PRIVATE CAPITAL MARKETS ASSOCIATION OF CANADA

THE NATIONAL VOICE OF EXEMPT MARKET DEALERS, ISSUERS AND INDUSTRY PROFESSIONALS

August 17, 2017

Office of the Superintendent of Financial Institutions Canada
255 Albert Street
Ottawa, Canada K1A 0H2
B.20@osfi-bsif.gc.ca

Dear Sirs/Mesdames,

Re: Commentary on OSFI Draft Guideline B-20 - *Residential Mortgage Underwriting Practices and Procedures*

The Private Capital Markets Association of Canada (the "**PCMA**") is pleased to provide the Office of the Superintendent of Financial Institutions Canada ("**OSFI"**) with our comments in connection with Draft Guideline B-20 *Residential Mortgage Underwriting Practices and Procedures* published July 6, 2107 (the "**Draft Guideline**") as set out below.

Who is the PCMA?

The PCMA is a not-for-profit association founded in 2002 as the national voice of exempt market dealers ("**EMDs**"), issuers and industry professionals in the private capital markets across Canada.

The PCMA plays a critical role in the private capital markets by:

- assisting its hundreds of dealer and issuer member firms and individual dealing representatives to understand and implement their regulatory responsibilities;
- providing high-quality and in-depth educational opportunities to private capital markets professionals;
- encouraging the highest standards of business conduct amongst its membership across Canada;
- increasing public and industry awareness of private capital markets in Canada;
- being the voice of the private capital markets to securities regulators, government agencies, other industry associations and public capital markets;
- providing valuable services and cost-saving opportunities to its member firms and individual dealing representatives; and
- connecting its members across Canada for business and professional networking.

Additional information about the PCMA is available on our website at www.pcmacanada.com.

PCMA Consultation Process

The PCMA consulted with its members, and in particular with the membership of its Mortgage Investment Entity (MIE) subcommittee, to gather member input into preparing and finalizing this comment letter. This included:

- a webinar for PCMA members to provide information and gather feedback and comments;
- consultation with representatives of the residential mortgage industry who may be affected, including mortgage brokers and non-bank lenders; and
- review by the PCMA board of directors of this letter;

This letter reflects the comments and input from all those who attended, participated and provided meaningful feedback and comments. The first section of the letter presents our general comments with respect to the Draft Guideline, followed by comments on the specific proposals.

GENERAL COMMENTS

Need to Assess the Impact of Policy Changes to Date

In the news release which accompanied the release of the Draft Guideline, OSFI states that the proposed changes to existing Guideline B-20 are merely to "align language" and to "clarify and strengthen expectations" set out in OSFI's public letter to Federally Regulated Financial Institutions ("**FRFIs"**), *Reinforcing Prudent Residential Mortgage Risk Assessment*, dated July 7, 2016 (the "**July 2016 Letter"**). With respect, far from being a "clarification" of the July 2016 Letter, the measures announced in the Draft Guideline represent new and substantive changes which will have a material impact on the business and operations of many of our members, and will be felt broadly throughout the industry.

We believe that industry members and the markets have yet to absorb and assess the full effects of the policy changes implemented in 2016. They include:

- the requirement for all borrowers having to qualify under maximum debt-servicing standards based on the higher of the mortgage contract rate and the Bank of Canada conventional five-year fixed posted rate; and
- the requirement for all insured mortgages to meet the eligibility that previously applied only to high ratio (greater than 80% LTV) mortgages.

These measures did not take effect until late in the fourth quarter of 2016. We are only now beginning to see the data reflecting the impact of these changes. For example, the Bank of Canada, in its June Financial System Review, notes that "the share of highly indebted borrowers among newly originated high-ratio mortgages has fallen nationally and is lower in all regions"[1] (please see Chart 3 below).

[1] Bank of Canada *Financial System Review*, June 2017, p.6

CMHC has yet to issue its Mortgage and Credit Trends Report for Q1 of 2017; its most recent report goes only to Q4 of 2016. What we have seen is a sharp decline in high ratio mortgage approvals.[2] Genworth MI Canada Inc. , Canada's second largest mortgage insurer, reported for its second quarter of 2017 that the total value of new insurance written in Q2 of this year was down $6.1 billion from $31.7 billion a year ago – an 81% year-over-year drop. Premiums written from portfolio insurance were $8 million, representing a decrease of $70 million compared to the same quarter in the prior year. [3]

In addition, other branches of government have introduced measures that affect the market. The Government of Ontario in April of 2017 unveiled its Fair Housing Plan. And of course, in July of this year, the Bank of Canada increased its overnight lending rate, the first such increase in seven years. There is an expectation from many analysts that the Canadian market will continue to have further interest rate hike pressures.

