



**HIGHLIGHTS**

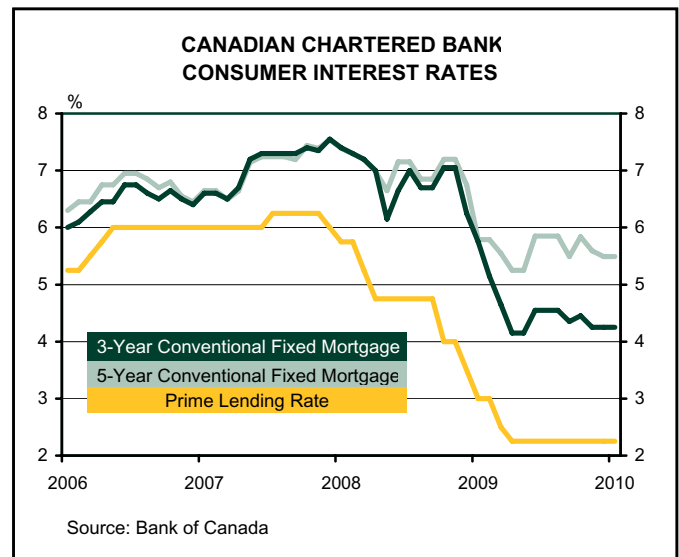
- 3 key changes to mortgage insurance rules.
- First, mortgage loans will be income tested against the 5-year posted rate.
- Second, mortgage refinancing will be restricted to 90% of the value of the home.
- Third, buyers of non-owner occupied dwellings will need to provide a 20% down payment
- The regulatory changes are not dramatic, but will act to cool the market.
- They will also diminish speculation in real estate by reducing leverage to real estate investors.
- The adoption of the 5-year posted rate for income qualification has less to do with the current strong state of real estate markets and has more to do with the high level of indebtedness of many individuals. The higher qualifying interest rate will temper sales in the near-term, but more importantly will ensure that buyers can handle the likely future increase in interest rates.
- While some will be unhappy with the new rules, the policies should reduce the risk of a boom/bust cycle in real estate that is no one's interests.

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**PRUDENTIAL CHANGES TO CANADIAN MORTGAGE INSURANCE RULES**

Today, Finance Minister Flaherty announced three key changes to the Canadian mortgage insurance rules. First, mortgage loans will be income-tested against the 5-year posted rate, rather than the current practice of using the 3-year posted rate. Second, mortgage refinancing will be restricted to 90% of the value of the home, down from 95%. Third, buyers of non-owner occupied dwellings will need to provide a 20% down payment. In our opinion, the announced changes are prudent. They will not dramatically impact housing; but, they will help to cool the market,

temper speculation and reduce the risk to personal finances from the inevitable future rise in interest rates. Although the policy adjustments are only to government-insured mortgages, which are for mortgages with less than a 20% down payment, the new rules will probably be applied to all mortgage lending. The changes will come into effect on April 19, but lending practices will likely change well before then.



**Government mortgage insurance**

In order to promote home ownership, the Government of Canada provides financial guarantees for the provision of default insurance on qualifying high-leverage mortgages (that is, mortgage loans at 80% or greater of the value of the property). The insurance is provided by the Canadian Mortgage and Housing Corporation (CMHC), a crown corporation that has 100% guarantee from the Federal government on the insured mortgages, or private insurers that have a 90% guarantee from the Federal Government. As one might expect, the Federal guarantee comes with certain conditions, which can be changed over time – such as in the amendments announced today.

**Government guidelines affect lending practices in general**

Changes to the mortgage insurance program cascade through the financial system, as lenders traditionally apply the same rules to all mortgage borrowers – regardless of whether they are taking a high leverage mortgage or not. This is to facilitate the application/compliance of the rules and ensure that all customers have the same experience. Moreover, the prudential rules for high leverage borrowers are prudent for all borrowers.



**Three key regulatory changes**

There were three key components to the regulatory changes announced today.

