Housing Market Digest

Canada, September 2022

Some Thoughts on the Mortgage Stress Tests

Some people are arguing that the stress test is going to reduce the damage that results from current interest rates. That is partly true, but there are also elements of the stress tests that have created risks, and those risks have become sharper. I see four trains of thought on this.

- The stress test for insured mortgages started late in 2016. Some of those are now being renewed, but that represents a minority of mortgages (according to Bank of Canada data, during 2017 29% of funds advanced for new mortgages were insured).
- The majority of mortgages are non-insured/federally-regulated mortgages, and the stress test for them started at the beginning of 2018. So, renewals of stress-tested mortgages won't start in earnest until 2023, and beyond.
- Therefore, what will future interest rates be?
- The most recent forecasts from the major banks suggest that rates are now at peak levels, but they expect only small reductions (not more than a half point for bonds and no change for the short end) during the coming year.
- My bearish view (expecting that rates will be considerably lower by the middle of next year) has three main parts: (1) rates are now at an unsafe level, creating a risk of a substantial recession starting late this year or early next year, so that by next spring, the BoC might have to sharply reverse direction. (2) The inflation that is occurring now is mainly due to disruptions to supply, and high interest rates won't fix that, in fact they will make it worse – this is another reason why the BoC ought to reverse direction. (3) However, if it happens that inflation is reduced due to the easing of the supply issues, the BoC might seize that as an opportunity to declare victory and reduce rates.
- What has happened to incomes will be an important factor for those future renewals. In most situations for people renewing mortgages, incomes will have increased. At present, growth in average weekly wages versus 5 years ago is about 20%, so most renewing borrowers will have a lot more capacity to afford increased payments. (On the other hand, for some borrowers, incomes will have been substantially reduced as the result of job losses that are induced by high interest rates.) Moreover, amounts of principal will have been reduced.
- Here are some calculations that I think will be typical for mortgages renewed during 2023. The initial mortgage rates (during 2018) will have been in the area of 3.25% (or higher). During the initial 5-year term, and assuming 25-year amortization, 14% of the principal will have been repaid (or more, if any pre-payments were made). Assuming a 5% rate at renewal (and applied to the remaining principal and the remaining amortization period), the monthly payment will increase by 16% - a lot of renewing mortgage borrowers will have seen income growth larger than their payment increase.
- On the other hand, people who have bought recently and took variable rate mortgages, at the very low rates that were available during mid-2020 until early this year, are much more vulnerable (typical variable rates have gone from a low of about 1.3-1.4% a year ago to a current 5%). Since the start of 2020, there have been about 1.5 million home sales in Canada. The data on mortgage vulnerability for those purchases is murky: the Bank of Canada has data on "funds advanced", but this includes renewals and equity take-out via HELOCs, in addition to purchases, so we don't know for sure what mortgage choices were made by those buyers. That said, according to the BoC data, about 37% of funds advanced (for purchases, HELOCS, and renewals) during that period were in variable rate mortgages and 63% were fixed rate. This implies that there might have been about 500,000 to 600,000 mortgage holders (out of about 10 million total owners and 6 million total mortgage holders) who bought during the Covid period, with a variable rate mortgage, and may now be highly vulnerable. A smaller number of people, who bought in the Covid period with short term (1 or 2 year) fixed rates, will be renewing this year and next, at sharply higher payments. The remainder of recent buyers have fixed rates that are mostly not due for renewal for a while - therefore, they are not immediately vulnerable, and when they do renew, they will have significantly lower remaining principals and higher incomes.
- In this situation, I can repeat something I've said many times, that the greatest risk to mortgage borrowers is not an unaffordable rise in payments, it is a loss of ability-to-pay - and the stress tests did nothing to control for this, let along reduce this risk. That said (as demonstrated in the prior bullet point) there is now a minority of mortgage holders who are currently extremely vulnerable due to the very sharp rise in interest rates.
- Something else I've said in the past (arguing that the qualifying rate should be the higher of 3.75% or the actual contract rate) is that if rates

are higher than that at the time of renewal, then it will be because the economy is very strong: incomes will also have increased a lot, mitigating the impact of the higher rates. It looks to me like that argument was correct.

