October 3, 2011

Memorandum to: Canadian Home Builders' Association

From: Altus Group Economic Consulting

Subject: Are Further Measures Needed to Cool the Canadian Housing Market?
Our File: P-3812

CHBA has asked Altus Group to provide an analysis on macroprudential policy measures, and on the question of whether further measures are needed to cool the Canadian housing market.

In the aftermath of the financial crisis, central bankers and government officials began to take a more active role in preserving financial stability through so-called "macroprudential" policies. Broadly speaking, macroprudential policies are distinct from traditional fiscal or monetary policies, and aim to use regulation and rules to control the quality of activity in the financial economy and to control asset prices, including housing. Studies show that macroprudential policies are useful in mitigating, although to a limited extent, the build-up of risks in the financial system and providing substantial loss absorbency capacity to financial institutions.

Most macroprudential housing-related policies are linked to mortgage financing. Some commonly used policy tools, internationally, include:

- Altering the allowable loan-to-value ratio for mortgage loans;
- Introducing a surtax on property "flipping" (the selling of a property shortly after purchase);
- Adjusting requirements related to government-backed insured mortgages;
- Altering the allowable debt-to-income or debt-service ratios related to the eligibility for new loans or mortgages; and

- Adjusting banking regulations on loan loss provisions and capital requirements for real estate related debts.

During the last several years, many countries have introduced macroprudential policies that help restrain housing price appreciation and prevent the formation of real estate bubbles similar to the ones in the United States before the financial crisis. Figure 1 illustrates recent examples internationally of measures aimed at curbing housing price growth and improving financial stability. Generally:

- China has the most restrictive macroprudential housing policies, due to growing concerns that its housing markets may be overheating;
- Most countries use the loan-to-value ratio as a tool to prevent housing bubbles; and
- Many policies are designed to prevent the flipping of properties and discourage real estate speculators.

In Canada, to support the long-term housing market and financial stability, the federal government has introduced various macroprudential policies related to mortgage financing over the last several years.

In October 2008, the federal government tightened its minimum standards for the government-backed mortgage insurance, including:

- Fixing the maximum amortization period for new government-backed insured mortgages to 35 years from 40 years;
- Requiring a minimum down payment of 5% for new government-backed insured mortgages;
- Establishing a consistent minimum credit score requirement;
- Requiring the lender to make a reasonable effort to verify that the borrower can afford the loan payment; and
- Introducing new loan documentation standards to ensure that there is evidence of reasonableness of property value and the borrower's sources and level of income.

In April 2010, the federal government took additional measures to ensure the long-term stability of mortgage financing in Canada, including:

- Requiring that borrowers meet the standards for a five-year fixed rate mortgage even if they choose a mortgage with lower interest rate and shorter term;
- Lowering the maximum amount Canadians can withdraw in refinancing their mortgages to 90% from 95% of the value of their homes; and
- Requiring a minimum down payment of 20% on non-owner-occupied properties purchased for speculation.

In January 2011, further adjustments to the rules for government-backed insured mortgages were announced by the federal government, including:

- Reducing the maximum amortization period to 30 years from 35 years for new government-backed insured mortgages with loan-to-value ratios of more than 80%;
- Lowering the maximum amount Canadians can borrow in refinancing their mortgages to 85% from 90% of the value of their homes; and
- Withdrawing government insurance backing on lines of credit secured by homes, such as home equity lines of credit.

Over and above the various policy rules, it is also important to keep in mind the long-standing role CMHC has played in ensuring the stability of Canada's housing finance system by "managing its mortgage loan insurance and securitization guarantee programs in a responsible, commercially-viable manager, at no cost to the Canadian taxpayers."[1] As the backbone of the housing finance system, CMHC works closely with lenders and mortgage brokers to provide insights into market trends, and constantly monitor and adjust its risk assessment models according to market conditions. CMHC has a "longstanding history helping Canadians make sound housing decisions".[2]

Recently, there have been calls for the Government of Canada to further tighten mortgage insurance rules to restrain growth in household debt and housing prices in Canada:

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[1] CMHC, *Canada Mortgage and Housing Corporation: At the Heart of Housing - 2010 Annual Report*, 2011, page 7.

- Craig Wright, chief economist at RBC Financial has recently suggested that even with the tighter mortgage measures, mortgage rules are still much looser than they were ten years ago – the required down payment used to be 10%, compared to 5% now, while amortization was previously a maximum of 25 years. Furthermore, the qualification for mortgage insurance had been 25% and is 20% today. Mr. Wright thinks that "there is still, if need be, some room to move back to where we were. We may not need to go back there, but there is an option if we don't see any moderation in debt going forward"[3] ; and

- Craig Alexander, chief economist at Toronto-Dominion Bank states that "given the limitations on monetary policy, which cannot target one segment of the economy, there might be a need to further tighten mortgage insurance rules if consumer debt growth accelerates once again."[4]

However, recent developments in Canada's mortgage market shows that already-introduced policies are taking effect and risks of financial instability are dissipating:

- Figure 2 shows that year-over-year growth in total household debt has stabilized recently, supported by the large decline in consumer credit;

- The growth in mortgage debt is still strong, although largely due to temporary factors. The April, 2011 mortgage rule changes likely brought forward some mortgage activity that would otherwise have taken place later. Also, the strong sales of existing homes in late 2010 continued to fuel credit growth well into 2011. However, since the resale market has moderated over the last several months, the demand for mortgage financing should also decline over the coming months;

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[2] Ibid. Page 10.

