OBSERVATION

TD Economics

September 12, 2014

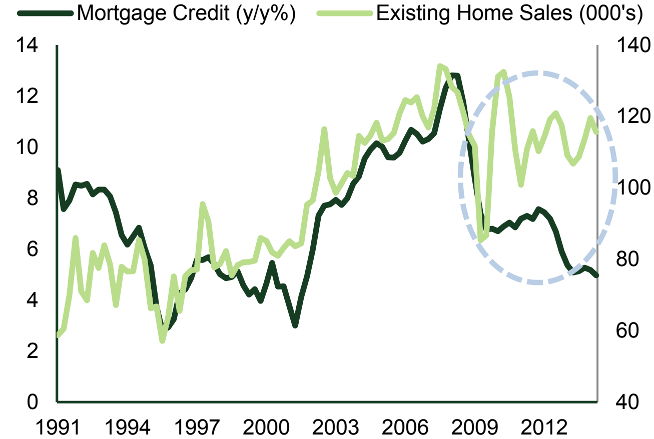
EXPLAINING THE MODERATION IN CANADIAN MORTGAGE BORROWING

Highlights

- In Canada's great household borrowing moderation, the diverging trends in housing activity and mortgage borrowing stand out. While housing activity is relatively lofty, mortgage credit is growing at its slowest pace since 2001.
- The moderation in mortgage credit has largely been due to households paying back principal more aggressively than they have in the past. Principal repayment has also been high relative to how quickly new mortgage credit has been growing. Evidence also suggests that households are drawing less equity out of their homes than they have in the past.
- While all of these signs are certainly a step in the right direction, we still are not out of the woods yet when it comes to risks surrounding the housing sector. The lure of low interest rates may prove to be too strong for Canadian consumers, and the potential for a reacceleration in debt growth remains high.

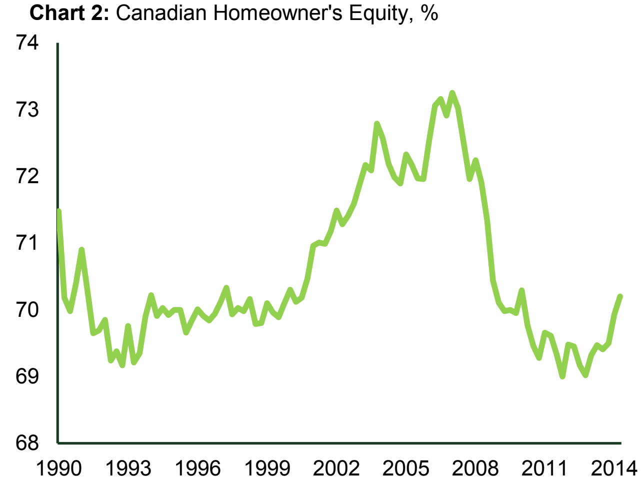
As household borrowing in Canada has moderated, the diverging trends in housing activity and credit growth stand out (Chart 1). The Canadian housing market has delivered a strong performance, yet household debt growth has slowed to its slowest pace since 2001, the household debt-to-income ratio has been stable since 2012. Canadian households have even been slowly rebuilding the equity in their homes (Chart 2), following a decade of drawing it down for consumption purposes. Since mortgages comprise of two thirds of total household debt, this begs the question of what is driving the slowdown in Canadian household debt? Evidence suggests that households are taking an active approach to debt management by paying down their principal more aggressively and drawing less equity from their homes for consumption purposes.

Chart 1: Housing Activity and Mortgage Borrowing



Source: Bank of Canada, Statistics Canada

Chart 2: Canadian Homeowner's Equity, %



Source: Statistics Canada

Low interest rates leave room for debt management

To get to the bottom of this apparent chasm, we decompose outstanding mortgages into its key components. Simply speaking, outstanding mortgages are calculated as total outstanding mortgages, plus new mortgages less principal repayment. As long as new mortgages are higher than principal repayments, outstanding mortgage balances will grow.

