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RISKY MORTGAGES POSE TROUBLE FOR PROVINCE

B.C. would be hit hard by repeat of housing shocks of the 1980s, 1990s

Significant stress in the household sector would affect Canadian financial institutions. BANK OF CANADA REPORT

Tucked inside the latest Bank of Canada report on risks to the financial system were two nightmare scenarios for heavily mortgaged homeowners, particularly newcomers to the market in and around the city of Vancouver.

THE CANADIAN PRESS/JONATHAN HAYWARD A Bank of Canada report points to two instances where housing prices dropped significantly: the 1980s in B.C. and Alberta, where prices fell by 25 per cent and the 1990s in B.C. and Ontario, where prices fell by 15 per cent.

What if housing prices were to drop by 15 per cent? The bank calculates that about one mortgage in eight would be plunged underwater, meaning the dollar indebtedness would be greater than the fair market value of the home.

What if housing prices were to drop by 25 per cent? In that case, almost one mortgage in four would sink into negative territory.

Some 600,000 mortgage holders would experience a reversal in the first instance and more than one million in the second.

Many of those troubled mortgages — a third in the first scenario, almost half in the second — would be held by some of the most heavily indebted households in the country.

All this matters in particular to British Columbia because, as the report further documents, this province has a disproportionate share of the country's biggest — and therefore most risky — mortgages. The bank flagged cases where mortgage indebtedness exceeds annual household income by 450 per cent or greater. An example would be a $450,000 mortgage held by a couple with a combined income of $100,000 a year. Such mortgages are the hardest to service and the most vulnerable to sudden shocks, such as a spike in interest rates. Not surprisingly, given what has been happening in the housing market, higher risk mortgages — those that are 450 per cent or more of annual family income — have been on the rise in B.C.

As of last year, fully a third of all the mortgages that were taken out in Vancouver were in the heavily indebted category. The provincial capital region was not far behind.

These were new mortgages, meaning the risk-takers would probably include many first-time buyers as well as couples moving up to gain room to have a family.

Couldn't happen here? On the contrary, it already has happened here, for the bank did not pick either example out of thin air.

"The scenarios used for the analysis reflect two regional experiences: those in Alberta and British Columbia in the 1980s — where house prices declined by 25 per cent — and in Ontario and British Columbia in the 1990s — where house prices declined by 15 per cent."

Thus, within the living memory of many British Columbians, housing prices have twice collapsed in alarming fashion. A sobering prospect for those baby boomers planning to retire comfortably on the equity built up in their homes, or perhaps going into debt again to help millennial children get into the market.

Nor would the fallout from either of the foregoing scenarios be confined to home buyers alone.

"Income losses and house price declines would lead to significant cutbacks in expenditures since households would be focused on servicing debt and attempting to offset the losses in wealth," says the bank.

"Financially constrained households that are unable to service their debt might be forced to sell assets, including their homes, or to enter into foreclosure. … Significant stress in the household sector would affect Canadian financial institutions, including mortgage insurers and lenders."

In a really bad scenario, like the housing market crash that happened in some parts of the United States in 20082009, the process could feed on itself.

But lest anyone here get into a panic, the bank cautions that the risk is "low" of either scenario coming to pass.

Even in B.C. with all those high loan-to-income ratios, "arrears rates remain very low and are falling. They are low because of the strong growth of house prices and growing employment."

What could change that? The report envisions a collapse in housing prices brought on by a major downturn in the economy.

"In this risk scenario, a severe recession in Canada generates a sharp increase in unemployment across the country that places many highly indebted households under financial stress and causes a broad-based correction in house prices. This chain of events would strain the financial system and the real economy … but the probability of this risk occurring remains low."

But suppose the shock were confined to the provincial economy, like the downturns that B.C. experienced in the early 1980s and again in the 1990s. Or suppose the shock were confined to the housing market alone, brought on by governments taking wellintentioned action to address housing affordability?

Governments should proceed cautiously when interfering in the housing market, particularly where prices are most inflated as they are here in B.C.

The risks are evident in the widespread arguments among those in the know about the best way to proceed to address housing affordability.

• Talk down the market as Bank of Canada governor Stephen Poloz tried to do last week with his warning about unsustainable housing prices in Vancouver and Toronto?

• Raise the entry threshold on mortgages by increasing the required down payment?

• Bring in another luxury tax, atop the one already imposed here in B.C. this year?

• Drive out foreign capital by whatever means?

None of these options is necessarily as surgical as advocates suggest. Taken singly or in combination they might produce unintended consequences for the most vulnerable participants in the housing market.

If that happens, all those homeowners who find themselves submerged underwater won't be going after the critics, the experts and the Opposition. They'll blame the government that popped the bubble.