CANADA'S HOUSING MARKET

October 17, 2017

As expected, OSFI tightens rules for non-insured mortgages

Starting on January 1, 2018, residential mortgage borrowers with a down payment of more than 20% will need to qualify at a significantly higher rate when they do business with a federally-regulated mortgage lender. This was officially announced today by the Office of the Superintendent of Financial Institution (OSFI) as part of final revisions to so-called Guideline B-20 on residential mortgage underwriting and procedures. The change isn't a surprise, though, because a close version of it was included in a draft circulated by OSFI in July. And superintendent Jeremy Rudin recently expressed the view that such a move was necessary to further safeguard Canadian households and the financial system.

Under the revised guideline, federally-regulated financial institutions (FRFIs) must set the qualifying rate for non-insured mortgages at the greater of the contractual mortgage rate plus 2 percentage points or the five-year benchmark rate published by the Bank of Canada. This brings the qualifying rules for FRFI non-insured mortgages more closely in line with those for insured mortgages (which were tightened a year ago).

The higher qualifying rate clearly represents a very stringent 'stress test'. For example, to be able to buy the same average home in Canada (slightly over $500,000) after the change, a buyer will be required to have a minimum income that is $16,000, or 18%, higher than is currently needed based on the increase from the current five-year rate (3.49%) to a rate that's 2 percentage points higher. This will be an impossible rise for many buyers. Indeed, Canada's large banks recently estimated that approximately 10% of their mortgage originations will be negatively affected by the change. The new rule doesn't require financial institutions to re-qualify borrowers at the end of their term if they renew at the same institution.

We expect that, following a brief run-up in activity fueled by buyers rushing to lock-in existing qualifying criteria, the change will have a dampening impact on the housing market shortly after it comes into effect in January. It has the potential initially to rock the market because non-insured mortgages represent a large share of the mortgage market. Roughly 45% of domestic banks' mortgage portfolios and more than 70% of originations are non-insured. Nonetheless, the ultimate impact on the housing market will depend on the extent to which borrowers will 'migrate' to non-federally regulated mortgage lenders that will not be subject to the new OSFI rule. These lenders include provincially regulated credit unions and caisses populaires. Our view is that such migration is likely to be material.

While today's announcement poses downside risks to our recently-released housing forecast, we believe that the most likely outcome for Canada's market remains a soft landing. We expect that, at the margin, the higher qualifying rate will drive some buyers out of the market and reduce the budget of others next year—both factors adding downward pressure on prices. Yet the odds of a crash landing are still low. Longer term, OSFI's revised guideline will enhance the resilience of Canada's households and financial system in the face of various potential shocks.

Other revisions to the B-20 guideline include more stringent requirements for the measurement of loan-to-value (LTV) ratios and more explicit restrictions on co-lending arrangements. We expect minimal impact on the housing market from these other changes.

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