White Paper

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Are Canadians ready for higher mortgage interest rates?

A closer look at trends in the Canadian housing market

Mortgage interest rates may not be low for long. The pace of quantitative easing will continue to slow during the summer and the first interest rate hike is now likely to take place in the second half of 2022. Bond yields will not be as patient and may resume an upward trajectory much earlier.

Canadian households, wooed by historically low interest rates, have accumulated mortgage debt at a rate never seen in a recessionary period. Are they ready for higher mortgage interest rates? In this joint research, Equifax Canada and CIBC take a closer look at the health of the Canadian housing market at this critical point.

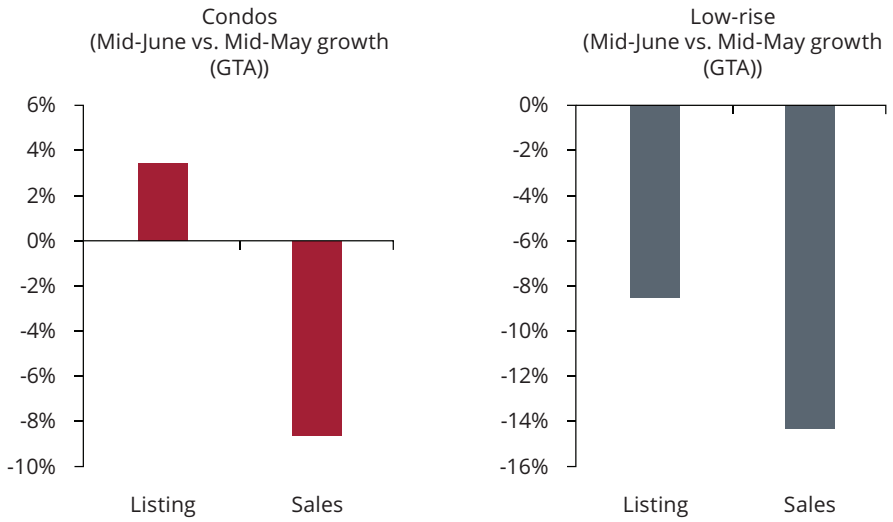
Canadian housing market — anything but locked down

The narrative is well known. The most asymmetrical recession on record gave birth to an unprecedented recessionary rally in the Canadian housing market. The deep but narrow economic damage inflicted by COVID-19 meant that a relatively large portion of mid-to-high income households were hardly impacted financially by the crisis.

Consequently, homebuyers were able to enjoy the benefits of a recession via historically low interest rates, without the usual recessionary cost of a broad-based increase in the unemployment rate and reduced job security.

Recent figures, however, suggest that the Canadian housing market rally is fading. During April and May, overall sales fell by a cumulative 21.5% while new listings fell by more than 12%. Recent figures from the Greater Toronto Area (GTA) show continued weakness in June with sales falling by 9.1% — led by the low-rise segment of the market (Chart 1).

Chart 1
Housing market activity slowing



Source: CREA, CIBC

Two trends affecting the Canadian housing market

That slowing is a welcome development as the Canadian housing market is still extremely tight with the level of available inventory still at a record low, and most centers displaying characteristics of a sellers' market. Two main factors are behind the recent softening trajectory:

