have legal maturity dates of five years or less. Since my earlier discussion of the issue in a C.D. Howe Institute study (Feldman 2018), the case for longer mortgages has received a high-profile endorsement that, in turn, justifies a closer look at their potential benefits and the regulatory hurdles that stand in their way.

In May 2019, Stephen Poloz, the Governor of the Bank of Canada, in published remarks to the Canadian Credit Union Association,[1] eloquently argued that greater diversity in mortgage durations should contribute to a safer financial system and a more stable economy.

According to information available to the Bank of Canada, just 2 percent of all mortgages issued in 2018 were fixed-rate loans with a term longer than five years.[2] Governor Poloz pointed out in

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1 Poloz, Stephen S., *Risk Sharing, Flexibility and the Future of Mortgages*, [https://www.bankofcanada.ca/2019/05/risk-sharing-flexibility-future-mortgages/].

2 *Ibid*.

his remarks that if more borrowers had longer-term mortgages, these borrowers would face the risk of having to renew at higher interest rates less often. Also, from a systemic point of view there would eventually be fewer borrowers in the economy renewing their mortgages in the same year. Finally, Governor Poloz noted that a longer term allows the borrower to build up more equity in the home, giving the borrower greater options at renewal.[3]

As will be discussed below, the prevalence of residential mortgage terms of five years or less has been supported in the past by legislation, including section 10(1) of the *Interest Act* (Canada), which gives the borrower the option of redeeming the mortgage after five years with a penalty of no more than three months' interest. This paper agrees with the governor's rationale for encouraging more longer-term residential mortgages in Canada. However, in order to accomplish this it will not only be necessary to reduce the impact of existing regulatory distortions; it will also be necessary to create consumer demand for longer-term mortgages to overcome the inertia of existing strong conventions in the Canadian residential mortgage market.

Why Canada Does Not Have a Market for Longer-term Mortgages

As noted in Feldman (2018), the Canadian practice of predominantly limiting residential mortgages to five-year terms appears to have grown out of a statute first passed by Parliament in 1880 and still contained in section 10(1) of the *Interest Act* (Canada) ("Section 10") that provides that any mortgagor may redeem the mortgage at any time following five years "after the date of the mortgage" upon paying a penalty of no more than three months' interest.[4] Sometime before the 1980s, the practice developed of having mortgagors sign renewals of their mortgages and lenders took the position that the date of each renewal should be understood as the "date of the mortgage" for purposes of Section 10, thereby establishing a new five-year period during which prepayment penalties (beyond the three months' interest) could be charged. Some borrowers challenged this practice in court, arguing that in the first year of a five-year renewal, being the sixth year following the date of the original mortgage, the mortgagor should be able to prepay in full by paying a three-month interest penalty. One of these cases, involving Royal Trust, went to the Supreme Court of Canada[5] and the court upheld the lender's practice of not permitting the borrower to prepay without penalty during a five-year renewal term so long as the borrower has an opportunity to prepay the mortgage at least once every five years subject to a maximum penalty of three months' interest.

As a result of Section 10 and the Royal Trust decision, a lender could avoid the re-investment risk associated with prepayments by offering mortgages with terms no longer than five years and renewals with terms no longer than five years. A lender offering a 10-year mortgage would be assuming the risk that any time after the fifth

3 Another systemic risk not mentioned by Governor Poloz is that a significant downturn in the real estate market could result in the insolvency of some mortgage lenders, particularly unregulated lenders. If this were to happen, borrowers from these lenders may not be able to renew their mortgages if their lenders were being liquidated and may not be able to refinance their mortgages due to the downturn in the real estate market. This would lead to additional defaulted mortgages, which could further depress the real estate market. This risk decreases with more longer-term mortgages because there will be fewer renewals throughout the amortization term.

4 *Interest Act* (Canada), RSC 1985, c. I-15, s.10(1).

5 The Royal Trust Company v. Potash [1986] 2 S.C.R. 351 (the "Royal Trust decision").

anniversary of the mortgage the borrower could fully prepay the mortgage upon paying a penalty of three months' interest.[6] If the lender could not re-invest the prepaid amount to earn a rate of return equal to the interest rate of the prepaid mortgage, it would bear all of the forgone earnings opportunity. This could be a particularly acute problem if the lender had locked in 10-year funding at a higher interest rate. In effect, Section 10 gives the individual borrower under a 10-year mortgage a five-year prepayment option.

