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In Focus

June 12, 2020

Income and Debt: Perspective

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CMHC's Latest Tightening Rules—Narrow but Deep

Last week, CMHC introduced modifications for underwriting insured mortgages. Now that we know that private insurers are not joining CMHC in tightening lending standards, we are in a better position to assess the actual impact of CMHC's actions on the market.

The reduction of the gross and total debt service ratios (GDS and TDS) was a move aimed at restraining borrowers who may be accumulating additional debt amidst lower interest rates, and stretching their finances as a result. GDS was lowered from 39% to 35% and TDS was lowered from 44% to 42%. The impact of those moves appears to be marginal, since in the CMHC portfolio less than one fifth of high loan-to-value originations have a GDS of over 35%. Further diminishing its impact is the fact that CMHC accounts for only 15% of total mortgage originations, which suggests an overall impact on only roughly 3% of originations.

The next change was to increase the minimum credit score required for at least one borrower to obtain insurance from CMHC. This appears to be even more negligible in terms of impacting the market. By raising the minimum credit score threshold from 600 to 680, only about 5% of CMHC's originations will be impacted, or less than 1% of total originations. Simply put, insured mortgages are a shrinking target and any policy move directed at this space will have a limited impact from an overall market perspective.

The final modification attempts to ban potential buyers from using non-traditional sources of funding to make a down payment. Those amount to only 15% of down payment funds, and this change is likely to be the least impactful given implementation issues.

The bottom line is that this is not a game changer for the market. But for the narrow segment of borrowers that are impacted, the change is significant, as it might reduce purchasing power by over 10% for an average sized mortgage. Given that these are insured mortgages, first-time homebuyers could see the most significant negative impact, presenting another barrier to entering the housing market after years of unaffordability in some major cities. The moves won't be material on the overall housing market in terms of prices, with our forecast for home prices to fall by 5-10% relative to pre-virus levels into 2021 still being intact, but this will work to remove risk in that narrow slice of the market.

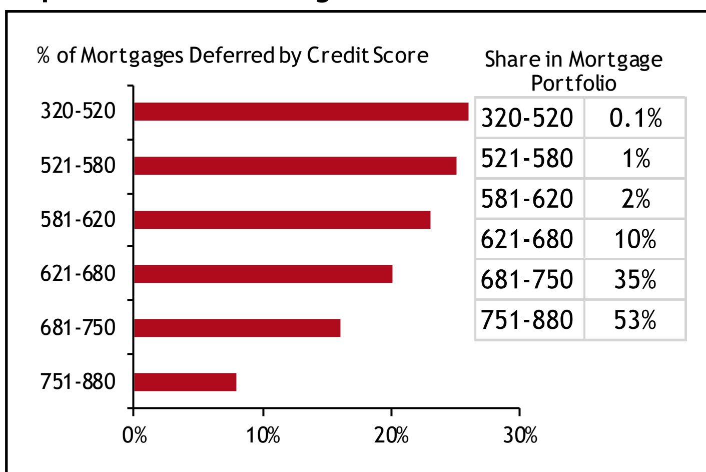
Mortgage Deferrals—a Closer Look

So far, just over 15% of mortgage holders have elected to defer mortgage payments for up to six months. It seems that that process is now slowing down notably with the number of new applications falling significantly in the past few weeks.

The big question here is, what will happen to those mortgages when we reach the end of the six-month deferral period, around October? The head of CMHC stated that "12% of mortgages are in deferral; that could be 20% by Sept. That 20% is at risk