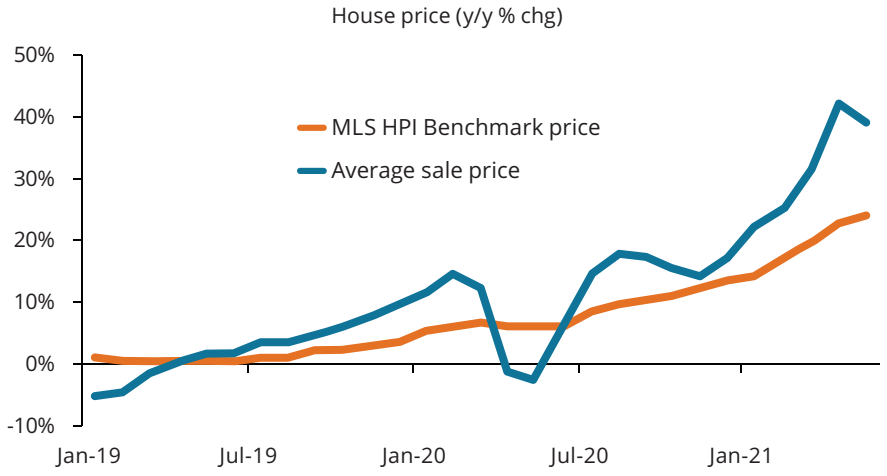
First, it appears that during the past year or so, the historically low mortgage interest rates generated a sense of urgency to get into the market. Thise created a situation in which activity was "borrowed" from the future. The recent slowing might suggest that the future has arrived.

Second, following the meteoric ascent in the price of detached units during the pandemic, prices have reached, in our assessment, a resistance level. This could indicate potential buyers are more reluctant to buy a new home despite low mortgage interest rates.

That shift from high-rise to low-rise units during the COVID-19 pandemic was inflationary in nature, as more activity was concentrated in the more expensive detached segment of the market. That development is illustrated in the widening inflation gap seen between the average home sale price and the benchmark price (Chart 2).

We estimate that close to one half of the overall increase of prices in Canadian housing market over the past year was due to that compositional factor. With prices of low-rise units reaching resistance levels and cities opening gradually, it is reasonable to assume that the more affordable condo market will outperform in terms of sales. This will work to ease price pressures via the compositional factor.

Chart 2
Shifting buying composition inflated prices



Source: CREA, CIBC

But the most significant test facing the Canadian housing market is still ahead. The Bank of Canada is widely expected to start tightening interest rates at some point in the second half of the year—notably earlier than what was assumed not too long ago.

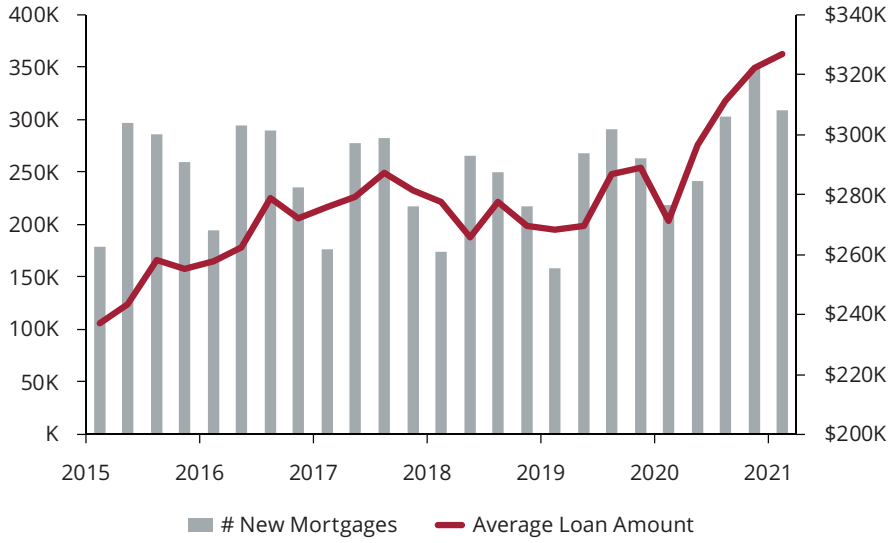
Furthermore, the risk of more sustainable and sticky inflationary pressures down the road might lead to a more aggressive tightening trajectory. And with the effectiveness of monetary policy much larger than at any point in the post war-era due to a record-high level of household debt, a relatively small increase in mortgage interest rates could have a notable impact on the Canadian housing market. Accordingly, we take a closer look at recent trends in the mortgage market to assess its current shape following the breathtaking acceleration in housing activity during the past year.

