June 7, 2024

Dear Madam Chair and members of the Senate Standing Committee on Banking, Commerce and the Economy:

I am writing on behalf of the Competition Bureau further to our appearance at your committee on May 29, 2024.

During that meeting, in response to a question from Senator Gignac, we undertook to share with you the Bureau's submission to the Department of Finance on strengthening competition in the financial sector and the data on the benefits of switching for consumers.

The Bureau's submission answers the Department of Finance's key questions about bank mergers, market concentration, and public reporting on concentration and competition in Canada's banking sector. It also makes two recommendations to lower switching costs for consumers and meaningfully advance competition:

- We encouraged Finance Canada to swiftly adopt a consumer-driven banking framework that will boost competition and innovation by challenging established providers and enabling new service providers; and
- We urged policymakers to reconsider the application of the stress test at (uninsured) mortgage renewal for borrowers, to allow them to switch lenders and benefit from competition.

Our recommendations stem from the principle that consumers' ability to switch service providers is an essential aspect of the competitive process.

When consumers can easily switch to new service providers, firms will offer better services at lower prices to win new customers and keep their existing customers. Barriers to entry and expansion will also be lower because new entrants can more easily enter and grow in the market when consumers can switch providers easily and cheaply.

This principle has practical application in the mortgage sector. When a borrower cannot switch to another lender, the current lender faces almost no competition and can offer higher rates to these captive borrowers without fear of losing their business. This contrasts with borrowers who can shop around or have other options, where lenders are incentivized to offer lower rates or better mortgage products that best fit their needs.

There is empirical evidence that borrowers pay more when remaining with their current lender. A Bank of Canada Staff Working Paper that examined the impact of the stress test notes that "*Borrowers who renew their mortgage with their incumbent bank on average pay interest rates 6.1* *basis points (bps) higher than new borrowers, and borrowers who switch banks at renewal on average pay 10.2 bps lower than those who stay*.[1]"

In a high interest rates environment, some borrowers may be unable to pass the stress test even though they have good credit and would have been able to service their loan. These borrowers will have to remain with their current mortgage provider, where they will not need to pass the stress test again.

It is important to emphasize that these borrowers present the same risk whether they stay with current lender or move to a new one, they have the same income and are seeking the same mortgage on the same house. In fact, switching, or the credible threat of switching, may actually lower the risk of a borrower's inability to repay their mortgage to the extent it results in lower interest rates or other more preferential financial terms.

Bank of Canada researchers made a similar point in a Staff Analytical Note*: borrowers unable to switch could face higher mortgage interest rates than if they could switch because of their reduced ability to play different lenders off against each other when negotiating the terms of their mortgage renewal*.[2]

To allow more borrowers with uninsured mortgages to benefit from competition among lenders, we encourage policymakers to consider removing the requirement for new lenders to apply the stress test to "straight switch" – that is, to switch loans with no increase to loan amount or amortization.

Such a change need not compromise other financial sector public policy goals. There are other rules in place to protect the safety of FRFIs and ensure they adopt good loan approval practices[3]. An outcome-based approach to risk based on the borrower's ability to pay their renewed mortgage may vary across lenders, depending on the lender's risk appetite, portfolio, and market strategy. This may let lenders innovate and compete for borrowers with good credit throughout the life of the mortgage, while still following their own risk assessments. Regulators can also monitor lenders to ensure the financial system remains safe and sound.

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[1] Jason Allen and Shaoteng Li (2020), Dynamic Competition in Negotiated Price Markets. Also see: Jason Allen, Robert Clark, and Jean-François Houde(2019) Search Frictions and Market Power in Negotiated-Price Markets. Using mortgage market data and a search and negotiation model, it was found that search frictions reduce consumer surplus by $12/month/consumer, 28 percent of which can be associated with discrimination, 22 percent with inefficient matching, and 50 percent with search costs.

[2] Bank of Canada, Staff Analytical Note (2018), Interest Rate and Renewal Risk for Mortgages.

[3] For example, with respect to incumbent lender, instead of a prescribed requirement to conduct the stress test at renewal, OSFI expects them to have a clearly defined risk-based approach for current and future mortgage renewals and to remain responsible for deciding what level of due diligence and review to place on borrowers' qualifications at the time of renewal. OSFI (2017) Final Revised Guideline B-20: Residential Mortgage Underwriting Practices and Procedures.

The stress test has been a key policy to ensure that borrowers qualify for loans they can afford when purchasing a new home. Such a safety net is important at a time when Canadians continue facing higher mortgage interest rates. The change we are recommending need not compromise these important financial sector public policy goals.

Should the committee have any further questions, we would be pleased to make ourselves available.

Sincerely,

Durocher, Anthony 0

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Anthony Durocher
Deputy Commissioner
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