ECONOMIC VIEWPOINT

In Short Supply: Long Mortgage Terms

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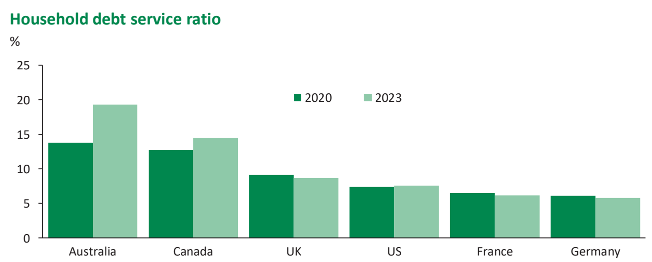
Highlights

- Canada seemingly avoided an outright recession in 2023, but aggressive post-pandemic monetary policy tightening has led to a significant increase in Canadian households' debt servicing ratio, placing it among the highest in advanced countries.
- Canada's mortgage structure, which focuses on short-term, renewing mortgages, has limited options for protecting against rising rates. This likely exacerbated the payment shock.
- Our analysis shows that if the option to lock in 10-year mortgage terms had been more prevalent and attractive, the payment shock would have been more manageable for households opting for it. A 10-year mortgage term would also make the stress test less necessary.
- But to make longer-term mortgages more prevalent in Canada, several obstacles will need to be overcome. These range from outdated legislation governing prepayments, an underdeveloped private-label mortgage securitization system and limitations on covered bond issuance.
- These constraints have been recognized for some time, but the pandemic halted the Bank of Canada's initiatives to unite stakeholders around this issue. In our view, advancing this agenda has become more critical than ever.

Canada seemingly avoided an outright recession in 2023, and recent aggregate economic data has exceeded expectations. But there can be no complacency about the painful toll that monetary policy tightening is taking on households in this country. Canada is among the countries for which the recent tightening cycle has delivered the sharpest responses in households' mortgage debt servicing ratio (graph 1). This is hardly surprising since Canada's mortgage market product offering is heavily concentrated in fixed-rate mortgages that have terms of up to 5 years, as well as in 5-year variable-rate mortgages. While longer-term fixed mortgages exist in Canada, they constitute only a negligible fraction of mortgage issuance.

Graph 1
Similar Tightening, Different Debt Servicing Responses



Bank for International Settlements and Desjardins Economic Studies

The fact that Canada's mortgage system in 2024 still predominantly offers very short-term mortgage options can arguably be seen as a legacy of the evolution of interest rates over the 40 years prior to the pandemic. As persistently declining interest rates shaped expectations and influenced financial decisions, households were incentivized to borrow at short terms. At the apex of easy monetary policy, many succumbed to the allure of then-cheaper variable-rate mortgages (graph 2 on page 2).

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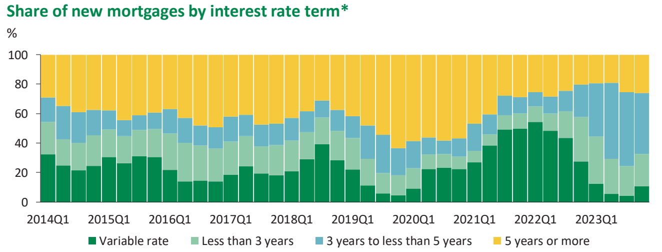
Graph 2
Variable-Rate Mortgages Were Very Popular in 2020–2021



*Flow of mortgage originations for insured and uninsured mortgages
Regulatory filings of Canadian banks, Bank of Canada and Desjardins Economic Studies

The abrupt shift to a higher interest rate environment is not only traumatic for many vulnerable households, but reveals some limitations in Canada's mortgage system. It comes at a particularly challenging time, as Canadian households rank among the most indebted in the developed world. The payment shock has important consequences for financial stability, as shown by work by the Bank of Canada that finds one-third of mortgage holders to be constrained.

