BOC highlights evolving risks

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The semi-annual Bank of Canada (BOC) Financial System Review highlights risks and vulnerabilities to the Canadian financial system. For several years the Bank has identified two key vulnerabilities — the "elevated level of household indebtedness" and "imbalances in the Canadian housing market".

The central bank for Canada reiterated their concerns, saying that "the most important vulnerabilities … have moved higher over the last six months."

Reigning in housing market speculators will require much more effort before authorities can declare, "Mission Accomplished".

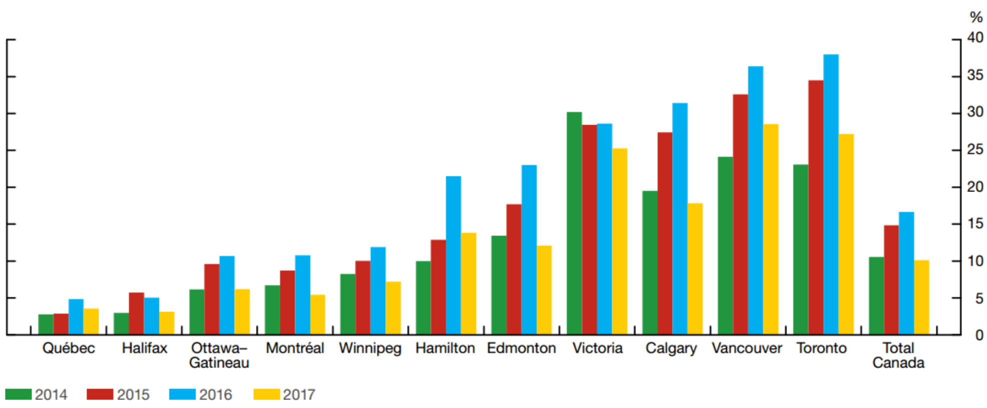
Housing market risks are growing as rapidly as household debt. Two pieces of evidence that the bubble is entering a new and volatile phase are the Home Capital imbroglio and the sudden reversal in the GTA housing market from a sellers' market to a buyers' market. Latest sales and listing data are showing weakness in that market, although year-over-year prices show gains.

The Bank of Canada report describes how these risks are evolving.

One important indicator cited is the number of heavily indebted households taking out new mortgages. The latest data demonstrate a significant change, probably due to changes in CMHC rules introduced in 2016.

The quality of high-ratio mortgage lending has improved across major markets

Percentage of new mortgages (used to purchase) that have a loan-to-income ratio greater than 450 per cent, first quarter of each year



Note: Cities are census metropolitan areas as defined by Statistics Canada.

Source: Department of Finance Canada – Last observation: 2017, Q1

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Looking closely at 2016 we can see a spike to even higher levels of leveraged borrowing, especially in Toronto, Hamilton, Vancouver and Calgary. And then, in the first quarter of 2017, a sudden collapse in demand from these borrowers.

The BOC points out that growth in mortgage credit had been outpacing growth in incomes and interest rates, at an increasing rate. The reports put a number of $55 billion on that difference over the last two years, suggesting that this new credit went mostly to Vancouver and Toronto.

The report talks about "extrapolative expectations" meaning that people are buying housing for "investment" purposes on the basis of a belief that prices will keep on rising forever. After doing dozens of interviews with media outlets across Canada I can attest that the belief of higher and higher prices forever is strongly held. But at these prices, investing in housing makes no sense and is dangerous, as the report explains:

"However, when fueled by high leverage and extrapolative expectations, this activity can be destabilizing."

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Freehold investment properties have generated modest and declining rental returns in the Greater Toronto Area

	2012	2016
Average home price (dollars)	669,564	949,175
Average rent (dollars)	2,124	2,283
Annual rental yield (per cent)	3.8	2.9
Five-year fixed mortgage rate (per cent)	3.1	2.5
Home sales associated with investment (per cent)	4	10

Note: Home sales associated with investment are those that were immediately listed for rent.
Sources: Realosophy Realty Inc. Brokerage and Bank of Canada Calculations

Source: Bank of Canada

The BOC goes on to explain that the riskiest borrowers, presumably because of multiple rule changes, are moving to taking out mortgages in the Low-Ratio category:

"An increasing share of new mortgage lending is for low-ratio mortgages. This growth has been strongest in the housing markets with rapid price growth: more than 80 per cent of new lending by the Big Six Canadian banks in the Toronto and Vancouver areas is for low-ratio mortgages, while in Edmonton and Halifax it is around half. One important reason is that price increases have led to a substantial share of homes priced higher than $1 million, especially in Toronto and Vancouver. These homes are not eligible for mortgage insurance."

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So the rule changes (see pages 24 and 25 for the details) are forcing homebuyers into the Low-Ratio segment where a 20 to 35 percent down payment is required, thus avoiding the more stringent rules applied to mortgages with a smaller down payment. In a frustrating development for authorities such as OSFI and the CMHC who are trying to reign in speculative borrowing, the speculators appeared to have moved to the segment of the mortgage market where the rules are less strict.

Higher prices and new rules are driving people to find more innovative and risky ways of coming up with the higher down payments for a home purchase, increasing their risk.

By pushing speculators out of the heavily regulated insured mortgage market, Canadian authorities might have made the situation worse. Desperate buyers, unwilling to give up on the home ownership dream, have gone further afield to find creative ways to access funds.

This means that further changes in the rules, to tighten credit terms, are inevitable, especially in the less regulated portions such as Low-Ratio.

As President George W. Bush found in 2003, it's way too soon to declare "Mission Accomplished" in the fight to unwind speculative excesses in the Canadian housing market.

Source: Navy.mil

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