An Overview of the Canadian Mortgage Market

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EXECUTIVE SUMMARY

Escalating debt leaves the Canadian consumer in a precarious position. Talk of crisis is overblown. Traditional measures of housing value do not account for incredible gains in mortgage affordability. There is little evidence of an out-of-control consumer. Delinquency rise is a regional story. A large mortgage does not mean certain deterioration in household finances.

CRISIS? WHAT CRISIS?

There is little doubt that Canadian debt levels are becoming a concern. While still affordable, escalating consumer debt leaves Canada susceptible to economic downturns or shocks. It also limits the ability of the Bank of Canada to leverage interest rates to manage the economy in a traditional way.

There is little evidence, however, that the credit situation represents a national crisis that parallels the one the U.S. experienced leading into the Great Recession of 2008. Headlines point to a housing crisis in Canada. Policy-makers are looking for ways to slow the unyielding uptrend in house prices and financial regulators are looking to tighten scrutiny of mortgage lenders in anticipation of an inevitable downturn.

Lost in the hyperbole, however, is the reality of the situation. With the debt-to-income ratio at an all-time high, the Canadian consumer has shown unexpected resilience. There is little doubt that the growth in credit is based on interest rates and not an out-of-control consumer.

While the weight of the data does not support a crisis story in Canada, it does, however, tell a cautionary tale that requires lenders and consumers to become increasingly more intelligent in their decision making.

HOUSING HYPE IS NOT COUNTRY-WIDE

By many traditional measures of valuation, the Canadian housing market is overheated. Compared to income or rent, house prices are at or near historical highs. In both cases, Canada sits near the top of the global charts (**FIGURE 1**).

House prices in general have been on a tear with stories of bidding wars and sale prices well above listing (**FIGURE 2**). The oil-induced slip in the Canadian dollar has made the housing market a globally affordable asset for foreign investors. That has regulators fretting over the role of foreign money in driving affordability out of reach for the average Canadian while allowing money-launderers to take advantage.

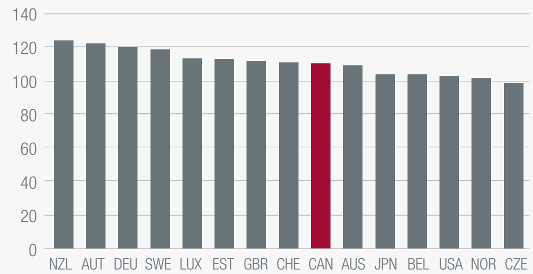
In reality, the housing hype is highly concentrated in Vancouver and in Ontario's Golden Horseshoe region. Outside those areas, home prices have been much more moderate. Major centres in the east, like Ottawa and Montreal, have had less than 10% growth over the last five years. Even Calgary is up only 17% since 2011.

With average home prices now $1,000,000+ in Toronto and Vancouver, the market is pushing household balance sheets to precarious levels. The debt-to-income ratio is now well-above the U.S. levels at the start of their housing crisis and it was the over-leveraged homeowner that ignited the financial crisis (**FIGURE 3**).

Even by global standards, Canada appears over-leveraged. Other than Australia, Ireland – which came through its own deleveraging period – and the Nordic countries, Canada sits at the top of the debt chart and is the most leveraged in the G8 (**FIGURE 4**). This leaves the Canadian consumer vulnerable to any potential downturn in the economy or a decline in the housing market.

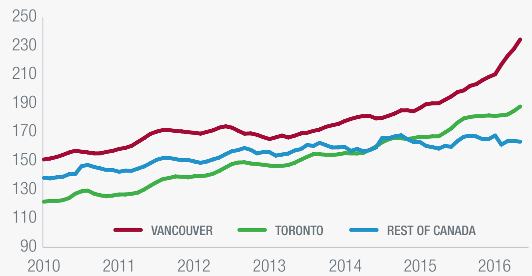
WITH WITH AVERAGE HOME PRICES NOW $1,000,000+ IN TORONTO AND VANCOUVER, THE MARKET IS PUSHING HOUSEHOLD BALANCE SHEETS TO PRECARIOUS LEVELS.

