Stress Test

Analysis and Implications of Changes to Mortgage Regulations

Recommendation

That Executive Committee recommend to City Council:

> That the motion on the floor be withdrawn and replaced with the following:
>
> That the Mayor write an open letter, on behalf of City Council, to the federal government to request a review of the Residential Mortgage Underwriting Practices and Procedures, including the following specific considerations:
>
> - Reforming the stress test to be flexible based on regional conditions;
> - Modernizing the lending rules to be more considerate of self-employment income;
> - Reinstating 30 year amortization periods for CMHC insured loans;
> - Removing the stress test for requalification and fixed interest mortgages;
> - Reducing the stress test from the current benchmark of two percent above current rate; to a maximum of 0.75 percent above current rate.

Previous Council/Committee Action

At the October 8, 2019, City Council meeting, the following motion was made:

> That the following Motion on the Floor be referred to Administration to return to Committee with an analysis.

Motion on the Floor

That the Mayor write an open letter, on behalf of City Council, to the leaders of the Liberal Party of Canada, Conservative Party of Canada, Federal New Democratic Party, Bloc Quebecois, and the Green Party of Canada requesting that, if elected, they commit to a review of the Residential Mortgage Underwriting Practices and Procedures, including the following specific considerations:

- Reforming the stress test to be flexible based on regional conditions;

- Modernizing the lending rules to be more considerate of self-employment income;
- Increasing the home buyer’s tax credit from $750 to $5,000;
- Reinstating 30 year amortization periods;
- Implementing a tax benefit for additional payments made to one’s mortgage;
- Removing the stress test for requalification and fixed interest mortgages;
- Reducing the stress test from the current benchmark of two percent above current rate; to a maximum of 0.75 percent above current rate.

Executive Summary

Federal mortgage underwriting rules were updated in 2018 to include a "stress test" for flexibility in a buyer's financial capacity for home ownership, regardless of whether the buyer requires mortgage loan insurance. The intent of this change was to reduce the level of mortgage debt risk in the event of income or interest rate changes.

The federal government has indicated that it will review the stress test to make it more dynamic for different markets. As per Council's motion, Administration has completed analysis of changes that would be suitable for the Edmonton region's housing market, which has slowed since the economic downturn in 2015-2016. Compared to other major Canadian cities, the cost of homes relative to the median income is lower in Edmonton. Amendments such as adjusting the stress test to consider local incomes and regional housing market conditions, reducing the stress test variance to 0.75 percent, or removing it for requalification or fixed rate mortgages could positively impact the housing market in Edmonton. Allowing 30 year amortization for mortgages would have minimal impacts on affordability unless combined with other measures.

Federal fiscal policy changes, such as a tax credit of $5,000 or tax credits for additional mortgage payments, would apply equally across the country. Without knowing the parameters of each proposal in Council’s motion, it is difficult to estimate the specific benefits of these fiscal policy changes to the Edmonton region.

Based on Administration’s analysis, Council may wish to restate the motion to reflect mortgage rule changes that would be the most effective in the Edmonton market.

Report

Background

The Office of the Superintendent of Financial Institutions (OSFI) updated its mortgage underwriting guidelines as of January 1, 2018. The most significant change was the introduction of a stress test that, according to the OSFI, “requires a borrower [to] be qualified for their mortgage with a buffer of affordability built in to ensure they can continue to pay their mortgage if conditions change.” The intent of the stress test is to manage Canada's growing level of household debt through stricter mortgage qualifying rules. It requires borrowers to be financially able to service their mortgage debt at either the Bank of Canada's interest rate or two percent above their qualifying rate, whichever is higher.

After the October 2019 federal election, Prime Minister Trudeau's mandate letter to the Department of Finance included the priority to: "review and consider recommendations from financial agencies related to making the borrower stress test more dynamic." This presents an opportunity for City Council to provide input about how the stress test could consider the Edmonton region's economic context.

