SPECIAL REPORT

TD Economics

October 20, 2016

NEW MORTGAGE RULES TO REINFORCE SOFT LANDING IN CANADIAN HOUSING

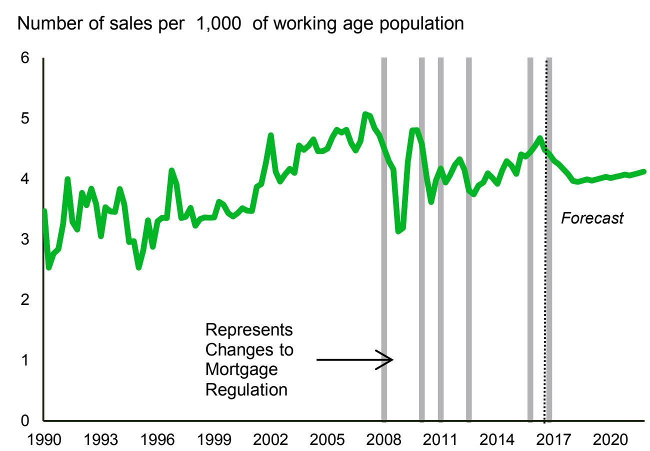
Highlights

- Earlier this month the Canadian government announced a new set of mortgage regulations and tax measures aimed at ensuring the health and stability of the Canadian housing market, marking the sixth time mortgage regulation has been tightened since 2008.
- The new measures may create near-term volatility in the existing home market, but should eventually help to reinforce a slowdown in Canadian housing markets amidst gradually rising interest rates – already embedded in our forecast.
- The scope and timing of the new rules pose a downside risk to our forecast, particularly for the Toronto and Vancouver markets which look to be most impacted by the new regulations.
- The gradual layering of regulation, amidst rapidly rising home prices, has made homes less attainable for many buyers, particularly those contemplating homeownership for the first time.

Early this month the Canadian government introduced another round of policy changes aimed at safeguarding the health and stability of Canada's housing market, marking the sixth time the government tightened residential mortgage lending regulation since 2008. While, previous rounds of adjustments to mortgage policy targeted high-ratio borrowers requiring mortgage insurance, the recent announcement instead outlined a multipronged approach, intended to limit the risk taken by households and lenders, as well as curb speculation activity. The measures include adjustments to income testing rules for borrowers requiring mortgage insurance, limits to the use of portfolio insurance by lenders, and increased oversight of the principal residence tax exemption rule.

Most of the past changes resulted in near-term volatility, but helped anchor existing home sales closer to their long-run average. Still, these past measures proved temporary, with activity subsequently rebounding helped along by falling interest rates. As such, mortgage regulation has increasingly become an important tool in the policy-kit, helping manage risks in a low interest rate environment. The most recent set of rules are expected to have a comparable impact, helping to reinforce the return of housing activity to more normal levels among the more heated markets – already embedded in our housing market forecast for next year (Chart 1). Their impact should also prove more longer-lasting, especially alongside gradually rising interest rates. Above and beyond the near-term volatility, the recent policy changes inject some additional risks into the outlook, particularly in light of their scope and timing.

CHART 1: CANADIAN EXISTING HOME SALES



Source: CREA. F: Forecast by TD Economics as of October 2016.

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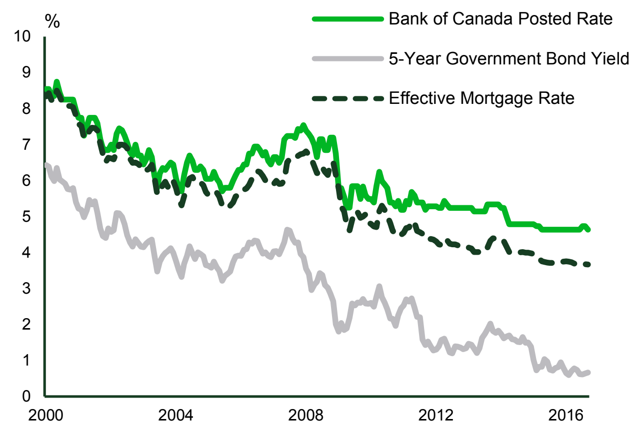
CHART 2: 5-YEAR INTEREST RATES



Source: Bank of Canada, TD Economics.

