The Impact of the Mortgage Stress Test on Local Economies

Issue

The mortgage financial stress test was introduced by the Federal Government in late 2017, followed by an augmentation in 2018 to include all mortgages. The stress test, initially designed to address household debt, has had negative consequences for all of Canada. The test, which was imposed amid an already-slowing housing market has had a dramatic and negative effect that will continue the longer the policy remains in effect.

Background

The Stress-Test in Guideline B-20 is a new regulation that was created as a way of determining what homebuyers can afford under the in the event mortgage interest rates rise between mortgage origination and renewal. This means that mortgage borrowers must not only qualify for a rate that they negotiate as part of a mortgage, but also a “stressed” version of their mortgage. “This entails subjecting their mortgage to a higher rate without adjusting the household’s financial situation. The borrower would still pay the rate they were preapproved for, they just need to qualify for a higher rate in order to lock it in.”[24] It was intended that buyers don’t overstretch their finances when dealing with financial hardship.[25] This regulation affects buyers who are intending to put a down deposit of at least 20 percent and buyers with default insured mortgages (i.e. anyone who makes a down payment of less than 20%) must qualify using either the Bank of Canada five-year benchmark rate or the rate offered by the lender (without adding the extra 2%) – whichever is higher. Ultimately, stress testing is about protecting the buyer, by ensuring that they can comfortably afford their monthly payment in case of interest rate increases.

The guideline failed to consider a few things about the ‘borrower’, as laid out by CIBC: “borrowers’ income is likely to rise during the mortgage terms. Average personal income has risen by a cumulative 12.5% over the past five years—the stress test does not take that into account. Nor does B-20 allow for the fact that during the course of the mortgage term, equity position rises due to principal payments. Another shortcoming is that the stress test doesn’t consider mortgage term and the decreasing borrower risk with longer terms selected. And finally, B-20 is in part behind the strong rise in alternative lending.”[26]

More than a year later we can see that the regulation has caused many unintended consequences. Instead of removing risk from the housing market a great share of buyers has been driven to alternative lenders, this is a transfer from the regulated to the less regulated segment of the market. The Teranet Market Insights Report from October of 2018 found that, “20% of refinanced mortgage transactions (defined as mortgages registered on a property that did not involve a sale) during the second quarter of 2018 were sourced from private lenders…Turning to mortgages for properties with a sale, private lenders accounted for 6.8% of mortgage transactions in Q2 2018, up from 4.9% two years ago.”[27] The regulation also does not provide an exemption for those who are purely are trying to switch lenders to lower their interest burden or those who want to refinance to reduce their total debt burden.[28]

In many regards, this policy has failed as there is little evidence that the housing market has cooled down in areas of Canada, but more importantly in those areas of the Canadian Housing Market where pricing was out of control. As well, there has been a slowdown in construction that has resulted in job losses in not only the housing industry that has created a ripple effect into other connected industries.

According to a 2018 report by The Canadian Real Estate Association (CREA), one job is generated for every three home sale transactions however at the time the report was written, however at the time the report was written, national activity for home sales was on track to hit a five-year low. Some parts of the country are being hit especially hard such as Calgary which is on track for the fewest sales since 2000; Regina and Saskatoon which were on track for the fewest sales in 2006; and St. John's which was on track for the fewest sales since the 1990s.

One of the impacts we are seeing in Alberta is the compression of the housing market into a narrower price range. This will impact future sales and could make it more difficult for people to sell their homes in oversupplied price ranges.

Utilizing a National policy on mortgage qualification will have a more dramatic and negative effect on slow housing markets as opposed to that on heated markets. The reason for this is that slow, unhealthy markets are very sensitive to factors that affect the availability of capital, along with employment rates impact on borrowing capacity.

Canadian Imperial Bank of Commerce's Deputy Chief Economist, and member of the Economic Committee of the Canadian Chamber of Commerce, Benjamin Tal said he supports the principle of a stress test but believes it should be flexible and adjusted to account for interest rate moves and market conditions.

"It's not something that has to be set in stone. It should be more dynamic," he said. "You have to assess the damage to the housing market, whether that damage is too severe, and what other forces in the market are leading to slower growth.

In a later interview, he went on to say, "Is 200 basis points the right number? At the end of the day, there is no real science behind that number."

The Alberta Chambers of Commerce recommends that the Government of Alberta works with the Government of Canada to:

1. Remove the stress-test for those who are merely trying to switch lenders to lower their interest burden, with no increase in risk, refinancing to reduce their total debt burden;

2. Remove the stress-test for those who are acquiring a mortgage in the same price range as their original mortgage;

3. Review the "one-size-fits-all" nature of this policy and create more flexible benchmarks: The qualifying rate needs to be established utilizing criteria designed to account for real-time market conditions, regional/community risk assessments and to allow for regional adjustments as unique community risks arise;

4. Lower the 200-basis points to a 75-basis point stress test, which achieves an appropriate protection to consumers in the event that rates rise, while not unduly pricing too many consumers out of the marketplace;[29]

5. OSFI should unify requirements for uninsured mortgages with those of insured mortgages, and to work with the Bank of Canada and the Department of Finance by implementing an independent mechanism that would see the benchmark set at approximately 75-basis points higher than commonly available market rates; and[30]

6. Provide a 30-year amortization option for first-time homebuyers.