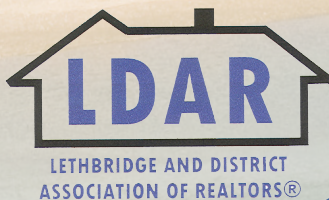


Impact of the Mortgage Stress Test on the Lethbridge Region Housing Market

**Prepared for Building Industry & Land Development (BILD) - Lethbridge Region
and Lethbridge and District Association of REALTORS®**

by Miguel Martinez Santillan, MA. Econ.

February 15, 2019





Preface

This report was commissioned jointly by Building Industry & Land Development (BILD) Association of Lethbridge Region and the Lethbridge and District Association of Realtors (LDAR) to assess the impacts of the new Government of Canada mortgage “stress test” on the housing market in Lethbridge and region. It focuses on the economic strengths of Lethbridge and district and housing market within the wider context of the Alberta and Canadian economies.

BILD Lethbridge Region is made up of Home Builders, Land Developers and Trade, Renovators, Suppliers and Service Professionals that support residential construction in Lethbridge and region. We have 130 members with approximately 3,000 employees. Our members build communities in Lethbridge, Coaldale, Taber, Picture Butte, Coalhurst and the County of Lethbridge. The residential construction industry in Lethbridge is a major employer and contributor to our economy. In 2017 new home building, renovation and repair provided 3,291 on-site and off-site jobs, contributed \$225 million in wages and \$504 million in investment value. The Lethbridge and District Association of REALTORS® is made up of 327 REALTOR® members who support Lethbridge and rural community residents. In 2018 the Lethbridge real estate board reported 2548 MLS® sales which equate to \$163 million in economic spinoff (CREA stat).

Changes in government policies, including the OSFI-mandated mortgage stress test in 2018, have increasingly placed constraints on homebuyers and had a perverse effect on the housing market in Lethbridge. BILD Lethbridge Region homebuilder members reported a dramatic increase in the number of rejected mortgage applications and a significant decrease in sales. LDAR REALTOR® members echoed similar sentiments.

Without movement across the housing continuum, land developers and builders do not build; residents do not buy and sell properties, this has a ripple effect that we are starting to see, including job losses. Job losses aren't just hurting big builders and developers. Residential construction is a unique industry. Eighty percent of it is skilled tradespeople, contractors, subcontractors, small businesses, and suppliers. Those are the people most deeply affected now because of the decline. The bottom line is when residential construction fails and the real estate market is stunted, Lethbridge suffers. This report is an effort to quantify the impact.

We would like to thank Miguel Martinez Santillan, MA Econ, for his work on this report to assess the economic context of our region, and the impacts of changes of mortgage rules on our housing market.

Bridget Mearns, Executive Officer on behalf of BILD Lethbridge Region

Cathy Maxwell, Executive Director on behalf of LDAR

Executive Summary – Economic Analysis

Interest rates are expected to increase over the foreseeable future. **The pace of increase will depend on developments in the oil market, housing, and global trade.**

Following implementation of the stress tests, it is estimated that homebuyer purchasing power in Lethbridge **decreased by 17.3%**. There has been an **additional decline in affordability of 5.5%** due to rising interest rates as of December 2018.

The new regulations **will likely cause many households to reevaluate their housing prospects**. Some will have to lower their expectations about what they can afford; others will put their house hunting on hold until they have saved more; still others will be “priced out” and forced into or need to remain in the rental market.

In 2018 new home sales are the **lowest since 2001**.

Over **12% of the population in the Lethbridge has been priced out** from purchasing an average single-family home following the stress test.

In 2016 and again in 2018, **the Government of Canada introduced new mortgage stress tests**, embodied in Guidelines B-20 and B-21 issued by the Office of the Superintendent of Financial Institutions (OSFI). The new Guidelines were meant **to ensure that Canadian borrowers take on mortgages they can afford**. They apply to mortgage loans made by all federally-regulated lenders, including all chartered banks.

Using traditional measures, such as the price to income ratio, **Lethbridge is one of the most affordable housing markets in Canada**.

Based on projected interest rate increases, by December 2020, **homebuyers in Lethbridge are estimated to be able to afford 27.2% less** compared to what they could prior to the stress test.

Lower income households have been impacted the most. **65% of the households in Lethbridge cannot afford to buy an average price new single-family home**.

