WILL DUNNING INC.
Economic Research

April 26, 2021

The Honourable Chrystia Freeland
Deputy Prime Minister and Minister of Finance

Dear Ms. Freeland:

I am writing to you concerning the mortgage stress tests that are now applied for almost all home purchases in Canada, as mandated by OSFI for federally-regulated financial institutions and as required by CMHC and other mortgage insurers.

During the past decade, federal mortgage policies have increasingly been used in active-management (suppression) of an important segment of the Canadian economy and our social infrastructure. These policies are a major (and worsening) **detriment to the financial well-being of hundreds of thousands of Canadians**.

The mortgage stress tests go far beyond reasonable measures to manage risk.

In these comments, I am urging you to use your authorities, to direct OSFI and CMHC to use a lower interest rate in the mortgage stress tests.

I am looking forward to any feedback you provide to me.

About Me

I am an economist who has been professionally engaged in housing market research since 1982. This includes 16 years with Canada Mortgage and Housing Corporation, 3 years with a boutique consultancy, and since September 2000, 20 years as a self-employed consultant.

My client list covers a wide range of interests in the public, private, and non-governmental sectors. During the past decade, my two major clients have been industry associations: Mortgage Professionals Canada and the Canadian Home Builders Association.

It would be reasonable for you to wonder whether I have biases that reflect the interests of my clients. No one has paid me or in any other way influenced me to make these comments. They are the product of 39 years of research on housing markets.

The Stress Tests

The purpose of the testing is to evaluate borrowers' abilities to afford their payments, especially following their future mortgage renewal. To this point, that testing has been done using the "posted rate" for 5-year fixed rate mortgages, as measured and reported by the Bank of Canada. Among the issues with this policy are:

- The “posted rates” are established by the lenders for their own administrative purposes, and are in no sense a signal from the marketplace, especially not in terms of expectations about future interest rates.
- At the time of a future mortgage renewal (usually in five years), the borrowers’ incomes will have grown, which will reduce the impacts of a higher interest rate. The tests do not consider this.
- The stress tests include implicit assumptions about how much principal will be repaid. Regular payments at an interest rate lower than the posted rate mean that actual repayment of principal will be considerably larger than is implicitly assumed. Therefore, the stress test calculations over-estimate the impact of a future rise in the interest rate.

The Bank of Canada publishes data on contracted mortgage interest rates, covering the period since 2013. That data shows that the highest monthly-average interest rate for “Funds advanced” for “Fixed rate, 5 years and over” is 3.76%. As of January this year, the average rate was 1.96%.

The mortgage stress tests currently use a minimum rate of 4.79%, and OSFI proposes raising the minimum rate to 5.25%. There is no historical precedent for the using these high rates in testing borrowers. Moreover, no credible analysts expect mortgage interest rates to rise to anywhere near the test rate in the foreseeable future.

Therefore, **within a risk management framework**, there is **no justification for the interest rate currently employed by the stress tests**, let alone OSFI’s proposal for an even-higher rate.

OSFI’s Mandate

The OSFI website provides a short description of its mandate, beginning with “OSFI advances a regulatory framework designed to control and manage risk.”

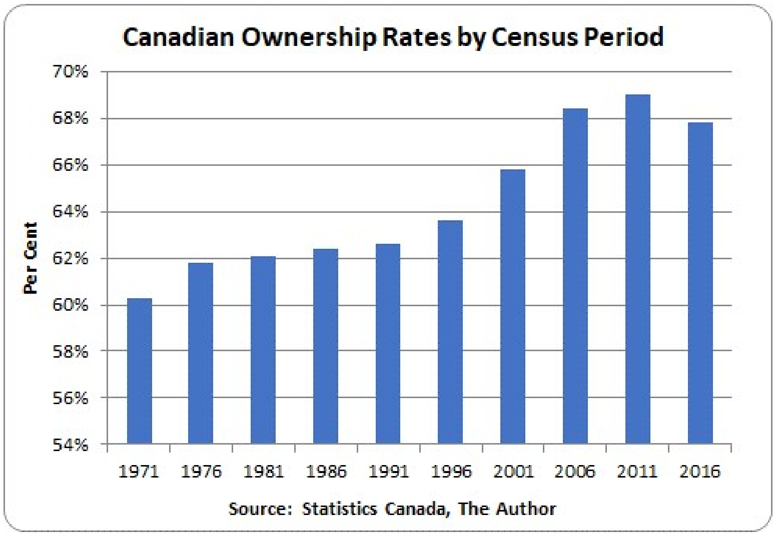
In the mortgage stress tests, reliance upon interest rates that are far higher than any credible risk scenarios goes far beyond OSFI’s mandate.