Another reason for the scarcity of residential mortgages with terms longer than five years is that most regulated financial institutions in Canada fund a majority of their uninsured residential mortgages by accepting deposits, including by issuing guaranteed investment certificates (GICs). For federally regulated institutions, these deposits are insured for up to $100,000 by the Canada Deposit Insurance Corporation (CDIC). At the time of writing, CDIC may only insure deposits having a term of five years or less.[7] For financial institutions relying on CDIC insured deposits to match fund their assets with liabilities of approximately the same duration, the CDIC term limit poses a challenge for issuing mortgages having maturities greater than five years.

Fortunately, a significant change is on the horizon. In the *Budget Implementation Act, 2018 No. 1*,[8] which received royal assent on June 21, 2018, the federal government amended the *CDIC Act* to eliminate the five-year term limit on insured deposits.[9] This provision was to be brought into force on a date set by order-in-council. On March 25, 2019, an order-in-council was passed fixing April 30, 2020, as the date this amendment to the *CDIC Act* comes into effect.[10]

This amendment should make it easier for federally regulated financial institutions to fund longer-term mortgages. This will depend upon the retail demand for longer-term deposits; in a flat yield curve environment, as we have now, one would expect that most retail demand would be for shorter-term deposits; however, once the yield curve reverts to a more common rising curve, a demand for longer-term deposits may develop.

Pricing the Embedded Prepayment Option

What would the additional cost be to borrowers of moving to a 10-year mortgage? One would expect that if the regulatory environment were to be adjusted to encourage a greater demand for 10-year mortgages, the increased competition by existing lenders to meet this increased demand would reduce the cost of the embedded prepayment option to the borrower. Of course, one would also expect the price differential between a five-year mortgage and, say, a 10-year mortgage to be dictated largely by the Canadian dollar Government of Canada bond yield curve which is currently "flat."[11]

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6 As a convention in this paper, I will sometimes refer to all mortgages having a term longer than five years as a "10-year mortgage" because it is easier to write about a specific example, although similar conclusions would be reached using different examples.

7 *CDIC Act*, Schedule s 2(2)(a).

8 *Budget Implementation Act, 2018, No. 1*, SC 2018, c 12.

9 *Ibid*, s 211(3).

10 SI/2019-17, Canada Gazette, Part II, Volume 153, Number 7, PC 2019-222 (March 25, 2019).

11 As at September 16, 2019, the five-year bond yield was 1.48 percent and the 10-year bond yield was 1.48 percent. In the period leading up to writing this E-Brief, the yield curve had been described as relatively "flat" (i.e., not a significant difference between short-term rates and longer term rates) and on occasion actually "inverted" (i.e., longer-term rates lower than the short-term rates).

A lender determining an acceptable interest rate to charge on a 10-year mortgage as compared to a five-year mortgage would have to accommodate at least two factors (i) the additional cost of funding a 10-year mortgage, and (ii) an appropriate additional return for accepting the prepayment risk after the fifth year.[12] On the first item, the fact that the yield curve is relatively flat does not necessarily translate into flat funding costs. Lenders would have to account for a normal upward sloping yield curve in a dynamic funding environment as well as their perception of yield-curve volatility.

On the second item, the scarcity of longer-term mortgages means that there is not a very deep pool of borrowers among which to spread the prepayment risk. It also means that the risk and reward profile for lenders may not be incentivizing them to offer longer-term mortgages unless they can charge large interest rate premiums. If the long-term mortgage market comprised 20 percent of the market instead of 2 percent, lenders would have to charge more competitive rates or risk losing significant market share. This argues for policies geared at increasing the size of this market by increasing demand for the product.[13] Although numerous factors go into pricing the embedded prepayment option, increasing demand for longer-term mortgages is one of the few variables that can be affected by a regulatory response.

Steps that Can Be Taken to Encourage Longer-term Mortgages

In order to significantly change the dominant custom in Canada of residential mortgage terms being five years or less, the federal government would likely have to provide inducements to borrowers (on the demand side) and lenders (on the supply side), and/or amend regulatory provisions or practices.[14] The following section makes some suggestions.

12 Another factor would be the additional origination fee that would likely have to be paid to a mortgage broker or third party originator for a 10-year mortgage as compared to a five-year mortgage. People who earn fees for originating or renewing mortgages will not likely embrace efforts to have fewer originations or renewals unless they are appropriately compensated for longer-term mortgages.

13 At the time of writing, according to a mortgage comparison website, the lowest rate difference between a 10-year mortgage and a five-year mortgage offered by the same lender was 0.35 percent (offered by two lenders); the second lowest was 0.40 percent; and the third lowest was 0.81 percent. Several listed lenders did not offer 10-year rates. The highest differential was 3.65 percent; the second highest was 3.45 percent; and the third highest was 3.35 percent. There were quotes on 10-year mortgages from 14 different lenders. It would appear that certain lenders have decided to be more aggressive in targeting this underserviced portion of the market than others.