The Canadian housing market is seeing strong growth

The Canadian housing market has been fueled by the surge in home sales and increased refinancing activity. Based on recent Equifax data, new mortgage volumes were up 41% year-over-year in the first quarter, and the total value was 70% higher (Chart 3). That followed a very strong Q4. Average new mortgage values were 20% higher than the same time last year, reflecting the strong rise in home prices.

Chart 3

Strong housing market driving acquisition and values up significantly



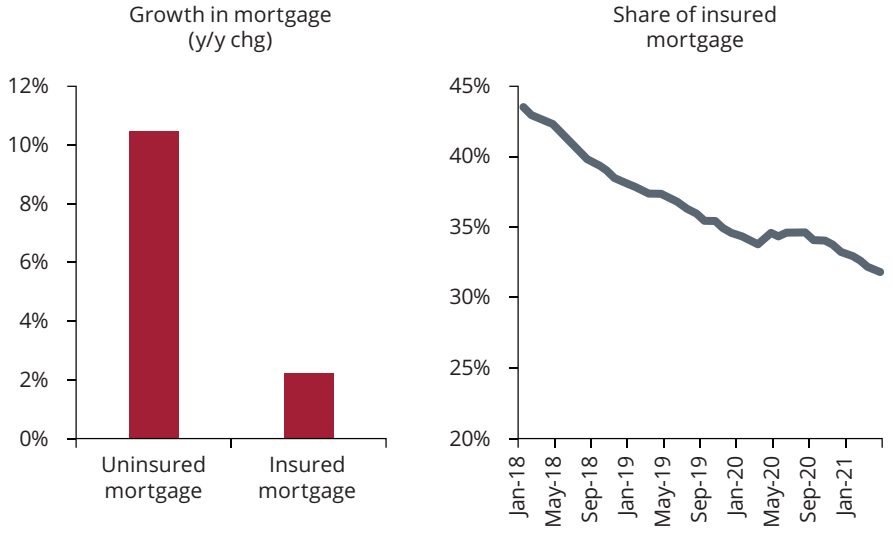
Source: Equifax Canada

While the recent regulatory change to high-ratio mortgages is a step in the right direction, we doubt that it will have a notable impact on overall activity given the falling share of insured mortgages in originations. In fact, over the past year, the vast majority of growth in mortgages outstanding came from the uninsured segment of the market (Chart 4).

So, despite rapidly rising home prices, more and more home buyers are able to come up with the necessary 20% (or more) down-payment and qualify for a conventional mortgage.

Chart 4

Conventional mortgages accounted for most of the growth



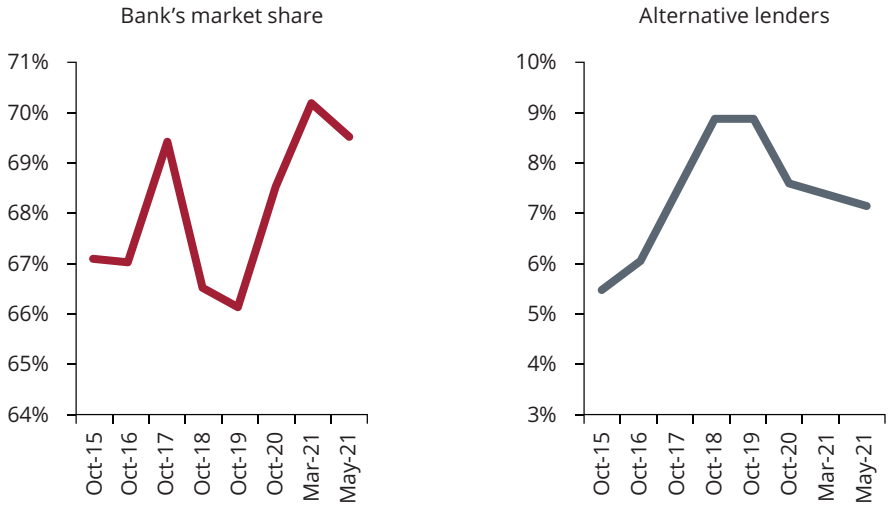
Source: OSFI, CIBC

Another interesting development during the COVID-19 pandemic was the change in composition of the supply of mortgages, with alternative lenders (private lenders and mortgage investment corporations (MICs) losing market share to banks (Chart 5).