[3] Financial Post, Low Rates Could Spure Mortgage Rule Change, published on September 8, 2011.

[4] Globe and Mail, *Rules Changes Spark Drop in Refinancing: CMHC*, published on August 29, 2011.

- The level of concern over credit being expressed by the Bank of Canada appears to be abating; it has recently said: "the growth of household credit will likely moderate from the pace observed in early 2011 to a rate closer to that of deposable income"[5]; and

- CMHC recently announced that that mortgage refinancing activity declined nearly 40% since the federal government introduced its latest mortgage insurance rules early in 2011. In addition, "after implementation, the purchase of CMHC's Homeowner mortgage insurance initially fell by approximately 10% and by the end of June was at approximately 5% below pre-implementation levels".[6]

In addition, the rapid growth in national housing prices over the last few years, as measured by MLS® data, and as widely reported in the news media, is largely biased by activities in Vancouver and Toronto:

- The average price of existing homes has rapidly appreciated over the last several years in Canada. However, most of this increase is driven by notable high-end transactions in Vancouver and Toronto. It is thought that these transactions are likely driven by foreign investors (thus, not largely controllable through the macroprudential policies under consideration);

- The average price of existing homes in Canada (excluding Vancouver and Toronto) was $294,000 in August, much lower than the "headline" national average of $363,000 (Figure 3). Recently, growth in average house prices has levelled off, and even declined in recent months; and

- Data from Statistics Canada shows that the growth in new house prices decelerated last quarter (Figure 4) – new house prices in Canada grew at less than 2% year-over-year. In B.C., the new housing price has declined over the last two quarters. Elsewhere, growth in new housing price has moderated except in Ontario.

Conclusion:

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[5] Bank of Canada, *Financial System Review*, June 2011, page 20.

Macroprudential policies are being increasingly relied on as tools to control asset prices and financial system stability. Canada has introduced several measures in recent years to control housing and debt market conditions, over and above traditional fiscal and monetary policy tools. Concerns over household debt conditions in Canada, alongside seemingly strong housing prices, have had some suggest that more such measures could be ahead.

Recent housing market performance alongside recent data on the performance of household balance sheets suggest that policies already introduced are probably already having the effect of cooling the market, and further measures are unnecessary. Moreover, with housing prices already flat or falling in Canada, and consumer deleveraging emerging, there is a risk that further measures undertaken by government to cool the housing market could have longer-term pernicious effects.

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[6] CMHC, *Quarterly Financial Report*, June 30, 2011, page 7.