The chart below shows that the housing market is responding to these and other government initiatives.

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[2] *Ibid.*

[3] http://investor.genworthmicanada.ca/English/media/news-releases/news-release-details/2017/Genworth-MI-Canada-Inc-Reports-Second-Quarter-2017-Results-Including-Net-Operating-Income-of-126-Million/default.aspx

Our members believe that policymakers should take the time to examine the data coming out of the 2016 changes. Only after assessing their impact in the current economic and interest rate environment, should they consider introducing more tightening of mortgage accessibility.

Private Mortgage Lenders Provide a Valuable Service

Certain of the measures contained in the Draft Guideline, particularly the proposed prohibition against "co-lending" (described in further detail below), appear to be directed at minimizing the participation of private lenders in the Canadian residential mortgage marketplace.

Private mortgage lenders, or mortgage investment entities (MIEs), while they represent a tiny fragment of Canada's overall market residential mortgage market[4], nevertheless provide an important and valuable service to their clients.[5] MIEs typically make mortgage financing available to borrowers who are unable to access conventional product offered by FRFIs.

Borrowers turn to MIEs for funding because of reasons such as:

- need for credit repair
- debt consolidation
- short-term credit restructuring
- difficulty with income verification due to self-employment
- lack of credit history due to recent immigration
- financing for renovation or construction
- Canada Revenue Agency debts.

MIEs work with borrowers to provide access in a timely fashion to short term funds and to avoid financial penalties. Most of our clients borrow money for short periods of time, typically 12 to 18 months. Residential mortgages offered by MIEs in excess of 36 months are uncommon. The majority of borrowers who access residential mortgage financing from MIEs go on to obtain a conventional mortgage on the maturity of their loans.

MIEs are much smaller than regulated financial institutions, and they are able to perform due diligence and underwrite risk in special situations and monitor assets in ways that are not cost effective for large FRFIs. Because of this, MIEs are able to charge a premium over interest rates offered by the financial institutions, but the incremental interest cost is not entirely attributable to incremental risk of default. It is also a reflection of the additional work required to assess and monitor the loan.

[4] The BOC's June 2017 FSR notes that mortgage investment corporations are currently estimated to make up less than 1 per cent of mortgages outstanding. p. 8.

[5] The term "mortgage investment corporation" generally refers to a Canadian corporation which meets the requirements to so qualify as set out in the *Income Tax Act* (Canada). The term "mortgage investment entity" includes mortgage investment corporations as well as other investment entities which pool investor capital to invest in mortgages primarily on property located in Canada.

The MIE industry is small and fragmented and it is difficult to obtain reliable data. However, our members report that their delinquency rates and loss ratios for their residential mortgage book reflect borrowers who are able to service debt. Most MIEs have very close relationships with their investors and have their own capital at risk. Accordingly, they are highly motivated to avoid loss and exercise prudence in their mortgage underwriting and collateral management.

The Canadian Residential Mortgage Market is Sound

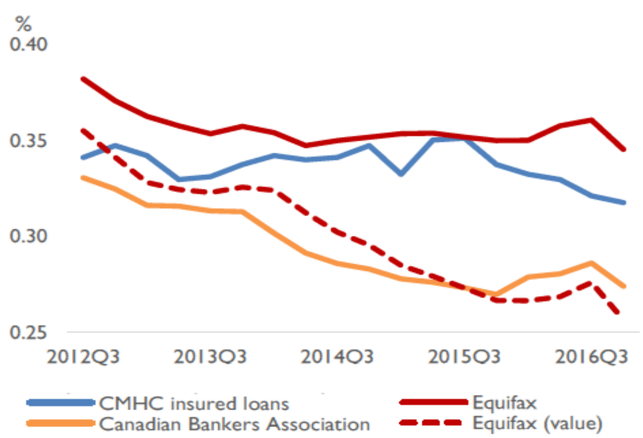
Our members submit that the Canadian residential mortgage market is well regulated and fundamentally sound. We question whether further regulatory intervention is needed at this time.