Edmonton's Housing Market

The Edmonton region's housing market has shown reduced sales in the existing housing market and lower starts for new housing units since the economic contraction in 2015-2016. Administration has heard feedback from industry stakeholders that the stress test is an additional hurdle to the recovery of the region's housing market, as it impacts first-time home buyers more significantly. Existing mortgage holders may be impacted by the stress test during renewal. Homeowners may also be indirectly impacted when selling their home, as the stress test could reduce the pool of potential buyers.

Analysis of City Council's Motion

Reforming the stress test to be flexible based on regional conditions

The stress test is a federal policy response to rising Canadian consumer debt levels. It was designed to ensure borrowers do not overextend themselves. The stress test applies to all Canadians and does not consider differences in local market conditions. For example, housing prices in the Toronto and Vancouver area markets are much higher relative to income than in other regions in Canada.

For its analysis, Administration estimated mortgage carrying costs for existing and new homes, and compared them with 2017 median census family incomes for the following regions: Edmonton, Calgary, Greater Toronto, Greater Montreal, Greater Vancouver, Saskatoon and Greater Moncton. Administration found significant differences in the share of monthly mortgage carrying costs relative to monthly median incomes across the various regions, as detailed in Attachment 1.

Reforming stress test flexibility based on regional considerations would require assessing a borrower's risks relative to the dynamics of the local housing market. In Q4 2019, analysis by the Canada Mortgage and Housing Corporation (CMHC) detected a moderate level of overbuilding in Edmonton's housing market, which presents different risks than accelerating prices in Toronto's housing market and overvaluation in Vancouver's housing market.

Modernizing the lending rules to be more considerate of self-employment income

Self-employed applicants are subject to the same stress test criteria as employed applicants to determine financial ability to afford a mortgage. CMHC announced changes to enable self-employed individuals to qualify for a mortgage based on variable or less predictable incomes. The changes came into effect on October 1, 2018, and included:

- Considering cash reserves, education and predictable earnings even if a potential borrower has been self employed for less than 24 months; and
- Allowing a broader range of documentation options for proof of income and employment.

Data from the 2016 federal census indicated that the national homeownership rate for families where the major income earner was self-employed rose slightly from 74.5 percent in 1999 to 75.5 percent in 2016. The 2016 national homeownership rate for families where the major income earner was a paid employee was 64.4 percent, up from 62.2 percent in 1999. While any relaxation of lending criteria for self-employed individuals might qualify a greater number of borrowers and provide additional stimulus to the housing market, it is not clear what the economic impacts would be for the Edmonton region. Administration does not have access to lending data specific to self-employed borrowers and is unable to provide analysis on changes to mortgage qualifications for self-employment income.

Increasing the home buyer's tax credit from $750 to $5,000

Tax credits reduce the tax paid on taxable income. The Government of Canada permits eligible home buyers to claim $5,000 in non-refundable tax credits for the purchase of a qualifying home

Claiming $5,000 results in $750 of tax credit, as the 2019 federal tax credit rate is 15 percent. Increasing the tax credit to $5,000 would mean either increasing the maximum claim amount to $33,333 under the current credit rate of 15 percent, or having a 100 percent tax credit rate for the existing claim amount of $5,000. Increasing the amount of federal tax relief offered to first-time home buyers and persons with disabilities may incentivize potential home buyers to make their first purchase, which could have a positive impact on new and existing housing markets.

Such a change in tax policy would have other impacts, such as greater federal government tax expenditures that would place pressure on the federal budget balance. The policy would be implemented through the tax code and would apply to all Canadians. As part of federal fiscal policy, this change would be weighed against other federal government priorities and considerations to see if it would benefit Canadians. It is unclear whether such a shift would be beneficial for most Edmontonians or Edmonton's housing market.

Reinstating 30 year amortization periods

Currently, the maximum amortization period in Canada is 35 years. Specifically for CMHC insured loans - mortgages for properties purchased with a less than 20 percent down payment - the maximum amortization period is 25 years. For its analysis, Administration estimated monthly mortgage carrying costs for existing and new homes in the Edmonton region and other home ownership costs, and compared them to the income required to satisfy the federal Financial Consumer Agency of Canada's Gross Debt Service (GDS) ratio.