We suspect that the vast majority of the underperformance of alternative lenders is due to the exit of small and less capitalized players since the beginning of the crisis.

Chart 5

Alternative lenders lost market share during COVID-19



Source: Teranet, CIBC

A new recessionary credit cycle during COVID-19

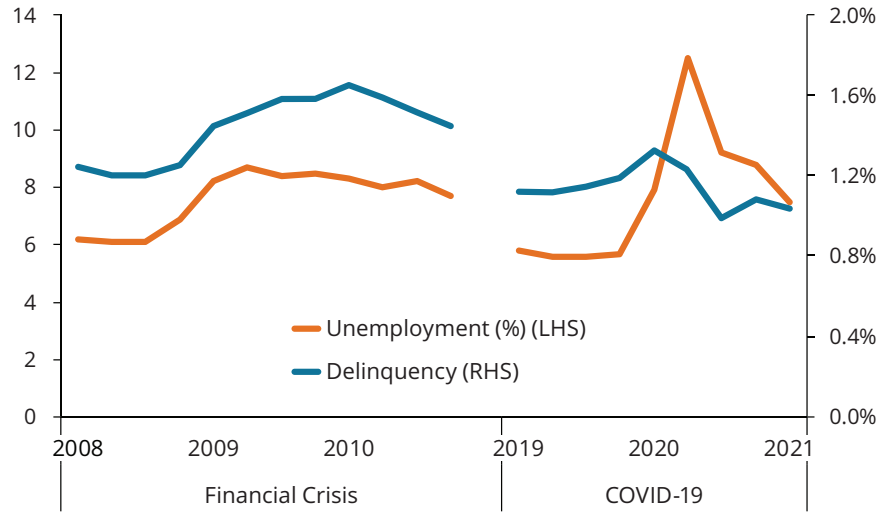
A significant component of the Canadian housing market story has been the asymmetrical nature of the COVID-19 economy. A large majority of households have had no negative impact to their income while government benefits have supported those in lower paying jobs that have been impacted the most.

The result is a fundamental break in the typical credit cycle during a recession. Delinquencies and bankruptcies have improved despite the most significant economic disruption since the Great Depression.

That was certainly not the case during the financial crisis of 2008/2009. Equifax data from that period shows delinquencies were closely linked to unemployment. In 2020, the opposite was true. With consumers leveraging payment deferrals, the initial improvement in the delinquency rate was not a surprise. And after a brief increase in missed payments as deferrals ended, the trend quickly improved (Chart 6).