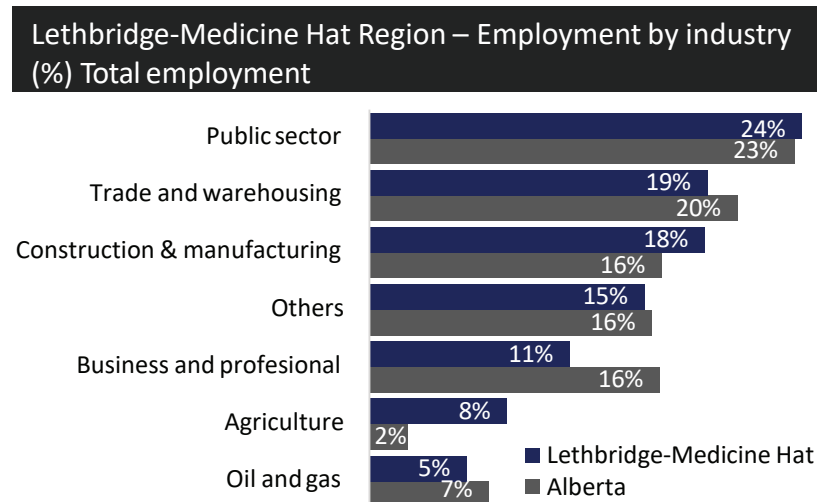
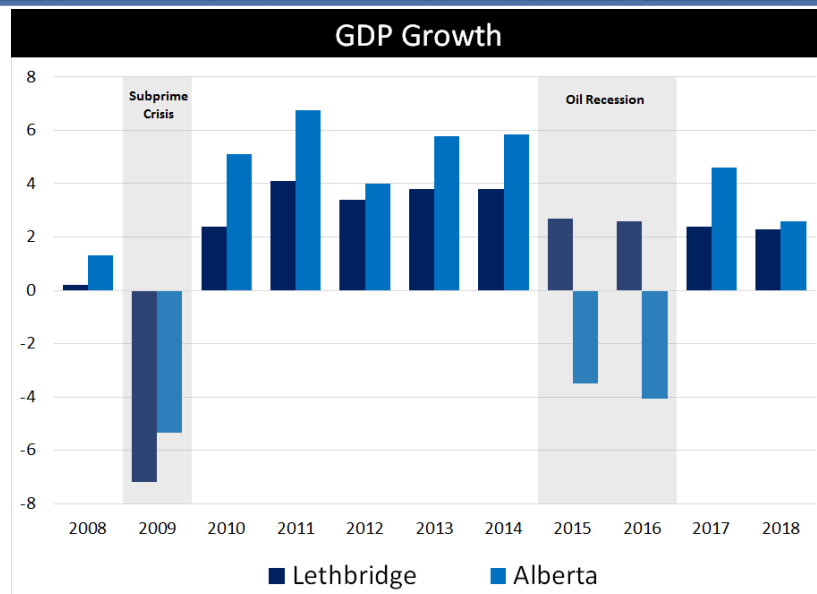
Economic Overview

The Lethbridge Census Metropolitan area (CMA) has been an outlier in the Alberta economy. The region continues to attract and employ people at record levels as a result of strong economic prospects, a diversified economy and a lower cost of living.

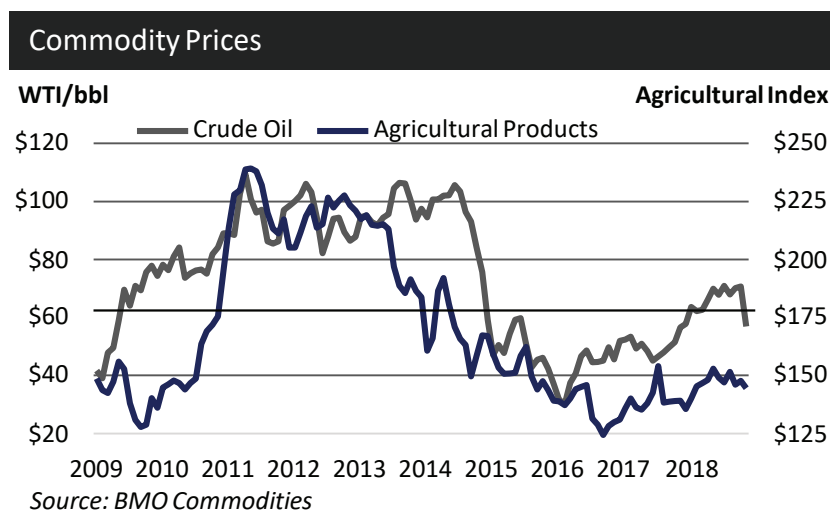
Over the past four years, Lethbridge has seen increased economic growth. By contrast, most of Alberta continues to struggle from low oil prices, lasting longer than expected, and a lack of oil export capacity to tidewater. Between 2014 and 2016, Alberta's economy shrank by 7.4%, whereas Lethbridge's expanded by 5.3%.

Recently, Lethbridge has seen strong business investment. Currently there are over \$1.1 billion worth of proposed and under construction projects in the region. The \$360 million Cavendish Farms potato plant and the \$260 million Science and Academic building at the University of Lethbridge are the two largest developments. While these projects are coming to completion in 2019, the region continues to be considered a good place to invest.