In its consultation on raising the interest rate (to a proposed floor of 5.25%) OSFI is attempting to justify use of an unrealistic and punitive interest rate, due to a need to assess the impacts of future job loss or income reductions: “The minimum qualifying rate adds a margin of safety that ensures borrowers will have the ability to make mortgage payments in the event of change in circumstances, such as the reduction of income or a rise in mortgage interest rates.”

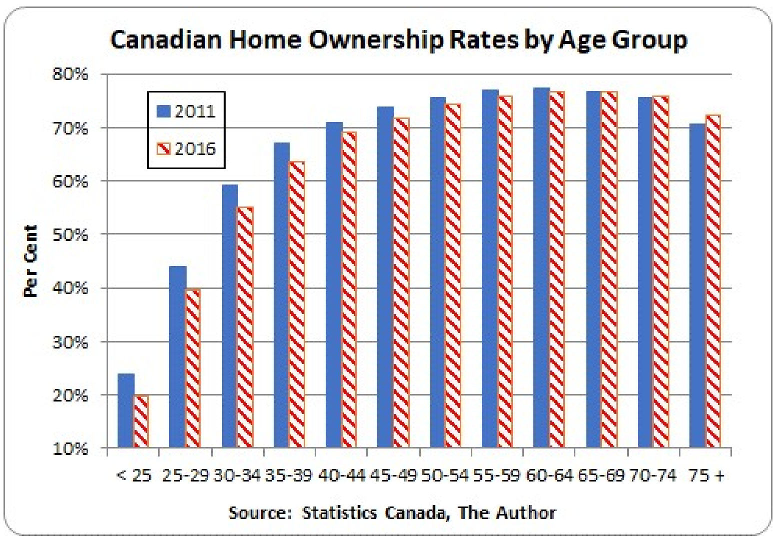
But, the consequences of reduced income will depend chiefly on the amounts of reduction. The interest rate is largely irrelevant to that concern.

To any informed observer, it is obvious that OSFI has been acting far in excess of its mandate. Its job is not to manage Canadian housing markets.

The Consequence of Suppressive Policies



The home ownership rate in Canada rose for a generation, from 62.6% in 1991 to 69.0% in 2011. There were multiple factors supporting this. Broadly-speaking, this can be seen as a very positive result of social and economic progress in Canada. But, after 2011, the home ownership rate fell by a substantial amount, to 67.8% as of 2016.



There are multiple causes for the reversal. Among these are regulatory changes: during the past decade, a series of new regulations has reduced access to mortgage financing. The impact has been especially hard on young Canadians, who are now finding it much more difficult to become home owners. This chart shows that for the age groups up to 39 years, the ownership rate fell by about 4 percentage points during 2011 to 2016.

Using Census data for 2011 and 2016, it can be calculated that if the home ownership rates had been unchanged, in 2016 **there would have been (in excess of) 200,000 more home owners in Canada than there actually were**. A large part of this reduction is due to changes in mortgage policies.

The hardest-hitting policy change was the elimination of 30-year amortization periods for insured mortgages, which took effect in July 2012: the drop in the ownership rate during 2011 to 2016 is clearly linked to that policy. Since the 2016, the mortgage stress tests have become an added impediment.

The most recent comprehensive data is from the 2016 Census. Based on housing market data, it appears likely that there has been further erosion of home ownership in Canada. Again, in significant measure this is due to policies.

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My Proposals

For immediate implementation, OSFI and CMHC should be directed by the Minister of Finance that:

- For fixed-rate mortgages with terms of five or more years, the floor rate for the stress tests will be the maximum actual contracted rate reported in the Bank of Canada data (3.76%).
- The stress tests should calculate future payments based on the expected remaining principal (and the remaining amortization period) for the future date of renewal.

Furthermore,

- Public consultations should be held on how to incorporate anticipated income growth within the stress tests.

Relatedly…

There is currently lively discussion in Canada about whether the recent over-heating in housing markets is due to supply shortages. My research (currently in process and not yet published) indicates clearly that new housing production in Canada has fallen far short of demographic requirements during the past decade and a half, by almost 500,000 dwelling units for "low-density" housing (single-detached and semi-detached homes). Conversely, there has been a small surplus for town homes (about 40,000 dwellings) and a larger statistical surplus for apartments (about 240,000 dwelling units). The overall shortage (in excess of 200,000 dwelling units), in a time when Canadians are reconsidering their housing needs, is contributing to extreme price growth, and with especially dire effects within the hugely-under-supplied low-density sector.

The mortgage policies have not just suppressed housing demand. By reducing sales of new homes, they have contributed to the under-production of new housing.

I am looking forward to any comments from you.

Yours Truly

Will Dunning
President,
Will Dunning Inc.