Chart 6

Delinquency has shrugged off losses during COVID-19



Source: Equifax Canada

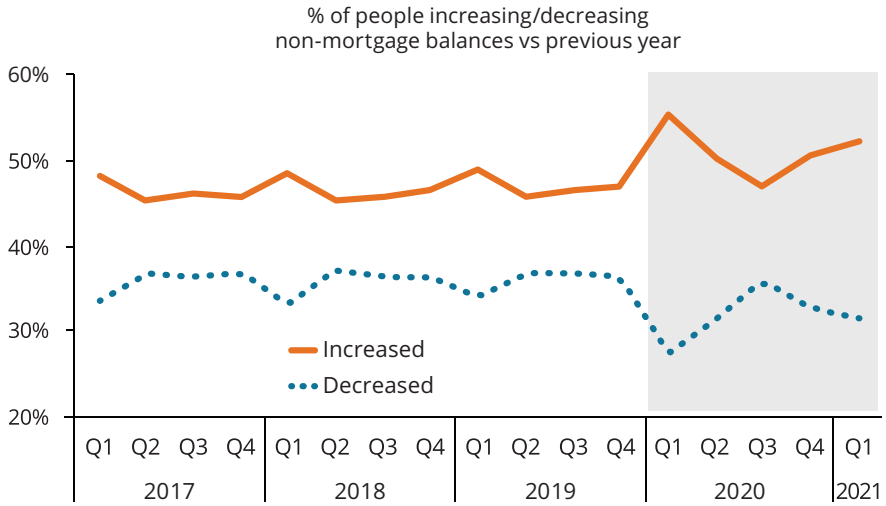
The strong delinquency and bankruptcy trend reflect the rise in disposable income. With government benefits more than offsetting lost income, payments for non-mortgage credit rose and allowed many to actually pay down their debt. Credit card balances have fallen back to 2015 levels despite the fact that spending returned to pre-COVID-19 levels last fall.

Delinquencies and bankruptcies have improved during the COVID-19 pandemic despite the most significant economic disruption since the Great Depression.

Equifax data demonstrates the significant pay down in non-mortgage debt. Except for Q3 last year, more than 50% of consumers reported lower non-mortgage credit balances versus the prior year (Chart 7). This is a significant improvement to the pre-COVID-19 period when those increasing debt were on the rise. This creates support for those looking to buy a home while mortgage interest rates are low.

Chart 7

More people have been paying down non-mortgage debt



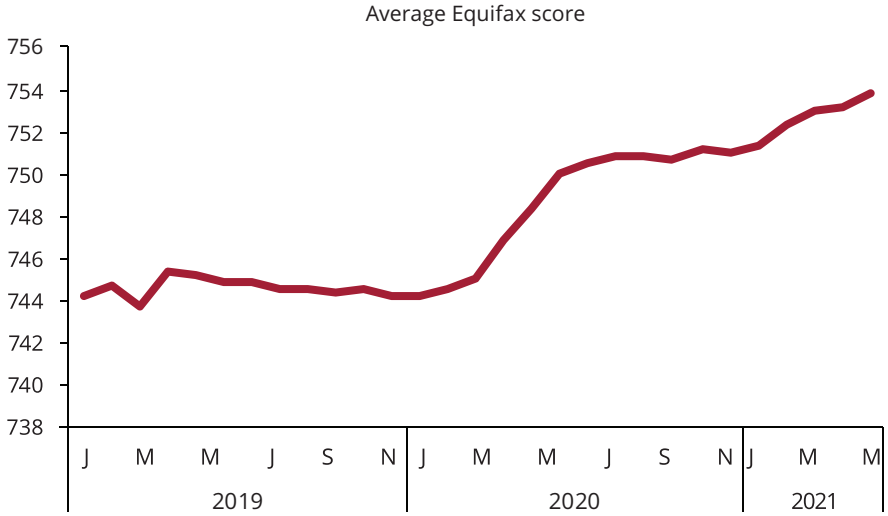
Source: Equifax Canada

More than 50% of consumers reported lower non-mortgage credit balances versus the prior year. This creates support for those looking to buy a home while mortgage interest rates are low.

Falling non-mortgage debt, fewer new credit products and lower delinquency rates have also helped boost credit scores over the past year—another atypical outcome during a recession. Payment deferrals had some initial impact, but the sustained improvement in credit performance has helped consumers. The average Equifax credit score has risen by almost 10 points to 750 (Chart 8). This provides another solid base for potential homebuyers as they secure new mortgages.