Lethbridge's economy is driven mainly by agricultural production and stable publicly-driven sectors of government such as health-care and education. While overall agricultural prices remain stagnant, global demand is on the rise for agricultural commodities produced in the area such as meat, oilseeds and plant-based protein. As well, the region has seen substantial developments in renewable energy generation. Over fifty projects have been proposed or are under construction.



Source: Statistics Canada



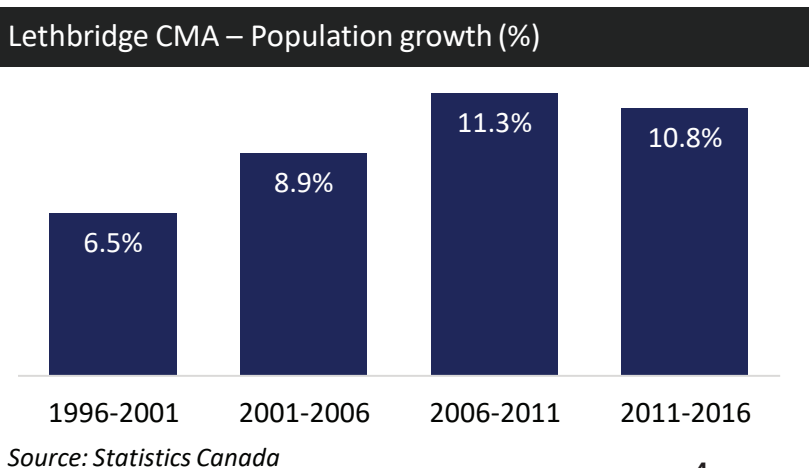
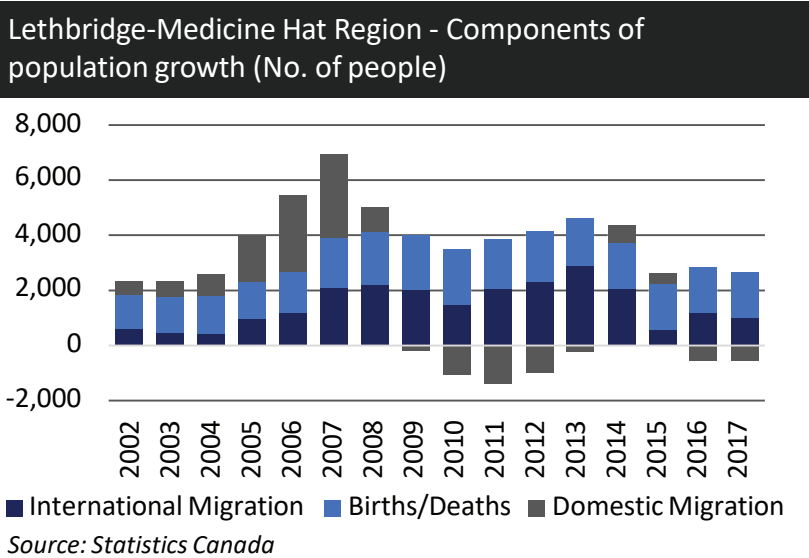
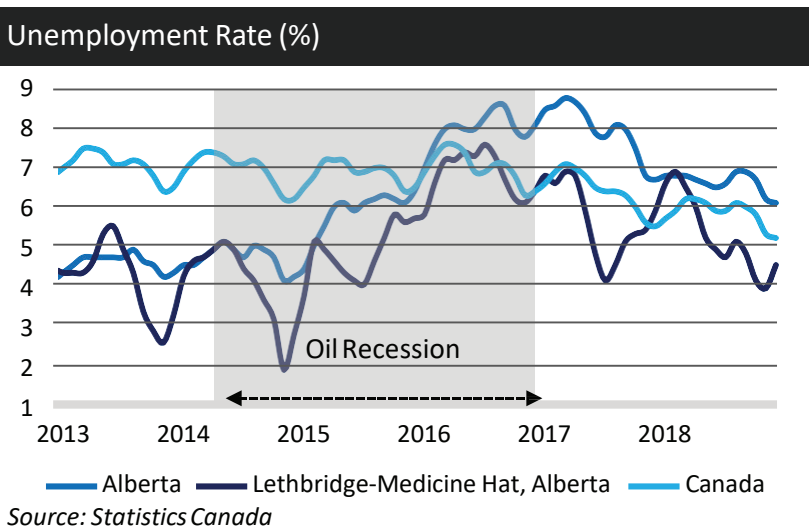


The Lethbridge & Medicine Hat economic region quickly recovered after losing 6,500 and 8,500 jobs in the energy and agricultural sectors, respectively, between October 2014 and June 2016. As of December 2018, the region posted a 4.5% unemployment rate, the lowest in Alberta and well below the national average.

Continued economic growth in the region has resulted in a higher demand for labour. As of Q3 2018, there were 3,700 job vacancies in the Lethbridge Medicine-Hat area which represents an increase of 33.3% compared to 2016. The availability of employment opportunities has led to sustained population growth in the region.