Data compiled by the Bank of Canada and the Canada Housing and Mortgage Corporation support the view that even before taking into account the policy changes implemented in the latter part of 2016. With respect to Q4 2016, CMHC reported a drop in overall delinquency rates.[6] Both the share of mortgage loans and the share of mortgage debt in arrears dropped in the last quarter of 2016, suggesting that the mortgage market is not under additional stress. Mortgage arrears at various degrees of severity in the fourth quarter of 2016 were all in decline compared to a year earlier. The share of mortgages that are written off by financial institutions decreased in Q4 to the lowest point since the first quarter of 2016. [7]

Figure 1

Seasonally adjusted mortgage arrears rates[9]

Number of loans 90 or more days past due (DPD) as a share of all mortgage loans; Equifax (value) is outstanding mortgage debt 90+ DPD as a share of total outstanding mortgage debt. Seasonally adjusted



Last data point: 2016 Q4
Source for data: Equifax, CMHC and Canadian Bankers Association

According to data compiled by the Canadian Bankers Association, arrears rates have remained remarkably stable over the past five years.

[6] Canada Mortgage and Housing Corporation, *Mortgage and Consumer Credit Trends, National Report – Q4 2016* p.3

[7] *Ibid.*

This suggests to us that residential mortgage assets on the books of FRFIs are not declining in quality and there is no urgent need to further tighten the rules.

SPECIFIC COMMENTS

Prohibition against "co-lending"

Guidance is Imprecise

The Draft Guideline states as follows:

> "A FRFI should not arrange (or appear to arrange) with another lender, a mortgage or combination of a mortgage and other lending products (secured by the same property), in any form that circumvents the maximum LTV ratio or other limits it establishes in its RMUP, or any requirements established by law, i.e., no co-lending."

Our members are struggling with how the Draft Guideline will translate into day-to-day operations. Does this prohibit the FRFI from consenting to the borrower's placing a second or subsequent mortgage on the property? Is that "arranging (or appearing to arrange)" another lending product secured by the same property? Is it that a mortgage from the FRFI cannot be combined with any other loan secured by the same property if the advances take place contemporaneously, as part of the same transaction? Does a subsequent mortgage advanced a year later fall under the prohibition? What if the purchase price of a property is financed partially by a FRFI mortgage and partially by a vendor take-back mortgage? Is the vendor in that circumstance "another lender" within the meaning of the above prohibition? Our members would caution of the risk of unintended consequences that may result from the broad use of the term "co-lending".

Our members request that the Draft Guideline provide more clarity and specify more precisely which practices are to be avoided.

"Co-lending"

Many of our members wish to point out that an arrangement under which there are two lenders on a single mortgage, but where one lender ranks ahead of the other, is not accurately described as "co-lending." We are not aware of the term "co-lending" having a legal meaning. However, industry professionals use the term to refer to a type of loan syndication in which the undivided interests of the all of the co-lenders are equal in ranking and proportionate to each lender's contribution to the amount advanced.

However, one common form of arrangement where an FRFI and a non FRFI cooperate to facilitate a mortgage loan is a mortgage loan with priority interests. This is sometimes referred to informally as a "bundled" mortgage. (We not that the term "bundle" also has its drawbacks: in finance, bankers and financial institutions "bundle" or pool, through an investment vehicle, a number of discrete mortgages or parts thereof for the purpose of creating a mortgage backed security. Given this, for the sake of precision, we are using the term "mortgage with priority interests".)

Mortgages with priority interests creates a single charge on the property. The borrower signs only one set of mortgage documents, and makes a single payment every payment date rather than separate payments to each lender. The lenders agree however that they have priority interests in the mortgage. Typically, the FRFI has the first priority and the non FRFI has the second ranking priority. In the event of default, the second ranking lender must absorb 100% of the loss before the first ranking lender (the FRFI) is exposed.

Additionally, conventional first and second mortgages by two different lenders representing two separate payment obligations may also be used, in which the FRFI acquiesces to the existence of the second ranking charge. As stated, we seek clarification as to whether this arrangement falls under the proposed prohibition.

Mortgages with Priority Interests are Not Designed to Defeat Prudent Underwriting

In the experience of our members, these arrangements are not entered into with a specific intention of defeating prudent underwriting guidelines established by the FRFI through its RMUP. Rather, these arrangements exist to facilitate lending to borrowers who, for one reason or another, may be unable to qualify for a conventional mortgage, but who present as good credits. The reason may be that the borrower is experiencing a temporary period of unemployment, or has been through a personal life event such as illness or divorce which has resulted in financial difficulty and a reduced credit score, or has been in Canada for fewer than three years.

Mortgages with priority interests are not a new development. To the contrary, these mortgage loans with priority interests have been in place for over a decade. And prior to mortgages with priority interests, there were more conventional first and second mortgages and vendor take-back mortgages.

