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Office of the Superintendent of Financial Institutions
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RE: Consultation on the guideline B-20: Residential Mortgage Underwriting

The Canadian Real Estate Association (CREA) is one of Canada's largest single-industry associations, representing more than 160,000 REALTORS® across the country. For several years REALTORS® have advocated in support of drastically increasing the supply of housing available to Canadians across the entire housing spectrum. We have focused on initiatives that acknowledge the scale of the housing crisis, specifically by leveraging the federal government's convening power on a national scale through a national housing roundtable, and the use of federal infrastructure dollars to incentivize the creation of net new housing units. In our view, this is where significant progress can and still needs to be made.

Thank you for the opportunity to comment on the debt serviceability measures as proposed by Office of the Superintendent of Financial Institutions (OSFI) to help reduce risks in the Canadian residential mortgage market. In preparing this submission, we consulted with a small working group of our members including British Columbia Real Estate Association (BCREA), Ontario Real Estate Association (OREA), New Brunswick Real Estate Association (NBREA), Toronto Regional Real Estate Board (TRREB), Winnipeg Regional Real Estate Board (WRREB) and Quebec Professional Association of Real Estate Brokers (APCIQ).

CREA consistently recommends measures that reduce household indebtedness and increase domestic housing supply. We would like you to consider the following suggestions for the effectiveness of the proposed measures and the potential of their unintended consequences for Canadian housing markets.

1. Loan-to-income and debt-to-income restrictions

Proposal: OSFI proposes to implement LTI and DTI limitations which will restrict how much a bank can lend to borrowers whose mortgage, or total debts, exceeds a certain percentage of their gross income. The objective of this is to help reduce indebtedness and ensure there is less likelihood of borrower default. One such recommendation to achieve this objective is to require banks to ensure that no more than 25 per cent of their mortgages have a loan amount greater than 4.5 times the borrower's annual gross income.

Impact: The proposal in its current form does not take into consideration that limiting LTIs would be more restrictive on the borrower as the qualifying rate falls. The proposal would make borrowers even more constrained from buying a home, making it especially difficult for lower- and single-income households such as single parents. Banks will be forced to pick and choose the borrowers that are included in the maximum percentage of above 4.5 LTI loans. Typically, banks go for the highest risk-adjusted returns (i.e. high income big loan) which would likely shut some Canadians with lower household incomes out of homeownership.

For example, a household with dual incomes and average weekly wage of $2771.16 per week, with 20% down and an average $21,183 non-mortgage debt load can afford a $726,000 home, which is above the national average $686,371 home value (as at March 2023). However, with a 4.5x LTI limit at today's leading uninsured 5-year fixed rate (5.14%, with a 7.14% qualifying rate), that same borrower can only qualify for a $648,451 home which is 10.7% less than what they would be approved for without the LTI limit. Similarly, if rates fell to 5.25% minimum qualifying rate the same borrower would be eligible for an $866,012 home without the LTI limit. However, with the limit in place they will only be eligible for a $648,451 home which is 25% less.

Therefore, the more rates fall, the more the LTI becomes a constraining factor.

Recommendations: Keeping in mind that LTIs do naturally fall on their own under the weight of high rates and lower home prices, CREA suggests the following to help OSFI achieve its policy objective:

I. As the impact of LTIs magnifies as rates fall, CREA proposes that the 450% LTI restriction is initially limited to one-third of the banks' mortgages (30-33%) only. Doing so will help protect first-time home buyers from being impacted by the restriction as they are important in supporting move-up buyers and a liquid market reducing bank risk. Furthermore, this will also prevent borrowers from migrating to riskier non-regulated lenders which otherwise could result in increased defaults and lower consumption consequently to the LTI restrictions. A 30% exception bucket would allow for most high-LTI borrowers to get financed.

II. CREA also proposes that LTI or the share of high-LTI loans are calibrated at least annually preferably at the same time as the MQR to ensure the economy benefits from BoC stimulus (falling rates) and is not hamstrung by artificially restrictive lending.

III. Furthermore, CREA recommends that the restrictions build in certain practical exceptions such as exempting:
   a. non-prime loans with sufficient equity (e.g., 35%), which have little correlation with bank stress,
   b. higher LTI on amortizations of 25 years or less as lower amortizations demonstrate debt serviceability,
   c. higher LTI on lender switches i.e., straight switches with no increase in borrower risk.