Chart 3 indicates that the moderation in mortgage credit has

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largely been due to households paying back principal more aggressively than they have in the past. Principal repayments have also been high relative to how new mortgage credit has been growing.

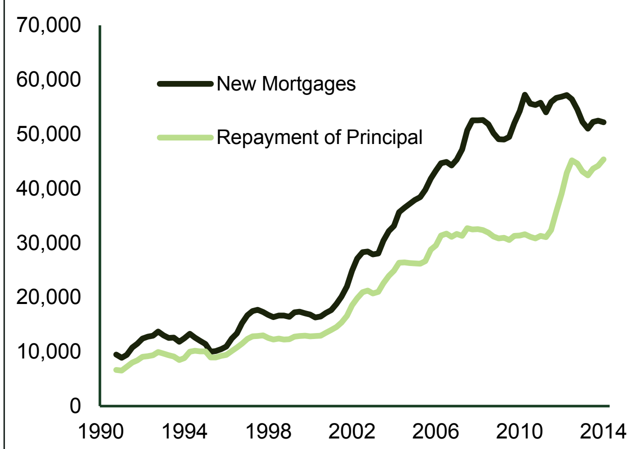
The trends exhibited in Chart 4 also suggest that households are taking advantage of a low interest rate environment to pay down their debt as quickly as possible. In its last Financial System Review, the Bank of Canada estimated that total debt payments (interest and principal) as a percent of household income has remained relatively stable since the recession. However, interest payments as a percent of income (also called the debt service ratio) is at a record low of 6.6%. So, a greater share of household income is being devoted to paying off outstanding balances. Put another way, Canadian households are paying roughly $4 billion dollars less in interest on an annual basis than they were heading into the recession, but on the flip side they are paying that much more in principal.

In addition, many households have taken the opportunity to consolidate debt – taking out larger mortgage balances to pay off other forms of debt that typically come with a higher interest rate, like credit cards. This has helped lower the interest cost on debt. The average interest rate on consumer credit is currently 10%, whereas the average effective interest rate on a five-year mortgage is only 4%. This has allowed households to pay back outstanding loans at a faster rate. Mortgages have grown as a share of total household debt, while credit card balances have been in decline since 2012.

Households drawing less on the equity in their home

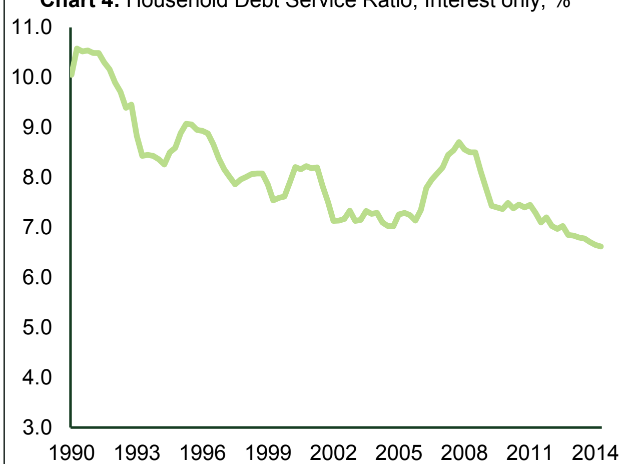
New mortgages can be further broken down into homebuyers using mortgages to finance a purchase and existing homeowners refinancing a mortgage to draw on the equity built up in their home. The slowing pace of new mortgage accumulation may be due to less refinancing activity. By 2013, 73% of borrowers had an interest rate of less of 4% on their mortgage, compared to just 6% in 2008. That share has been growing much more slowly over the last two years suggesting that households have already had the opportunity to take advantage of record low interest rates and refinancing activity has likely cooled. In addition, evidence suggests that households are drawing less off the equity in their homes than they have been in the past. The Canadian Association of Accredited Mortgage Professionals mortgage market report indicated that roughly 10% of households borrowed from the equity in their homes in 2012 and 2013, down from 18% of households in the spring of 2011.