According to the latest Census data (2016), Lethbridge was the third-fastest growing metro area in Alberta with a population boom of 10.8% between 2011 and 2016. The region had an estimated 117,394 inhabitants in 2016 and is expected to expand by 7.8% between 2016 to 2021. The 30-39 year age group has seen the fastest population increase, expanding 25% between 2012 to 2017.

International migration and natural increase are the main sources of population growth. Out-migration, particularly of recent graduates in their mid-to-late twenties, is expected to continue throughout the foreseeable future.



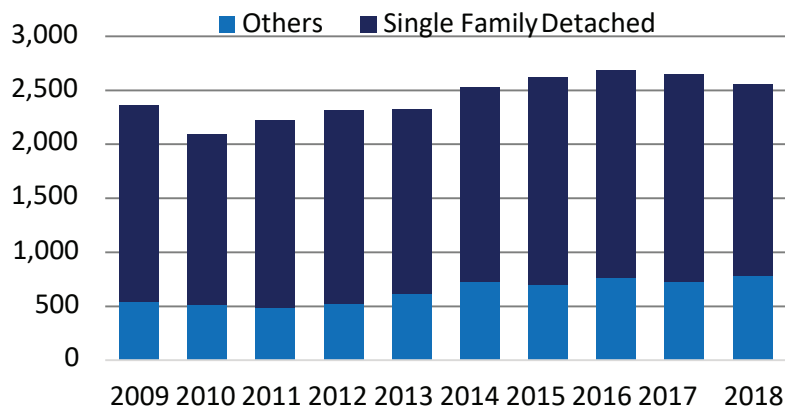
Housing Market Overview

Home sales in the Lethbridge area slowed down for the second year in a row in 2018. According to the Lethbridge Real Estate Board, residential sales decreased 3.6% in 2018 compared to 2017. This was primarily driven by a 7.9% decrease in single-family home sales during the same period. While single-family is still the most sought-after property type in Lethbridge, demand for more affordable types of housing units is on the rise. Apartment and townhouse sales increased 10.4% and 16.8% between 2017 and 2018. This includes properties sold via MLS® System. This portion of the market is primarily resale, though some builders may also market newly-constructed properties via the MLS.

Demand for new residential construction in Lethbridge continues to decline. 2018 home sales in the Lethbridge area are at levels not seen since 2001. New home sales are 40% lower compared to highs reached in 2008. Single family home sales decreased 8.6% in 2018 compared to 2017 with 459 units sold in 2018. New semi-detached homes decreased 38.3% during the same period with only 29 sales. On the positive, while overall demand continues to soften, prices for new construction have held up. Prices in 2018 are at historical highs with an average of \$418,437 for single-family homes in the region.

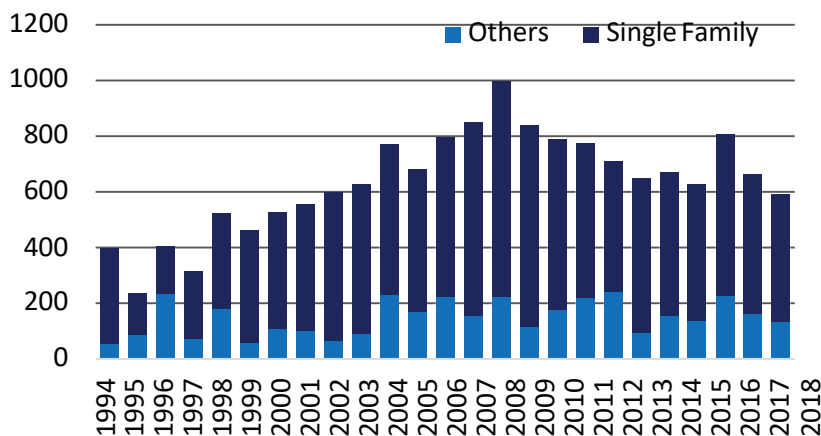
While new home construction increased 6.0% in 2018 compared to 2017, it remains below the 10-year average. Builders have reacted to market conditions by decreasing supply. Additionally, despite the slow down in sales, Lethbridge housing market fundamentals remain strong. Household formation, the number of new families to call Lethbridge home, outpaces new housing supply. This trend is expected to continue throughout the foreseeable future due to the region's strong employment and economic prospects.