2. Debt service coverage restrictions

Proposal: OSFI proposes to use lender-level volume restrictions on loans with high debt service ratios to help reduce the risk of lenders creating workarounds to the stress test through higher debt ratio limits, exceptions, or calculation loopholes. To achieve this objective OSFI recommends limiting GDS and TDS ratios across all FRFIs confirming lending or limiting the percentage of conforming mortgages that exceed these limits. This could also include standardizing the lender's debt ratio calculations.

Impact: The proposal will place hard limits on GDS/TDS ratios along with tiered limits or new capital restrictions for high GDS/TDS mortgages. Limiting the percentage of conforming mortgages that exceed GDS/TDS limits will add complexity for lenders and far less underwriting predictability for borrowers and mortgage professionals. This could lead to added complexity for lenders. Furthermore, standardizing lender's debt ratio calculations could lead to specifying a maximum amortization period such as 25 years for GDS/ TDS calculations. This could impact qualified higher-TDS borrowers who would have previously benefitted from the greater cash flow flexibility of a 30-year amortization to find fewer lending options. This is an economically unfavorable outcome, given that mortgage payments are often not the best use of marginal dollars.

Recommendations: The housing finance system needs more liquidity and flexibility to ensure qualified borrowers with short-term challenges can get financed without resorting to punishing private lenders. Therefore, to combat any negative impacts while ensuring that OSFI achieves its objective of reducing risk CREA suggests the following:

I. Proposed standardized 39%/44% GDS/TDS calculations are used for prime conforming uninsured mortgages only. This would help make lending more straightforward and predictable.

II. It could also be beneficial to have an exception bucket wherein 20% of FRFI mortgages could have above-standard GDS/TDS ratios. This would allow for otherwise well-qualified borrowers to still retain financing if assets or other risk mitigants supported it.

III. Furthermore, to offset the inflexibility OSFI could consider allowing higher GDS/TDS limits for borrowers with high credit scores. For example, there could be tiered limits based on score, similar to what CMHC offered in previous years.

IV. Lastly, there should be an exemption for non-conforming loans (those with 35%+ equity) as the default rates are far lower for these mortgages, and their equity provides FRFIs with a more than adequate safety net.

3. Interest rate affordability stress tests

Proposal: OSFI indicates concern about the Minimum Qualifying Rate (MQR) in its current form and its ability to reduce risks arising from high household indebtedness. Therefore, OSFI proposes exploring design elements that could result in the adoption of more risk-sensitive tests of affordability. The suggested design elements could include applying different MQR formulas to higher-risk terms, for example a higher MQR for variable rate. It could also include applying an MQR to non-mortgage debt.

Impact: The MQR in its current state and form may have been useful in steering some buyers into fixed-rate mortgages in 2021 and early 2022, but it makes for an unresponsive policy now in 2023 when variable rates are arguably most beneficial to borrowers and the probability of falling rates is highest. Therefore, a more adaptive MQR should be considered to ensure it responds to the current economic environment.

Recommendations: An ideal MQR should help protect short-term borrowers, while still allowing people to qualify and take advantage of falling rates at cycle peaks. Therefore, to help OSFI achieve its objective to make high household debt less risky CREA suggests the following:

I. A quarterly revised MQR that specifically applies to variable and short-term rates. It could be done in different ways. One of which could be Bank of Canada's overnight rate plus 200 bps, with a minimum (e.g., 5.25%). This objective calculation would be responsive and will reinforce monetary policy. Also having one rate for all terms will help avoid incentivizing higher-risk mortgages. Another method would be to use a 300 bps MQR buffer minus half the difference between prime and its 5-year average. For example, given a 6.10% mortgage rate, this would equal = 7.60% (6.10% + 300 bps - 150 bps) instead of 8.10% now. An adaptive MQR such as this will help ease the buffer at cycle tops, when variable rates are most beneficial to borrowers and the probability of falling rates is highest.

II. To help borrowers access better term at new lenders and reduce their debt servicing risk, OSFI should consider exempting straight switches (those with no net increase in system-wide risk) from the minimum qualifying rate.