Fig. 1: House Price-to-Income Ratio



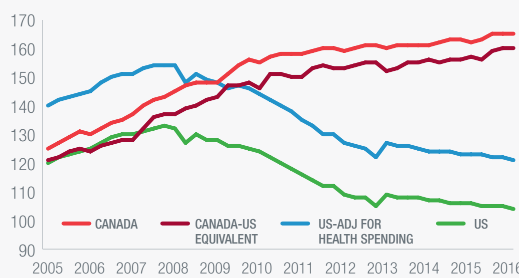
Source: IMF

Fig. 2: Teranet House Price Index



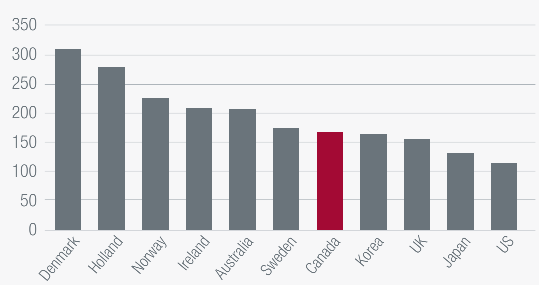
Source: Teranet

Fig. 3: Canada vs U.S. Debt-to-Income



Source: Statistics Canada; US Federal Reserve

Fig. 4: Debt-to-Disposable Income



Source: OECD

DATA IN ITS MOST POWERFUL FORM

IT'S ALL ABOUT THE RATES

Undoubtedly, Canadians have been taking on debt at a concerning pace. If the story ended there, the picture for the Canadian consumer would look bleak. But, as usual, there is another aspect we can shed some light on.

Generational low interest rates have had a substantial impact on affordability. Despite the run-up in credit, debt servicing has actually trended down in recent years. (**FIGURE 5**) The U.S. trend, conversely, has been relatively flat despite their significant deleveraging.

With mortgage rates dipping down below 2%, the cost to carry a mortgage is substantially lower today than it was in 1988. The monthly payment for a $100,000 mortgage in 1988 would cover a $177,000 mortgage today. If the monthly payment is adjusted for inflation, the equivalent mortgage in 1988 would have been $300,000.

	1988	1998	2008	2016
Mortgage Amount	$100,000	$142,000	$146,000	$177,000
Monthly Payment	$998	$999	$1,000	$998
Mortgage Amount in 1988	$100,000	$171,000	$221,000	$308,000

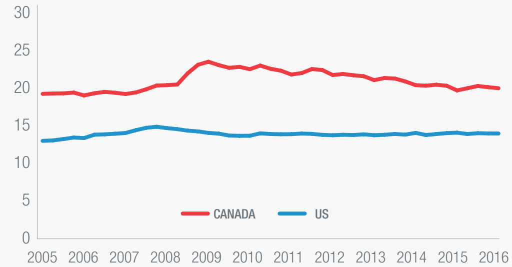
Many of the traditional measures used by economic pundits to value the housing market simply do not hold up over time. Valuing the market requires measuring the effective cost of homeownership to rent or income, and not simply the price of houses. In that case, more appropriate measures imply a more balanced market.

A UNIQUE CANADIAN DEBT EXPERIENCE

The headlines imply that most Canadians are taking on more credit, even retirees. That masks the reality. In the first quarter of 2016, 15M Canadians reported lower non-mortgage credit balances than in the previous year. That compares to 7M that reported increases. (**FIGURE 6**) Those adding debt did so quicker than those cutting, which drives the overall growth.

The growth in debt is highly influenced by the low rate environment. Canadians are not turning to high cost credit cards or eating into their home equity to support their discretionary spending. (**FIGURE 7**) Instead, it is auto loans, where low rates are offered for long periods, and traditional mortgages that account for the majority of the growth. This is rational behaviour when a very low interest rate frees up cash flow for other investments.

