CANADIAN BUSINESS

The Incredible Shrinking Mortgage Rate

Banks are keeping the housing market bubbly with the cheapest mortgages in history. Just how low can they go?

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When the Bank of Montreal dropped its key mortgage rate below the 3% threshold in March, Paula Roberts started to get calls from her clients. They wanted to know if they should break their mortgages and refinance at BMO's limited-time, bargain-basement 2.99% rate—the lowest rate ever officially offered by a Canadian bank for a five-year, fixed-rate mortgage. The sudden surge in interest baffled the Toronto mortgage broker. After all, these were clients who were already locked into mortgages with even lower rates and better terms than BMO's. "All of our lenders were at lower than 2.99% at that point," Roberts said.

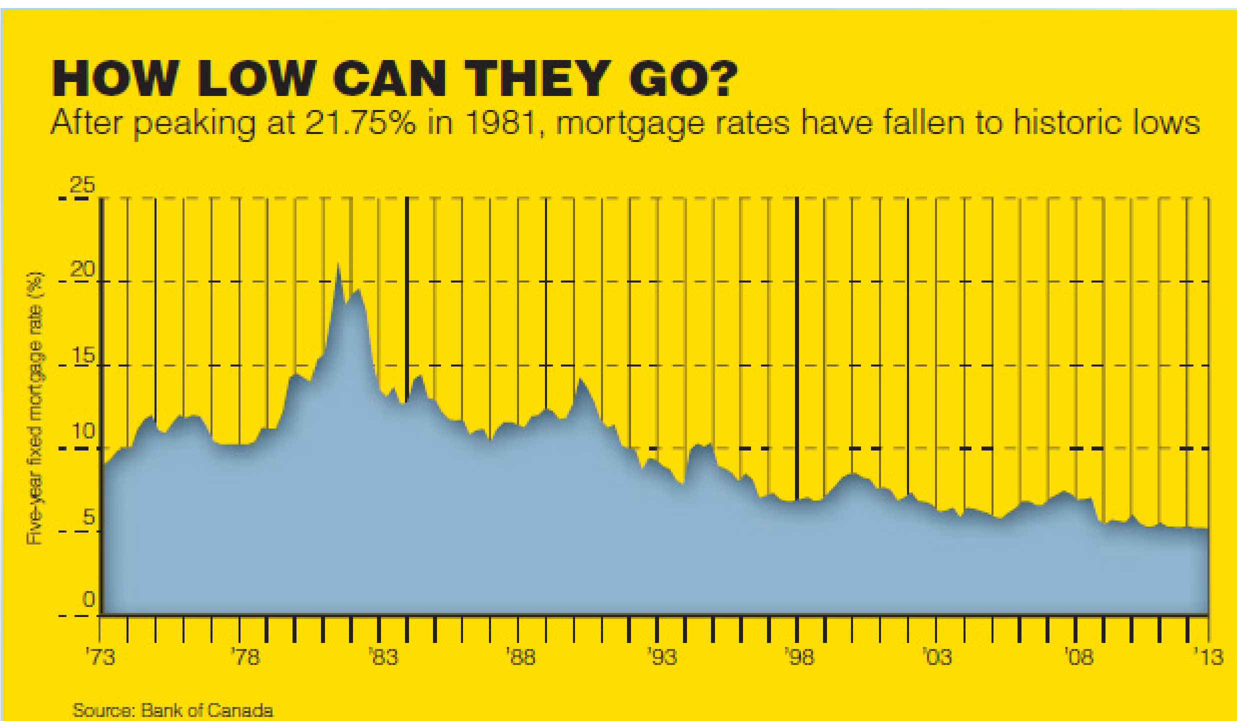
It's an open secret that Canadian homebuyers can secure mortgages on the cheap these days. BMO simply advertised the kind of lending practices that were already widespread. But stating the obvious got the bank plenty of attention—from media, from Canadian borrowers and from the federal government.
Finance Minister Jim Flaherty also picked up the phone, calling BMO to register his disapproval of the rate reduction. "My expectation is that banks will engage in prudent lending—not the type of 'race to the

bottom' practices that led to a mortgage crisis in the United States." He thanked the country's other big banks for not following BMO's lead. Manulife Bank apparently missed the subtext of that message, subsequently announcing a 2.89% mortgage offering. Flaherty blasted the promotion, calling it "unacceptable."

After "consulting with the Department of Finance," Manulife withdrew the offer the next day. BMO let its promotion expire at the end of March. Thus was restored the don't-ask-don't-tell practice of supplying discount mortgages without making too much of a fuss about it. "I bet if you went out today to any bank, if you have the right credit score and the down payment, you'd get a 2.89% mortgage," says Peter Routledge, an analyst at National Bank Financial.

