The Trust Companies Association of Canada

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Office of the Superintendent of Financial Institutions
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Introduction

The Trust Companies Association of Canada (the "TCA") represents 25 trust companies and small and medium-sized banks that are federally regulated financial institutions. Many of our member institutions are engaged in the business of residential mortgage lending and are pleased to be able to respond to OSFI's invitation to provide feedback on draft changes to Guideline B-20 (the "Proposal"). The TCA would like to thank OSFI for meeting with representatives from its member institutions on August 1, 2017 to discuss the Proposal.

In framing our response, we have considered matters beyond OSFI's remit of ensuring the safety and soundness of individual financial institutions it supervises, but, also to consider the broader consequences in allowing the Government to meet its policy goals under the *National Housing Strategy* ("NHS") and consider the consequences for the housing finance market as a whole. Our view is that good policy should promote safety and soundness of the system while providing affordable access to housing finance.

We note that the NHS's working vision is:

"All Canadians have access to housing that meets their needs and they can afford. Housing is the cornerstone of building sustainable, inclusive communities and a strong Canadian economy where we can prosper and thrive."

Housing is a complicated area of economic policy and the TCA makes no claim to expertise across the full spectrum of policy prescriptions that should be considered to meet this ambitious vision. Where our member institutions do have special expertise and experience is in lending to the self-employed and people that are new to Canada. Our member institutions typically participate in the Alternative mortgage market serving borrowers that do not qualify to meet the underwriting standards for Prime loans applied by Canada's largest chartered banks or the mortgage insurance companies for an insured loan. Lenders participating in the Alternative market charge a modest interest rate premium to Prime rates to compensate them for the additional underwriting work required to assess more complicated lending scenarios and to allow for an appropriate risk/reward trade-off.

We believe that inclusive communities include homeowners that are self-employed and people that are new to Canada and we are concerned that the Proposal overly restricts these groups from accessing affordable housing finance from FRFI's.

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<u>The Key Changes</u>

Many of the changes in the Proposal were flagged well in advance by OSFI and are well-formulated policy changes as the next iteration and improvement to B-20. Our goal is to limit our comments to those issues where we can provide useful feedback in the following three areas:

1. Uninsured mortgages are to be qualified from a debt service perspective at the greater of the Bank of Canada Conventional Mortgage 5-year Rate (the "Benchmark Rate") or the contract rate plus 200 basis points (the "Stress Test Proposal");
2. Expressly prohibiting co-lending arrangements that are designed, or appear to be designed to circumvent regulatory requirements (the "Co-lending Proposal"); and
3. The changed language with respect to income verification expectations from a supervisory perspective (the "Income Verification Expectation").

The Stress Test Proposal

The Issues

The Stress Test Proposal is the most troubling aspect of the Draft for our member institutions. The Stress Test Proposal is likely to exclude creditworthy borrowers that are self-employed or new to Canada from accessing housing finance. The Stress Test Proposal is focussed on the capacity to pay metric that forms only one of the five metrics of creditworthiness that are typically used in assessing mortgage credit. Any stress tests are necessarily simplifications of a more complicated economic reality and the Stress Test Proposal contained in the Draft appears to make the following implicit assumptions:

1. The income of the homeowner does not change over the life of the mortgage;
2. A borrower that is accessing the Alternative mortgage market will renew that mortgage paying the premium associated with an Alternative mortgage;
3. The term of the mortgage the homeowner selects will be for a long enough period of time that a significant increase in interest rates during the term of the mortgage is expected; and
4. Mortgage debt is only serviced and paid down from earned employment income and not from sale of assets or the capital appreciation on business investments.

These assumptions may be close enough to the truth to be useful for assessing a mortgage loan for employed Canadians with an established employment track record, but, are less useful when considering the creditworthiness of self-employed people and those that are new to Canada.

Self-employed and new Canadians are more likely to see increases in income over time than other homeowners. A business becomes more established or an individual professional gains a reputation in his or her field, income is likely to rise and allow debts to be serviced more easily. New Canadians are also likely to see earnings gains at a disproportionate rate from the population as a whole as they gain contacts and expertise in the Canadian context.

Our members can clearly see, from their own lending experience, how borrowers' transition from the Alternative market to become Prime borrowers from Canada's large chartered banks. In our experience, a very high proportion of our members' customers qualify for Prime rates at the end of the mortgage term, the vast majority of which are for less than five years, and can access funding at a lower interest rate than prevails in the Alternative market at that time. In this sense, the Stress Test Proposal is overly conservative in assessing these borrowers that would more correctly be assessed at a rate closer to the Benchmark Rate.

