MORTGAGE
PROFESSIONALS
CANADA

Discussion Paper on "Posted" Mortgage Interest Rates, Which Are Published by the Bank of Canada

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Introduction

The Bank of Canada publishes data on interest rates because it is information useful to people and entities who are considering transactions that involve the payment or receipt of interest. Knowing what interest rates are being paid in similar situations can help borrowers and lenders decide whether proposed interest rates are reasonable in their circumstances.

A secondary reason is that the data can be used in analysis, and thereby contribute to discussion of economic conditions and the outlook, as well as supporting policy-making.

This discussion paper is concerned with the extent to which the Bank of Canada's data on "posted" mortgage interest rates is best serving these goals.

The conclusion is that since the data is determined by the administrative policies of a few lenders and is not based on market realities, it misrepresents actual conditions and is potentially misinforming market participants and policy makers.

In consequence, publication of the data may be doing more harm than good.

In particular, these posted rates have been given a public policy role in the mortgage stress tests that are required for mortgage insurance and by the Office of the Superintendent of Financial Institutions ("OSFI", via its Guideline B-20). These policies ought to utilize interest rates that are determined by the marketplace, rather than being determined administratively by the major banks.

Mortgage stress tests are intended to reduce the risk that, at the time of future mortgage renewals, mortgage interest rates might be higher than at present and therefore increase the possibility that a borrower either would not qualify for their loan size or face an increased propensity for default at their new, higher interest rate. The current tests anticipate that those future interest rates will be two percentage points higher. However, at current interest rates, in five years approximately 15% of principal will have been repaid, and more importantly income will have increased (likely by 10%). As designed now, ***the stress tests take neither of these events into consideration***.

Doing the stress test today using a rate 0.75 points above the contracted interest rate would reasonably simulate the impact of a 2 percentage point rise in 5 years.

By using the 2-point increment today, the stress test is unduly restrictive, and unnecessarily impairs the housing market and the broader economy.

Very Few Mortgages are Transacted at Posted Interest Rates

For 10 years, Mortgage Professionals Canada's (formerly the Canadian Association of Accredited Mortgage Professionals) consumer surveys have compared rates for recently transacted mortgages with the posted rates published by the Bank of Canada (for fixed rate mortgages with terms of five years). These surveys have found repeatedly that actual contracted rates are far below the posted rates, although the amount of discounting has varied over time.

In the fall 2016 edition of the survey, Canadians reported that their 5 year term, fixed rate mortgages initiated, renewed, or refinanced since the beginning of 2016, had an average interest rate of 2.72%. In contrast, the average posted five-year mortgage rate over the same period was 4.66%. Based on this data, actual negotiated mortgage rates averaged 1.94 percentage points less than the posted rates published by the Bank of Canada. Moreover, only one respondent had an actual interest rate higher than the average posted rate; that one response showed a rate of 5.2%.

The amounts of discounting have varied over time, and discounts have tended to increase. A decade earlier, in the fall 2006 survey, the average negotiated rate was 1.38 percentage points below the posted rate.

It is well known that mortgage rate discounting is widespread. For example, a search of the Bank of Canada website using the phrase "mortgage rate discounts" returned 634 items. The first item was titled "Competition in the Canadian Mortgage Market" (this document was published in the Bank of Canada Review for Winter 2010-2011). A chart within that document shows that discounting has existed for a long time and, as of 2004, has increased over time. The red line shows an "average discount" exceeding 1.20 percentage points as of 2004. See "Chart 3" on the following page.