Lethbridge CMA MLS Sales



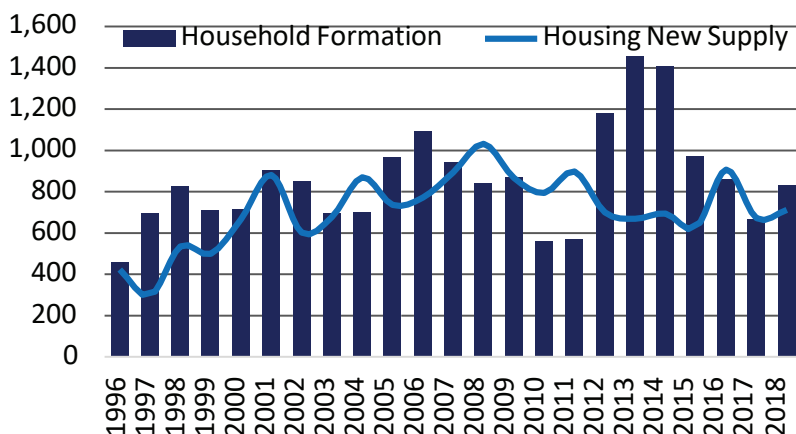
Source: Lethbridge Real Estate Board

Lethbridge CMA New Home sales



Source: CMHC Housing Information Portal

Lethbridge CMA Housing Market Fundamentals



Source: Statistics Canada

Policy Changes – Bank of Canada, CMHC, OSFI

Following the 2007-2009 global financial crisis, The Bank of Canada dropped its overnight interest rate to a historical low of 0.25%, aiming to decrease borrowing costs and stimulate economic growth. However, disappointing results exacerbated by the collapse of oil prices in 2014 kept interest rates at low levels, unwinding a near-decade long era of cheap money.

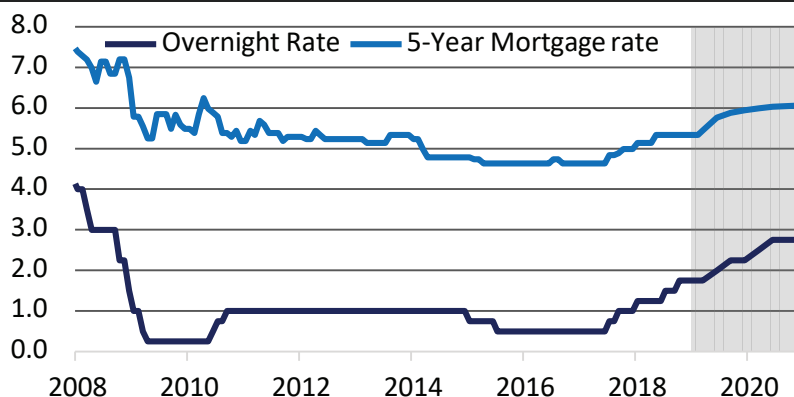
Strong economic growth in 2017 signaled the end of the expansionary monetary policy as the Bank of Canada increased interest rates for the first time in 7 years in July 2017. The Bank has hiked rates 5 times since then. Although the rate increases have been modest, monetary policy is expected to continue tightening over the coming years. The pace of increase will depend on developments in the oil markets, housing, and global trade.

Over the past two years, home prices in the Greater Toronto and Greater Vancouver areas have risen substantially, driven by strong demand and limited supply. The increase in prices has led some borrowers to take on high levels of debt pushing Canadian household liabilities to an all time high.

As interest rate rises loom over the horizon, a number of new regulations were put in place via the Office of the Superintendent of Financial Institutions (OSFI) to ensure that Canadian borrowers take on mortgages they can afford. Prior to October 17, 2016, borrowers could qualify for a larger loan by selecting a 5-year fixed-rate mortgage which had a low interest rate. The qualification rules for a 4 years or less mortgage required a "stress test" using the higher Bank of Canada "Benchmark-Rate" in the affordability calculation. As a lower rate equated to a higher loan amount, borrowers gravitated to the 5-year fixed rate.

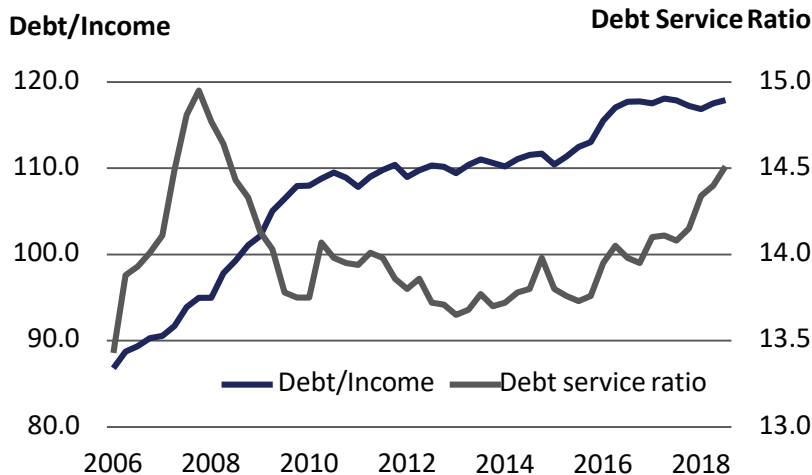
An additional set of OSFI guidelines introduced on January 1, 2018 require buyers, despite a higher down payment amount, also to undertake a "stress test". This is to determine if borrowers could afford to pay back a loan if interest rates were to go higher. Homebuyers are assessed against the Bank of Canada five-year benchmark standard rate (5.34 per cent as of January 11, 2019). The mortgage benchmark rate is higher than the rate offered by lenders in the market. Additionally, a homebuyer must have a Gross Debt Service ratio (cost of homeownership relative to income) no greater than 35 per cent and a Total Debt Service ratio (cost of homeownership plus all other debts relative to income) no greater than 42 per cent.