Data on immigration to Canada shows that many new immigrants continue to have assets abroad after arriving in Canada. These assets would typically not yield on-going income that can be used in a debt service calculation, but, will be sold over time and the capital be patriated to Canada to pay down mortgage debt. In a similar manner, self-employed individuals might ultimately be rewarded for their labour through the value accruing in their business.

Our Feedback

As outlined above, the TCA believes that a blanket 200 basis points addition to the contract rate is overly conservative in underwriting many aspiring homeowners. We encourage OSFI to consider a principles-based approach to underwriting whereby borrowers that the lender can demonstrate exhibit characteristics of having a high propensity of migrating into the Prime lending space would qualify on the basis of the higher of the contract rate or the Benchmark rate. Such an approach could be applied considering a variety of borrower attributes including: credit history and credit score, GDS/TDS ratios, net worth, sustainability of income and income growth potential. Lenders would be required to apply higher stress tests to borrowers with a lower propensity to qualify in the Prime space with a 200 basis points stress test over the contract rate applying to borrowers with a less than 50% probability of migrating to Prime over the life of the loan.

The Co-lending Proposal

We had a lengthy conversation about the Co-lending Proposal at our August 1st, 2017 meeting with representatives from OSFI. As part of that meeting we agreed to come up with an industry standard definition of co-lending to ensure that both regulatory bodies and industry participants start with a common understanding. A definition of co-lending that aligns with the understanding of industry participants is as follows:

> *Co-lending refers to a formal, arranged residential property financing structure involving more than one lender advancing mortgage financing at the time of mortgage origination. Typically, this involves a FRFI extending a first mortgage and, through a structured program, arranging for another non-prudentially regulated lender to provide a mortgage in subordinated position to the FRFI over the same property, both at the time of origination.*

As was made clear at our meeting, the intent under the Draft is that co-lending would be acceptable under a number of circumstances. If, for example, a FRFI was prepared to advance 75% LTV to a borrower and a non-prudentially regulated entity was prepared to advance a further 5% of the value, subject to other constraints in an FRFI's RMUP and other aspects of B-20, this approach would continue to be permissible.

In contrast, a co-lending arrangement where the combined LTV of the FRFI and the non-prudentially regulated lender exceeds the 80% LTV threshold contained in the *Trust and Loans Company Act* and *The Bank Act* would not be permissible. Our members believe that the language of the Draft could be clearer to ensure that this policy intent is clearly reflected in the Guideline and that it will apply to all new co-lending arrangements going forward and not to existing mortgages structured under a co-lending arrangement.

Income Verification

At the August 1st 2017 meeting, we had a good conversation related to the changed language for supervisory expectations for income verification. OSFI representatives expressed the clear view that the use of Bank statements and other methods for proving income would continue to be acceptable and that there is no intention to limit the evidence of income to the T1 General or Notice of Assessment. We would appreciate some clarification of the language in the Proposal to ensure that the policy intent is clear and we look forward to the more detailed conversation about supervisory expectations that we understand will form part of the implementation of the final version of the document.

Systemic Consequences

The Proposal is likely to have consequences for Canada's housing, and housing finance markets that may have consequences for the overall effectiveness and stability of the system. Our members are concerned about how the Proposal will influence the following aspects of the market:

1. It will encourage growth in the non-prudentially regulated lending or shadow banking sector. Until now, this sector has formed a relatively small part of Canada's housing finance system, but, the changes included in the Proposal will be a catalyst for growth of this sector as FRFI's are less able to compete. Potential consequences of this change include less stability in housing finance and reducing consumer's access to the protection provided by FCAC;
2. Prudentially regulated institutions at the Provincial level will take market share given up by FRFIs;
3. At the margin, the Proposal creates incentives for Borrowers to shorten the term of their mortgages and increase the length of amortizations. At the system level, this will make the economy more sensitive to interest rate increases;
4. The potential for the Benchmark Rate to move in a manner that is not correlated to a 5-year fixed rate Prime mortgage has the potential for unintended consequences including more leverage in the system;
5. Our overall assessment is that the Proposal has the potential to make smaller institutions less competitive relative to our larger peers that could restrict consumer choice and competition; and
6. People that are self-employed or new to Canada with good creditworthiness will have access to mortgage credit restricted more than employed people with a more conventional credit track record.

Conclusion

The TCA would like to thank OSFI for listening to the concerns of trust companies and small and mid-sized banks. We would be happy to provide: clarification to the issues we have set out above; insight into the analytics some of our member institutions have completed to support our positions; and, any other assistance that would be helpful to OSFI in finalizing the Proposal. We look forward to working with you to meet supervisory expectations with the finalized guidance.

Yours sincerely,

Andrew Moor
Chairman
Trust Companies Association of Canada