The presence of significant financial vulnerabilities would put the Bank of Canada in a bind if inflation were to surge again. Suffice it to say that new interest rate hikes would deal a blow to households whose mortgage renewals are coming up, and there would likely start to be more forced sales and defaults. It would be less the case if mortgages didn't need renewals, or at least if they could be renewed less often.

Does It Have to Be This Way?

The short answer is no. The functioning of Canada's mortgage system is more a matter of tradition than of reason. That said, other countries have similar traditions. In fact, Canada's mortgage market shares many similarities with those of the UK and Australia. Yet these markets are having different experiences. In the UK, mortgages are also typically fixed over a period that usually goes from one, and up to five years. However, one key difference in the UK is flexibility in amortization periods. In Canada, insured mortgages typically cannot exceed 25 years at origination. While insured mortgages of 30 years are now permitted under the recently announced new housing incentive for first-time homebuyers, take-up is likely to be limited given qualification barriers first-time homebuyers are currently facing and the restriction to purchases of newly built homes. For uninsured mortgages, 30-year mortgages are possible, but under certain conditions that vary by lender, and they tend to be uncommon.

By contrast, the UK does not have a strict maximum amortization period set by regulations. Mortgage terms extending over 30, 35 or even up to 40 years are available to borrowers, offering them the possibility of making payments more affordable by spreading them over a longer period. This means that when terms renew and are renegotiated in the UK, lenders have more flexibility to adjust the amortization period to lessen the payment shock (in rising rate environments) compared to Canada. The drawback is that a borrower will be paying more interest over the life of the mortgage.

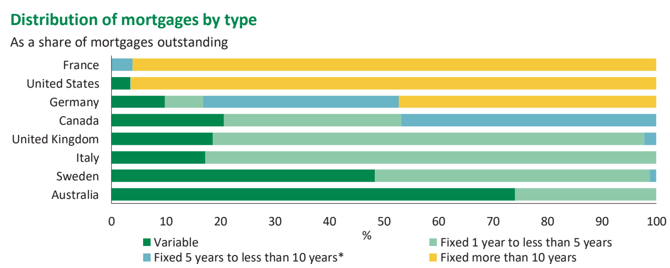
The case of Australia is interesting because it is also contending with fast-rising debt servicing costs, but for reasons different than Canada. In Australia, variable-rate mortgages tend to dominate, representing roughly 75% of mortgages outstanding. Moreover, variable-rate mortgages tend to see their payments adjust, unlike in Canada where many variable-rate mortgages have fixed payments.

Thus, the concepts of "trigger rate" and "negative-amortizing mortgages" are foreign to Australia, since the payment shock tends to be experienced in real time. In fact, the concern is rather about fixed-rate mortgages, because unlike variable-rate mortgages, which have experienced the shock already, borrowers on fixed-rate mortgages haven't seen their payments go up yet.

This being said, the Reserve Bank of Australia (RBA) expects most of these households to be able to afford the higher payments upon renewal. Moreover, the payment shock period is drawing to an end. The RBA expects that by the end of this year, the majority of mortgages will have been reset to higher rates. So far, lenders there are not reporting major increases in mortgage delinquency rates. In contrast, mortgage delinquency rates have been creeping up in Canada. In Ontario and British Columbia, where household debt is highest in Canada, they are now above their pre-pandemic levels. Delinquency rates on non-mortgage products have also noticeably increased across Canada. Things would be looking even worse if it wasn't that only a minority of variable-rate borrowers have seen their payments adjust.

At the opposite end of the payment shock spectrum, mortgage borrowers in the US and France have little to worry about. This is because they are able to obtain mortgage terms covering the full length of the mortgage (graph 3). Higher interest rates still have repercussions on housing affordability for first-time buyers,

Graph 3
In the US and France, Borrowers Don't Lose Sleep Over Renewals



*In Canada, this category is predominantly composed of 5-year mortgages
Federal Reserve Bank of Dallas and Desjardins Economic Studies