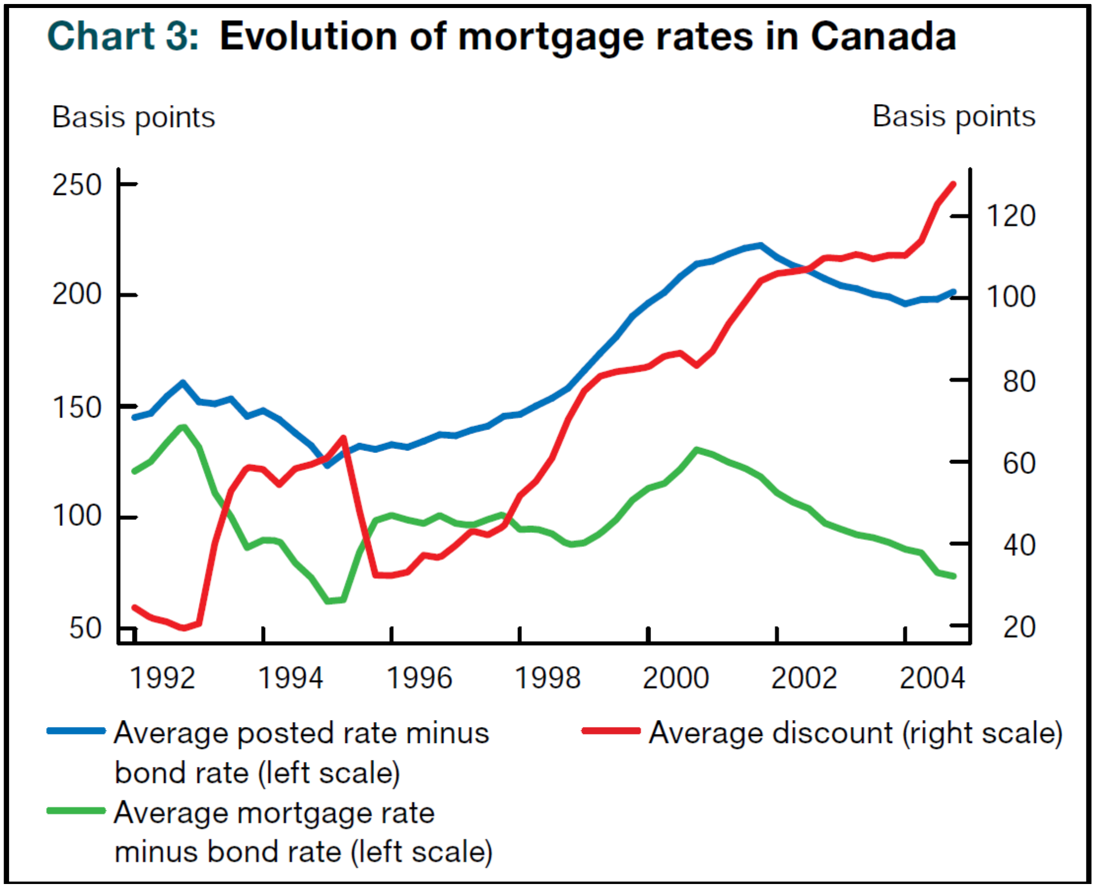

Chart 3: Evolution of mortgage rates in Canada

Source: Bank of Canada Review, Winter 2010-2011

Posted Rates Have Become Less Reliable as Benchmarks for the Mortgage Market

As the gap between actual contracted rates and posted rates has increased over time (the average gap being 1.38 points as of the fall of 2006 and increasing to 1.94 points as of fall 2016), the Bank of Canada posted rate has become increasingly unclear as to what can be achieved in the marketplace.

Another way to put this is that while actual rates are determined in a competitive marketplace, it appears that the setting of posted rates has become less competitive. The use of posted rates has become increasingly imbalanced to the detriment of borrowers, since posted rates are generally used in the calculation of IRD (interest rate differential) penalties for early repayment.

Posted Rates are Not Predictive of Future Interest Rates

If posted rates provided an indication of what actual rates might be in future, then the data would be useful to borrowers, so that they could calculate how their payments might change in future and they could assess their ability to afford their future costs. But, there is no evidence that actual contracted mortgage interest rates do tend to move towards the posted rates.

Material published by mortgage lenders does not indicate their rationale for the posted rates they set or how the rates are set. We are not aware of any argument from a lender that it sees its posted rates as predictors of future market interest rates.

