In Focus

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ECONOMICS

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Mortgage Stress Test: The Operation Was a Success, But...

by Benjamin Tal

You usually need to be in a recession to see household credit rising this slowly. And most of that slowing is happening in the mortgage space—not exactly surprising, given the ongoing adjustment in the housing market. The market is still in price-searching mode, and the adjustment is not over yet—especially in Vancouver and Toronto. How much of this slowing is due to the gravitational forces of unaffordable markets? Or higher interest rates? Or the impact of the mortgage stress test (B-20)? Of course, there's no way to fully disaggregate those forces. But more than a year after the introduction of B-20, we are in a position to say more about the impact of that change on the trajectory of the market in general, and alternative lending in particular.

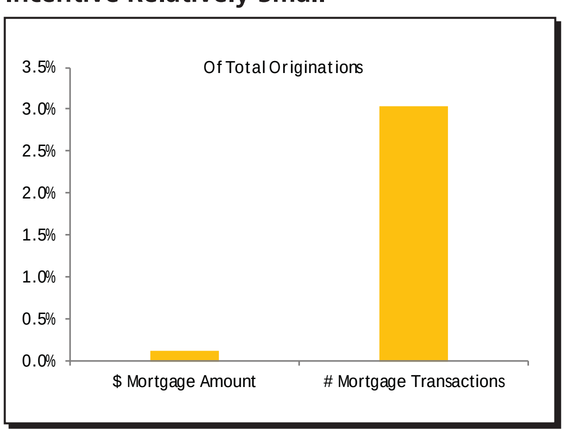
CMHC's Interest Free Loans—Not Big Enough to Make a Difference

First let's get one thing out of the way: yes, home prices in Canada are falling, but many markets remain out of reach to many potential first-time homebuyers. The recent federal budget allocated $1.25 billion over 3 years to try to help here, by providing mid-to low-income first-time homebuyers interest-free loans of up to 10% of the property value towards a down-payment. But as illustrated in Chart 1, this program is simply too small to make a significant difference. We estimate that, fully utilized, this plan will impact only 3% of borrowers and 0.12% of mortgage origination dollars—not quite a game changer.

Growth in Mortgage Originations in Negative Territory

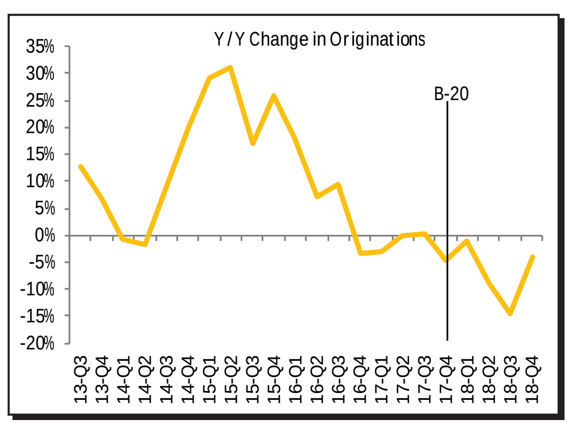
The mortgage stress test took effect in January 2018. The qualifying rate on non-insured five-year fixed-rate mortgages was raised by at least 200 basis points. In today's market you can get a five-year fixed rate of 3.5%, but you must be qualified at 5.5%. What impact did that have on the market?

Chart 1
Scale of CMHC's First-Time Homebuyers Incentive Relatively Small



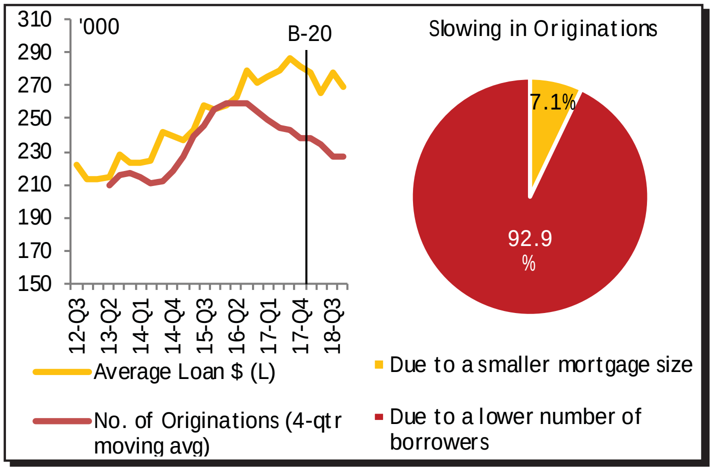
Source: Equifax, CIBC

Chart 2
Mortgage Originations Started to Soften Well Before B-20



Source: Equifax, CIBC

Chart 3
Fall in Number of Borrowers Mostly Behind Softening Originations



Source: Equifax, CIBC

Let's begin with originations. During 2018, growth in mortgage originations continued to decline (Chart 2). The value of new mortgages fell by 8% (or $25 billion) during the year. Note, however, that the slowing in the pace of mortgage origination growth started well before B-20 was introduced. In fact, originations hardly grew at all during 2017. So, B-20 was imposed on a market that was already on a slowing trajectory.