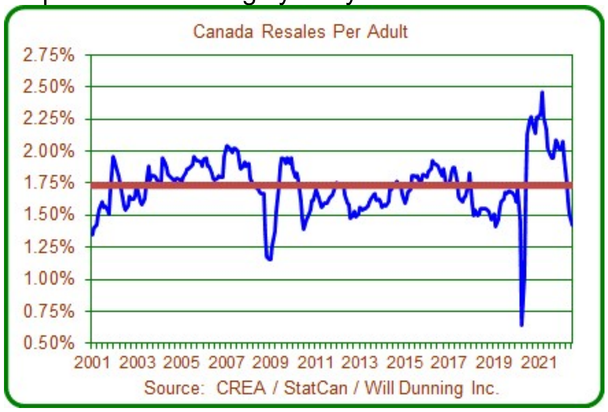
- The second train of thought is about how the stress tests have affected mortgage choices. In particular, there was increased lending via non-insured, non-traditional (non-federally-regulated) lenders, often at higher interest rates. Already, this effect has had negative economic impacts, by raising the amounts of interest that are paid compared to what would be paid if the mortgages were via prime lenders.
- At present, alternative-lender mortgages are subject to two forms of renewal risk: increased payments and secondly, will there be situations where these mortgages can't be renewed at all at a reasonable rate, either at the same lender or via a transfer? Given the increased sense of risk in financial markets, there may be less funds available for renewals by alternative lenders.
- I think the risk for alternative mortgages is currently a major threat to the housing market and the economy. The federal government should discuss this, and what it can do. This should include lowering the barriers that prevent transfers of those mortgages to regulated lenders and/or insured mortgages.
- Thirdly, a succession of tightenings of mortgage regulations during the past decade has weighed on not just housing resales, but also on pre-construction sales of new homes. This is one of the multiple factors that have contributed to the supply crisis and therefore to the excessive price growth that has occurred.
- Fourthly, as used to be discussed, OSFI requires stress testing of mortgages that are transferred to a federally-regulated lender and this creates a risk that borrowers could be trapped at their current lender, and therefore be exploited by that lender. Current interest rates will result in qualifying rates in the area of 7%, so this risk has become elevated. OSFI should eliminate (or sharply lessen) that requirement. I see that CREA is also making this argument.

On balance, due to these harms, I'm not persuaded that we are better off as a result of the stress tests. Yes, stress testing has been necessary, but the design is flawed.

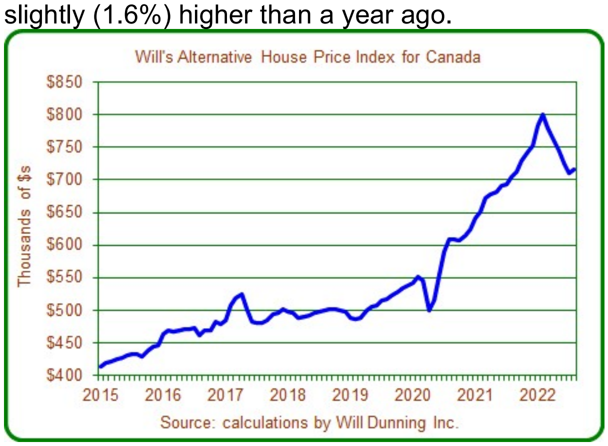
At present, the important issue is – how long are interest rates going to stay excessively high (and how much damage will be done to Canadians)?

Resale Market

The sales rate fell again in August, to an annualized rate (443,000). This is now 19% below the population-adjusted long-term average. As I discuss in the Toronto edition, August sales reflected interest rates seen earlier, and further drops in sales are highly likely.



My alternative price index rose in August (by about $5,000). This is entirely due to Ontario, as prices were flat or fell elsewhere. The national index is down by 11% versus February, although it is slightly (1.6%) higher than a year ago.



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