14 So far, I have only mentioned supply side influences (Section 10 and the five-year limit on deposits insured by CMHC). But if borrowers wanted to lock in interest rates that are currently at historical lows, why do longer-term mortgages only represent 2 percent of the market? I am not aware of any studies that have been done to explain this, but I suspect that the reason borrowers are not asking for longer-term mortgages is the same reason that when they go to a restaurant they will not think of ordering a dish that is not on the menu. A customer who is a frequent patron of a restaurant may be familiar enough with what the chef is capable of preparing and so may order something other than what is offered on the menu. However, a borrower who only deals with their lender or mortgage broker once every few years at mortgage renewal time is unlikely to choose an option that is not being offered. So I believe that one of the most important influences on the demand for longer-term mortgages is the willingness of lenders to supply longer-term mortgages.

1. Revise the Stress Test for Longer-term Mortgages

In 2017, the federal government passed regulations to revise the eligibility criteria for access to government-backed mortgage insurance.[15] Among other changes was the tightening of debt service coverage tests so that all borrowers had to satisfy such tests with respect to the higher of the contract rate and the five-year benchmark rate determined by the Bank of Canada.[16] Effective January 2018, the Office of the Superintendent of Financial Institutions (OSFI) revised its Guideline B 20 to require federally regulated financial institutions to apply a similar stress test to uninsured mortgages as well.[17]

Since the main purpose of the stress test is to predict the ability of borrowers to continue to service their mortgages if they must renew at maturity at a higher interest rate, it would be logical to loosen the stress test for borrowers willing to fix their rates for terms longer than five years. For example, if the stress test for a 10-year mortgage was set at the contract rate plus 1 percent (or zero percent) without any reference to a "Bank of Canada 10-year mortgage rate" (in recognition of the added refinancing flexibility after 10 years compared to five years), then borrowers could qualify for larger mortgages by opting for 10-year mortgages. This would encourage them to seek out longer-term mortgages and require lenders to offer competitive rates to retain market share.

2. Amendments to Section 10 of the *Interest Act*

a. Lengthen the Section 10 Period

If the redemption right under Section 10 was lengthened from five years to 10 years, it would greatly reduce or eliminate the premium that a lender would have to charge for its re-investment risk on mortgages up to 10 years. A reduction in this pricing premium would be expected to lead to more 10-year mortgages.

One problem with this approach is that it would significantly increase the interest rate differential penalty that borrowers who are forced, or who choose, to prepay their mortgages would have to pay. The higher rates that all borrowers under long-term mortgages have to pay to compensate lenders for assuming the re-investment risk serves to socialize this risk among all such borrowers. By lengthening the redemption period to 10 years this would lower interest rates for all such borrowers but only because the cost would be borne by those borrowers who actually prepay more than they are allowed penalty free (beyond the three months' interest) within the

15 For CMHC, pursuant to amendments to the Insurable Housing Loan Regulations under the *National Housing Act* (SOR/2017-27) and for Canada's private mortgage insurers pursuant to amendments to the Eligible Mortgage Loan Regulations under the *Protection of Residential Mortgage or Hypothecary Insurance Act* (SOR/2017-271).

16 The Bank of Canada calculates this rate based on the statistical mode of the rates posted by the six largest Canadian banks: https://www.bankofcanada.ca/rates/interest-rates/canadian-interest-rates/notes-on-canadian-interest-rates/

17 The stress test prescribed by the Ministry of Finance for insured mortgages requires borrowers to maintain a gross debt service ratio and a total debt service ratio of 39 percent and 44 percent, respectively, calculated using the annual payments that would be required to conform to the contract's amortization schedule if the interest rate were the greater of the contract rate and the five-year benchmark rate established by the Bank of Canada. The stress test prescribed in OSFI Guideline B-20 for uninsured mortgages is substantively similar, with the notable exception that the interest rate for the calculation is the greater of the contract rate plus 2 percent and the Bank of Canada's five-year benchmark rate.

first 10 years. As noted in Feldman (2018), the public policy behind Section 10 was to protect borrowers from unduly large prepayment penalties. In other words, there has long been a policy to protect disadvantaged borrowers from having to negotiate their own prepayment terms without the benefit of Section 10 protection.

