Housing Market Digest

Greater Toronto Area, September 2024

The Changes to Mortgage Insurance

Thinking about the housing system as a whole, I see the announcement as a good move. But, a lot of other tough challenges remain.

During the past 12 years, multiple changes to mortgage regulations have made it more difficult for Canadians to meet their reasonable housing needs. I have concluded that in combination, those changes have caused resale activity to be about 10% lower than it should have been, and through impaired sales of new homes, the changes may have contributed about 200,000 units of the housing supply shortage.

Most of the changes had negligible impacts. The most consequential have been the elimination of 30-year amortization periods for insured mortgages (summer of 2012) and the overly-onerous mortgage stress tests (for insured mortgages in the fall of 2016 and for uninsured federally-regulated mortgages at the start of 2018 – the OSFI test).

Part of the argument made for the escalation of mortgage regulations has been that it is necessary to reduce demand in the housing market, to reduce pressures on pricing. But, it's important to understand the distinction between housing demand and housing transactions. Demand is the requirement for housing that results from growth of the population. The regulations haven't affected that demand, they have just affected the decisions that people can make about how to meet their housing needs. This has constrained numbers of transactions. As home buying has been reduced, fewer people have been able to move out of rentals into ownership. The regulations might have caused pressures in the ownership sector to be less than they might have been otherwise. But, pressure was increased in the rental sector (with consequences like a significant drop in the ownership rate during the past 12 years and rent growth that was more rapid than it would have been otherwise, which in turn has encouraged increased purchases by investors).

The changes in regulations have not reduced the amount of pressure in the total housing system, they have just changed the consequences.

Well, actually, because the regulations have very likely impeded the construction of new housing, they have, increasingly, caused the supply situation to be worse than it would otherwise be.

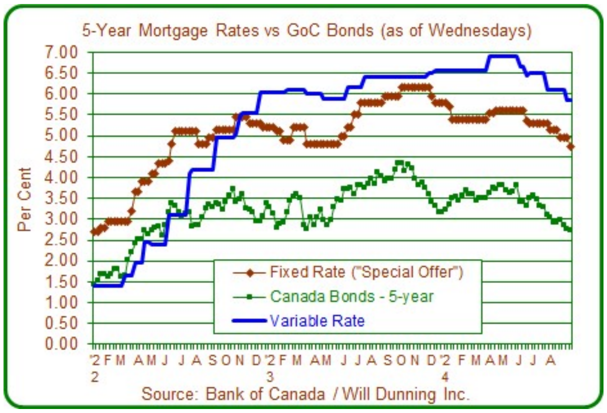
There are two analogies to childhood games that I find useful in understanding the effects of the escalating regulations, and in interpreting the new announcement. Here is a short piece (from a year ago) that mentions Whack-A-Mole:
https://www.theglobeandmail.com/investing/personal-finance/household-finances/article-playing-whac-a-mole-in-the-housing-market/
I have also referred to Musical Chairs in understanding the worsening pressures in the housing market.

The most important part of the new announcement is that 30-year amortization periods will soon be allowed for insured mortgages. This reverses one of those harmful changes. It will raise pressures within the ownership sector, but it will also reduce them within the rental sector. Therefore, this will not affect total demand or total supply within the housing system, and therefore total pressure within the housing market will not be altered, at least not in the short-term. But, to the extent that it results in more pre-construction sales of new homes, in the longer term this change will cause the supply to increase to some extent: in the future the overall pressure in the entire housing market will be less than it would be otherwise.

To be a bit more precise, in April, the government announced that 30-year amortization would be allowed for new homes, but not existing homes. I argued at the time that this was a mistake, that the best way to encourage new construction is to allow insurance for existing homes: first-time buyer purchases of existing properties set off chains of moves that often culminate with new construction. I am relieved to see this earlier mistake has been corrected fairly quickly.

The other notable change is the increase in the price ceiling for insured mortgages, to $1.5 million from $1.0 million. This should have very little impact, especially in communities outside of Toronto and Vancouver (and their surroundings). In the highest cost markets, there is a theoretic impact, but given current interest rates, with the layering-on of the 2-point increment for the stress tests, I expect that there will be few insured purchases over $1 million.

Overall, I expect that sales will be stronger next year than this year, due to the allowance of 30-year amortization but also due to the reductions seen in mortgage interest rates during the past few months.



But, in the highest cost markets, interest rates are still much too high – I think the neutral rate in those places is in the area of 3%, and at this time no one expects that bond yields or the Bank of Canada policy rate will fall by enough. to produce a balanced market in Toronto. Therefore, I continue to see downside risks for the housing market and the broader economy in Toronto.

The federal government has little ability to influence the supply of housing. Constitutionally, the provinces create the rules that are used by the municipalities (for land use approvals, as well as development fees and charges). The municipalities can also add rules and interpretations.

Previously, the federal efforts were mainly to offer money to municipalities that ease their land use restrictions (with a limited amount of take-up). With the change in amortization, we are now seeing a federal effort to act in an area where it is actually in charge.

But, they still need to address the design of the mortgage stress tests: as I discussed in the Globe and Mail article, there is a critical flaw that the testing fails to consider that at the time of the future renewal, the borrowers' incomes will have increased. Until that is fixed, home buying will continue to be unduly constrained.

Most mortgage activity is uninsured and therefore is tested under the OSFI rules. While OSFI is part of the federal system, it is an independent agency, and therefore the government has chosen not to intervene. But, it can order CMHC to change the parameters for its test.

The federal government is certainly aware of the arguments about income growth (I expect that they do read the Globe and Mail, and they have received submissions from associations that make arguments similar to mine). They haven't publicly responded to those arguments, and in fact I have never seen them even acknowledge them.

There is an important area in which the federal government has affected the demand-supply balance in the housing market – international migration (most notably the very high numbers of people arriving on temporary permits for work and education). There's a lot of discussion happening on this now. Based on recent announcements, it looks like the rate of population growth will slow quite sharply during the next three years (to perhaps 0.5% per year). This might allow housing production to exceed housing requirements. If so, there would be a gradual reduction in the supply deficits. But, it will take a long time to get to a balanced situation.

While that happens, critical factors that will affect new housing production will include:

- Mortgage interest rates and decisions by the Bank of Canada.
- Mortgage regulations.
- Fees and charges (these force prices to rise for existing homes, not just new construction).
- Land prices (maybe I'll discuss this another time).
- Changes in the employment situation.

Those fees and charges are determined by municipalities, within frameworks created by the provincial governments. I have been arguing for a while that these charges need to be mostly eliminated, and funding infrastructure needs to done through borrowing that is serviced by property taxes. The federal government should encourage the provinces to act on this, and it can assist in setting up funding mechanisms.

How to Reach Will Dunning Inc.

Email: wdunning1955@gmail.com
Web site: www.wdunning.com
Twitter: @LooseCannonEcon
Want to say thanks?
https://buymeacoffee.com/wdunning

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