Posted Rates Have Been Given a Policy Role

Yet, even though posted rates do not appear to have a predictive value, they have been given an important role in the mortgage market, in the mortgage qualification process:

- Starting in early 2010, for mortgage insurance, borrowers with variable rate mortgages or fixed rate mortgages with terms less than five years were to be qualified based on posted rates for 5-year fixed rate mortgages.
- Since the fall of 2016, all insured mortgages are to be qualified at the 5-year posted rate.
- Most recently, OSFI has implemented a new policy that as of January 1, 2018, all uninsured mortgages funded by federally-regulated financial institutions must be stress tested at the greater of two percentage points above the actual contracted rate or the Bank of Canada 5-year posted rate.

The purpose is to ensure that borrowers have capacity to afford their payments in future, in the event that they have to renew mortgages at substantially higher interest rates. Yet, no argument has been advanced that supports the selection of the 5-year posted rate as a reasonable indicator of likely future interest rates.

Perhaps there has been some research that has drawn conclusions about a reasonable interest rate to use, and that interest rate might have been equal to (or close to) the 5-year posted rate at the time.

In that case, that specific, expected interest rate should be used in the testing, rather than an interest rate that is set by lenders and can be changed at their choice. As it is, these mortgage stress tests are major regulatory policies with substantive consequences, in which the most important parameter is being set by the lenders who are being regulated.

A Better Way Forward?

The stress test that is used for mortgage insurance uses today's parameters for an event that will occur far in the future (usually five years).

Five years from now, much will have changed:

- So long as the borrower makes the required payments, a substantial amount of the principal will have been repaid (at current interest rates and assuming the amortization period is 25 years, about 15% of the original principal will have been repaid in five years).
- Making the calculation on the initial principal amount will therefore overstate the amount by which the payment might increase in future.
- In addition, the borrower's income is likely to have increased in five years: the estimated future payment should be compared to a reasonable projection of the borrower's future income.

If the government believes that a reasonable scenario is for interest rates to be two percentage points higher in future, then there should also be an expectation that strengthened economic conditions will have allowed for income growth that is at least as rapid as has been seen in the past (roughly 2% per year).

Taking principal repayment and increased income into account, ensuring a borrower can afford his or her mortgage repayments if a 2 percentage point increase in mortgage interest rates occurs five years in the future can be simulated by using an interest rate that is 0.75 points higher than the initial actual interest rate at mortgage issuance.

More generally, regardless of the expected amount of increase for interest rates, if the rate increase is expected to occur five years in the future, the premium above the actual contracted rate to be used in the stress test should be only 3/8 or 0.375 of the expected rise in interest rates. If the expected rate rise is 2 points, the premium would be 3/8 of 2, or 0.75 points; if the expected rate rise is 1 point, the premium would be 0.375 points; etc.

While this may be more complicated to communicate to the consumer, it is market-based measure that can protect consumers in the wake of rising rates, while not unduly restricting mortgage financing to borrowers who are able to afford their initial obligations as well as their likely future obligations.

Conclusion

Data that inaccurately portrays available mortgage interest rates is detrimental to consumers, as it may confuse them as to interest rates that would be reasonable in their circumstances. Today's borrowers can obtain data via interest rate comparison websites, however, those websites may indicate "special offer" interest rates that are used to get the attention of potential borrowers, but they do not reveal the rates that can actually be obtained through negotiation. The rates actually negotiated may, in individual circumstances, be lower than or higher than the special offer rates.

As such, it is important for the Bank of Canada to publish reliable data on actual contracted mortgage interest rates. In lieu of using the 0.75% stress test for insured and insured mortgages, one possible way to ensure the posted rate is a market based rate would be to take the spread between the five and ten year bond yields.

Taking the spread between the five and ten year bond yields, better reflects investors' expectations of where interest rates are headed and we believe provides a better aggregate target over today's big six bank posted rates.

Changing the posted rate to better represent consumer's contract rates or a predictive rate based on where rates could be headed will improve and reflect the policy role that has been assigned to the current posted rate.