At the same time, the gradual layering of regulation amidst rapidly rising home prices has made homes less attainable to many buyers, particularly those contemplating homeownership for the first time. We estimate that when purchasing an average priced home in Canada using an insured mortgage, the new rules have raised the threshold for annual income required to qualify by approximately $5,000. This is likely going to push some potential purchasers, particularly first-time buyers, further down market. The impacts will be most pronounced across the Toronto and Vancouver markets given the already high prices and stretched affordability. As such, while the policy changes may help cool activity in Toronto, they may exacerbate the correction that is already underway in Vancouver. Additionally, the new rules will be felt more broadly across Canada and may dampen the still-fragile recovery across housing markets in the oil patch. Should such a scenario materialize, mortgage regulation could maintain flexibility and be adjusted to reflect developments within the housing market.

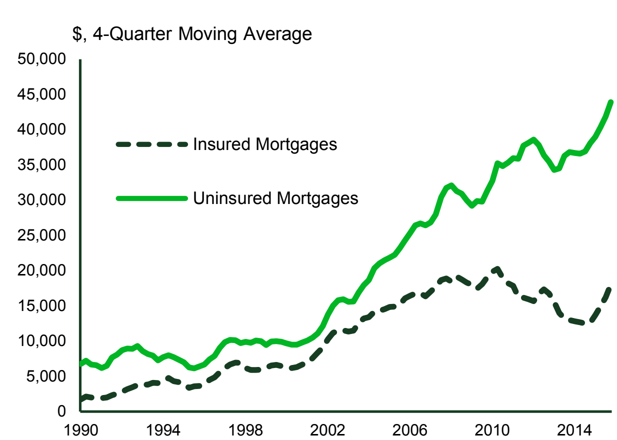
New income testing rules target borrowers

The first policy measure, effective on October 17th, adjusts the way high loan-to-value borrowers requiring mortgage insurance are income tested. The test ensures that the borrower's gross debt service ratio (GDS) and total debt service ratio (TDS) do not exceed 39% and 44%, respectively. The prior yardstick used the contractual mortgage rate to evaluate these ratios, but the new process will instead use a rate that is the greater of the contract rate and the Bank of Canada posted 5-year fixed mortgage rate. The latter is currently more than two percentage points higher than the lowest fixed rate available to borrowers (Chart 2). This more stringent test has already been in place since 2010 for borrowers taking out shorter term fixed or variable rate mortgage, and is meant to ensure households can absorb a potential increase in interest rates.

Overall, we expect this rule adjustment to impact about 2% to 3% of existing home sales across Canada. This change is likely to be less impactful than past regulatory changes tied to insured mortgages due to the declining reliance on insurance. Insured mortgages accounted for 20% to 30% of all new mortgages last year, lower than the 40% they comprised in 2008 when the government first started tightening qualification rules (Chart 3). Moreover, the majority of insured mortgages transacting at a 5-year fixed rate will meet the more stringent requirements. The new rules are likely only to impact about 10% of insured buyers. The average price of a home purchased using an insured mortgage is about $300,000, while the GDS of an average borrower purchasing a home in 2016 was 25.5%. Income testing at an interest rate that is two percentage points higher will raise the GDS of an insured borrower earning an average household income of $72,000 by almost 5 percentage points. But, the impact could be as large as 7 percentage points, when purchasing an average priced home (about $493,000). As such, borrowers with a GDS greater than 35%, who account for about 10% of all insured borrowers, are most at risk of not being able to qualifying for a mortgage.