The Edmonton region's 2017 median income was sufficient to service monthly mortgage costs for all units at a rate of 4.09 percent (CMHC's 5-year conventional mortgage rate in October 2019) and all other assumed costs, over a 25 year amortization period. However, after applying the two percentage point increase to qualifying rates (6.09 percent), the required income for a mortgage on a new single-family detached home was above the median income level. Extending the amortization period to 30 years brought the required income to service the mortgage down, though it remained above the median income level. Detailed analysis is in Attachment 2.

Implementing a tax benefit for additional payments made to one's mortgage

There is no precedent in Canada for mortgage payments to be eligible for a tax benefit, so its implementation and impact on borrowing are unknown. This benefit could incentivize borrowers to pay down their mortgage faster, should they have the financial means to do so. It would only affect existing homeowners and may not incentivize any additional home purchasing. At present, there is little formal consideration of this type of tax policy reform in Canada. Without specifics such as the annual maximum amount of additional mortgage payments that can be claimed, or the tax credit rate, financial analysis cannot be completed.

Such a change to federal fiscal policy would warrant significant fiscal and economic analysis at the national level prior to implementing. Consumer spending is complex and dynamic, and incentivizing individuals to undertake more of one form of expenditure activity—in this case additional mortgage payments—means less spending in other areas, savings or investments. The total economic impact of such a policy on the Canadian economy is unclear, and Administration is unable to conclude whether such a policy would be a net benefit for Edmonton.

Removing the stress test for requalification and fixed interest mortgages

The stress test is applied when a borrower chooses to switch lenders upon time for mortgage renewal, provided the lender is a chartered bank. To avoid the risk of going to another mortgage lender and not being able to pass the stress test, borrowers may opt to stay with their existing lender, even if their rate is higher. Although chartered banks are not required to use a stress test for mortgage renewals, they can still do so. As well, if the borrower requires mortgage loan insurance, chartered banks and other lenders are not required to use the stress test, though they may do so.

Specific data on the stress test's impacts on borrowers in the Edmonton region are not available. However, it is expected that removing the stress test for mortgage requalification and fixed interest mortgages, would ease pressures on borrowers and reduce mortgage renewal denials.

Reducing the stress test from the current benchmark of two percent above current rate; to a maximum of 0.75 percent above current rate

Relaxing the stress test from two percent to 0.75 percent brings the income required to satisfy the GDS ratio below the region's 2017 median income level for all housing types except new single-family detached homes (Scenario 4 in Attachment 2). Both extending the amortization period to 30 years and relaxing the stress test to 0.75 percent brings the income required to satisfy the GDS ratio below the 2017 median income level for all unit types (Scenario 5 in Attachment 2).

Conclusion

Based on Administration's analysis, Council may wish to restate some items in the motion to advocate for changes based on local carrying costs, incomes or rate variability, as outlined in this report. With the difficulty in confirming whether the tax credit would be beneficial to Edmonton home buyers, the motion could be restated as follows:

"That the Mayor write an open letter, on behalf of City Council, to the federal government to request a review of the Residential Mortgage Underwriting Practices and Procedures, including the following specific considerations:

- Reforming the stress test to be flexible based on regional conditions;
- Modernizing the lending rules to be more considerate of self-employment income;

- Reinstating 30 year amortization periods for CMHC insured loans;
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Corporate Outcomes and Performance Management

Corporate Outcome(s): Edmonton has a diverse and prosperous economy that thrives locally and globally			
Outcome(s)	**Measure(s)**	**Result(s)**	**Target(s)**
Homeownership in Edmonton is affordable	Mortgage carrying costs as a share of median family income	Existing single family home: 19%	N/A
		Existing apartment home: 9%	N/A
		New detached home: 24%	N/A
		New semi-detached home: 18%	N/A

Attachments

1. Summary of regional differences in mortgage carrying costs
2. Mortgage carrying cost and required incomes scenarios

Others Reviewing this Report

- C. Owen, Deputy City Manager, Communications and Engagement
- S. McCabe, Deputy City Manager, Urban Form and Corporate Strategic Development