Chart 1

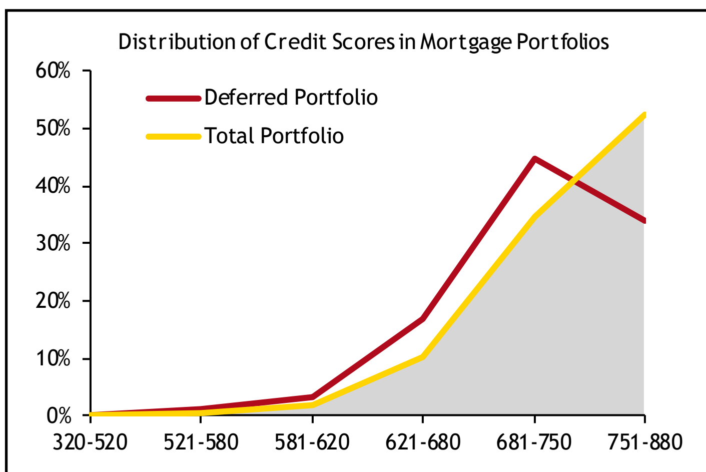
Lower Credit Scores More Likely to Defer, But Represent a Small Weight in Portfolio



Source: Equifax, CIBC

Chart 2

Credit Score Distribution: Deferred vs. Total Portfolio



Source: Equifax, CIBC

of being in arrears 90 days after a required payment is missed." We explore the underlying fundamentals of those who have deferred mortgages so far to show that the 20% risk is overstated.

Let's take a look. Unsurprisingly, the lower the credit score is, the higher the probability of a deferral application. No less than one in four mortgage borrowers in the 320-520 score range are now deferring payments. But as illustrated in Chart 1, that segment of borrowers accounts for less than 1% of the entire mortgage portfolio.

In order to get a sense of the impact on the overall portfolio, we have to multiply that share by the proportion of each credit score range in the mortgage portfolio as a whole. Chart 2 presents the score distribution of the deferred portfolio vs the distribution of the market as a whole. Clearly the distribution of the deferred portfolio is a bit risker (skewed to the left), but close to 80% of those mortgages are above the 680 mark—hardly a portfolio in distress. Granted, a credit score is not the ultimate default predictor, the job market is usually a better indicator here. But given that most of the job loss during the crisis were in low-paying occupations, it's reasonable to assume that the credit score distribution is a good proxy this time around.

Income Assistance Matching Lost Income for CERB Recipients

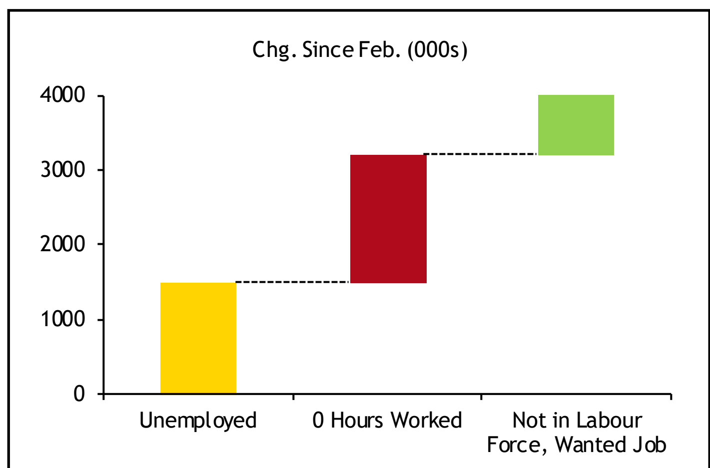
As we all know, the CERB program has been very popular. As of last week, the amount of money distributed reached $43.5 billion. The goal here, of course, is to replace lost income. We did not include the close to $10 billion of income support via the wage subsidies in this exercise.

So the question is, how much income was lost? We narrow in on the lost income of CERB recipients using data from the Labour Force Survey. Weekly labour income averaged around $1,200 a week before the crisis. However, it is well documented that job losses since then beginning of the crisis have been concentrated in low paying occupations. Therefore, it is reasonable to assume that the average weekly income lost was lower than $1,200.

