ECONOMIC VIEWPOINT

Mortgage Debt in Canada:

A Ticking Time Bomb?

By Royce Mendes, Managing Director and Head of Macro Strategy, and Tiago Figueiredo, Associate – Macro Strategy

Canadians shoulder a high level of household debt. While strength in underwriting standards suggests there is some buffer for households, the sharp increase in interest rates is likely to cast a long shadow for years to come. In the near term, many lenders have been flexible with borrowers, but that flexibility could cause issues down the road. Our simulations indicate that many mortgage holders will face a large increase in their monthly mortgage payments, which could be as high as 40% at renewal. That suggests that Canadians will continue to dedicate an elevated share of their income towards debt payments. While this doesn't put Canada on the verge of catastrophe, it will be a structural factor that could weigh on Canadian economic growth over the medium term.

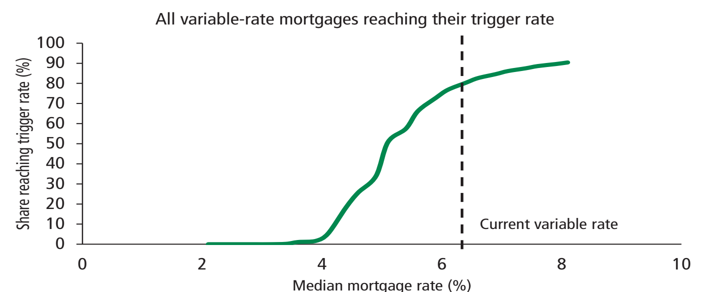
Canada is notorious for the high levels of debt shouldered by households.

Global investors consistently analyze the economy through the lens of this key risk. The strength in underwriting standards and high levels of capital and liquidity held by banks have historically helped the country avoid the catastrophes faced by other nations with high household debt ratios. Over the years, the resiliency of the financial system has been reinforced with additional regulations further strengthening the macroprudential landscape. But more recently, it's still taken some unusual tactics on the part of financial institutions to skate around potential problems.

When the facts change, it's time to run some more simulations. Lenders are making surprising accommodations for troubled borrowers. That's removed some near-term downside risk from our Canadian economic forecasts. Of the roughly three quarters of all variable-rate mortgages that have hit their trigger rate (graph 1), many are not being asked to make additional payments on these fixed-payment variable-rate products. But the money owed still needs to be paid back. The question is whether this is a ticking time bomb with the detonation set for a couple of years in the future.

For the moment, the extra interest owed on variable-rate products that have reached their trigger rate is being added to the principal amount outstanding. A number of financial institutions have disclosed that they will allow the principal owed to grow to 105% of the original loan value before requiring any additional payments. That's a high bar to exceed. Our latest simulations show that leaving the policy rate on hold through 2024 would not see any mortgages breach that threshold. In fact, the Bank of Canada would have to raise rates to almost 7.00% by July and leave them unchanged until the end of 2024 for the worst-off borrowers to owe more than 105% of the original loan value before renewal. As a result, many of the 75% of variable-rate mortgages that have hit their trigger rate will not feel the full pain of higher rates until renewal.

GRAPH 1
More than Three-Quarters of All Variable-Rate Mortgages Have Breached Their Trigger Rate, but Not All Lenders Are Enforcing Additional Payments



Sources: Bank of Canada and Desjardins Economic Studies

The immediate impact of the accommodation afforded to borrowers is that a growing share of mortgages on the

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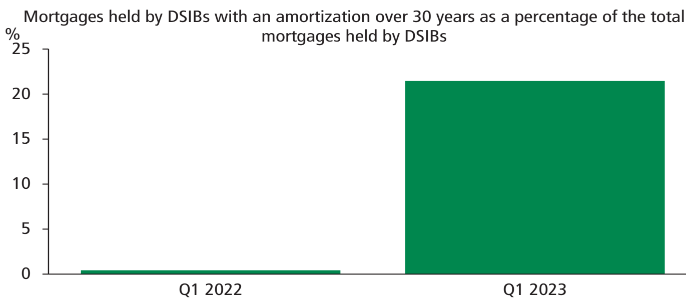
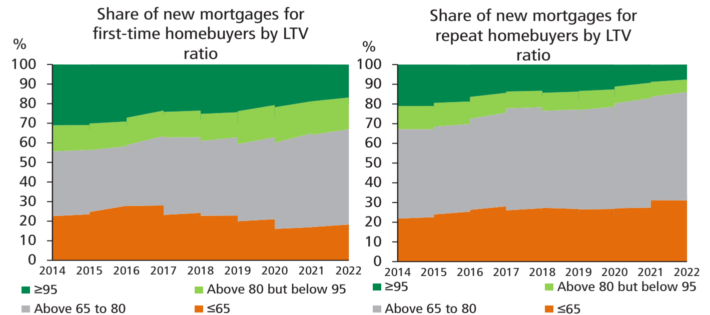
books of Canada's largest financial institutions now have amortization periods of 30 years or more (graph 2). The Office of the Superintendent of Financial Institutions (OSFI) is watching this closely. Recently, the regulator stated that it's considering whether the capital that financial institutions hold against these mortgages is sufficient. That comes on top of the tougher lending requirements OSFI proposed earlier in the year. Furthermore, the regulator has recognized how quickly bank runs can happen in this new digital age and has said it is intensifying its focus on liquidity. In the face of a potentially heavier regulatory hand and an uncertain economic outlook, non-price lending conditions are tightening, adding to the restrictive impacts from higher interest rates.