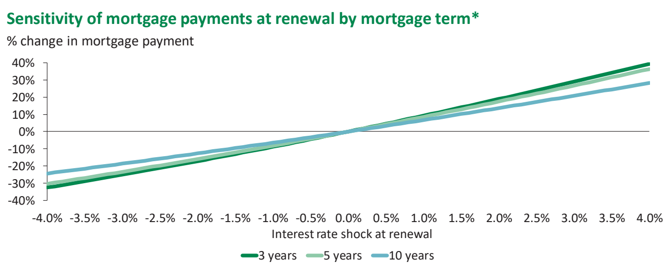
and they also inhibit selling activity, as a sale forces households to break their existing advantageous mortgage contracts. But homeowners with a mortgage who intend to stay in place will not be affected. In this sense, mortgage payment shocks tend to be more optional, as opposed to mandatory, in countries that don't have renewals.

Overall, these examples reveal that while Canada might not be entirely alone in its payment shock, other countries that have experienced a just-as-aggressive tightening cycle as Canada have features that help households either alleviate payment shocks or avoid them altogether. This provides a compelling case for improvement in Canada.

Ten Years Long and Bulletproof

One way to improve the mortgage market in Canada would be to simply offer consumers the option of mortgage terms greater than 5 years. Longer mortgage terms lead to mortgage payments that are less sensitive to interest rates at renewal, resulting in more stability in payments over time (graph 4). That stability is driven by the principal outstanding on the loan, which is mechanically lower for a longer mortgage term.

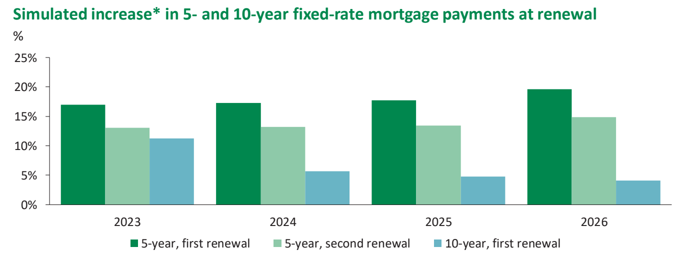
Graph 4
Longer Mortgage Terms Are Less Sensitive to Interest Rate Shocks



*Analysis run on a hypothetical mortgage with an interest rate of 5% and an amortization period of 25 years
Bank of Canada and Desjardins Economic Studies

However, stability does come at a cost. The declining interest rate environment of the 20 years leading up to the pandemic benefitted shorter-term mortgages by reducing interest paid over the first 10 years of the loan.[1] However, periods that captured the recent increase in interest rates would have benefited holders of longer mortgages (graph 5). On a typical 5-year renewal cycle, first-time home buyers would have faced an average payment shock of around 17% in 2023, and as high as 20% over the coming years based on our latest interest rate forecasts. A homeowner renewing a 5-year mortgage for the second time would face a slightly smaller payment shock. However, if an individual had opted for a 10-year term, the payment shocks would be materially lower in 2024 and beyond.

Graph 5
10-Year Loan Terms Would Have Resulted in Smaller Payment Shocks



*Simulations run using average home prices assuming a 20% down payment and Desjardins's rate forecasts
Bank of Canada and Desjardins Economic Studies

Moreover, a household would have seen stronger income gains over a 10-year period. For example, between 2011 and 2021, a two-income family saw a 35% increase in median total income. This extra buffer would make the payment adjustment even more manageable for a majority of borrowers.

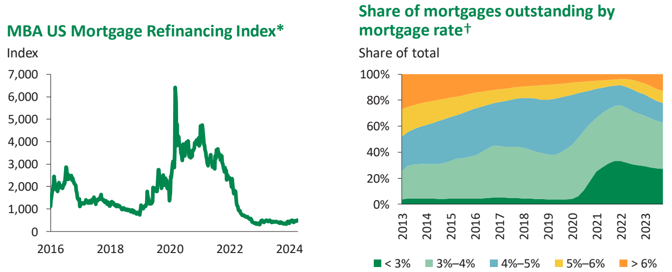
If Longer Mortgage Terms Would Be Beneficial, Why Are They So Scarce?