In order to account for the number of CERB recipients that lost income, we combine the number of newly unemployed since February, the net increase in the number of workers that reported zero working hours during the survey period, and the increase in the number

Chart 3

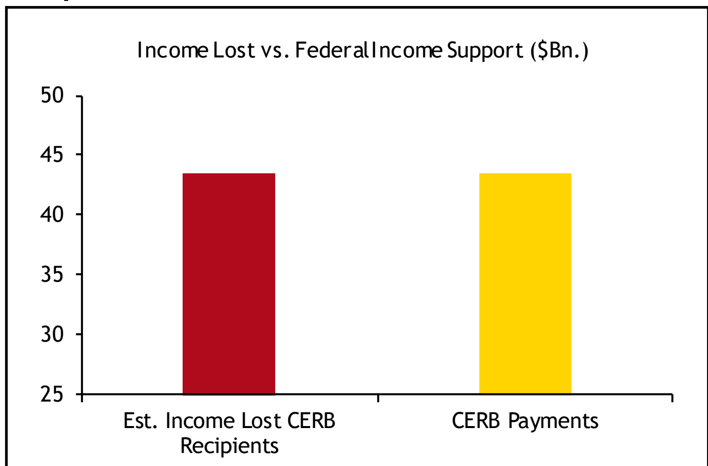
Composition of Lost Income



Source: Statistics Canada, CIBC

Chart 4

Income Assistance vs. Income Lost for CERB Recipients



Source: Government of Canada, Statistics Canada, CIBC

of those who dropped out of the labour force but still wanted to be employed (Chart 3).

Overall, we estimate that total income lost for CERB recipients since mid-March was $43.5 billion. Accordingly, total income assistance from CERB has roughly matched total income lost for CERB recipients (Chart 4). This means that since the beginning of the crisis, personal income in Canada has at least remained stable.

Debt Ratios to Improve—For Now

What about debt? Did Canadians use their lines of credit to compensate for lost income? How big was the decline in credit card balances outstanding? What about the mortgage market?

Chart 5

Recent Trajectory: Selected Credit Products

Source: Equifax, CIBC

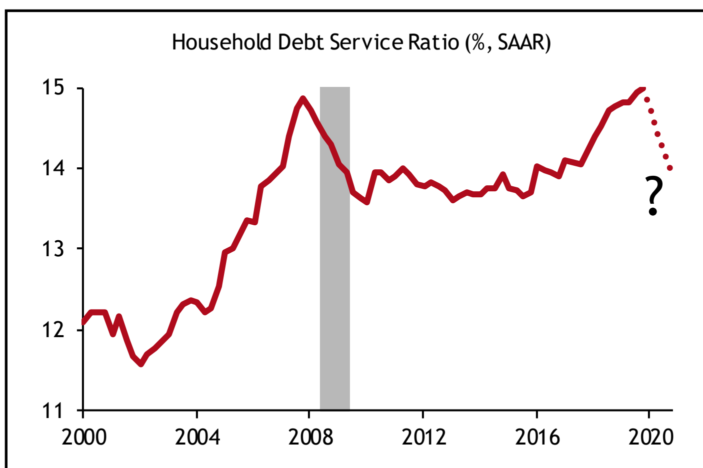
Utilizing information obtained from Equifax, the charts below present those trajectories as of last week. Taking into account some seasonality in the data, the charts show that households reduced credit utilization across most major products. Overall credit has fallen by close to 1% since mid-March, with outstanding balances on credit cards falling by more than 10% since the onset of the crisis– no big surprise. Auto-loans outstanding are down by close to 2.5%. Mortgages outstanding were relatively stable, reflecting deferred payments and a frozen market that is only now starting to wake up. Secured lines of credit have shown some increase in utilization during April and May, but that trend appears to soften lately (Chart 5).

Now, with income assistance offsetting income losses for CERB recipients, and debt outstanding falling, the highly watched debt-to-income ratio is likely now to be stable or even lower than it was before the crisis, a totally different experience than was seen in the 2008 recession, when the debt-to-income ratio rose from 140% to 150%.

The combination of stable incomes, payment deferrals, and lower interest rates, will most likely lead to a notable temporary decline in the debt service ratio, which reached a record high of 15% before the crisis (Chart 6). While such an improvement was seen in all other recessions, the current one will probably be more notable given the large scale of the income and debt payment assistance available to households.

Chart 6

Debt Service Ratio To Fall



Source: Statistics Canada, CIBC

Households appear to have emerged from the depths of the crisis in a relatively healthy position thanks to government assistance. The trajectory of household financial health in the medium term will be a function of how quickly and in what fashion the assistance programs are removed, and to what extent labour income can replace them.

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