December 15, 2016

TD Economics

Data Release: Risks to Canada's financial system unchanged, focus remains on household indebtedness

- The Bank of Canada released the latest issue of its biannual Financial System Review (FSR) this morning. The FSR provides the Governing Council's evaluation of the key risks to Canada's financial system. The Bank sees the overall level of risk to the financial system as unchanged from its assessment six months ago.
- Canada's financial system was again described as 'resilient'. Nevertheless, three key vulnerabilities were identified. Unchanged from the June FSR, these vulnerabilities are: the elevated level of Canadian household indebtedness, imbalances in the Canadian housing market, and 'fragile' bond market liquidity.
- Vulnerabilities generally need a 'trigger' to metastasize into a financial system event. The Bank identified four key risks that could trigger such an occurrence: household financial stress and a sharp correction in house prices, a sharp increase in long-term interest rates, stress emanating from China and other emerging markets, and prolonged weakness in commodity prices. The risks and the Bank's assessment of their probabilities and impacts are unchanged from June, except for the risk of weakness in commodity prices, which is now seen as a low probability event (previously: 'moderate')
- Regarding household indebtedness, the FSR notes that the share of borrowers with high mortgage debt levels (loan-to-income ratios above 450%) continues to rise, particularly in the key Toronto and Vancouver markets. It is noted however that new mortgage regulations should mitigate this increase, highlighting that many of the high loan-to-income ratio mortgages issued in the last year would not have qualified under the new rules.
- Home prices continue to rise, and the FSR notes home prices are now at their highest recorded level (nearly six times average household income). The imbalances in regional markets are of particular concern, and the report notes that "… self-reinforcing price expectations may also be supporting price increase" in Toronto and Vancouver.
- The Bank of Canada remains worried about bond market liquidity. In the face of an adverse shock, some markets may see reduced liquidity, exacerbating price movements and thus amplifying the underlying shock. The market is seen as in transition away from a principal trading model (using one's balance sheet) to an agency model (matching clients). Results from a Bank of Canada survey reinforce the strength of this trend, and at the same time notes a slight decline in overall liquidity, particularly for corporate bonds. At the same time, the FSR notes that two recent stress events (the U.K. referendum and the U.S. election) which saw large bond price movements, and brief declines in liquidity, but no widespread or long-lasting disruption to markets.

Key Implications

- As far as the Bank of Canada is concerned, the riskiness of the Canadian financial system remains unchanged, for better or worse. The key focus remains on household indebtedness, where although little progress has been made to date, recent macroprudential changes should help address imbalances. The FSR again put the Vancouver and Toronto markets on notice, warning of the risks of expecting price gains to continue. Indeed, recent developments in Vancouver (as seen in today's CREA report) have reinforced that rising home prices are not a given.
- While the Bank of Canada continues to ring the alarm bells on housing markets (and associated increases in indebtedness), the pendulum appears to be swinging in the opposite direction. As discussed in our December Quarterly Economic Forecast, macroprudential measures and mortgage interest rates are now working together to slow momentum in housing markets. However, as the Bank points out, a

swing of the pendulum too far in the other direction is not ideal either: too sharp a rise in borrowing costs is one of the Bank's key triggers to cause a risk to become an event. The Bank is likely not overly concerned with the recent back-up in bond yields given the passthrough to mortgage rates as been modest so far, but significant further increases are likely to warrant a monetary policy reaction.

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