There are at least three factors that have contributed to shaping Canada's mortgage product offering. First, Big 6 banks and credit unions (which together account for over 85% of mortgages outstanding) largely fund mortgages via their retail deposits. This highlights the asset–liability mismatch issue lenders are naturally facing. Term deposits can help address the duration mismatch issue. However, until 2020, the Canadian Deposit Insurance Corporation guaranteed deposits only up to 5-year terms, disincentivizing longer-termed deposits. Although some institutions offer deposits longer than 5 years, the current economic environment which features an inverted yield curve means these are rarely utilized, limiting their role as a funding source.

Second, lenders face increased mortgage prepayment risk with longer mortgage terms. When interest rates drop, borrowers are motivated to break their current agreements and refinance. In the US, where 30-year mortgages are predominant, refinancing surged (graph 6 on page 4, left) in response to the pandemic as households seized the chance to secure historically low mortgage rates. As of year-end 2023, less than 13 percent of outstanding mortgages had rates above the current 30-year mortgage rate (graph 6 on page 4, right). In Canada, mortgage agreements include prepayment clauses that mitigate lenders' losses. Yet the *Interest Act* restricts prepayment penalties for loans exceeding 5 years to no more than three months of interest beyond the first 5 years of the term. To offset the prepayment risk in offering long-term financing, financial institutions would need to charge higher interest rates.

[1] 5-year terms are renewed at the prevailing market rate or our forecast mortgage rate.

Graph 6
Refinancing Has Shielded US Households from Higher Interest Rates

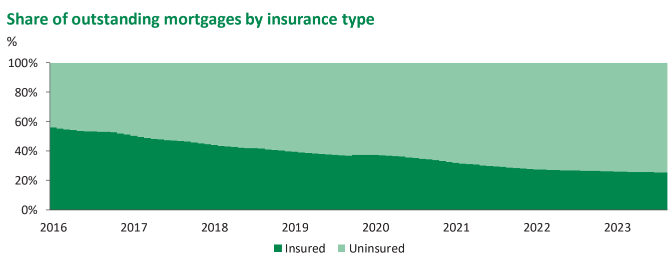


*A higher number indicates more refinancing
†Last observation 2024 Q4
Bloomberg, MBA, FHFA and Desjardins Economic Studies

Third, and related to prepayment risk, Canada lacks a rich securitization market capable of supporting mortgage underwriting at longer amortizations. The ability to package mortgages and sell them to private investors is what allows US lenders to be able to offer longer-term mortgages at low interest rates. Mortgage securitization not only transfers the prepayment risk to owners of mortgage-backed securities (MBS), but offers financial institutions the opportunity to fund mortgage underwriting via financial markets in addition to retail deposits.

Canada's mortgage securitization system is limited primarily to the two programs administered by the Canada Mortgage and Housing Corporation (CMHC). These government-backed programs have a restricted scope. For instance, only insured mortgages can be included in Canada Mortgage Bonds. The share of insured mortgages in total mortgage underwriting has diminished (graph 7), notably as some of the more expensive Canadian housing markets feature average home prices in excess of the $1 million eligibility limit for CMHC mortgage insurance. Other restrictions in insurance criteria over the years, as well as increased premiums, have contributed to reducing the footprint of insured mortgages.

Graph 7
Insured Mortgages Now Represent around 25% of Outstanding Mortgages



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As a result, the CMB program, while generating assets of high quality and safety for investors, operates in a rigid framework that limits product range and prohibits innovations that could yield solutions to the economics of financing mortgages with longer terms.

Time to Jazz Up Canada's Mortgage Securitization Ecosystem

In the presence of these constraints, there have been calls for the expansion of private-label securitization, which could allow for the pooling of uninsured mortgages. Two main options exist in Canada: residential mortgage-backed securities (RMBS) and covered bonds.

Private-label RMBS can be structured based on the quality of the underlying assets and rated accordingly by ratings agencies. Prepayment speed is a key consideration for investors, although it constitutes an intrinsic variable in the market price of a mortgage-backed security. Prepayment risk can be further mitigated through geographic diversification and the use of derivative instruments. In practice, private-label RMBS issuance has been scarce in Canada. One of the reasons is the existence of another securitization vehicle for uninsured mortgages: covered bonds.