Prohibiting the well-established practice of advancing mortgages with two lenders with priority interests will restrict access to mortgage financing. Any future incremental enhancement to the overall quality of the mortgages on the books of the FRFIs resulting from such prohibition is, we believe, almost impossible to quantify. And as stated, private lenders represent less than 1% of the entire Canadian residential mortgage market.

However, the proposed prohibition will result in real hardship for those Canadian borrowers and their families who find themselves in situations where the financing available through these arrangements is the difference between owning or keeping, and losing, their homes.

Stress Test for Uninsured Mortgages

With respect to qualifying rates, the Draft Guideline provides that:

> For uninsured residential mortgages, FRFIs should contemplate current and future conditions as they consider qualifying rates and make appropriate judgments. At a minimum, the qualifying rate for all uninsured mortgages should be the contractual mortgage rate plus 2%.

Too Rigid

We urge OSFI to consider whether such a rigid test is necessary for appropriate risk management. This "stress test" is helpful in assessing the borrower's ability to service debt, but leaves little room for other factors. An across-the-board application of the contracted-rate-plus-2% test as the minimum threshold for eligibility seems to us to be arbitrary and unreasonable. It unduly punishes both regulated (and indirectly regulated) lenders and borrowers.

Our members do not see that borrowers obtaining an uninsured mortgage at origination are uniformly all risky credits. The 200 basis points stress test will put a conventional mortgage out of reach for borrowers who may well be able to comfortably service their debt. In particular, a borrower who would otherwise be able to obtain mortgage financing through a mortgage with priority interests as described above may find themselves declined.

We question whether it is necessary to specify a hard number as the threshold. Two hundred basis points may seem an appropriate reference point today, but its usefulness may decrease if rates move up substantially over the next several years.

Our members work with many borrowers who find themselves unable to access conventional mortgage financing, generally temporarily. We know from lived experience that these borrowers need and are determined to find lenders in order to purchase and keep their homes. If they are unable to obtain the loans in the regulated marketplace, they will turn to the unregulated, or "grey" markets, where there is little supervision or intervention by government agencies. Lenders in these markets are less likely to be concerned about the borrower's ability to service debt. The focus is on the value and marketability of the underlying asset and lenders are often quick to enforce, with little motivation to assist a defaulting borrower in financial difficulty with grace periods or restructuring. We do not believe that borrowers who may well qualify for an uninsured mortgage but for the application of this stress test will be better served in the grey market.

CLOSING REMARKS

We would be pleased to expand on our submissions, through subsequent correspondence or at an in-person meeting.

We respectfully request that OSFI address our comments, as we are concerned that the measures contained in the Draft Guideline, if implemented, may result in serious negative outcomes not only to some of our members but to Canadian home buyers and owners.

* * * *

We thank you for considering our submissions and we would be pleased to respond to any questions or meet with you to discuss our comments.

Yours truly,

COMMENT COMMITTEE MEMBERS

"Dean Koeller "
Co-Chair PCMA MIE Committee

"Diana Soloway"
Co- Chair PCMA MIE Committee

"Susan Han"
PCMA MIE Committee Member

PCMA Executive

"Doug Bedard "
Chair

"Georgina Blanas"
Executive Director

Appendix A

<u>Equitable Bank Q1 2017 Earnings Conference Call Transcript</u>
May 1, 2017

<Q - Jeffrey Fenwick>: Okay. And then maybe one more area to talk about here that's getting a lot of attention obviously is the idea of bundled mortgages, and I think you gave a little bit of disclosure around that in terms of how that plays in your portfolio. But maybe you can give us – characterize how much of that has contributed to your existing residential mortgage portfolio? And how do you treat that from a risk perspective when you're writing a mortgage?

<A - Andrew R. G. Moor>: When mitigating risk, one thinks about – if we are happy to lend, let's say, 70% to loan-to-value and somebody else wants to risk another 5% behind it and then wants to combine with us. Then clearly,[ph] we'd (22:40) be exposed to first loss, it's a way of reducing our risk. ***There is good disclosure I think in the supplementary package that shows it's actually a relatively small part of our business, and hasn't been growing over the last few years. It's been, in fact – it's basically stable in nominal dollars while the rest of the business is growing around it***

<u>Home Capital Q2 2017 Earnings Conference Call Transcript</u>
August 3, 2017
<Q - Dylan Steuart>: A quick question on just the B-20 Guidelines. The co-lending or bundled restriction, just wondering if you can speak to, I guess, how prevalent that was in your recent originations and sort of what your view on that is, if it goes through as implemented or as proposed?