**Mortgage applications to be income tested against 5-year posted rate**

First, mortgages will be income tested against the 5-year posted rate. At the moment, mortgage applications are typically income-tested, with a qualifying interest rate of the 3-year posted rate. This ensures that even if interest rates rise, the individual can meet their financial obligations. This effectively lifts the qualifying interest rate by 1 percentage point. It is important to stress that this policy only constrains the size of the mortgage for which an individual can be approved. It has no impact on the payments made on the mortgage. Moreover, at a time when Canadians are heavily indebted, the new policy helps to reduce the risk associated with the future tightening of monetary policy.

An illustration might be useful. The current 5-year closed variable mortgage rate being offered is 2.25%, while the 3-year posted rate is 4.30%. By using the 3-year posted rate, a borrower in a variable mortgage is being evaluated on their ability to meet their payments if short-term interest rates rise 2 percentage points. However, the Bank of Canada currently has the overnight rate at 0.25%, when a neutral stance to monetary policy is likely in the range of 3% to 4%. Eventually, interest rates will have to rise back to neutral. Under the new rule, mortgages will be income-tested against the 5-year posted rate, which is roughly 1 percentage point higher than the 3-year rate. In other words, individuals will be tested to ensure that they can meet their financial commitments if interest rates were to rise 3 percentage points. Given the interest rate outlook, this makes considerable sense.

The changes are likely to be welcome news to the Bank of Canada. In recent months, the Bank has revealed some concern about how personal finances might respond to a higher interest rate environment. As shown in the accompanying table, the Bank's latest Financial System Review provided a stress test of personal finances under alternative interest rate scenarios. The Bank's sensitivity to the high indebtedness of Canadians can also be observed in recent speeches that warned that interest rates would eventually have to rise.

In terms of the impact on real estate markets, the policy change will have an effect on a large portion of new buyers. Perhaps a quarter of all new mortgage originations might be influenced. But, the tighter rules do not mean the impacted individuals will not buy. They will simply have to limit the

HOUSEHOLD STRESS TEST		
	Scenario 1	Scenario 2
2010-2012		
Household Credit Growth (Ann. %)	5%	
Household Income Growth (Ann. %)	8%	
At Q2/2012		
Overnight Rate (%)	3.20	4.50
Effective Borrowing Rate (%)	4.82	5.41
% of households with DSR>40%	8.5	15.9
% of debt owed with DSR>40%	9.6	18.9

Source: Bank of Canada  
Note: Debt-Service Ratio (DSR) is Monthly Payments on Principal and Interest relative to Household Income

size of home they purchase. As detailed in the table below, based on the national average home price of \$337,000, a buyer with only 5% down would require roughly \$9,200 more in annual income to qualify under the new rules. To buy a \$200,000 home, potential buyers with only 5% down would need \$5,500 more in additional annual income.

It is clear that the regulatory change will temper demand from buyers. However, the impact will be constrained by the fact that many buyers may elect to still purchase, but at a lower price level.

**Refinancing limited to 90%**

The second policy change is to limit the refinancing of homes from 95% of the value of the property to 90%. In other words, homeowners will not be allowed to draw equity from their homes back to the 5% down payment they put on the property. Instead, as they make principal payments over time and build equity, they will not be allowed to reduce their equity position until it exceeds 10% of the value of the home and then they cannot draw down below 10% mark.

The impact of this change should be quite limited. Less than one-third of refinancing is done by individuals with mortgage loans in the range of 90% to 95% of the value of the property. On the margin, it will act as a small negative for consumer purchases (largely on durable goods) that are financed through mortgage refinancing – but the amount will be small.

EFFECT OF CHANGES ON INCOME CUT-OFF					
House Price	Assessed Fixed-term	Interest Rate	Ann. Mtg Payments*	Income Cut-off**	Difference
\$337,000	At 3-year	4.25%	\$19,080	\$59,626	
	At 5-year	5.50%	\$22,028	\$68,838	\$9,211
\$200,000	At 3-year	4.25%	\$11,324	\$35,386	
	At 5-year	5.50%	\$13,073	\$40,853	\$5,467

Note: 5% down payment assumed  
\* Payments include both principal and interest.  
\*\* Mortgage payments assumed not to exceed 32% of household income