Another problem is that most provinces have passed their own legislation similar to Section 10.[18] If the federal government lengthens the period for which borrowers can be subject to a prepayment penalty, the shorter period dictated by the provincial legislation would govern in that province until the legislation in that province was brought in line with the longer federal period. Given that such an amendment may not be popular among mortgage borrowers, it is quite possible that some provinces would not follow the federal lead, leading to a patchwork of different rules across the country.

b. Amend the Interest Act to Clarify Borrowers' Redemption Rights.

As noted in Feldman (2018), Canadians have had the five-year redemption right on residential mortgages since 1880. Any reluctance by the federal government to tinker with a rule that has worked generally very well for so long would be understandable. In fact, the author believes that it would not be helpful to change the five-year period in Section 10.

On the other hand, a small adjustment to the drafting of Section 10 could significantly reduce the re-investment risk for lenders of longer-term mortgages. So long as a borrower under a 10-year mortgage is given a right to redeem the mortgage on the fifth anniversary of the mortgage without penalty (beyond the three months' interest), the borrower ought not to have an option for five years thereafter to redeem the mortgage at any time without penalty. It should not be necessary to limit mortgage terms to five years and require the borrower to sign renewals at least every five years to achieve this result. Section 10 could be clarified to stipulate that residential mortgages could not be locked in for more than five years without a short-term redemption right (for example, for 30 days once every five years) rather than, as currently drafted, mortgages remaining open indefinitely after the fifth anniversary.[19] In theory, the cost to the lender of hedging a 30-day prepayment option should be materially less than hedging a multi-year prepayment option.

Unfortunately, the common commercial practice approved by the Supreme Court of Canada was to renew mortgages at least every five years, not to have longer-term mortgages be open for 30 days once every five years. If Section 10 was amended appropriately it could give rise to this more desirable commercial practice of having longer-term mortgages.

This amendment to Section 10 would still have to deal with the fact that it would take time for provincial legislation to reflect this amendment across the country. However, this amendment should not be as controversial as one that lengthens the penalty free redemption period. Also, even in provinces that do not adopt this amendment right away, courts are likely to apply the Royal Trust decision[20] to accept the applicability of not having mortgages open at all times following the fifth anniversary so long as the mortgage was drafted correctly.

18 See for example, section 18 of the *Mortgages Act* (Ontario).

19 This was the interpretation given to Section 10 by the Supreme Court of Canada in the Royal Trust decision (Supra, note 5, at p. 368.).

20 *Supra*, note 4, at p. 368.

3. Increase Covered Bond Limits

The largest Canadian financial institutions are able to fund uninsured mortgages by issuing covered bonds, so-called because they are secured by uninsured mortgages.[21] OSFI currently caps the amount of assets that any federally regulated financial institution may pledge as collateral for its outstanding covered bonds to 5.5 percent of its total on balance sheet assets.[22] In setting this limit, OSFI must balance the need of financial institutions for alternative funding sources against the fact that CDIC acting for insured depositors of a regulated financial institution would be subordinate to covered bond investors. If OSFI believes that it would reduce systemic risk for banks to provide more residential mortgages with terms longer than five years, it could encourage such activity by increasing the covered bond limit, but only permit the additional cap space to be secured by mortgages having a term greater than five years. Although it may be challenging for existing covered bond issuers to amend their programs to permit longer-term mortgages into their cover pools, the reduced refinancing risk associated with longer-term mortgages could be attractive to investors.

4. Private Residential Mortgage-Backed Securities ("RMBS")

Governor Poloz mentioned in his May 2019 speech that the development of a private residential mortgage-backed securities (RMBS) market (that is, one that is not backstopped by the government through CMHC) could help both lenders and borrowers seeking longer-term mortgages and investors seeking alternative longer-term investments.[23]

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21 Those institutions that currently have covered bond programs are: Toronto-Dominion Bank, Royal Bank of Canada, Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce, National Bank of Canada, Fédération des caisses Desjardins du Québec and HSBC Bank Canada.

22 Office of the Superintendent of Financial Institutions, *Revised Covered Bond Limit Calculation* (Letter) (Ottawa: OSFI, 2019) (effective August 1, 2019, this figure increased from 4 percent to 5.5 percent to account for overcollateralization requirements associated with covered bonds).

