Bank of Canada warns of growing mortgage risks as home prices soar

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Canada's central bank is warning about "increased riskiness" in the mortgage industry as buyers, particularly in Toronto and Vancouver, stretch themselves financially to get a foothold in the housing market.

The share of new mortgages that topped 450 per cent of a borrower's income hit 15 per cent last year, up from 12 per cent a year earlier, the Bank of Canada said in its financial system review.

The proportion was the same whether or not borrowers had contributed a down payment of at least 20 per cent, which meant they were not required to have mortgage insurance.

The increase in mortgage debt was most dramatic in the Toronto and Vancouver regions. In Toronto last year, nearly 40 per cent of all new insured mortgages were for more than 450 per cent of a borrower's income, up from less than 30 per cent in 2014. Vancouver saw a similar, although smaller, increase in highly-indebted borrowers, who represented 30 per cent of all new mortgages in the region. Outside of those two markets, fewer than 20 per cent of borrowers had taken on insured mortgages that topped 450 per cent of their income.

"Higher household indebtedness, its growing concentration in highly indebted households and an increase in the proportion of mortgages with riskier characteristics make households more vulnerable," the bank said. The runup in debt has "potential consequences for lenders and mortgage insurers."

The central bank pointed to soaring home prices, which have picked up steam since the bank's last assessment of the market in December.

Resale home prices in Vancouver have increased by an annualized rate of 30 per cent in Vancouver's and 15 per cent in Toronto. The bank said such price gains were being fuelled by "self-reinforcing expectations" that encouraged more financially stretched buyers to get into the market in the belief that home values will continue to rise.

The central bank also noted that 58 per cent of uninsured mortgages written by the big six banks last year had amortization periods beyond the standard 25 years, a sign that even borrowers who had been able to save large down payments were struggling with affordability.

Federal regulators have introduced several rounds of tightening to insured mortgage rules since 2008, including limiting amortization periods on loans with down payments of less than 20 per cent to 25 years. The stricter rules don't apply to uninsured mortgages, since borrowers with at least 20-per-cent equity in their homes are considered to be less risky.

But while longer amortization periods have helped borrowers lower their monthly mortgage payments, the Bank of Canada warned they were leading to the buildup of household debt.

The International Monetary Fund has also sounded the alarm on the sharp increase in uninsured mortgage debt in Canada, which has grown from roughly 40 per cent of the market in 2012 to nearly 60 per cent today, according to an early analysis by Toronto-Dominion Bank. Analysts expect the share of uninsured mortgage to increase as Canada Mortgage and Housing Corp. continues to look to shrink its mortgage insurance business.

Among major banks, the share of total mortgage loans that are uninsured ranges from about 37 per cent at National Bank of Canada to as high as 54 per cent at Royal Bank of Canada. It can be even higher for non-bank lenders that serve the subprime market. Most lenders offer uninsured mortgages for up to 30 years, while

some non-bank lenders and credit unions will go as high as 35 years.

Mortgage brokers said the trend toward longer amortization periods for uninsured mortgages has been partly driven by soaring home prices in Toronto and Vancouver that have pushed many detached houses above $1-million, the maximum home price eligible for default insurance.

Despite soaring prices, many buyers in those markets have managed to find enough of a down payment to avoid paying for insurance, either by saving or borrowing from relatives, but are still struggling to afford the monthly costs of carrying a large mortgage.

"Just because someone puts down 20 per cent to avoid default insurance doesn't mean they're breathing easy," says mortgage broker Robert McLister. "Hundreds of thousands of people are house poor in this country."

Toronto-based mortgage broker Alyssa Furtado and her husband saved for a 20-per-cent down payment when they purchased their home in 2014 and then took out a 30-year mortgage with the expectation that their incomes would rise over time and they could prepay their mortgage to reduce their debt.

Many families in expensive markets are making the same choices, she said. A survey by private sector mortgage insurer Genworth MI Canada Inc. last year found that 62 per cent of first-time buyers in Toronto and 53 per cent in Vancouver had down payments of at least 20 per cent, far higher than the national average, despite being the country's most expensive markets.

Ms. Furtado estimates that extending the amortization period by five years on a $1-million property would cut monthly mortgage costs by $500. "That's a car payment or a payment for daycare," she said. "For some people it absolutely makes sense that all of the stretching is happening at the down payment level and people are trying to find a break through the monthly payments."

The Canadian Bankers Association played down the risks of rising mortgage debt, pointing out that just 0.28 per cent of mortgages were in arrears in March, down from 0.45 per cent at the start of 2011 and about half the level seen during much of the 1990s.

These figures have bolstered the view among many bankers that the overall housing market remains healthy, despite rising prices in Vancouver and Toronto.

"We continue to watch the Canadian housing market very closely and remain very comfortable with our underwriting processes and standards," TD said in a statement. "The government has taken a number of actions already, including those in December, with the aim of slowing the market."

This month Bank of Montreal chief financial officer Tom Flynn told the Deutsche Bank Global Financial Services Conference that the bank requires higher down payments on more expensive homes and the average equity in its portfolio of uninsured mortgages was 43 per cent. "We've got significant equity balance beneath our uninsured mortgage position," he said, "which makes us feel good."

Craig Alexander, vice-president of economic analysis at the C.D. Howe Institute and the former chief economist at Toronto-Dominion Bank, said the economic impact of a housing downturn is likely a greater concern to the banks than specific concerns about their loans.

"The banks are making loans that they feel will get repaid," Mr. Alexander said, noting that even in Alberta, where the economy is being challenged by a depressed commodities market, loan delinquencies have not risen dramatically.

"The risk is to the economy," he said. "If you had a 20-per-cent correction in house prices, it would affect household wealth, it would have an impact on consumer confidence, and it could drive an economic cycle. This is where the anxiety in the financial services industry is."