Canadian Interest Rates (%)



Source: Bank of Canada, Conference Board of Canada & RBC

Canadian Debt Indicators (%)



Source: Statistics Canada

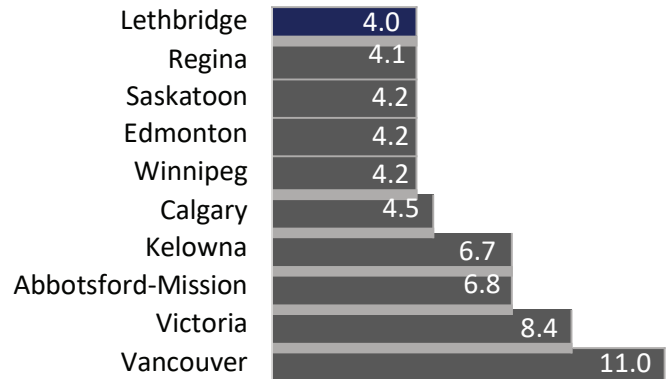
Lethbridge Housing Affordability and the Stress Test

Since 2012, the federal government has introduced a range of new mortgage rules, including more stringent GDS and TDS caps, a \$1 million cap on purchase prices, a 10 percent down payment requirement on the portion of an insured mortgage over \$500,000, OSFI B21 and B20 guidelines, a restriction on mortgage refinancing and, most recently, a stress test for low-ratio loans based on an interest rate 2 percent higher than the actual rates being charged.

Using traditional measures such as the price-to-income ratio, Lethbridge is one of the most affordable markets in Canada. However, the new stress tests have artificially reduced purchasing power in market as shown in the second and third charts.

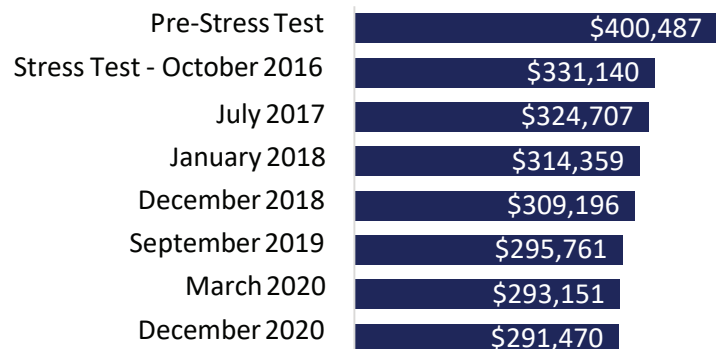
A household earning a median income in Lethbridge, approximately \$75,000, was able to afford a \$400,000 home prior to the implementation of the stress test. Immediately after the enactment of the new rules on October 2016, the same household earning the same income was only able to purchase a \$331,000 home. This represents an instant reduction of 17.3% attributed to the new rules. As of December 2018, that same homebuyer is now only able to afford a \$309,000 home. This represents an additional 5.5% decrease in affordability due to the rising interest rates. The expectation is that the Bank of Canada will continue to raise rates over the foreseeable future. By December 2020, the same household would be able to afford only a \$291,000 home.