GRAPH 2
Banks Are Being More Flexible with Mortgage Repayments, and That's Leading to Longer Amortization Periods



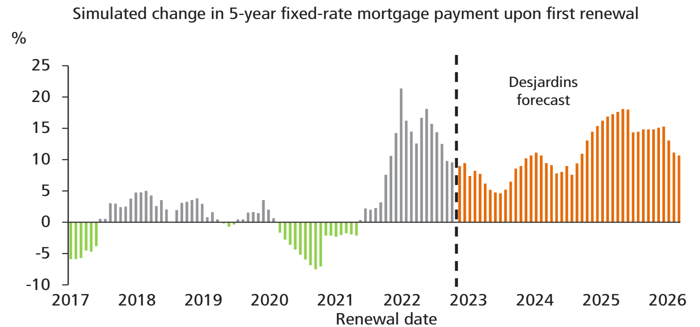
DSIB: Domestic systemically important bank
Sources: Bank financial documents and Desjardins Economic Studies

GRAPH 3
First-Time Homebuyers Have Less Equity than Repeat Homebuyers



LTV ratio: Loan-to-value ratio
Sources: Bank of Canada and Desjardins Economic Studies

GRAPH 4
5-Year Fixed-Rate Mortgages Are Renewing with Payments Up to 10% to 20% Larger



Sources: Bank of Canada and Desjardins Economic Studies

The following simulations focus on borrowers that will face the greatest challenges: households with mortgages up for renewal for the first time, five years after they originated the loan. Roughly half of the homes sold in any given year are to first-time homebuyers, so the group renewing for the first time is not a small one. These borrowers generally have less equity in their homes (graph 3) and lower incomes. As a result, they face the greatest hurdles at renewal.

According to our calculations, fixed-rate mortgages taken out five years ago have already been renewing with materially higher payments over the past year (graph 4).

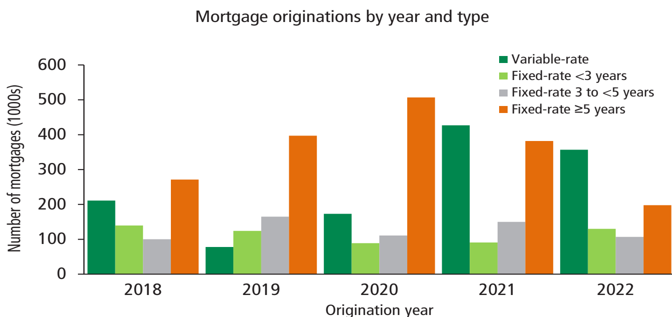
While we expect payment shocks to wane for five-year borrowers renewing in the coming months, the forecasts embedded in our simulations use our interest rate outlook as an input, which is more dovish than the consensus. We expect the Bank of Canada to begin cutting rates around the turn of the year, ending 2024 with a 2.50% policy rate. That, in addition to the fact that these borrowers originated their mortgage in 2019 when rates were at cyclical peaks, should see five-year borrowers renewing in 2024 face less of a shock than those renewing today.

While there were some mortgages with terms of less than 5 years taken out in 2020 and 2021 that are facing renewal this year or will be in 2024, they're not very large in share or absolute numbers (graph 5 on page 3). So a reprieve for the economy in 2024 seems likely, albeit temporary. Our work shows that fixed-rate borrowers renewing in 2025 and 2026 for the first time five years after they bought their house will see payments rise roughly 15% even with our dovish rates forecast. Many households will likely be facing such a shock since fixed-rate mortgage originations with five-year terms surged in 2020.