Now, B-20 can impact borrowers in two ways. If you don't qualify under the new provision, you can simply exit the home-buying space, or you can settle by compromising and buying a smaller or cheaper house, accompanied by a smaller mortgage. Chart 3 suggests that the vast majority of the decline in mortgage originations in 2018 was due to fewer borrowers (down by 4.9%), as opposed to a smaller average mortgage. Overall, based on various sources[1], we estimate that B-20 accounted for 50%-60% (or $13-$15 billion) of the overall decline in originations throughout 2018.

B-20 is Working as Planned

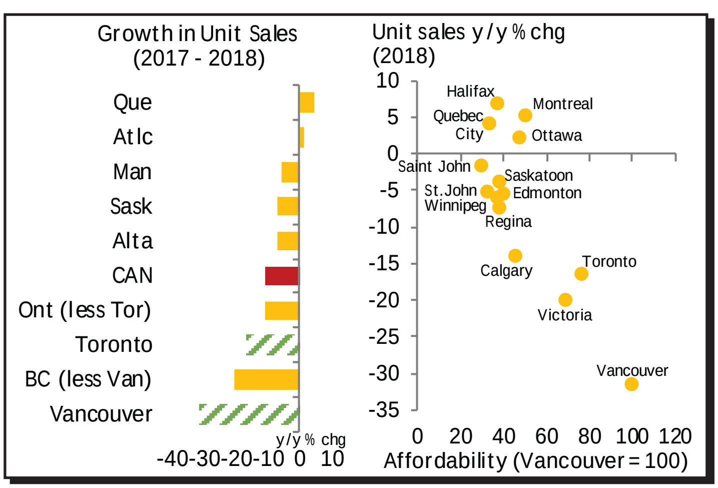
There is little doubt that the architects of B-20 had Vancouver and Toronto in mind when they designed the new rule. The more stretched you are, the more likely you are to fail the test. And from Chart 4, we learn that this is exactly what took place. The damage to the housing market was directly linked to unaffordability.

B-20 was also designed to improve the overall credit quality in the market. And indeed, the share of high-quality mortgages (i.e. credit score >751) in originations is currently at a record-high of more than 52%. Note, however, that this trend of quality improvement was in place well before B-20 was introduced (Chart 5). The 21 policy changes related to residential mortgage lending introduced by governments and regulators over the past decade played a significant role in improving overall credit quality in the Canadian market. The point being that, B-20 was introduced to an already healthy credit market.

Shedding Light on Shadow Banking

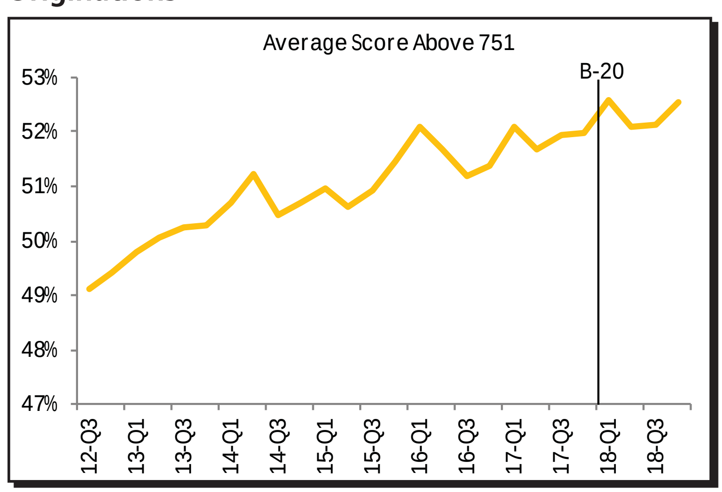
The improvement in credit quality is obviously a good thing. But, is that the full picture? The mortgage credit score information presented in Chart 5—obtained from Equifax—covers roughly 85% of the market. However,

