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TD Economics

Data Release: Risks assessment of Canada's financial system is unchanged, despite increase in household vulnerability

- The Bank of Canada released the June issue of its biannual Financial Systems Review (FSR) this morning, which includes the Governing Council's evaluation of the key risks to the Canadian financial system. The overall level of risk is largely unchanged from six months ago. Household vulnerabilities have moved higher, but the ongoing recovery in Canada's economy means that the probability of the vulnerability being triggered has declined, leaving the overall level of risk the same.
- While Canada's financial system is described as "resilient and functioning effectively", the report highlighted three key vulnerabilities. The first two are related to Canadian households: elevated household indebtedness and imbalances in some regional housing markets. The third vulnerability was the same as in December and is fragile fixed income market liquidity.
- These vulnerabilities could propagate shocks throughout the financial system if a major event were to trigger one of the four identified risks, which remain the same as in December, and with the same risk ratings. 1) A severe recession and ensuing sharp increase in unemployment that leads to a broad-based correction in house prices. 2) A sharp increase in interest rates due to higher global risk premiums, 3) stress emanating from China and other emerging market economies and 4) a prolonged weakness in commodity prices.
- Specifically on household indebtedness and regional housing market imbalances, the Bank singles out Toronto and Vancouver (and their adjacent areas) on several fronts. On household indebtedness, these markets have seen an increase in the share of mortgages with high loan values relative to income. Loan-to-income ratios in newly originated mortgages have increased for both insured and uninsured mortgages. The proportion of mortgages with a loan-to-income ratio greater than 450% jumped up from 12% to 15% of new originations (both insured and uninsured borrowers). For uninsured borrowers, homebuyers are making payments more manageable by increasing amortization periods beyond 25 years. 58% of uninsured mortgage debt originated in 2015 had an amortization longer than 25 years. The bank points out that mortgage debt continues to rise among highly indebted households that have less capacity to cope financially with employment loss or an unexpected rise in interest rates.
- On regional housing market imbalances, the FSR points out that the rapid appreciation of prices seen over the past year in Toronto and Vancouver "raises the possibility that prices are also being supported by self-reinforcing price expectations". The FSR points out the employment growth and migration in the two cities is among the strongest in the country, and so there is fundamental strength underlying the price increases. However, it states that "it is unlikely that the current pace of price increase in the GVA and GTA can be sustained".
- The FSR also highlighted that stress tests for Canada done by the IMF and CMHC demonstrate the big six banks are resilient to a scenario that includes a significant drop in oil and house prices. And that CMHC has sufficient capital to handle an extreme but plausible house price correction.
- The FSR typically features two reports, and this issue they were "Large Canadian Public Pension Funds: A Financial System Perspective" and "Securities Financing and Bond Market Liquidity".

Key Implications

- While its overall assessment of the level of risk in Canada's financial system remains unchanged from six months ago, the Bank of Canada have put the Toronto and "especially" Vancouver housing markets on

notice. It points out that the pace of recent price increases is unsustainable in these markets, and that mortgage growth in these markets is raising household indebtedness and vulnerability.

- Notably, the Bank said "that prospective homebuyers and their lenders should not extrapolate recent real estate performance into the future when contemplating a transaction." The Bank has repeatedly stated that it does not view interest rates as the best tool to deal with imbalances in the housing market and household indebtedness, and that regulation and prudent lending practices are the best tools. So in the face of increased risk in Toronto and Vancouver housing, and the full impact from recent mortgage market changes still working through the system, it is now trying moral suasion. The Bank is certainly not the first to sound the alarm bells on Toronto and Vancouver housing, with CMHC also using fairly strong language. TD agrees with the Bank of Canada's warnings and expects that home prices to lose some steam next year as rates begin to tick higher and overvaluation in key market weighs on demand.

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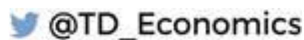

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