<A - Robert J. Blowes>: I may be – I'll add a couple remarks, Dylan, and I think Pino's probably the best suited to give you more color on that. So co-lending has been a part of our business for some time. I think it would be, as said earlier today, it would be hard for a lot of people in the major markets [indiscernible] (31:27) Vancouver to have the size of down payment that would be required to buy a house, if they didn't have some kind of assistance, often it's from family or other friends, ***but sometimes it comes through some kind of secondary financing and we have had a program over the last few years where we've made [ph] accruals (31:50) to parties that would provide second charge lending. We ended that earlier this quarter or last quarter;*** so we don't have a structured program on that, but it is part of the business. Maybe I'll let Pino talk about the sort of the extent of that.

<A - Pino G. Decina>: Yes. ***So we discontinued the program Bob was referring to, which we called our bundled program back in May, and this is where we had certain partners that lend secondary lending behind us. So that's discontinued***. What we do need to know now is, and we're trying to gain this information during the current discussion period of B-20, the long-term impact to co-lending as a whole, so it's about commission and that is referenced in B-20,and then of course what impact that will have, because certainly we do have a group of customers that on their own will seek to gain secondary lending behind our home trust mortgage. So, looking at that clarity, we just don't have it today.

<A - Robert J. Blowes>: ***I think today [indiscernible] (33:06) of view roughly one in 10 or one in 8 of our customers would have some kind of co-lending structures that we were aware.***

<A - Pino G. Decina>: Yeah. I mean, if we apply the same sort of numbers that we've seen in the past, ***our bundled program itself I think last checked was 5% or somewhere around there by origination, then roughly another 10% to15% would gain financing on their own where need be, so certainly a [ph] sensible (33:39) rate than the 15%***

<u>CWB 2Q Call</u>
June 1, 2017

Chris Fowler, President and Chief Executive Officer
From a mortgage origination and pricing perspective, the recent turbulence has resulted in higher-than-normal mortgage application volumes for CWB Optimum Mortgage and incrementally higher market yields on newly originated mortgages. CWB Optimum has been a strong contributor to our recent growth, and Alt-A mortgages now represent about 10% of our overall loan portfolio. As we said before, we'll focus on good quality borrowers in this segment

Our risk appetite is conservative and we are disciplined in focusing on the borrower's ability to pay. Optimum's business model targets affordably priced homes with an average loan to value at initial funding of 68% this quarter, on an average origination of $337,000. The average size of each outstanding mortgage is $231,000. At more than half the total, Ontario represents the largest geographic exposure within Optimum's portfolio, followed by Alberta at 21%, and BC at 17%

Sumit Malhotra, Analyst
And last one is a numbers one, Chris and maybe ties in your strategic view. You gave us -- and it was referred to in the last question, you gave us a target on where you want Optimum to get to in terms of absolute dollars. But in terms of the portfolio or the

reliance on it, right now Optimum's 11% of the loan book. Is there a cap in your mind as to how big Optimum should be relative to the entire bank portfolio or do you not think about it that way?

Chris Fowler, President and Chief Executive Officer
Well, we do that with every portfolio. We have sectorial limits that we set, because we've got a risk appetite on how it is we look to grow in every part of our book. ***And Optimum is 11% and the Alt-A is 10% of that. So as we think about growth of Alt-A, we want that to be measured growth that is in step with the other parts of our book. We're not looking for that to immediately jump to a higher number. So we will be managing that growth, and that's how we'll -- we approach that with all of our portfolios***.

<u>Atrium MIC - 2Q Call</u>
July 21, 2017
<A - Robert G. Goodall>
So, I think it could be good news for us on that basis***. It will be interesting to see just how owner if the changes on the regulated lenders are like, they're also talking about removing bundling, but we never did bundling.*** So, that advantages us because when we do single-family loans, at least 80% of them are first mortgages, and the ones that are second mortgages, they are generally at lower loan to values, where the first mortgagee for whatever reason isn't increasing the loan

<u>Laurentian Bank - 2Q Call</u>
May 30, 2017

Francois Desjardins
Mortgages through the branch network are all prime, while those through B2B Bank are mostly prime. ***Alt-A mortgages are a very small portion of our portfolios and account for less than 7% of all mortgage loans and less than 4% of the Bank's total loans. We do not participate in the sub-prime mortgage market at all***