Chart 4
B-20 - Most Effective In Less Affordable Markets



Source: CREA, Statistics Canada, CMHC, CIBC

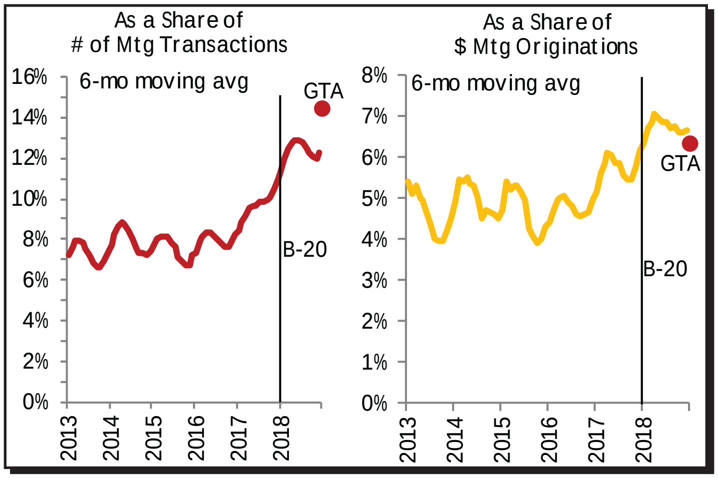
Chart 5
Rising Share of High Quality Mortgages in Originations



Source: Equifax, CIBC

Chart 6

Alternative Lenders



Source: Teranet, CIBC

what is not captured in the data is the credit score of borrowers that don't use traditional lenders. So, to the extent that more borrowers use alternative channels, due to policy changes in general, and B-20 in particular, the market might be riskier than perceived. Let's take a look.

Using information obtained from the Ontario Land Registry, alternative lenders account for close to 12% of the total number of transactions (about 15% for the GTA). A year ago, that number was close to 10%, meaning that alternative lenders' share has risen since the introduction of B-20 (Chart 6). But, what's interesting is that the upward trajectory was established in 2017 when alternative lenders accounted for only 8% of new loans. Over the past two years, mortgage originations provided by alternative lenders rose by a cumulative 27% while originations in the market as a whole fell by 11%. Beyond B-20, that might reflect the impact of the stress test that was imposed on high-ratio mortgages in late-2016 as well as regulatory-related credit restrictions on new immigrants and those self-employed.

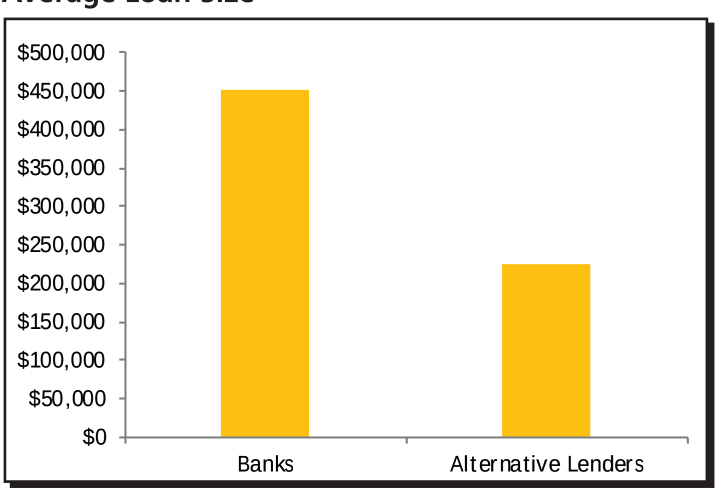
When we calculate the share of alternative lenders in the value of dollar originations, they account for close to 7% of the market—up from 5% in the pre-2017 period. The share of alternative lenders in dollar originations is lower than their share in the number of transactions because their average loan size is roughly half the size provided by banks (Chart 7).

While we are on the subject of alternative lending, let's use this opportunity to dig deeper into the segmentation of that market. Chart 8 presents information pertaining to the composition of those alternative lenders: individual lenders account for just over 50% of all alternative lenders, while institutional lenders—mostly Mortgage Investment Corporations (or MICs)—account for the rest[2]. Also note that we estimate that only 10% of individual lenders in that space consist of family-related loans[3]. In terms of their trajectory, both segments of the alternative lending space witnessed strong increases in activity since 2017 (Chart 9), with the average loan size provided by individual lenders rising more quickly, as shown by the dollar-value gain in their market share (Chart 9, bottom left).

Alternative lending is an integral part of any normally-functioning market. But a fast-growing alternative lending market is not. Behind the scenes, there is a transfer of risk from the regulated to the less regulated segment of the market—from where there is light to where it's dark. That was certainly not the intent of B-20, and any other mortgage-related change to regulations.