Chart 8

Lower debt and delinquency helping credit scores



Source: Equifax Canada

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First-time homebuyers rush to low mortgage interest rates

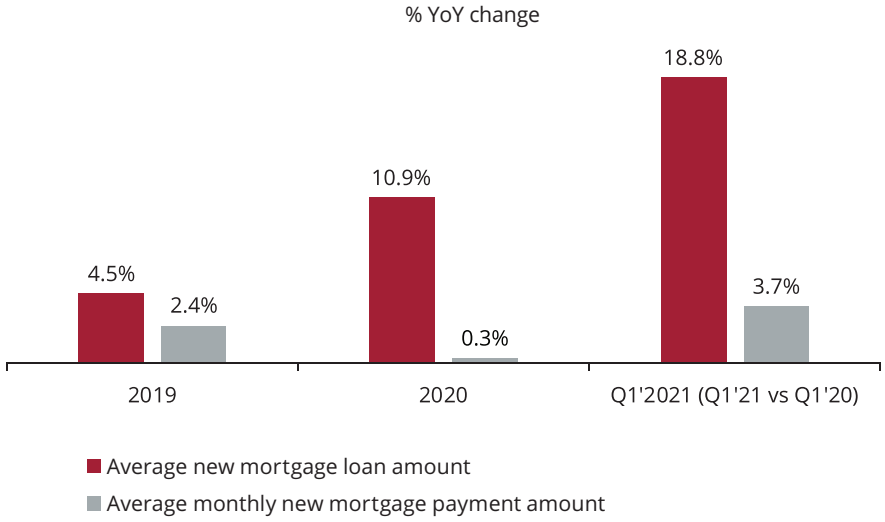
There is little doubt that interest rates were the motivator for the housing surge. First-time homebuyers led the housing recovery in 2020, but existing homeowners became an important source of activity in Q1 of 2021, according to Equifax data.

While the average mortgage size rose by almost 19% for first-time homebuyers in Q1, monthly payments were up only 3.7%. Affordability has remained consistent despite the rapid increase in prices (Chart 9).

Longer term, however, there are concerns that the rise in mortgage values in lower-income areas could be a challenge as mortgage interest rates rise.

Chart 9

First time homebuyers getting more house for similar monthly payments



Source: Equifax Canada

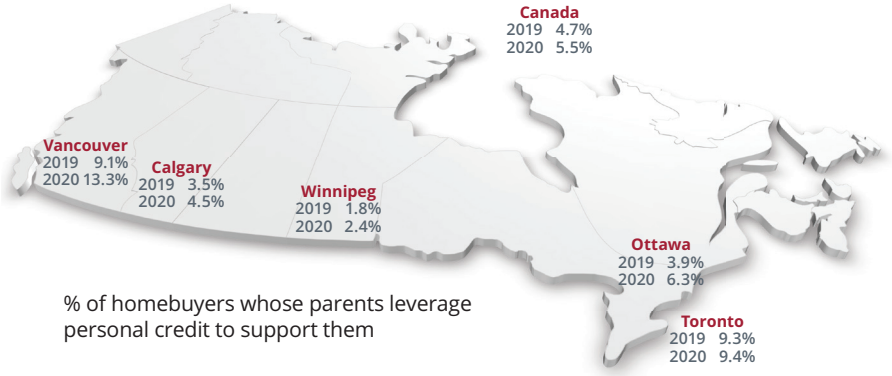
One indication of the increased urgency to get into the market while interest rates are low is an increase in "gifting". In some cases, first-time homebuyers improved their down payments through cash gifts from family or by leveraging a guarantor.

Equifax was able to connect parents with adult children to identify their credit behavior when the child bought their first home. The analysis shows that more parents used their personal credit to support their children buying their first homes in 2020.

The analysis considered increased balances on lines of credit or new personal loans of $50,000+. The share of homebuyers across the country who received support rose from 4.7% in 2019 to 5.5% in 2020. Increases were most noteworthy in regions that had relatively soft housing markets in 2019 but reported recent price gains including Calgary, Vancouver, Ottawa and Winnipeg (Chart 10).

