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TD Economics

Data Release: Bank of Canada sees risks to Canada's financial system as unabated

- The June 2017 issue of the Bank of Canada's biannual Financial System Review (FSR) was released this morning, providing an update of what the Bank perceives to be the main risks facing Canada's financial system. It was noted that household indebtedness and housing market imbalances, the most important vulnerabilities, have escalated over the last six months. Despite this, the financial system is still seen as 'resilient', and macroeconomic conditions continue to improve.
- Vulnerabilities often need triggers, which the FSR refers to as 'key risks'. The key risks facing the Canadian economy have shifted somewhat since the previous report (published in December 2016). A sharp correction in house prices, seen as a "moderate" risk, is now considered separately from a severe nationwide recession with associated financial stress – the latter being considered 'elevated'. These two risks had previously been considered together, with an 'elevated' assessment. A sharp increase in long-term rates driven by higher global risk premiums remains a key risk, assessed as 'moderate'. Finally, the risk of stress coming from China or other emerging market economies – something viewed as a medium probability and medium impact event – continues to be assessed as an "elevated" risk.
- Of note, prolonged weakness in commodity prices is no longer considered a key risk.
- Regarding household indebtedness, the FSR indicated that household indebtedness has continued to rise, driven by growth in mortgages and HELOCs. It was noted that the expansion in credit over the past two years has been about $55 billion more than expected given the income growth and interest rate environment. The quality of credit among high-ratio mortgages is seen as improving, while low-ratio lending has been growing. Clustering behaviour around key thresholds for low ratio mortgages was noted, suggesting that borrowers are hoping to avoid more stringent qualification requirements as well as the resulting higher costs. There has also been an uptick in high loan-to-income ratios in the sector.
- Imbalances in housing markets – that is, home prices that rise faster than fundamentals suggest – such as in Vancouver and Toronto, can lead to financial stress in the event of a price correction. The price acceleration observed in Toronto in early-2017 was a key factor increasing this vulnerability. The FSR suggests that fundamentals are supportive of growth in the key Greater Toronto Area markets, but extrapolative expectations (buying on the basis of expected price gains) are also playing a role.
- Beyond the key vulnerabilities, fragile fixed-income market liquidity as well as cyber threats and financial interconnectedness remain of concern, although relatively less space was dedicated to these issues.

Key Implications

- The risks to the Canadian financial system remain unabated. Households continued to pile on debt, and gains in home prices are, according to the Bank of Canada, at least somewhat divorced from fundamentals. Indeed, when it comes to home prices, a correction in overheated markets is now seen as enough to trigger a downturn on its own, rather than requiring household financial stresses to occur simultaneously (although such an outcome would almost certainly trigger a financial stress). Moreover, although a decline in the share of high ratio (insured) mortgages is welcome, the Bank has identified some concerning trends in the uninsured mortgage market.
- It is not all doom and gloom however. The macroeconomic backdrop is seen as improving, with 'tentative signs of the desired broadening'. The situation at Home Capital Group appears idiosyncratic, the quality of high-ratio mortgage lending is seen as improving, and recent data points to at least a temporary breather for Toronto home prices.
- Indeed, while not explicitly a monetary policy document, today's FSR continues the recent trend away from a dovish tone and towards a more neutral outlook for monetary policy. Solid and broadening economic growth, expectation of rising inflationary pressures, and the impact of past macroprudential

measures on the quality of lending should all line up to enable the Bank of Canada to begin tightening monetary policy next year.

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