Chart 7

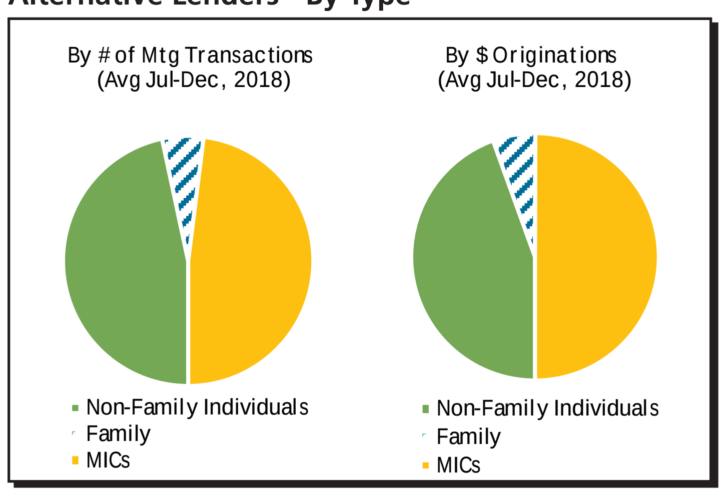
Average Loan Size



Source: Teranet, CIBC

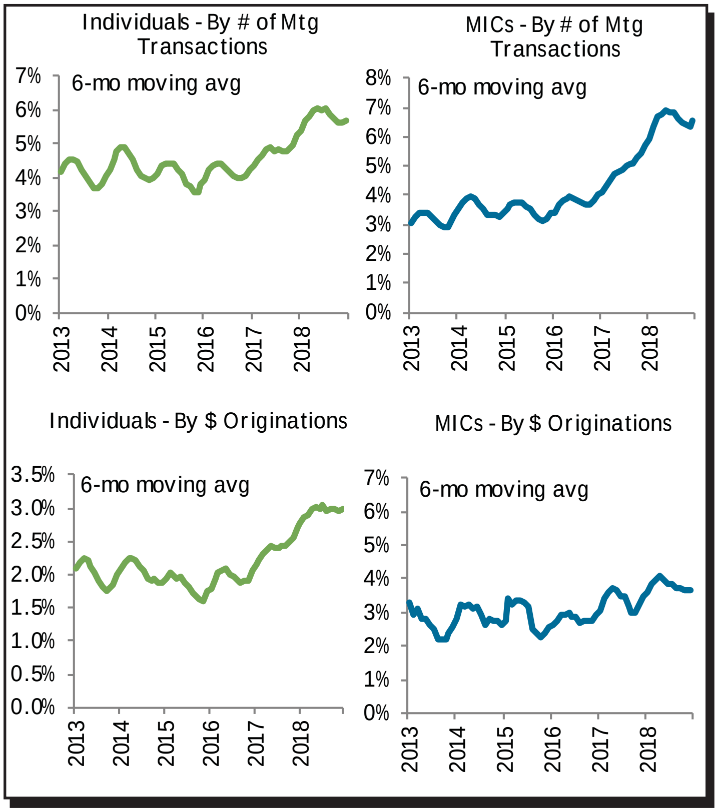
Chart 8

Alternative Lenders - By Type



Source: Teranet, CIBC

Chart 9
Share in Originations



Source: Teranet, CIBC

Now, we must put this into perspective. Zooming in first on MICs, given that MICs focus mostly on short-term loans (median being one year vs. five years for banks) that potentially can be moved elsewhere, the impact on overall mortgage outstanding is limited. Furthermore, limited funding sources put a cap on their ability to aggressively continue to gain market share. That's not the case for private lenders. Their funding model does not require short-term credit, they are free from any regulations, and can potentially continue to gain market share. Accounting for more than 50% of the alternative lending space, this segment of the market is where the regulators' focus should lie.

Time to Rethink B-20?

The stress test imposed on the market was probably necessary, since there was a need to save some Canadian borrowers from themselves. But is 200 basis points the right number? At the end of the day, there is no real science behind that number. Let's remember that the rule was introduced in an environment of an already slowing market, and that since then, the Bank of Canada has hiked rates by 75 basis points, and the five-year mortgage rate has risen by 35 basis points.

Furthermore, 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.

Accordingly, regulators should revisit B-20. We need a more flexible benchmark, potentially a narrower spread over the contract rate when interest rates approach cyclical peak, and perhaps to establish a reasonable floor under which the qualifying rate will never drop below.

Note

1. *Sources: CIBC, Equifax, MPC.*
2. *Since MICs dominate this group, from this point forward we refer to it as MICs.*
3. *This was done by matching the names of lenders and borrowers.*