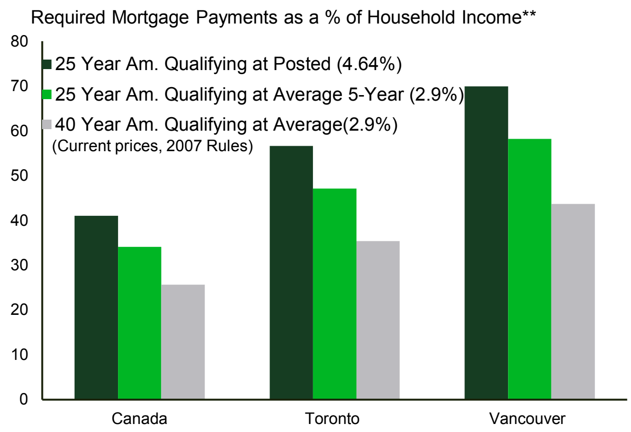
For homebuyers requiring mortgage insurance, the affordability impact of this individual rule is on par with the cumulative impact of shortening the allowable amortization from 40 to 25 years (Chart 4). For first-time buyers, in par-

CHART 3: NEW MORTGAGE CASH DISBURSMENTS



Source: Bank of Canada, TD Economics.

CHART 4: CHANGES TO TD ECONOMICS HOUSING AFFORDABILITY INDEX



Source: Statistics Canada, Estimated by TD Economics.
**Based on 10%, and an average priced home and an average income household in 2016.

ticular, the aggregate impact of all six rounds of regulatory changes over the years has increasingly made it more difficult for those requiring mortgage insurance to qualify for a mortgage. For example, in the regulatory environment of 2007 – 0% down payment, 40-year maximum amortization term, and income testing at the 3-year fixed rate – an average income earning household with a 10% down payment and requiring mortgage insurance would be able to qualify for a mortgage to purchase an average priced home. Under the current rules, they would not. Shifting to a 25 year amortization term added roughly $6,000 to the required mortgage payment for that buyer annually. Layering on the recent stress testing rule raises the bar for the income test by another $5,000. The combined effects increase the annual income required by nearly $11,000. Although the average insured borrower purchases a home that is significantly below average, the higher bar for qualifying for a mortgage is likely to push these buyers down a notch in terms of what they can afford.

This new rule is likely to impact a larger share of purchases in the Toronto and Vancouver markets. While regional data is scarce, home values across these two markets are substantially higher with affordability significantly stretched for many households. In fact, insured borrowers in Ontario and B.C. had an average GDS of 27% at the time of purchase, compared to 24.5% across the rest of Canada. Toronto and Vancouver borrowers likely exhibit higher debt-service readings. Given their lofty home prices, the impact on the income threshold for borrowers in Toronto and Vancouver looks to be all the more pronounced, up $17,200 and $20,000, respectively, on an average priced home, although the differential is somewhat less stark when accounting for the higher average incomes in these cities.

Portfolio insurance changes may lead to higher mortgage rates

The second rule, set to come into effect on November 30, targets lenders through what is referred to as "portfolio insurance." Chartered banks and alternative lenders use this feature to insure low loan-to-value ratio mortgages that have already been approved and originated, so that they can be securitized and sold as a low risk asset. This technique helps lenders lower the cost of raising capital by about 30 to 40 basis points.