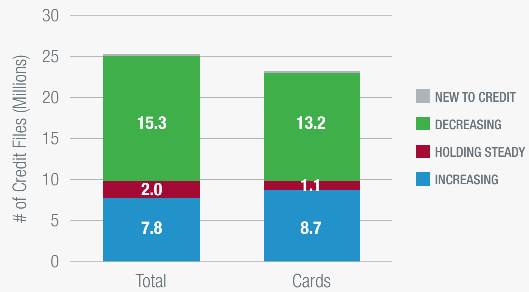
Fig. 5: Total Debt Service Ratio



Source: Statistics Canada; US Federal Reserve

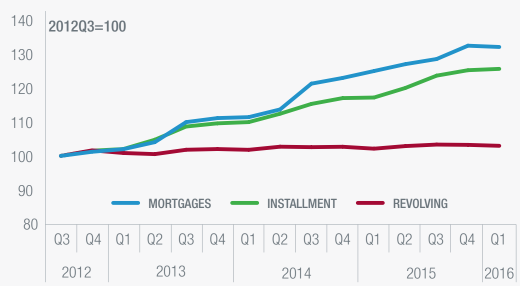
Even with the significant de-leveraging, US debt service has remained relatively flat over time while Canada has trended lower

Fig. 6: Canadian Debt Behaviours



Source: Equifax Data

Fig. 7: Canadian Debt Growth



Source: Equifax Data

The slow growth in revolving products and reluctance to tap into home equity is a significant difference from the U.S. experience. Even prior to the downturn in home prices, U.S. home equity had turned down sharply, as consumers used new found real estate wealth to drive spending. (**FIGURE 8**) By comparison, Canadian home equity has held flat, implying it is growing at roughly the same pace as prices. This provides more cushion and lessens the impact of negative equity mortgages that had many US homeowners simply walking away during the crisis.

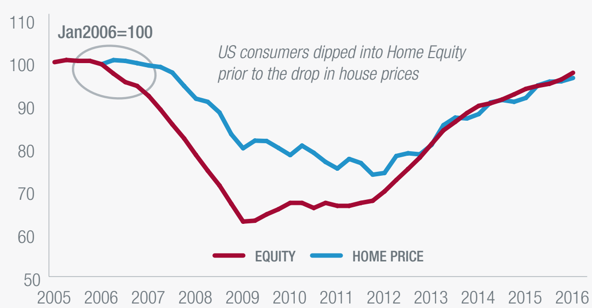
RISK IS HOLDING STEADY

With consumers being somewhat selective in their use of credit, the underlying performance of debt has been relatively stable, outside of some regional challenges. At 1.15% in Q1 2016, non-mortgage delinquencies were up modestly from 2015 but still remained below the same period in 2013/2014. (**FIGURE 9**) The increase from 2015 reflected the weakness in the previously strong prairies courtesy of the commodity price slump. Ontario, British Columbia and Quebec actually reported lower delinquency rates from last year.

Relatively muted increases in delinquency rates have also kept underlying credit scores stable. Score distributions for those applying for new credit have been flat for some time. (**FIGURE 10**) The modest decline in the high score population in Q1 2016 at least partially reflected the end of a long-standing retail program.

RELATIVELY MUTED INCREASES IN DELINQUENCY RATES HAVE ALSO KEPT UNDERLYING CREDIT SCORES STABLE. SCORE DISTRIBUTIONS FOR THOSE APPLYING FOR NEW CREDIT HAVE BEEN FLAT FOR SOME TIME.

