# Canada: The doomsday view of the mortgage market

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Canwest News ServiceFormer Tory Cabinet Minister Garth Turner has been forecasting for years a crash in Canada's long-running housing market boom. So far he has been wrong but Turner's day may yet come.



For years Garth Turner has been telling anyone who will listen that Canada's long-running housing market boom is about to crash. The politician-turned-financial commentator has been wrong so far, much to the delight of realtors, bankers and homebuilders. But, like the boy who cried wolf, Turner's day may have come.

How bad could things get?

"If you bought in '08 you better be damn sure that your income will be 40% higher in order to qualify for the same mortgage at renewal time," says Turner. "I just can't see economy of Canada percolating enough over the next three years in order for people to reap those huge salary increases."

Even the Bank of Canada seems to agree things are not looking particularly rosy. The central bank's latest Financial System Review indicates that almost 6% of Canadian households are vulnerable to rising interest rates because servicing their debts eats up more than 40% of their gross income. A 300-point rise in interest rates would increase that number to 8.5%. And yet mortgage credit is rising at more than 7% a year and the household debt-to-income ratio is at an all-time high. Something has to give when interest rates undoubtedly start rising this year and it just might be the housing market.

To put it into dollar terms, a $300,000, five-year mortgage amortized over 35 years sets you back about $1,360 a month at today's rock-bottom interest rates of around 4.2%. But if rates rise to, say, a not unreasonable 7% when that mortgage comes up for renewal, your monthly payment will be almost $1,840. If rates jump to 10%, you'll end up paying about $2,400. And if rates return to the bad old 20% days of the early 1980s, your bill will be $4,480 and you'll still pay off less than $1,500 on your next five-year term. Few people could take that kind of hit.

The harsh truth is that while those attractive 5%-down/35-year mortgages-and 0/40 ones before them-allow more people to buy, especially when interest rates are so low, not much is taken off the principal in the first five years.

Worse, real estate prices may decline in your particular neighborhood, meaning you could very easily owe more than your home is actually worth. That's called negative equity and just the prospect of it could send homeowners, especially first-timers, into panic mode, flooding the market with new listings that would further deflate the market.

That chain of events is what keeps Turner up at night. "We're at the highest price point in Canadian history; mortgage indebtedness has never been higher; and household finances have never been worse," says Turner. "And 2010 contains the seeds potentially for the start of a fairly significant market correction."

Those seeds include rising interest rates in July, August and September, the Harmonized Sales Tax in July, which will put a new tax on new homes in Ontario and British Columbia, and maybe even a move by Finance Minister Jim Flaherty to enforce a 10% down payment rule on new mortgages. All of which could flatten the market.

"If we have a real estate correction of even 10%, which is not much given the increases we've seen in Toronto, Vancouver and Calgary, we'll see a lot of buyers from the last three years with negative equity," says Turner. "That helps to accelerate a 10% market decline into a 15% decline, maybe even 20%, and that starts to impact other people who have bought in the past four or five years."

There is likely some sort of correction looming, but it may not be a crash similar to the one that crippled the United States, where so-called NINJA loans were handed out to people with no income, no jobs and no assets. Benjamin Tal, a senior economist at CIBC World Markets, believes only 4% of Canadian households are vulnerable to interest rate increases and that most home owners will be able to absorb modest hikes.

Even though Tal says the $350,000 tab for an average home is about 7% higher than market fundamentals such as rates, income growth and demographics would suggest, there no cause for panic in the short term. Indeed, most economists believe rates won't rise until mid-year-and then only by 100 points when they do. And, says Tal, many Canadians have some built-in defences.

For one thing, only about 350,000 of the five million Canadian households that have a mortgage are in a high-risk position, meaning they have a loan-to-value ratio of more than 80% and a debt-service ratio greater than 40%. That means most people have already built up some equity in their homes, giving them the option of downsizing if mortgage rates skyrocket. For another, 80% of those in the at-risk category who bought a house in 2009 took out five-year, fixed-rate mortgages, providing them protection until 2014.

Tal also points out that four in 10 Canadian households have accelerated mortgage payments (for example, paying bi-weekly instead of semi-monthly), meaning they can effectively absorb the first 75 points of any increase by simply decelerating. It's also worth pointing out that a higher unemployment rate has had historically more effect on mortgage defaults than higher interest rates.

"If we're talking about a 200-300-point increase, clearly there will be some impact. It will lead to stagnation in the housing market and when I say stagnation, I mean a leveling off, not a crash," says Tal. "If interest rates go to 10, 12, 13%, it won't be pretty. Then housing prices will fall."

If that happens, nobody should expect relief from the Bank of Canada. "The Bank of Canada will raise interest rates if there's a need, regardless of the housing market," says Tal. "The housing market is not the chief factor." In other words, you're on your own.