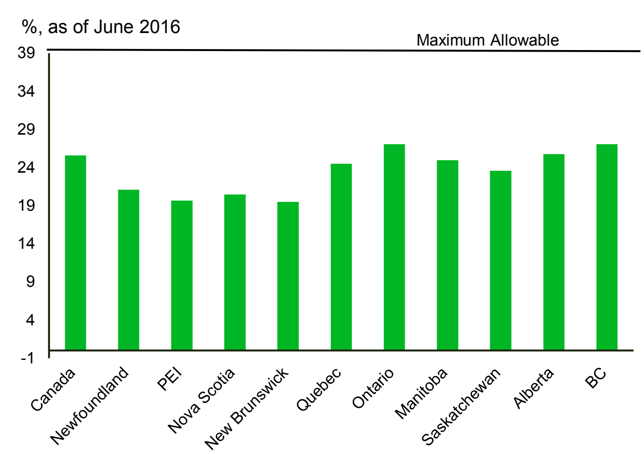
Under the new guidelines, the type of assets that lenders can purchase portfolio insurance for will be restricted to loans that meet the same qualification guidelines as insured mortgages. Banks can now only buy portfolio insurance on mortgage loans where:

1) Homes are worth less than $1 million
2) Homes are owner occupied
3) Amortization term is no longer than 25 years
4) Borrowers have a credit score greater than 600
5) Borrowers are subject to GDS and TDS rules

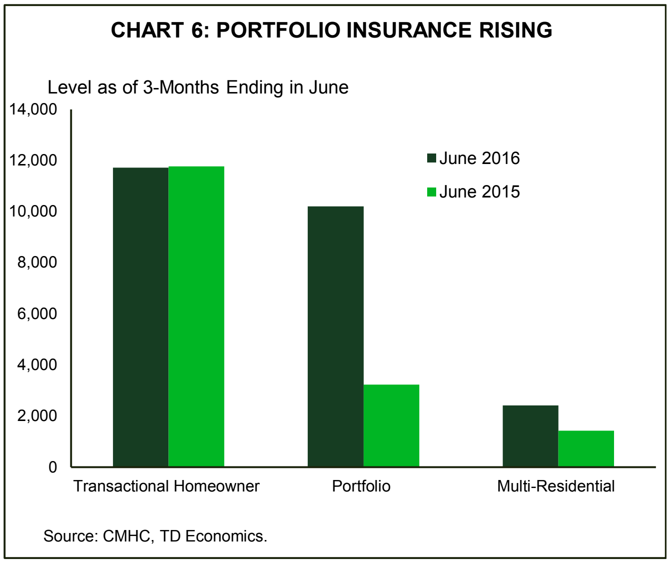
These measures will not affect a borrower's ability to qualify for a loan, but could prevent lenders from buying portfolio insurance on that loan, potentially altering the way mortgages are funded.

Portfolio insurance was smaller size than transactional homeowner mortgage insurance over 2014 and 2015, but has grown rapidly in recent quarters. Portfolio insurance

CHART 5: AVERAGE GDS OF INSURED MORTGAGE BORROWERS



Source: CMHC, TD Economics.



accounted for 20% of all new mortgage insurance put in force with CMHC in the first half of 2015, but accounted for 40% during the second quarter of this year. In particular, the increased use of portfolio insurance has helped alternative lenders offer competitive pricing on mortgages. According to the Department of Finance, alternative lenders now account for 15% of overall mortgage lending. At this point, most mortgages currently insured through the portfolio insurance program at CMHC already conform to these rules. The new million dollar cap on homes will, at a minimum, rule out the insurance of mortgages in excess of $800,000, which comprise 5% of the portfolio insurance market and are largely concentrated in Toronto and Vancouver. Additionally, the new amortization rule poses another constraint on the portfolio insurance program, with nearly 60% of mortgages insured in the program having amortization terms of greater than 25 years, which would be ineligible for insurance under the new rules.

There are three scenarios which could materialize as a result of the new rules:

1) Lenders pass the higher cost of funds onto consumers in the form of higher mortgage rates. Under this scenario, mortgage interest rates could rise up to the full amount of 30 to 40 basis points.

2) Lenders absorb the higher cost of funds due to competition.

3) Lenders become more stringent on approval guidelines in order to continue to take advantage of the cost savings offered by portfolio insurance. As such, borrowers could potentially be held to a maximum amortization period of 25 years.

