



TD Economics

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Data Release: Tighter Mortgage Insurance Rules to Temper Personal Debt Growth and Cool Real Estate

- In a surprise move, the Government of Canada announced today that it was tightening mortgage insurance rules for the fourth time in four years. In total, four new measures were announced for new government-backed insured mortgages.
- The maximum amortization period was lowered from 30 years to 25 years.
- The maximum amount that Canadians can borrow when refinancing their homes was lowered to 80% from 85% of the value of their homes.
- Households are now being constrained to a maximum gross debt service ratio and maximum total debt service ratios of 39% and 44%, respectively.
- Government-backed insured mortgages will now be only available on homes with a purchase price of less than \$1 million.
- These new rules will take effect on July 9, 2012.

Key Implications

- We view the changes announced today as a prudent decision to address the increasing risks from consumer debt growth
- The regulatory action helps to take pressure off the Bank of Canada. The rapid personal debt growth in recent years has been fuelled by strong real estate markets in a sustained, incredibly low interest rate environment. The Bank of Canada acknowledged in the Financial System Review report that household indebtedness is “the most important domestic risk to financial stability in Canada.” This situation created a challenge for the conduct of monetary policy. On the other hand, the outlook for modest economic growth implies that inflation should remain well-contained in a low interest rate environment. The low interest rate environment is aimed at stimulating economic activity. In addition, with the U.S. Federal Reserve on hold, the Bank of Canada must be sensitive to the fact that higher domestic interest rates would propel the Canadian dollar higher, dampening exports and economic growth.
- Since the imbalance is concentrated in real estate, monetary policy would be a blunt tool to address the concern. Tighter regulations could target the risk more directly. And, the impact on real estate markets is roughly equivalent to a 1% increase in interest rates.
- While the real estate market remained firm after the prior tightening of mortgage insurance rules, our assessment is that they did indeed slow personal debt growth. Had the government not previously taken action, the ratio of personal debt-to-disposable income would be higher than 160%, the peak in the U.S. before their financial crisis. Because the government did act, the ratio stands at 152% today. The problem is that while debt growth did slow in response to the policy tightening, it continues to grow faster than income. Given the pace of debt growth, further regulatory action was called for. The effect is akin to gradually tapping on the brakes to temper borrowing and real estate markets. This gradualist approach is sound given the risks involved.
- It should be noted that the tightening of the mortgage insurance rules is coming amid stricter guidance from OSFI, the chartered bank regulator, which includes limiting Home Equity Lines of Credit (HELOCs) to a maximum loan-to-value of 65% and imposing more restrictive equity lending criteria. Together, the new mortgage insurance rules and the more constrained supply of credit should go a long way in addressing the risks from personal debt and overvaluation in real estate. The actions support our long standing view that the current 10-15% overvaluation in Canadian real estate will be unwound over the next couple of years. It also suggests that personal debt growth should slow to a low single digit pace over the coming year.

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