Threat from housing, high debts still growing, Poloz says

By David Parkinson
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The dual threats of runaway regional housing markets and high household debt have grown over the past six months, the Bank of Canada said, but it believes Canada's financial system "remains resilient," thanks in part to a strengthening economic backdrop.

In its semi-annual Financial System Review, a key report outlining risks to the country's financial stability, the central bank said that the booming housing markets in Toronto and Vancouver have added to already high debt burdens for Canadian consumers, as surging home prices, especially in Toronto and surrounding regions, have dramatically increased the size of new mortgages. It noted that Canada's national ratio of household debt to disposable income, a key metric for consumers' debt burdens, is approaching 170 per cent, a record high.

"Household credit growth has been strong, exceeding disposable income gains for the past several years," the report said, noting that "about 90 per cent" of this debt growth has come from mortgages and home equity lines of credit (HELOCs).

"The vulnerability associated with household indebtedness has increased. The overall level of mortgage debt relative to income continues to rise," it said. "As the number of [highly indebted] households grows, it is more likely that adverse economic shocks to households would significantly affect the economy and the financial system."

And a major contributor to that rising concern is the housing market in the "Greater Golden Horseshoe area," encompassing Toronto and an increasingly large region surrounding the city where housing prices have been surging in recent months. The Bank of Canada noted that the price increases have become even more acute over the past year in communities more than an hour's commute away from Toronto proper, as prospective buyers who have been priced out of the expensive Toronto market "have looked increasingly farther in search of more affordable housing."

The bank argued that while strong fundamentals are partially responsible for the high prices in Toronto and Vancouver, it is concerned that those markets continue to see price increases that exceed fundamental drivers – evidence of speculation and unsustainably high expectations.

"Where house prices have grown at a faster pace than can be readily explained by fundamentals – such as in the Toronto and Vancouver areas – there is an increased likelihood of a price correction that could lead to financial stress," the bank said.

However, it said, "macroprudential and housing policy measures," such as the federal government's tighter lending requirements introduced last fall and the foreign-speculative-buyers' taxes introduced by the British Columbia and Ontario governments, should "help mitigate this vulnerability over time." It noted that the federal measures, in particular, have already shown signs of improving mortgage equality by reducing the number of loans to highly indebted households.

Despite the concern about the dangers of a housing correction in those two overheated markets, the bank said that a sharp regional price decline likely wouldn't have significant spillover effects on the broader national economy.

The bigger concern, it said, is the fallout from high debt levels and housing excesses in the event of a broader economic shock - "an externally generated severe recession, where a nationwide correction in house prices is only one of the channels through which the economy and the financial system are affected." It said that in this case, rising unemployment and falling household income would put serious strain on households paying their debts, "potentially generating broad financial system and economic stress."

The bank characterized this broader risk as "low," but said it would have "a severe impact should it occur." However, it said the improving Canadian economy in recent months "reduced the probability of this risk occurring."

The report also briefly touched on the situation at troubled mortgage lender Home Capital, saying that the bank is confident that its problems are an isolated event and that the company has found a market-based solution to its liquidity issues.

"Mortgage rates more broadly have not been affected, but there is some evidence that borrowers who do not meet all the criteria of traditional lenders have experienced increased rates," the central bank said.