Fig. 8: U.S. Home Equity



Source: S&P/Shiller Index; US Federal Reserve

Canadian Home Equity

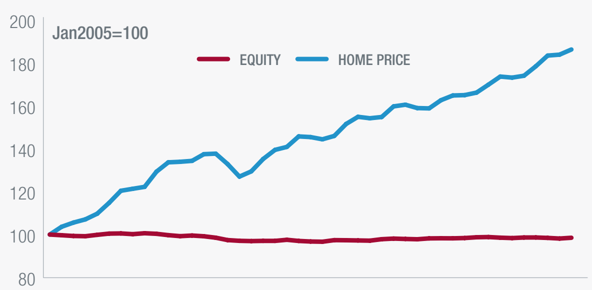
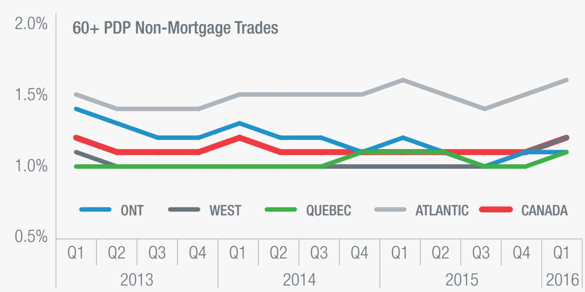
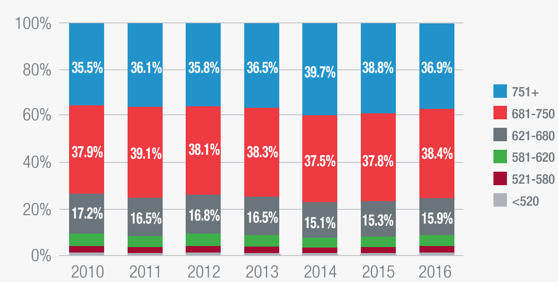


Fig. 9: Non-Mortgage Delinquency



Source: Equifax Data

Fig. 10: Equifax CRP Score – New Accounts



Source: Equifax Data

DATA IN ITS MOST POWERFUL FORM

MORTGAGES RIDING THE WAVE

While the overall debt picture may not be as bleak as described by the media, there is little doubt that hot housing markets are continuing to push consumers into taking on more debt. Mortgage debt was up 5.6% year-over-year in Q1 2016 with the average outstanding mortgage sitting at $189,000 – 9% higher than Q1 2014. (**FIGURE 11**)

The growth is reflective of the hottest markets in Vancouver and the Golden Horseshoe. Outstanding mortgage in Vancouver is up 13% relative to 2015. By comparison, Calgary and Edmonton are up only 5%, as the market has slowed significantly after a large increase in 2015. (**FIGURE 12**)

Despite the mounting mortgage debt, consumers appear to be handling the situation with relative ease. Mortgage delinquencies have been low for some time and are declining modestly as a percentage of balances. (**FIGURE 13**)

There are sharp regional differences in performance, however. Not surprisingly, Alberta has seen a significant increase in mortgage arrears, along with Halifax. Ironically, Vancouver and Toronto, where prices are most inflated, are posting better delinquency rates in 2016. (**FIGURE 14**)

#MORTGAGEDTOTHEHILT

Overall mortgage debt does mask the escalating cost of new houses. The average new mortgage reported to Equifax rose to $258,000 in early 2016, 8% higher than 2015 and 15% above the 2014 level. (**FIGURE 15**) For first-time homebuyers, the escalating prices are making it more difficult to enter the market.

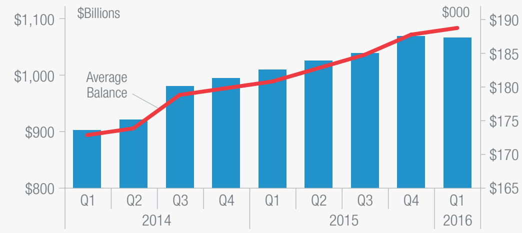
The cost of homeownership is most evident in the average mortgage amount for the key home buying market. Those in the primary first-time buying segment (26-35 years old) saw a jump in the average mortgage amount to $283,000+, a 14% increase from 2014. Those in the 36-45 year old age group have similar mortgages, as equity from another property funds their move up the market.