Chart 3: Breakdown of Mortgage Credit, Millions of C$



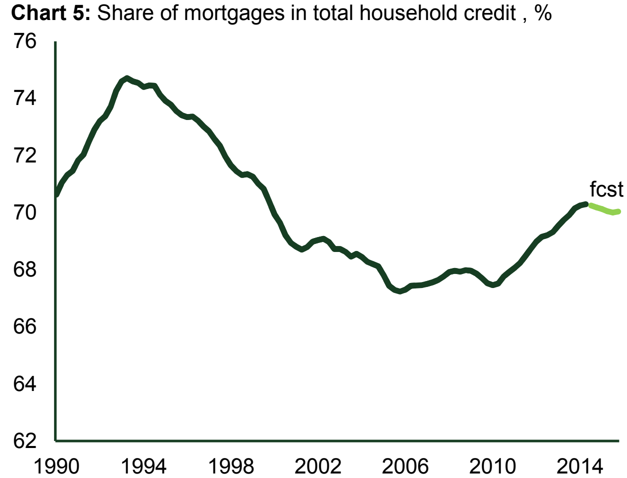
Source: Bank of Canada. New mortgages actually equals cash disbursments of mortgages

Chart 4: Household Debt Service Ratio, Interest only, %



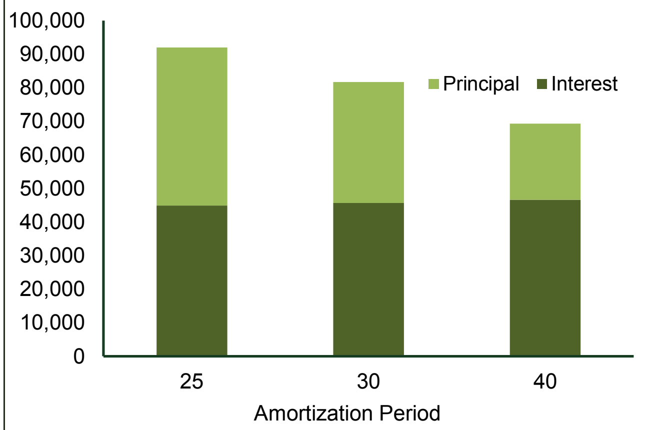
Source: CMHC, Bank of Canada

Chart 5: Share of mortgages in total household credit , %



Source: Bank of Canada. F. by TD Economics as of September 2014

Chart 6: Mortgage payments over a five-year term on a conventional mortgage for an average priced home.



Source: Calculated by TD Economics. Based on a conventional mortgage with 20% down, on an average priced home and a five year mortgage rate of 3%.

Regulation encourages good behaviour

Households have been more cautious when it comes to managing debt. However, regulation changes may also be at play. Following several years of loosening policy from 2004 to 2008, the Canadian federal government reversed course, tightened requirements on what mortgages could be insured by banks. The two measures implemented by the federal government since 2008 with the biggest impact on mortgage borrowing has been the reduction in the allowable amortization period for insured mortgages from 40 years to 25 years and the increase in the required down payment from 0% to 5%. The lower amortization rate means that the cost of the mortgage is spread over fewer years. As an example, suppose you wish to purchase an average priced house at current interest rates. A mortgage holder with a 25 year amortization will have a higher monthly payment, but the homebuyer will pay off almost $25,000 more in principal over a five year period than if taking out a mortgage with a 40 year amortization rate (Chart 6). Banks still offer a 30 year amortization rate to borrower's who do not need mortgage insurance, which may have made conventional mortgages more attractive. A conventional mortgage is one that has a 20% downpayment and does not require mortgage insurance.

The change in mortgage insurance rules has also led to a lower share of mortgages being insured (Chart 7). Information provided by CMHC suggests that a homeowner taking out an insured mortgage puts down roughly 10% as a down payment, on average. Homebuyers require at least a 20% down payment to secure a conventional mortgage. Higher down payments might partly explain why housing activity is still rising faster than households are accumulating new mortgages.