A combination of these scenarios may come to be, but all would have a net impact of dampening activity. For instance, if lenders adjust their lending standards instead or passing on higher funding costs, the impact could be less severe in the near term, but persist further over time. Chartered banks insure a small share of their originations, and thus may have enough room to adjust which mortgages they include in portfolio insurance. The big unknown is the alternative lenders.

New tax measures to stem speculative activity

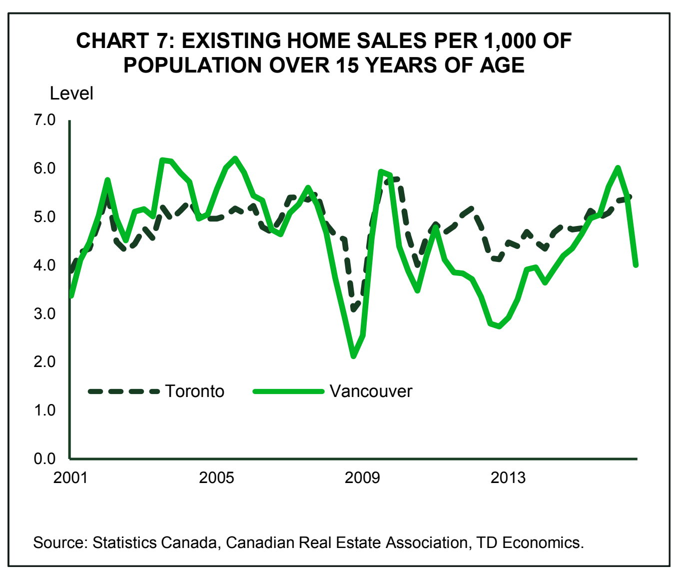
The newly announced measures also include adjustments to the tax structure, in which the impact is far less certain. Proceeds from the sale of real estate are currently taxed in three different ways:

1) If the dwelling is a primary residence, the seller pays no tax on the sale. This is called the principal residence exemption.

2) If the dwelling was held for a sustained period of time, or if it was an income property, the proceeds are taxed as a capital gain.

3) If the dwelling was not held for a sustained period of time, and was effectively a 'flip', the proceeds are taxed as business income.

The new rules disallow the use of the principal residence exemption for purchasers who were not residents of Canada at the time of purchase. The rules have not been changed for Canadian residents, but the transactions will come under more scrutiny. The sale of a principal residence is now required to be reported along with income tax filings to the



Canadian Revenue Agency (CRA). Previously, the CRA only required a seller to kept records of the transaction.

Assessing the impact of this change requires information on the share of speculation and foreign investment in the Canadian housing market. While this remains an unknown, there is a fair bit of certainty that the share is likely highest in the Vancouver and Toronto regions. In the case of Vancouver, the new rules will further serve to keep foreign investors out of the market, coming closely on the tail of the recent imposition of a nonresident land transfer tax. In Toronto, the new tax rules could have significant impact because an elevated sales-to-population ratio is indicative that speculative activity has been on the rise.

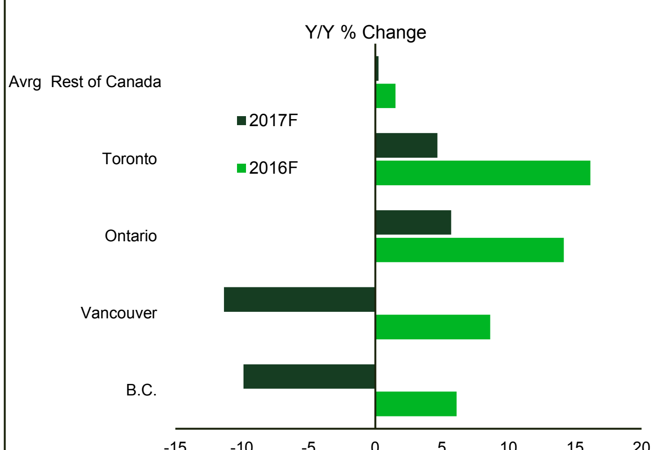
The timing of the new rules leaves some uncertainty

While each of the above-mentioned changes may be modest and target a small segment of the overall housing market, there is a large degree of uncertainty. First, the relative importance of these rules on alternative lenders, who have been rising as a share of the market, is unclear. These lenders could be impacted to a greater degree given their dependence on securitization as a source of funding mortgage activity.