Chart 10

More parents are using credit to support their children buying homes

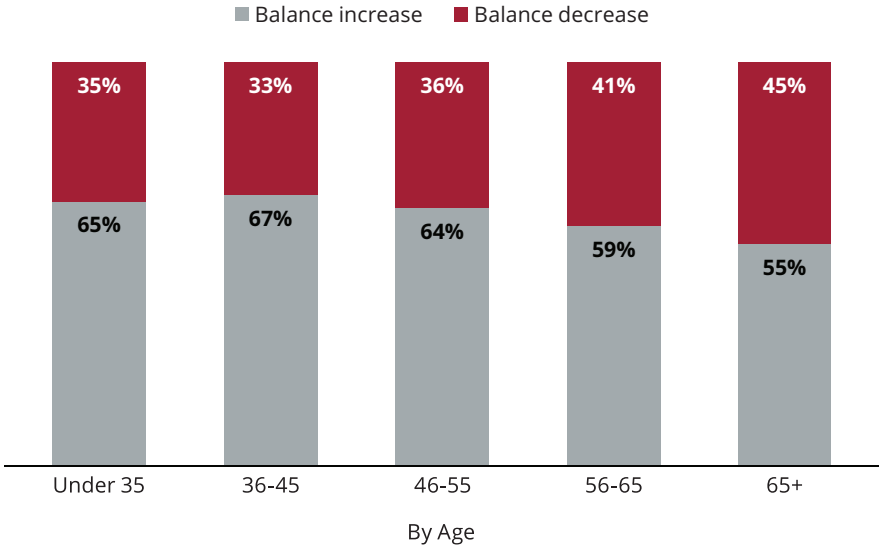


Source: Equifax Canada

For existing homeowners, many have leveraged strong market conditions to downsize. For those 55+, more than 40% moved to a lower mortgage and monthly payment schedule (Chart 11). This allows many older consumers to significantly reduce their debt and monthly payments, a concern for many prior to the COVID-19 pandemic.

Chart 11

Older homeowners using the hot market to downsize



Source: Equifax Canada

The share of homebuyers across the country who received support rose to 5.5% in 2020 from 4.7% in 2019.

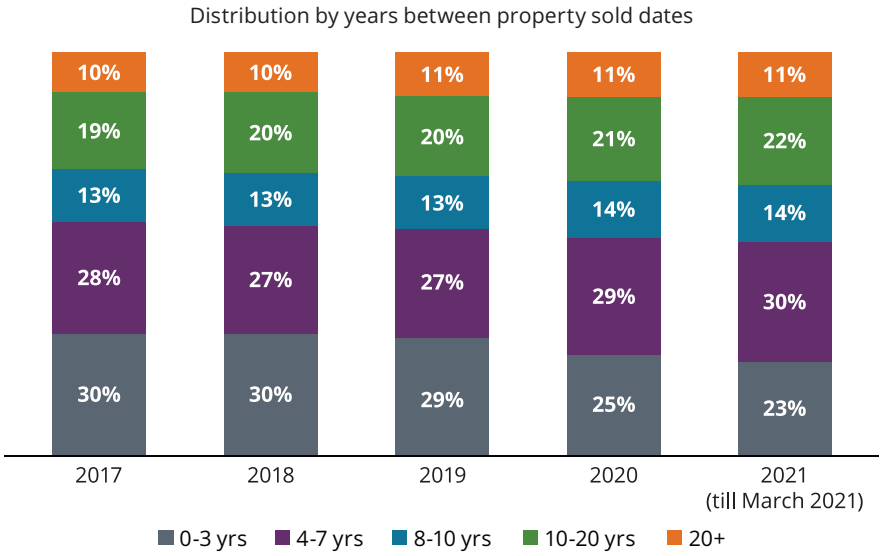
On a positive note, there are few signs that the current Canadian housing market is being driven by speculation. Analyzing property registration data from Teranet, homeowners who have held a property for less than 3 years have not seen a significant lift in profits upon the sale of their home compared to similar sellers in 2019. The data also shows those sellers have actually been falling over the past few years with the trend continuing into 2021 (Chart 12).