That said, variable-rate borrowers renewing for the first time will face the greatest shock of all at renewal.

According to our simulations, to remain on the original amortization schedule when renewing their mortgage, variable-rate mortgage holders have already been seeing fixed payments increasing more than 30% (graph 6 on page 3). Borrowers can make a lump sum payment at renewal to reduce the payment shock. But our simulations find it's currently taking a lump sum payment equal to roughly 20% of the original loan value to keep the payments unchanged (graph 7 on page 3). To put that in perspective, a first-time homebuyer who purchased a house in 2018 for $1,000,000 and put $200,000 down

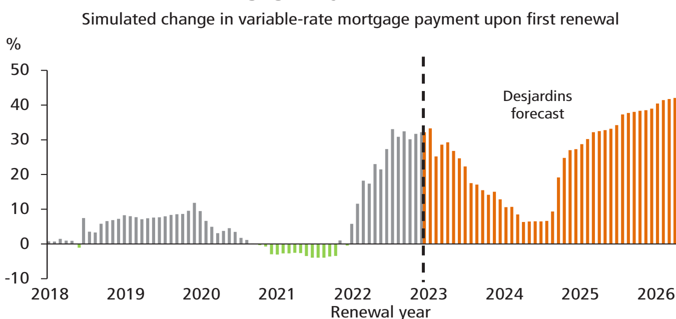
GRAPH 5
Not Many Fixed-Rate Mortgages with Terms of 3 Years or Less Were Originated during the Pandemic



Sources: Bank of Canada and Desjardins Economic Studies

would need to put up another $160,000 to keep their monthly mortgage payment steady. Those are the two extreme cases where either the borrower makes no lump sum and sees the shock fully reflected in the monthly payment or makes a lump sum that would keep the monthly payment the same. Many borrowers will of course do some combination of both. But any way you slice it there will be pain, particularly if rates don't fall as much as we forecast.

GRAPH 6
Variable-Rate Mortgage Holders Are Expected to See the Largest Increases in Their Mortgage Payments



Sources: Bank of Canada and Desjardins Economic Studies

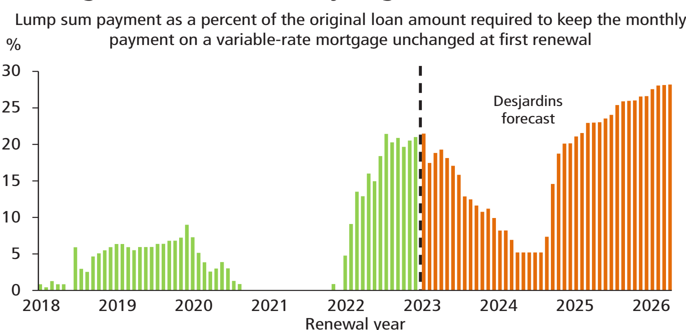
As with fixed-rate mortgages, there will be a bit of a reprieve in 2024. But in the case of variable-rate renewals, the situation gets ugly in 2025 and 2026 for many borrowers. Variable-rate mortgage holders on five-year terms could see payments spike more than 40% in 2026 or be required to make a lump sum payment of almost 30% of the original loan value to keep the monthly payment unchanged. Variable-rate mortgage originations surged in 2021 to more than half of the total share of mortgages, so it's safe to assume that 2026 will see many Canadians in these situations.

It is true that our simulations don't take into account any potential mitigation strategies.

Many borrowers will try to extend the amortization of their mortgage to reduce the payment shock at the time of renewal. But that's hardly a foolproof plan. Fixed-rate borrowers facing renewal for the first time might have some success with this strategy, but changes to the borrower's employment situation, the value of their home or the interest rate environment could all make it more challenging to pass a stress test. A variable-rate borrower who has paid down barely any principal because of the sharp rise in interest rates will face another hurdle.

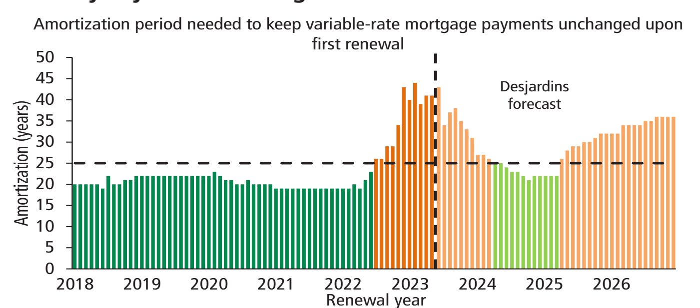
To keep the monthly payment the same as before without making any lump sum payments, the amortization would have to extend to almost 40 years at renewal in some cases (graph 8). The Canadian Housing and Mortgage Corporation has stated that it has no plans to extend the maximum 25-year amortization for insured mortgages. For uninsured mortgages, the federal government has stated that, when extending the amortization for troubled borrowers, the commercial banks must ensure the amortization period remains "reasonable." There's been no additional guidance about what's "reasonable" and what's not, but anything above 35 years doesn't seem likely to be eligible. Without any lump sum payments, some previously uninsured variable-rate borrowers might also need to purchase