Price to Income Ratio – Selected Western Canada CMAs



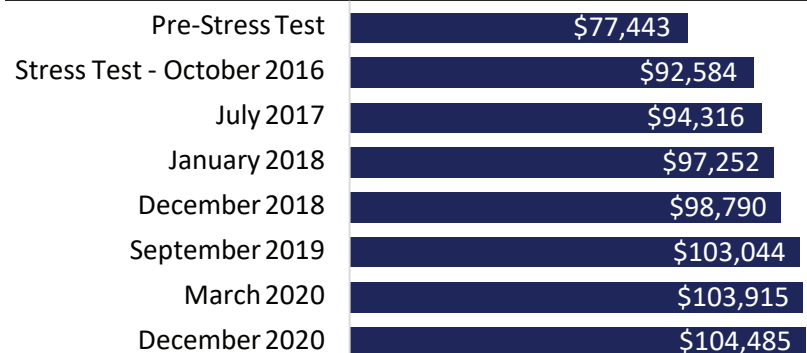
Source: Lethbridge Economic Development

Maximum Affordability- Lethbridge Median Income



Source: Calculations based on NAHB "Priced-Out" Methodology

Income Required to Buy a New Single Family Home



Source: Calculations based on NAHB "Priced-Out" Methodology

Further Indicators of Stress-Test Affordability Impacts

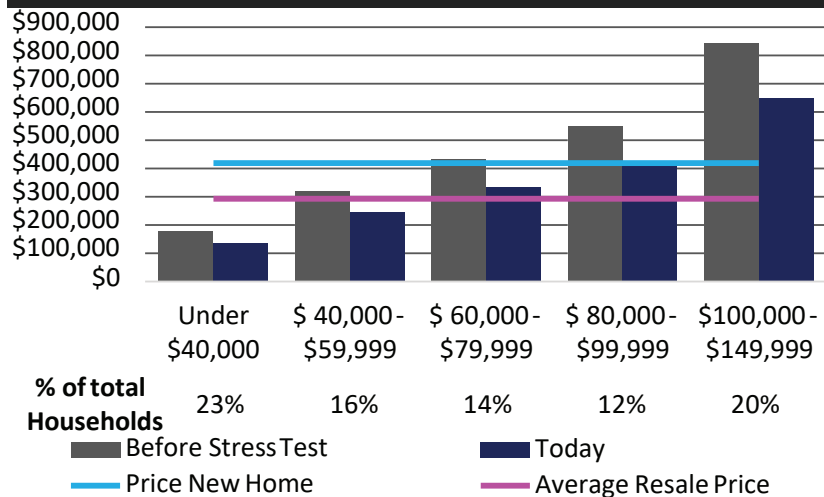
Although the new regulations apply to every Canadian, lower-income households have been impacted the most. This will further worsen income inequality as the lower income groups traditionally include a larger share of vulnerable groups, younger families and newcomers to Canada.

The bottom line is that 65% of the households in Lethbridge cannot afford to buy an average price new single-family home. The average price is hovering around \$420,000. Over 12% of the population in the region has been priced out from purchasing an average single-family home following the stress test. Moreover, almost 14% of the population in Lethbridge has been priced out from buying an average-priced home in the resale market.

The recent increase in economic and political uncertainty impacting Alberta is compounded with the effects from the stress test. Lethbridge new home sales decreased 11% between 2018 and 2017. 2018's total new home sales are the lowest since 2001. Only the more affordable row housing registered higher sales with a whopping 40% year-over-year increase. Additionally, the unabsorbed inventory, completed but unsold new homes, continues to be above the 10-year average with 2,227 homes in 2018. This represents over an 11% increase from 2017.

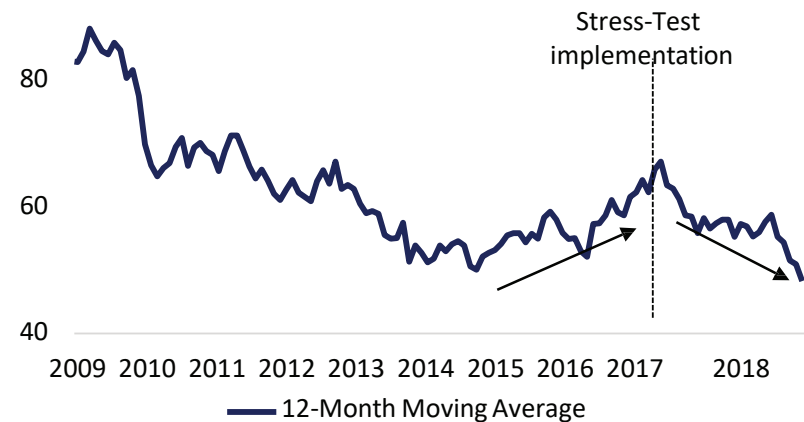
The new regulation will likely cause many households to reevaluate their housing prospects. Some individuals will have to lower their expectation about what they can afford shifting from the dream of owning a single-family home to a half-duplex or a condo. Other families will put their house hunting on hold until they have saved more for a bigger down payment. A larger portion of the population will be priced out and need to stay in or move to the rental market.

Lethbridge Maximum Affordability by Income Group



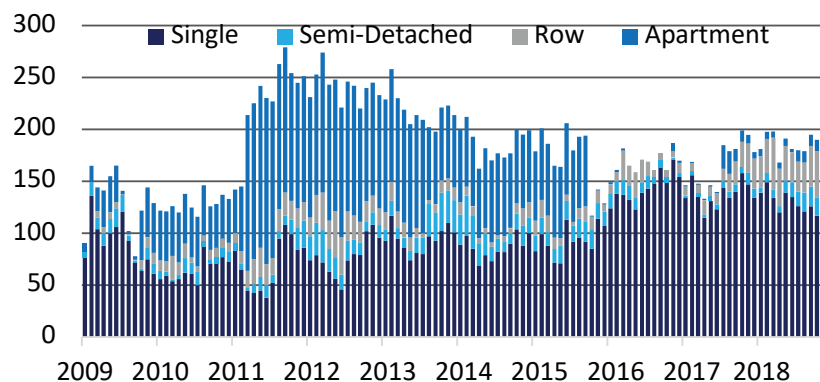
Source: Calculations based on the NAHB "Priced-Out" Methodology