Covered bonds are a type of secured funding backed by a pool of high-quality assets. Among the differences with RMBS are the fact that assets in the covered pool stay on the issuer's balance sheet and the fact that covered bonds offer dual recourse, providing bondholders with claims on both the covered pool and the issuing financial institution if the covered pool proves insufficient. Financial institutions are also obligated to keep the quality of the pool unchanged and replace delinquent mortgages with mortgages of equivalent quality that are in good standing.

The covered bond market has a long history and is well developed in Europe. Canadian financial institutions have embraced this funding vehicle in recent years and have become increasingly active. As per S&P Global Ratings, Canada issued $54 billion in covered bonds during the first eleven months of 2023, accounting for over a fifth of global covered bond issuance.

However, there are at least three constraints limiting the issuance of covered bonds in Canada. First, OSFI (and the Autorité des marches financiers in Quebec) restricts the size of a financial institution's covered bond program to 5.5% of its assets. This is to address the fact that, as mentioned above, under a liquidation scenario, owners of covered bonds would have priority claim on a financial institution's assets. As a result, they would have seniority over CDIC-insured depositors. Second, covered bond demand remains more extensive overseas than in North America, and thus Canadian lenders usually focus issuance in these markets, swapping back into Canadian dollars. Lastly, covered bonds are complex structures and therefore out of reach of smaller lenders.

This being said, despite restrictions limiting its development, the Canadian covered bond market appears to have just enough significance to inhibit the development of a private-label RMBS market. This is unless there is a deliberate policy initiative to promote this sector. On the demand side, there are good reasons to believe Canadian and foreign long-term investors would have an interest in these products. Assuming other issues are resolved, they could provide attractive returns and diversification benefits. Additionally, the conservative underwriting practices of Canadian lenders and the fact that Canadian mortgages are recourse loans add to the appeal of these products.

On the supply side, steering securitization innovation to encourage the development of a viable secondary market for longer-amortization mortgages would help address one of the key factors exacerbating the mortgage payment shock, namely the excessive burden of interest rate risk on borrowers.

Picking Up Where We Left Off

So what should be done at this stage? In an ideal world, Canada would do away with payment shocks altogether and bring innovations to make full amortizing mortgages feasible. While this should be fully explored, expanding the availability and attractiveness of a 10-year term is perhaps a more attainable first step.

But in order for a 10-year mortgage term to escape from the realm of niche products, much needs to be accomplished. Updating legislation governing prepayment rights, which dates back to the 19th century, would be a necessary start. In effect, the legislation forces lenders (or potential RMBS investors) to provide borrowers with a potentially significantly advantageous prepayment option beyond the first five years at an uneconomical price. Revising the legislation to address this would be an important step towards engaging lenders in this space and would ensure 10-year mortgage terms can be offered at attractive rates.

An economically viable 10-year term would make feasible the development of a responsibly structured private-label RMBS market. Developing an anonymized public database of mortgages, as some have proposed, would also help. The idea would be to provide investors with full transparency about the underlying RMBS assets, helping them price these securities more accurately and reduce costs. Such a database could also help garner insights into borrower behaviour, which could lead to the creation of improved financial products.

The bottom line here is that while there are frequent calls for stimulating innovation in Canada, the mortgage market is no exception. And like so many areas needing fresh ideas, the issues have been recognized for some time. Before the pandemic, there was a concerted effort led by the Bank of Canada to unite stakeholders around the mortgage innovation question. The pandemic halted these initiatives, even though advancing this agenda has become more critical than ever. The Canadian government is now in a position of having to urge lenders to show leniency towards borrowers facing mortgage renewal shocks. This plea might have been unnecessary if better products had existed in the first place. Similarly, the stress test would become less relevant for a borrower locking in at longer terms. This underscores why policymakers need to pick up where they left off.