GRAPH 7
Lump Sum Payments Needed to Keep Mortgage Payments Unchanged at Renewal Are Very Large



Sources: Bank of Canada and Desjardins Economic Studies

GRAPH 8
An Increasing Share of Renewing Mortgages Will Have to See Their Amortization Periods Extended Significantly to Keep Their Monthly Payments Unchanged



Sources: Bank of Canada and Desjardins Economic Studies

mortgage insurance if they try to extend the amortization and the loan-to-value ratio has risen above 80%.

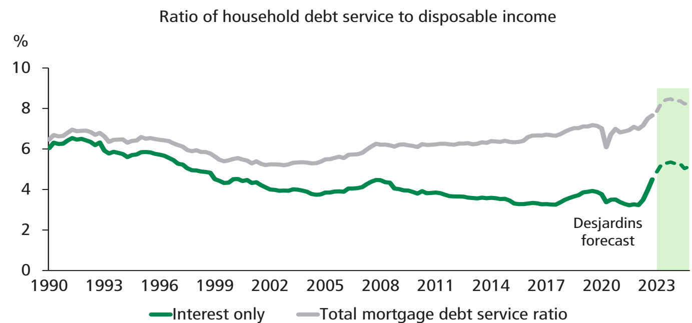
Other tactics for cushioning the blow won't be available to all borrowers at renewal. To make lump sum payments, some borrowers might make a withdrawl from the bank of mom and dad. That, however, seems like a small group. Assuming that many of these borrowers already would have gone down that route at the time of purchase, there might not be as many resources to pull from at the time of renewal. Others might be able to draw down on pandemic-era savings. However, excess savings no longer look as elevated relative to spending. Part of that is a result of inflation, which means those dollars saved don't buy as much as they used to. Whenever it's used, that cash will be distributed across a number of sectors which have all seen prices rise dramatically since 2019.

Some households might assume that pay increases will help them cushion the blow by the time their mortgage is up for renewal. But recent pay increases have not made up for the purchasing power lost to the high inflation of the past couple of years. Moreover, compensation per hour worked only barely stayed ahead of inflation pre-COVID. So while it's true that wage growth might help, it will most likely be nowhere near enough to offset the payment shock at renewal. It's also true that the Bank of Canada's efforts to bring the labour market into better "balance" will likely negatively affect the employment situation of some borrowers.

While there is a lot of uncertainty about what will happen between now and 2025, we do know that Canadians are already paying more towards their mortgage as a share of their income than they have since at least 1990.

Our forecasts suggest that ratio is set to rise further even though the total debt service ratio in Canada began the year 5 percentage points higher than that of the next-highest G7 economy. Extending amortizations on mortgages could also see the household debt-to-income ratio rise further as older borrowers are paying down debt at a slower pace than before, while new borrowers are accumulating debt at the same pace as before (graph 9).

GRAPH 9
Debt Service to Disposable Income Is Expected to Remain Elevated



Sources: Statistics Canada and Desjardins Economic Studies

None of this is to say that Canada is on the verge of catastrophe—certainly not the housing market, which should continue to be supported by strong population growth. Relative to the US right now, there's less of an inflation problem, a more resilient banking sector and no debt ceiling shenanigans. But mortgage renewals are counting down in the background. Borrowers can use a combination of mitigation strategies to deal with the shocks. However, those are not foolproof, and the market has seemingly yet to catch on to the complications the Canadian economy will face.

While 5-year US Treasury yields are already trading 40bps higher than 5-year Government of Canada yields, that spread could widen as the market recognizes the difficult path ahead for Canada. Spread widening could extend further out the curve, particularly if the Bank of Canada restarts bond buying while the Fed allows its balance sheet to continue shrinking. A more pessimistic view of Canada could also put downward pressure on the exchange rate. This all assumes the US economy avoids some of the near-term potholes that lie on the road ahead and that its economy isn't mired in a crisis in two years' time. But that is our base case outlook. Unless Canadian policymakers lean into this problem, our medium-term outlook will remain more pessimistic for Canada than the US.