Second, these rules could alter buyer sentiment, while lower anticipated returns on real estate assets could erode speculative activity, both foreign and domestic. Speculation and foreign investment are a large unknown in most markets across Canada, with the exception of Vancouver, where data collection has only recently begun.

Third, the timing of the rules poses a risk. The recent changes are being layered on top of a number of other factors that may cool the market in 2017. The banking regulator in Canada has committed to increasing capital requirements for chartered banks, which could increase mortgage costs next year. Moreover, risk-sharing discussions with lenders and their potential implementation may also play a part of weighing on the mortgage market. As a further effort to reduce the financial sectors dependency on mortgage insurance, the federal government has announced that it will begin consultations with market participants on risk sharing. Risk sharing implies that the government is looking for ways to reduce CMHC's obligation to lenders, which currently guarantees 100% of a loss on insured mortgages. This could potentially be a significant measure to cool housing activity, but the details and timing of this remain uncertain.

CHART 8: AVERAGE HOME PRICES



Source: CMHC, Canadian Real Estate Association. F: Forecast by TD Economics as of October 2016.

Fourth, the balance of risks is already skewed towards higher interest rates in the medium term. The Federal Reserve is expected to raise rates by another quarter point this December. Although future U.S. rate hikes are expected to be very gradual, the tight correlation of Canadian yields to their U.S. counterparts suggests an upward pull on Canadian longer-term bond yields.

Lastly, the new rules are coming at a time of heightened uncertainty in Canada's largest markets. Vancouver was already undergoing a moderate correction and the layering on of more regulation could magnify the downturn, or cause greater persistence. Toronto remains frothy, but the market could turn quickly alongside sentiment. In addition, the new rules may serve to dampen any recovery experienced in the oil patch markets, such as Calgary, Edmonton, Saskatoon and Regina. The CMHC has highlighted these markets as amongst the most vulnerable in Canada. Unemployment rates across these economies are historically elevated, leaving them susceptible to even small changes to interest rates, economic conditions and regulatory changes.

Bottom Line

Overall, the mix of housing policy changes recently announced by the federal government is targeted at safeguarding the health of Canada's overall financial system. While each individual rule is incremental in nature, when taken together they will likely serve to cool the housing market alongside other dynamics that are also in place. However, ultimately, we believe these regulations will only reinforce the moderation in housing activity already baked into our forecast. From a national perspective, we forecast sales to ease back in line with their long-run average and prices to dip slightly next year. From a regional perspective, home prices in Toronto are already expected to sharply decelerate from a red-hot 18% y/y pace in September to a pace more in line with inflation by the end of next year. The new foreign tax rule in Vancouver has already virtually wiped out foreign investment in that city, and the additional mortgage regulations are likely to limit the market from re-heating. There is no doubt that the new rules will create some near-term volatility, but we believe these rules will anchor sales activity to its long-run average. However, how the multitude of colliding dynamics ultimately play does pose downside risks to our outlook. In many respects, the ongoing layering of regulatory rules and oversight is a trial-and-error exercise to find the right balance between demand dynamics and mortgage oversight. However, demand dynamics are very fluid to economic conditions and sentiment. While the current rules may be appropriate for today's backdrop, the day may come when the economy takes a hard downturn. In such an event, the government should consider which of the rules in those years are best positioned to alter in order to act as a counter-cyclical influence.

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