23 The connection between RMBS and longer-term mortgages is not obvious; however, rating agencies and presumably investors in RMBS, such as pension funds, insurance companies or investment funds, are concerned with the refinancing risk for mortgages in an RMBS pool. Since the rating of the RMBS (most commonly, the largest tranche is rated AAA or equivalent) is supposed to be independent of the credit-worthiness of the mortgage originator, and since Canadian residential mortgages have to be renewed (or fully repaid) on their maturity dates in order not to default, the resilience of an RMBS transaction does depend in part on the ability of the mortgage originator to offer a renewal. If the mortgage originator is insolvent at the time of mortgage renewal and the borrower is unable to refinance with another lender, then this mortgage in the RMBS pool will go into default and have to be liquidated. If liquidations have to take place during a depressed real estate market this could lead to losses for investors. A longer-term mortgage will mitigate this risk, as it is likely to be easier for a borrower to refinance a mortgage that has amortized for a longer period of time. However, the best way to eliminate this refinancing risk while preserving the consumer protection aspect of Section 10 would be to have a mortgage that matured at the end of its amortization term with a prepayment window every five years (as described in Part 2b. above). While these mortgages in an RMBS pool would still leave investors with prepayment risk, this risk would be significantly lower than if all mortgages remained fully pre-payable at any time after the first five years.

Governor Poloz highlights a couple of conditions that he sees as necessary for a private RMBS market to develop in Canada. One is for the RMBS to be carefully designed. While there are various reasons why the federal government is not able to dictate the design of private RMBS (constitutional jurisdiction being one), the federal government or its agencies or Crown corporations could develop characteristics that they would want to see in private RMBS before such securities could be used for various purposes (for example, qualifying as investments by federal government agencies, or qualifying as collateral under the Bank of Canada's standing liquidity facility,[24] or qualifying as replacement assets under the Canada Mortgage Bond program).[25] But without offering some kind of benefit, likely in the form of materially increased liquidity, it is hard to see how the federal government will be able to influence the design of these private securities.

Another condition suggested by Governor Poloz is transparency. This could be achieved through the development of a public (but anonymized) database of mortgages used in securitization. The governor indicated that "we hope that all financial institutions in Canada, from the Big Six banks to the smallest credit union, will co-operate here."[26] In addition to co-operation it will take funding, and the financial institutions mentioned above are not likely going to willingly contribute to the cost of a database they are unlikely to use.

Right now, there are too few participants in the Canadian private RMBS market (both issuers and investors) to fund the creation of a better "infrastructure" to enhance the development of this market. If there really is a systemic benefit to having a viable private RMBS market in Canada, then it would likely be up to the federal government to fund the creation of this infrastructure, such as the proposed public database.

Other factors that investors are concerned about in the private RMBS market are (i) how accurate are the originator's systems at screening out mortgages that do not meet the eligibility criteria for the program? and (ii) how difficult would it be to determine that a mortgage was ineligible and then successfully require the originator to repurchase ineligible mortgages? The first of these issues is normally addressed in the United States through a requirement for a third-party review of a sample of the mortgage files in an RMBS transaction and the filing of the third-party report on the file review with the Securities and Exchange Commission so that it is available to the public.[27] The second issue is often dealt with by the establishment of an efficient adjudication process where there is a disagreement over the eligibility of a mortgage loan in an RMBS program. The federal government, likely through CMHC, could fund programs that would (i) make third-party pre-offering due diligence reports available to the public and (ii) provide for an efficient adjudication mechanism to deal with disputes between RMBS investors and originators or sponsors. These "infrastructure" enhancements would have to be made available to the public free of charge or else an attempt to pass the costs on to market participants would retard rather than assist the development of a private RMBS market in Canada.

24 Bank of Canada, *Assets Eligible as Collateral under the Bank of Canada's Standing Liquidity Facility* (Policy) (Ottawa: BOC, 2019). An example of when this was done was the establishment of criteria for eligibility of asset-backed commercial paper for the standing liquidity facility following the 2007 freeze in the ABCP market.

25 Canada Mortgage and Housing Corporation, Canada Mortgage Bonds Program User Guide, 2018 (Guide), (Ottawa, CMHC, 2018) at 7-1.

26 *Ibid*, note 1 at p. 6.

27 See SEC Rule 15Ga-2.

Conclusion

For longer-term mortgages to comprise a significant portion of the entire Canadian mortgage market it will likely be necessary for the federal government to modify certain rules that are currently geared towards a five-year mortgage market. The custom in Canada for residential mortgages to have a legal maturity of five years or less is too well-entrenched to be overcome organically without incentives or changes to laws or government policies and programs to encourage this development. Since there are currently no barriers to existing lenders who wish to offer longer-term mortgages, and since such longer-term mortgages comprise only about 2 percent of the Canadian residential mortgage market, lenders do not currently seem to be eager to change the status quo. This paper sets out a number of proposals that should be considered if the federal government, for financial stability reasons, wishes to see a significantly greater proportion of longer-term residential mortgages in the market.

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Michael K. Feldman is a Partner at Torys LLP.