National numbers skew the picture for those in Toronto or Vancouver, however. For young buyers (26-35), the average mortgage in Toronto is now $380,000, a full 20% higher than in 2014. The story is even worse in Vancouver, where the average new mortgage in the young cohort is $442,000 – 23% above 2014.

There are few indications that those taking on big mortgages face immediate financial distress. Indeed, lenders appear to be applying reasonable criteria to their approval decisions and the big mortgage holders are actually performing better.

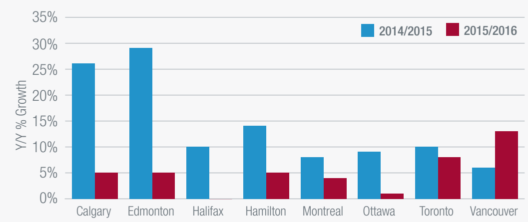
Delinquencies for large mortgages are now below average after a big improvement in the past two years. (**FIGURE 16**) Unlike the issues in the U.S. at the peak, Canadian lenders are making prudent decisions. Recent mortgage rule changes have helped ensure that appropriate tests are in place.

Fig. 11: Canadian Mortgage Debt



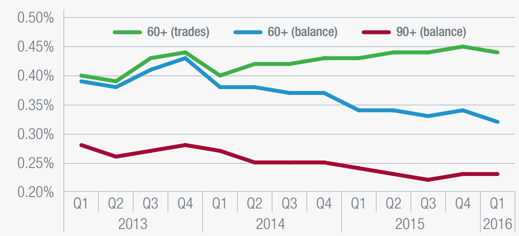
Source: Equifax Data

Fig. 12: Mortgage Growth – Major Centres



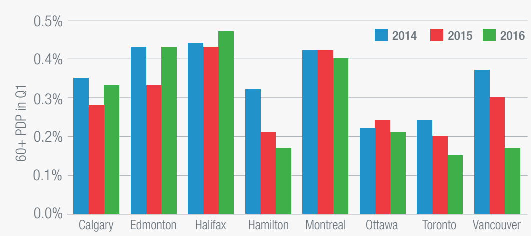
Source: Equifax Data

Fig. 13: Mortgage Delinquency



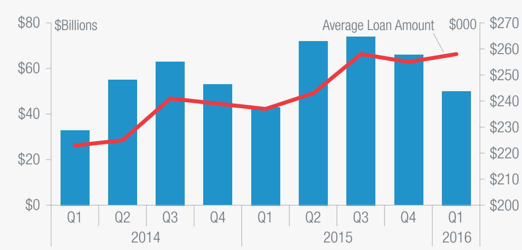
Source: Equifax Data

Fig. 14: Mortgage Arrears



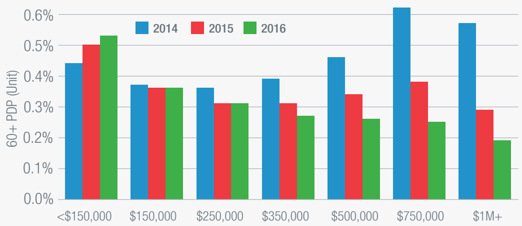
Source: Equifax Data

Fig. 15: New Mortgage Originations



Source: Equifax Data

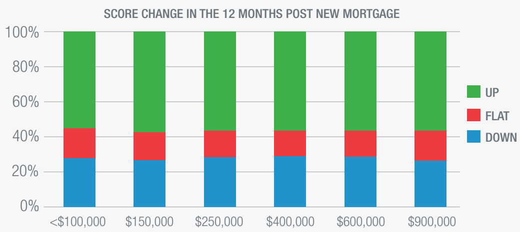
Fig. 16: Mortgage Delinquency by Loan Balance