Other, unobservable explanations

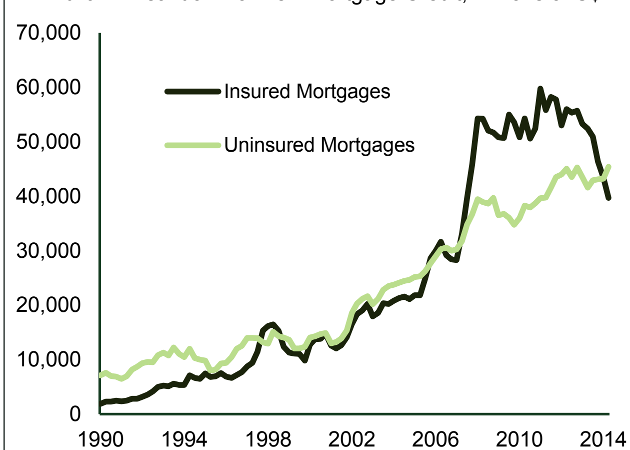
There are a few other explanations as to why mortgage credit is slowing faster than housing activity, which are often talked about but hard to quantify.

The first is that first time homebuyers are relying on gifts from family members for down payments. Higher down payments mean they require less of a mortgage to make their purchase. There is little evidence, other than anecdotal, to support this claim. However, we do know that debt is growing more quickly among those aged 55 and older in Canada. It could be that older Canadians are carrying more debt as they continue to support their children through adulthood.

Second is foreign investment. Foreign investors tend to be wealthier and often require less of a mortgage to purchase a home in Canada, or maybe don't even need one at all. There are often anecdotes of home seekers who show up to open houses with brief cases full of cash. We don't have good data on foreign investment in Canada, or of home purchases made solely through cash deals. However, Sotheby's Real Estate tracks the number of high end sales tied to foreign investment. In some markets like Vancouver and Montreal, foreign buyers account for 30% of high end home sales.

Third, a greater share of sales lately have been driven by current homeonwers. Whether they are downsizing or moving up, these homebuyers will typically have greater down payments and take on a mortgage with a lower loan-to-value ratio.

Chart 7: Breakdown of New Mortgage Credit, Millions of C$



Source: Bank of Canada.

Proceed with caution

While households appear to be accumulating mortgage credit at a quick pace, they are paying down that debt faster than they have in the past. While all these signs are certainly a step in the right direction, we still are not out of the woods yet when it comes to risks surrounding the housing sector. For one, mortgage credit is still growing faster than household income and households are still more sensitive to the possibility of higher interest rates than they have been in the past. At the same time, the low interest rate environment poses the risk that household credit reaccelerates:

- Consumers appear to be back to their old ways. Consumer spending is on track to average 3% in 2014, led by the strongest Canadian auto sales on record.
- There appears to be significant lags between housing activity and mortgage borrowing. As such, there still is a possibility that mortgage credit could rise sharply in the next year due to current strength in home prices, sales and new home construction. In particular, a sharp drop in mortgage rates since earlier this year has pretty much offset the impact mortgage insurance rules have had on housing affordability- particularly for first time home buyers.
- Equifax data shows that households are building their borrowing capacity. Applications for new debt accelerated over the first quarter of 2014 with installment loans (personal lines of credit and student loans), mortgages and credit cards growing 11.8%, 93.2% and 4.8% year-over year, respectively. At the same time, the credit limit households have available to them through various measures of debt has been increasing faster than outstanding balances since 2012. This means that households have a significant amount of debt they could use at their fingertips.

Overall, households have taken advantage of the low interest rate environment to reduce debt burdens, both by consolidating debt to reduce interest costs and beef up the speed at which they have been paying down their loans, and by slowing the speed at which they have been accumulating debt. However, the lure of low interest rates may prove to be too strong for Canadian consumers, and the potential for a reacceleration in debt growth remains high.