High interest rates often trap more people with their lenders, forcing them to pay higher interest and thus creating financial risk. By allowing transferring borrowers to qualify at their contract rate, or contract rate plus a smaller increment, will help reduce risk while adding no material risk to the overall lending system.

Renewing borrowers who have paid as agreed, and meet all other underwriting criteria, show prima facie empirically supported evidence of their insignificant default risk. Hence, competitive lenders that attract such renewal business would not take on meaningful portfolio exposure. Moreover, all such lenders would still be incentivized to minimize arrears given OSFI supervision and investor demands.

4. Potential collective impact

After reviewing evidence on the likely effectiveness of OSFI's proposals, CREA believes that implementing them as such without considering the changes suggested above will result in Canadians experiencing longer waiting times to become homeowners as qualification becomes more challenging. This can have real-life social and economic ramifications, not the least of which is less opportunity to build equity for downpayments or retirement.

Furthermore, the reduction in access to lower-cost mortgages would exacerbate defaults and worsen the rental crisis. As borrowers are shut out of institutional lending they will have to gravitate towards the rental market which is already experiencing the lowest vacancy rate in two decades. It is one thing to be held back in the rental space, quite another to fall out the bottom of the rental space which is increasingly looking like the next stage of the housing crisis.

In addition, reducing demand from borrowers disincentivizes developers to start new construction which reduces the chance of increasing housing supply. This tighter supply in turn creates even more housing imbalances and price extremes, exacerbating debt servicing and collateral risks at financial institutions.

Moreover, the presented proposals will lead to lower prime lending volumes which can then impair retained earnings, making banks less resilient. They will also result in higher costs for borrowers as they will migrate to non-regulated lenders, which can offset any improvements to financial system safety due to heightened borrower risk outside the federally regulated system.

While prudent underwriting is essential for an undersupplied housing market, but most often it is the loss of income that is the dominant reason for defaults and having a lower debt-to-income ratios at origination does not meaningfully offset any potential major income shocks. Instead, driving borrowing into higher-cost lending can exacerbate income shocks.

OSFI might also consider regressive risks associated with certain designs of macroprudential policy. When faced with new lending constraints, banks generally lend to borrowers promising the highest perceived risk-adjusted return. As such limiting the share of LTI ratios above arbitrary levels would most likely result in banks making fewer lending exceptions to lower-income applicants and to households in less affluent areas.

Given Canada doesn't track lending discrimination as closely as in other jurisdictions (e.g., the U.S.), this raises the risk of discriminatory lending. In practice, for example, bank management might argue that an LTI over 450% is more warranted for a newly-minted doctor/lawyer/engineer who has higher income potential, a higher loan amount but a lower credit score, as compared to a working-class family, which also has temporarily high debt service ratios, but has

better credit, or even as compared to a single parent looking to put down roots but having to compete against dual-income households.

Certain types of new lending constraints will force banks to pick and choose. It's likely that some of those choices will be made in a discriminatory fashion, as a recent RBC/City National case demonstrated.

In summary, it is important that OSFI policy makers carefully analyze the system-wide and socio-economic side effects of relegating a (potentially sizeable) segment of today's prime borrowers to the non-prime market. Besides less profitability and retained capital in the banking system, such a move could result in higher lending costs, less consumer spending, and a greater incidence of borrower instability. This could lead to an unintended consequence of greater banking risk amid financial shocks.

That is not to say OSFI should put all proposals on hold but to highlight that recommended modifications should be considered to avoid any unintended consequences.

Conclusion

We understand and agree that OSFI's role is to safeguard the financial system and we support a strong effective underwriting policy. CREA believes in fairness and equity and therefore advocates against policies that favor large lending institutions over consumers. For example, policies such as applying a stress test on refinancing only when a new lender is sought. It is important to design policies that are fair to all and do not lead to greater discrimination against certain groups. Furthermore, we believe policies that provide flexibility and promote financial literacy should be encouraged. For example, promoting longer terms or encouraging Canadians to have healthy credit scores. It is also important that the measures that are taken at the federal level, in general, take into account the economic and regulatory specificities of each provincial real estate market. Lastly, we promote action that supports people across the housing spectrum, therefore all policies must be mindful of the potential impact on renters as well as aspiring homeowners.

REALTORS® will always focus on helping Canadians find homes and look forward to continuing sharing policy solutions that make homeownership more affordable in the future.