The market has been driven by low mortgage interest rates and lifestyle changes during COVID-19—not house flippers. As a result, three key trends were evident:

- gains in previously weak markets fueled by low mortgage interest rates
- a sharp rise in markets farther from downtown cores
- a rally in cottage properties

Chart 12

There are few signs of speculative selling in the past year



Source: Teranet, Equifax Canada

The market has been driven by low mortgage interest rates and lifestyle changes during COVID-19.

The Bank of Canada will be the key market force

The fact that low interest rates and excess savings have fueled the Canadian housing market is good news near term, but there are concerns as the Bank of Canada changes its stance.

Despite relatively small rate increases in 2017/2018, data at that time showed immediate impacts on consumers. The percentage of people paying their credit card in full each month dropped sharply at the time, a strong sign of cash flow constraints (Chart 13).

This was especially true for those with large home equity lines of credit —typically with variable interest rates— as they had to cover larger monthly payments when rates rose. That drove higher bankruptcies and delinquencies for older borrowers.

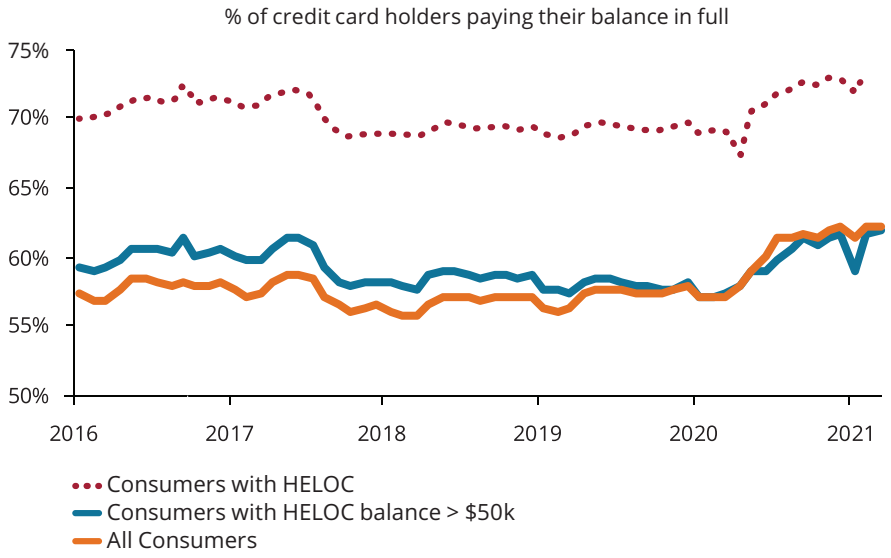
With signs of cooling appearing this spring in the Canadian housing market, attention will quickly shift to the impact on prices.

Suburban markets that surged in the past year, and properties in cottage country, are likely to be the first to pause. The real impact will become evident if mortgage interest rates rise in 2022.

To the extent the Bank of Canada starts hiking rates in mid-2022 as we expect, the tightening trajectory is likely to be gradual enough to allow the housing market to adjust at a healthy pace. Accordingly, delinquency and bankruptcies rates are expected to return to pre-COVID-19 levels by early 2022.

Chart 13

Rate hikes in 2017/2018 had immediate impact on many borrowers



Source: Equifax Canada

How Equifax can help reduce risk and grow your mortgage business

In a highly competitive mortgage market, understanding the direction of key housing market trends across Canada, benchmarking against other lenders, and gaining insight into underlying consumer credit behaviour can help you proactively mitigate risk and grow your mortgage portfolio.

We offer specialized products and services to help you analyze and understand current trends,measure and monitor your mortgage portfolio and guide your acquisition, retention, and delinquency decisions.

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When we work together, we'll help identify needs and provide solutions for your most important lending, credit and risk management priorities. Our mortgage insights can help turn greater market intelligence into powerful mortgage portfolio performance.

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