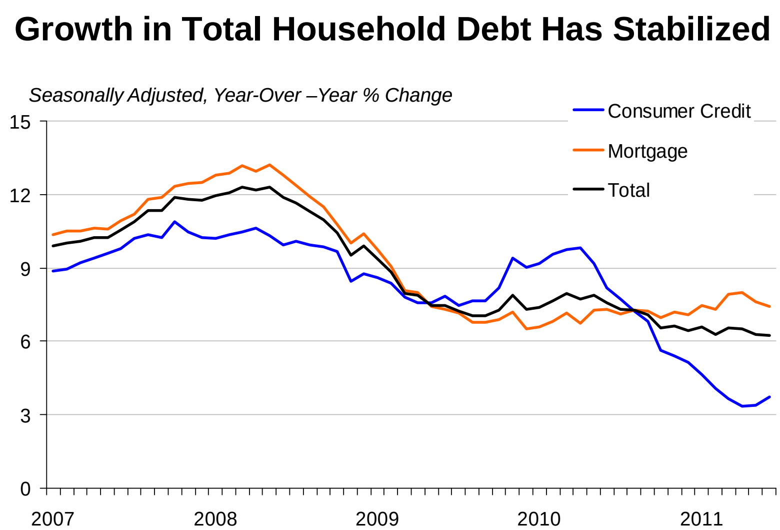
Figure 1

Recent International "Macroprudential" Housing-Related Policies

Country	Policy Details
China	Policies in certain cities limit the number of homes that one family can purchase to tw o units.
	Interest rates for second-home mortgages at no less than 110% of benchmark rates.
	Raised dow n payment ratio for second homes from 50% to 60%.
	For properties that are purchased and re-sold w ithin five years surtax w ill be levied on the sales value.
	Recently introduced property taxes for those buying second homes in Shanghai and Chongqing are likely to expand to other cities across the county.
Hong Kong	An additional transaction levy of up to 15% on properties that are resold w ithin tw o years.
	No home loan insurance to very high-end homes.
	No home loan insurance for homes that aren't ow ner occupied.
	No home loan insurance for mortgages higher than 90% of the purchase price.
	Dow n payments for apartments costing HK$12 million or more changed from 30% to 40%.
	Stamp duty on home selling for more than HK$20 million w as increased to 4.25% from 3.75%.
Singapore	Increased the holding period for imposition of Seller's Stamp Duty (SSD) from the current 3 years to 4 years.
	Raised the Seller's Stamp Duty rates to a maximum of 16%.
	Low ered the loan-to-value limit to 60% on housing loans granted by financial institutions regulated by Monetary Authority of Singapore (MAS) for property purchasers w ho are individuals w ith one or more outstanding housing loans at the time of the new housing purchase.
	Low ered the loan-to-value limit to 80% from 90% for all housing loans provided by financial institutions regulated by the MAS.
Israel	Require banks to hold an additional provision of not less than 0.75% for outstanding housing loans in w hich the loan-to-value ratio greater than 60%.
	For housing loans NIS 800,000 and above, the new directives require banks to increase their capital provision for floating-interest-rate housing loans, in w hich the loan represents more than 60% of the value of the property, and the ratio betw een the floating interest rate part of the loan and the total sum of the loan equals or exceeds 25%. Loans fitting into this category on w hich the capital requirements w ere w eighted at 35 percent or 75 percent respectively, are w eighted at 100%.
	Limited the part of a mortgage issued at a variable interest rate to one third of the total mortgage.
Taiwan	The Government imposed a 15% tax on investment properties sold w ithin a year, and 10% on properties sold w ithin tw o years.
	The loan-to-value is capped at 60% for second homes.
Malaysia	Imposed a new loan-to-value ratio of 70% on homeow ners buying a third residential property.

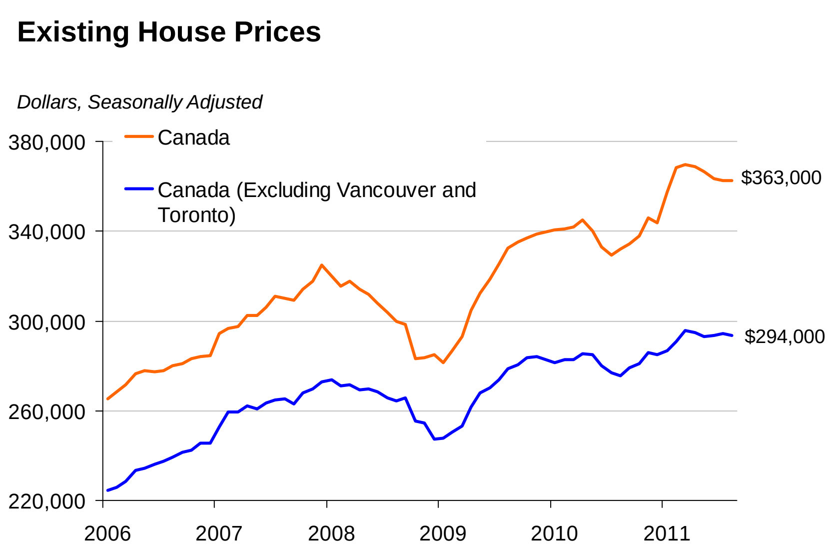
Source: Altus Group Economic Consulting

Figure 2



Source: Altus Group Economic Consulting based on data from Statistics Canada

Figure 3

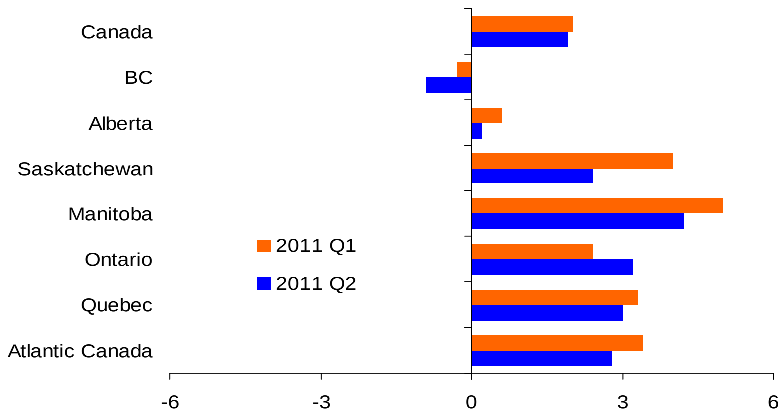


Source: Altus Group Economic Consulting based on data from CREA

Figure 4

New House Prices Decline in B.C.; Softer Increases Elsewhere but Ontario

New Housing Prices, Year-Over-Year % Change



Source: Altus Group Economic Consulting based on Statistics Canada data