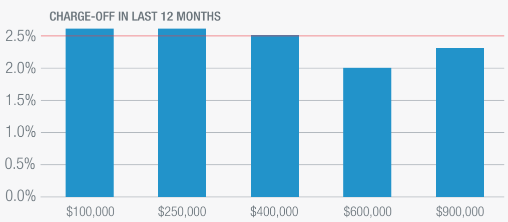
Source: Equifax Data

Fig. 17:

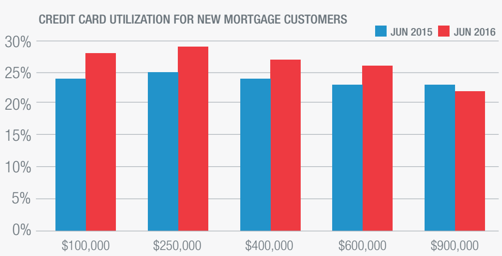
Large Mortgages Show Score Gains...



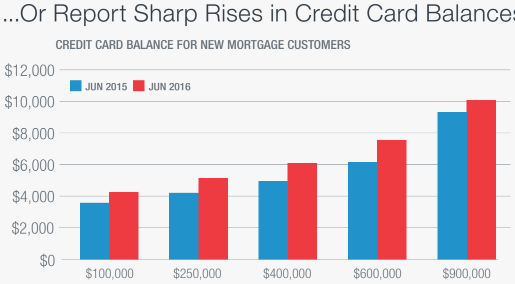
...And Have Modestly Better Early Delinquency



They Do Not Post Jumps in Card Utilization...



...Or Report Sharp Rises in Credit Card Balances



Source: Equifax Data

Early performance for those with large mortgages does not demonstrate cash-strapped consumers. Almost 57% report a higher credit score in the first year of the new mortgage, in line with the average. The likelihood to charge-off any credit product is actually below average and the use of credit cards is up only modestly. The use of other credit products is similar to those with smaller mortgages. (**FIGURE 17**)

THE OIL SLICK IN THE ROOM

Canadian consumers have shown great resiliency and kept delinquencies low despite their rising debt. Though the broad data does not paint a picture of a housing crisis, there are clear warning signs. Danger lies in the medium to longer term should an economic shock hit the system.

At one time Alberta was the poster child of economic strength. Unemployment was well below the national average since December 1988. The province was a magnet for workers looking for big salaries in the oil sands. Delinquency rates and bankruptcies were near historic lows. Alberta was the envy of the other provinces.

The subsequent downtrend since the oil price shock serves as a warning for apathy about the current debt situation. Unemployment is up by more than 200 basis points from 2014 to 7.9% in June 2016. That is a full percentage point above the national average.

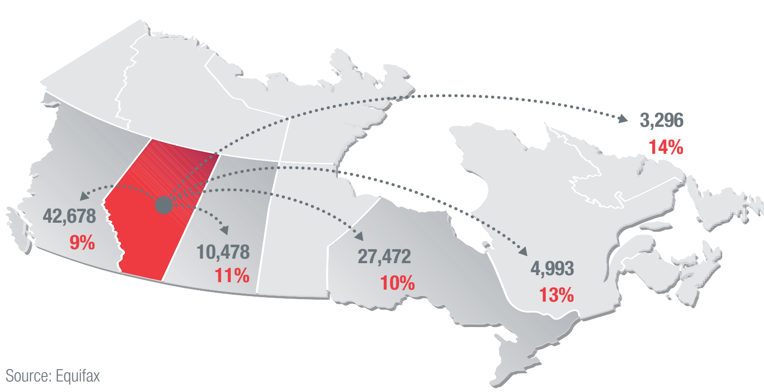
Credit delinquencies have been on a steady march higher as a result. At 1.3%, 60+ day delinquencies are now above the national average of 1.15% and well above the sub-1% levels of the past few years.

Mortgage arrears are also on the rise. Now at 0.43%, the 60+ day delinquency rate for mortgages is up sharply from 0.32% in 2015. While concerning, the current rate is only marginally higher than 2014 and low in historical terms.