**Real estate investors will need to put 20% down**

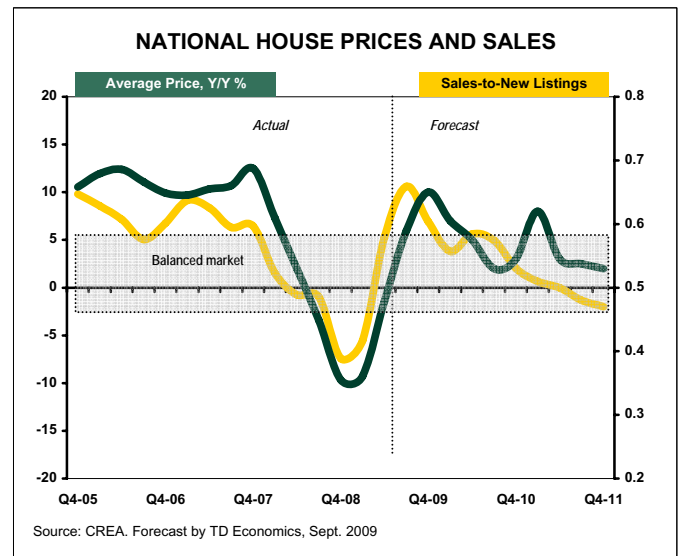
For purchases of non-owner-occupied dwellings, buyers will be required to provide a 20% down payment, up from 5%. This measure is likely aimed at tempering speculative buying of real estate by reducing the leverage available to buyers. It will, however, also impact individuals buying real estate for investment purposes more generally, including those looking for rental properties. In rough ballpark terms, the change might impact about 5% to 15% of new mortgage originations. But, it could have a significant impact on action in this area, as raising the requisite down payment could be a significant deterrent to making the investment.

Although there is much talk of a possible housing bubble at the moment, the data really doesn't support the view that one has formed. The general view is that the real estate market is already starting to cool, driven by an increase in supply through higher listings. The real question is whether this cooling trend will be maintained in the coming months. If it doesn't occur, or, worse still, if the market heats up considerably from current levels, there would be a real risk of a bubble forming. However, in order for this real estate imbalance to develop, it would likely require a significant increase in speculative buying, which traditionally always accompanies excessive home price appreciation relative to its fundamental economic value. The actions announced today by the government for non-owner-occupied dwellings significantly reduce the risk of speculation driving the market forward.

**Conclusions**

The regulatory policy changes are limited, but they will help to cool the market. There is little supporting evidence that a housing bubble has formed in Canada. Accordingly, a change to the minimum down payment for owner-occupied homes or a reduction in the amortization period was not warranted at this time. Such actions might be considered if the housing market significantly heats up during the spring and summer. Nevertheless, for a housing bubble to form, speculative buying would be a major contributor. The announcements today about the larger downpayment for non-owner-occupied dwellings reduce the risk of this speculation occurring.

Regardless of the current state of the real estate market, the reality is that many Canadians are carrying consider-



able debt and the Bank of Canada will eventually have to raise interest rates by at least 3 percentage points. Such a tightening of monetary policy would likely raise variable mortgage rates by a similar amount and raise medium term interest rates by about 2 percentage points. Accordingly, changing the practice of income-testing to use the 5-year post rate seems prudent. And, limiting the equity that can be withdrawn from a home to 90% seems a sensible change that encourages personal wealth accumulation over consumption.

In terms of our outlook for housing in the coming year, the policy changes do not materially alter the outlook. We continue to look for sales to decline by 5-10% in year-over-year terms by the fourth quarter of 2010 and for national average home price growth to moderate to 2-3% in that time frame. If anything, the regulatory changes simply reduce the upside risks to this projection.

Many borrowers, lenders, builders and others affected by activity in real estate markets may not like changes to the regulatory environment. However, it must be stressed that boom/bust cycles in real estate are not desirable for anyone. The optimal outcome is moderate sales growth, accompanied by sustainable price increases, which keep affordability accessible to potential buyers, and within a market that provides the right incentives for debt management. Today's regulatory changes seem consistent with these objectives.



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