New mortgage stress tests could disqualify 10% of buyers

By Barrie McKenna
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New mortgage stress tests coming in 2018 could disqualify about 10 per cent of prospective home buyers, affecting $15-billion a year in new borrowing, the Bank of Canada says.

The impact of the new restrictions is expected to be concentrated in the Toronto and Vancouver areas – the markets that have seen the steepest run-up in prices in recent years.

Indeed, two-thirds of the dent in new mortgage borrowing is expected to be concentrated in those two markets, which combined account for half the value of home sales in Canada. The tighter rules could disqualify as many as 12 per cent of buyers in those cities.

The central bank issued the projections Tuesday as part of its twice-yearly review of the country's financial system.

Overall, the Bank of Canada says the main threats to the system – rising household debt and overheated house prices – remain elevated. That's roughly where the threat level has been since 2013.

But for the first time in a while, the bank says there are "preliminary signs of improvement" in the quality of new lending triggered by the improving economy, higher interest rates and tighter mortgage rules announced in 2016.

"Our financial system continues to be resilient, and is being bolstered by stronger growth and job creation, but we need to continue to watch vulnerabilities closely," Governor Stephen Poloz said in a statement, accompanying the bank's Financial System Review.

Debt and housing vulnerabilities will take "a long time" to return to more normal levels, Mr. Poloz added.

The report also highlighted the possibility that a cyberattack could knock out key parts of the payment system. The bank said it is now working closely with the various players involved in clearing financial transactions to bolster their ability to deal with a major attack. The various players are looking at setting up "standby relationships" with the major Canadian banks to keep the payment system running if a prolonged outage hits one of the four major clearing networks – for cheques, electronic payments, stocks and derivatives.

Elsewhere, the Bank of Canada pointed out that a combination of higher mortgage rates and tighter lending rules are starting to work – by cooling the housing market and discouraging riskier borrowing.

Most borrowers will be able to handle a "moderate increase" in mortgage rates, especially if their incomes also rise, according to the bank. Nearly half of outstanding mortgages in Canada face an interest rate reset within the next 12 months, according to the report.

House prices were rising at a rate of 10 per cent a year across the country in October, brought down by a significant slowdown in Toronto. Prices are heating up again in Vancouver, particularly in the condominium market, the bank said.

Starting in January, federal regulators are extending mandatory stress tests to ensure that people taking out low-ratio, uninsured mortgages can handle setbacks, such as higher rates, according to new rules issued by the federal Office of the Superintendent of Financial Institutions.

The impact of the measures is expected to be less severe than the earlier 2016 changes for so-called high ratio mortgages, where borrowers put down less than 20 per cent of the value of the home.

Low ratio mortgages are ones where borrowers put up down payments of 20 per cent or more. These represent three-quarters of mortgages across the country, and 9 out of 10 mortgages in Toronto and Vancouver.

Borrowers who put down less than 20 per cent on a mortgage must buy mortgage insurance and face other restrictions.

The bank acknowledged it isn’t sure exactly how borrowers will react to the new rules. The assumption is that most will choose to buy smaller homes. Others may put off buying a house or put more money down.

However, some borrowers may try to get around the rules by taking out riskier loans with longer amortization periods from alternative lenders that are not federally regulated, including credit unions and private mortgage lenders. Right now those lenders have a relatively small share of the mortgage market.

The bank said it will be closely monitoring developments in the private lending market, worth as much as $15-billion a year. That includes watching new mortgage registrations to track how many borrowers are trying to duck the new regulations.