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TD Economics

Data Release: Bank of Canada sees the risks to the financial system as elevated, but stable

- The Bank of Canada released its Financial Systems Review (FSR) this morning, in which it highlights risks tied to the Canadian economy and financial system.
- The Bank judges that Canadian economic conditions have firmed in the second half of the year and risks to the financial sector have remained unchanged since the June FSR. While financial vulnerabilities edge higher, increased financial regulation has made the financial system more resilient.
- Some key developments since the last FSR in June include: increased financial volatility due to an economic slowdown in China and other emerging markets; a rate hike by the U.S. Federal Reserve has become more likely (pushing up Canadian longer-term yields), while Europe has embarked on more quantitative easing (divergent monetary policy); and corporate bond spreads have widened, particularly for those tied to commodities. However, financing conditions remain accommodative for households and businesses.
- The Bank of Canada has highlighted three key vulnerabilities in the Canadian economy. The first two are the usual suspects: elevated household debt and rising housing market imbalances due to rapidly growing home prices. The third was "uncertain liquidity" in Canada's fixed income market. The Bank is highlighting that it is uncertain how demand and supply of Canadian bonds will be affected by economic and financial conditions going forward, given changes to financial regulation among other things.
- The Bank also offered some additional information on vulnerabilities in the household sector. The Bank noted that most of the mortgage growth over 2015 has been concentrated in uninsured mortgages (with more than 20% down). However, there are still growing vulnerabilities. Household debt is growing faster than income, particularly for younger Canadians who may be less prepared to deal with a negative income shock. At the same time, the likelihood of a household missing a debt payment increases when a household debt-to-income ratio rises above 250% after a negative economic shock. Risks rise further when the debt-to-income ratio exceeds 350%. The share of households with a debt-to-income ratio of more than 350% has risen to 8% from 4% pre-2008 crisis. In addition, the mortgage market has become more complex with lenders relying more on less regulated mortgage lenders. These lenders still insure their mortgages, but have less qualification guidelines than the federally regulated chartered banks. Underwriting standards are also a concern for these lenders.
- On the flipside, the Bank of Canada removed its reference to an overvaluation in home prices. Sharply rising home prices are concentrated in Toronto and Vancouver and are likely being driven by supply constraints in the wake of rising employment and migration. Along that line, the Bank believes that there is little risk of overbuilding in Canada and therefore the probability of an across-the-board home price correction is low. The Bank also noted that while the impact of recent mortgage insurance qualifying guidelines are uncertain, they will help ease some of the growing vulnerabilities tied to housing.
- Household vulnerabilities are regional. Much of the highly indebted households are in B.C., Ontario and Alberta. Meanwhile, sharply rising home prices are mostly concentrated in Toronto and Vancouver.
- Given these vulnerabilities, the Bank of Canada listed four key risks to the Canadian outlook. First is a negative economic shock that would trigger a sharp downturn in household debt and the housing market. This risk is rated as elevated, but remains a low probability event. Second is the spillover effects from weak global economic growth and financial stability (divergent monetary policy in the U.S. and Europe), which could raise risk premiums in Canada. This is a moderate but low probability event. Third, is a deeper slowdown in China and other emerging markets, risks of which are elevated, have a medium probability and could severely impact the Canadian economy.

Key Implications

- During the webcast, Governor Poloz was asked how the economic scenario now differs from the one in January when the Bank cut the overnight rate. Governor Poloz suggested that at that point, the Bank had shifted its outlook from one with moderate economic growth to one of negative consequences from falling oil prices. However, now the shock is largely behind us and some of the positive offsets to oil prices are starting to pop up. The bank still judges that positive developments in the U.S. economy will help pull up Canadian economic growth. Under this scenario, positive income growth makes consumer deleveraging and/or home price correction very unlikely. The Governor noted that he remains confident in the fundamentals of the Canadian economy and banking sector to help avoid a financial crisis in Canada. He also noted that the first line of defense against rising vulnerabilities should be strong mortgage underwriting criteria. In other words, the Bank doesn't seem prepared to cut interest rates given expectations for moderate growth, nor does it appear ready to raise rates due to accelerating home prices and debt growth.
- We largely concur with the Bank of Canada on the housing market developments. In large part, some of the strength in Ontario and B.C. has been driven by underlying fundamentals. Fairly balanced conditions will likely keep the hottest markets from crashing, but we will likely see housing market activity moving back in line with long-run averages (or more sustainable levels) as interest rates start to rise (albeit gradually). Having said that, foreign investment is certainly the black swan in the room. While we have relatively little data on foreign purchases in Canada, we do know that they have picked up considerably in the U.S. as foreign investors look for yield. CMHC research suggests that Toronto and Vancouver have also benefited from some of these trends in 2015, although the degree and how fleeting this investment can be is still a big question market.
- TD Economics estimates that real GDP growth in the fourth may come in at a very soft 0.9% annualized, below the Bank of Canada's view of 1.5%. Nonetheless, positive growth in combination with an anticipated pick-up in 2016 will likely keep the central bank on the sidelines.

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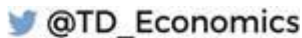

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