Part of the concern in Alberta is the possible contagion effect. Alberta was an attraction for inter-provincial workers. It was an opportunity to make a good wage for low skill roles. As the jobs dried up, many people began to leave Alberta.

Given the nature of their work, it is not surprising that these would represent a higher risk when returning to their home province. On average, these returning workers report double the delinquency of the non-movers in the area.

Delinquency Occurrence For People Leaving Alberta



Source: Equifax

IN SUMMARY

There is little doubt that rising house prices and escalating debt are creating long term risks to the Canadian economy. Inflammatory words like crisis, however, overstate the situation. Traditional measures of indebtedness and housing value fail to capture the unprecedented improvement in the cost of borrowing. Lenders have not lowered their standards, and performance remains stable.

Regulators need to remain diligent but should be cautious in implementing rules to slow down the credit trend. Focus needs to remain on the consistency of credit decisions and verification with greater insight into high risk private mortgages. Misaligned regulations could actually create more risk if it impacts affordability.

A significant economic shock will be the primary instigator of a downturn in the mortgage market. As Alberta illustrates, a sudden change in a local economy will quickly impact credit performance. On its own, the rising debt level is unlikely to cause a sharp deterioration in performance.

With the Canadian economy stuck in a low growth cycle, lenders and consumers need to take steps to mitigate potential downtrends.

IDEAS FOR CHANGING TRENDS

Manage HELOCs

HELOCs are generally under-utilized in Canada and lenders take on unnecessary exposure with the assumption that real estate security mitigates the magnitude of losses. Lenders can reduce capital and exposure by leveraging lower HELOC limits, particularly in markets with reduced equity and housing risks.

Align pricing to risk

Mortgages will remain a highly competitive market with homebuyers shopping for the best rate. In some markets, particularly the prairies, caution is urged with a willingness to miss out. This could include limited use of variable rates for specific vulnerable borrowers.

Stay ahead of the trends

Understanding the direction of key markets and benchmarking against other lenders will ensure risk policies stay in line with emerging trends, as will gaining insights into underlying credit behaviour by measuring changes over time and providing insight into competitor behaviours. Consumers should frequently check their credit files to ensure they have a clear understanding of their personal debt situation.

ABOUT EQUIFAX

Equifax empowers businesses and consumers with information they can trust. A global leader in information solutions, we leverage one of the largest sources of consumer and commercial data, along with advanced analytics and proprietary technology, to create customized insights that enrich both the performance of businesses and the lives of consumers.

Businesses—large and small—rely on us for consumer and business credit intelligence, portfolio management, fraud detection, decisioning technology, marketing tools, and much more. We empower individual consumers to manage their personal credit information, protect their identity, and maximize their financial well-being.

Headquartered in Atlanta, Equifax Inc. operates in the U.S. and 15 other countries throughout North America, Latin America, Europe and Asia. Equifax's common stock is traded on the New York Stock Exchange under the symbol EFX.

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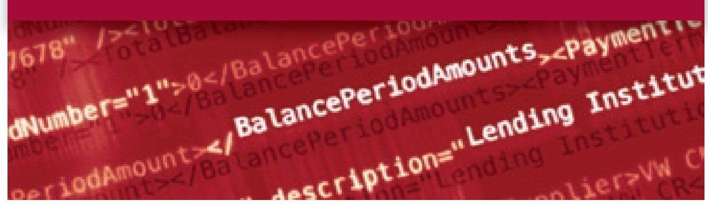
With more than 20 years leading Data & Analytics teams in Credit Risk, Marketing and Loyalty Management, Bill presents complex analytical solutions through meaningful business stories, thinking from the customer perspective to address true business needs. Prior to Equifax, Bill implemented an Analytical Centre of Excellence at Canada Post, consolidating data management, data sciences and data governance. In addition, he led the analytics team at Chase Credit Card Services and managed acquisition credit risk at Citi Credit Cards. Bill holds a MA in Economics from the University of Guelph.



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