Lethbridge CMA – New Home Sales



Source: CMHC Housing Market Portal & author's forward projections

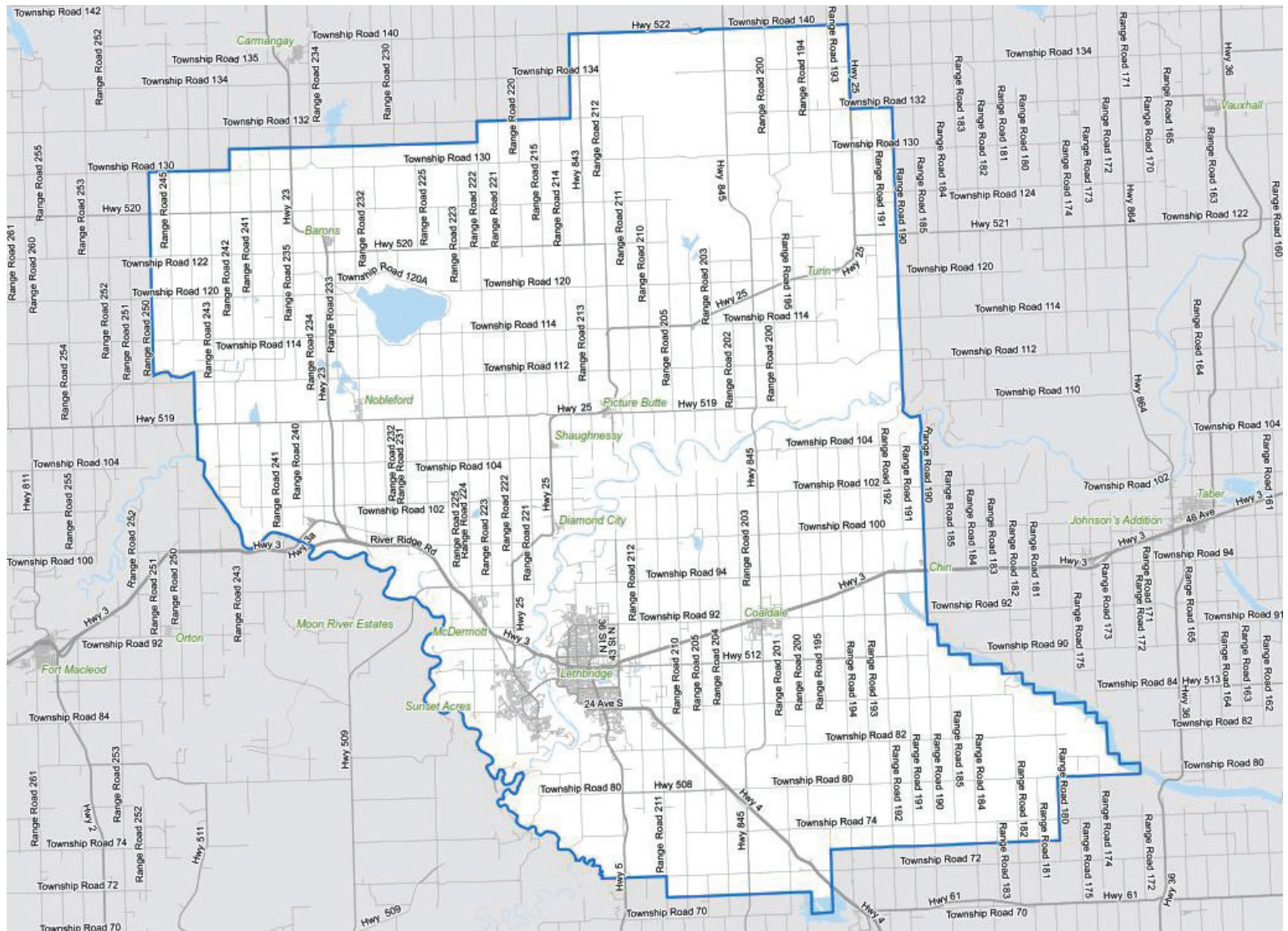
Lethbridge CMA - Unabsorbed Inventory



Source: CMHC Housing Market Portal



Lethbridge Census Metropolitan Area



Affordability Calculation:

Assumes a 10% down payment, a starting B20 stress-test interest rate of 5.34%, a 3.1% insurance premium, \$150/month heating costs and \$350/month for other debts. Historical mill rates as per The City of Lethbridge. Interest rates are projected to continue to increase at recent increments to 2020.

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