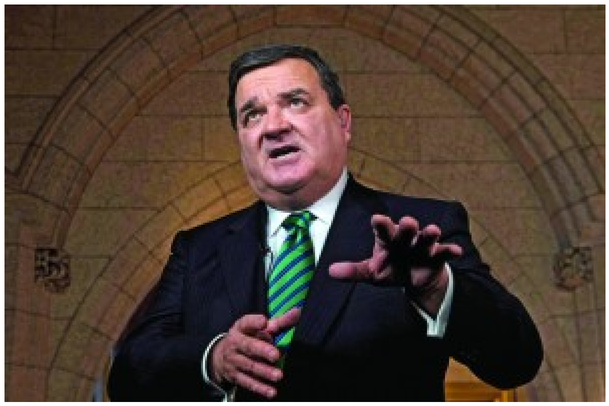
In reprimanding the financial sector, Flaherty again warned of risky household debt accumulation. But he also objected to the optics of the mortgage fire sale, adding: "It's also symbolic." In the midst of the effort to avert a housing crash and convince Canadians to stop borrowing, here were BMO and Manulife publicizing cut-rate housing debt with all the discretion of used-car salesmen. But you can hardly blame them. Fewer homes are being sold in Canada, reducing the demand for new mortgages. It's simple economics: when demand falls, so do prices. To vie for the patronage of the dwindling ranks of borrowers, banks have to sweeten the terms of their mortgages.

Banks can afford to slash rates because money has never been cheaper in Canada. While the federal government appeals for restraint in debt accumulation, the Bank of Canada's interest rate policy encourages just the opposite. And since policy rates aren't likely to budge for at least another year, Flaherty is left to glower at banks from up on high while mortgage rates continue to drop. Just how low they go will be limited only by the banks' profit margins and the government's persuasiveness in discouraging loose borrowing and lending. "I really can't see them going any lower. But I said that before," Roberts says. "Who would have thought they would have gone this low?" There's never been a better time to get a mortgage than right now. But there soon could be.



Having saved up enough money for a down payment while living with his parents in Toronto, Lucas Shearer decided to make his first foray into the real estate market in January. He quickly found the right place—a $344,000 condo in the Yonge and Eglinton neighbourhood—after qualifying for a 2.89% five-year fixed-rate mortgage. "At a higher rate, it definitely would not be as attractive," he says. "I probably would have just stayed at home, saved more money and assessed it in a year from now." Compared to the average discounted rate on five-year mortgages over the past five years, which according to ratehub.ca is about 4.25%, Shearer will have saved about $18,000 in interest and owe $6,000 less by the time his mortgage expires. Compared to the 6% peak five-year rate over the past five years, Shearer will save more than $50,000.

While Shearer wasn't compelled to buy real estate by low mortgage rates alone, they were an added incentive that made the market more attractive to him. This runs counter to the government's deliberate attempt to contain housing activity. Bank of Canada governor Mark Carney warned of a "brutal reckoning" when rates eventually climb and expose the finances of many households as unsustainable. There are those homeowners who can afford a $700,000 home today, but could only afford a $500,000 home at 6.5%, which is where rates could conceivably sit in five years when new mortgages expire, says John Andrew, a real estate professor at Queen's University.


(CP/Adrian Wylde)

Four times in the past four years, Flaherty has tightened mortgage insurance rules, each time making it a little more difficult to get home financing. And although household debt continues to hit new record highs—reaching 165% of disposable income by the end of last year—Flaherty has succeeded in slowing housing activity in Canada. But that comes at the expense of the mortgage market, which is the largest of the banks' lending businesses. Mortgages in the banking sector are currently growing at about 6% a year—half of the pre-recession rate of growth. "The competition between institutions is so fierce that they really have no choice but to compete by offering as low a rate as they possibly can," Andrew says.

Lenders still make money on low-rate mortgages. Their profit margins are roughly measured by the difference between mortgage rates and the banks' own costs of borrowing, which is approximated by the Bank of Canada's five-year benchmark bond rate—about 1.2%. Most of the money the banking sector lends out is provided by retail deposits, supplemented by borrowing on the "wholesale" market. The minimum spread at which a bank would be willing to offer five-year mortgages is about 140 basis points, says ***Ohad Lederer***, a financial services analyst at ***Veritas Investment Research***. That would put a floor on five-year mortgage rates of about 2.6%—assuming the five-year bond rate doesn't fall any further. Variable or shorter-term mortgages are already available for even less. So yes, there's still room for rates to fall, and banks may prove willing to sacrifice profitability for market share. "You're talking about a long-term customer. The vast majority of mortgage borrowers are on a 25-year amortization period, and if they're with a major lender, they will probably never leave," Andrew says. "It also opens up other opportunities. Once you've got a relationship with a lender, maybe you're more likely to get a savings account, get a line of credit, or take another mortgage out."

To Flaherty, the competitive strains of the market do not justify a mortgage rate war in the banking sector. But it's unusual for a finance minister to publicly scold a financial institution like Manulife for a pricing decision. "The whole thing is puzzling," Andrew says. "It's like phoning up Galen Weston and saying I don't like the price of milk."

Criticism came from many quarters, including the Conservative party's own ranks. "Me, personally, I would not dictate to businesses what prices to decide," Small Business Minister Maxime Bernier said. "It's the market. It's supply and demand that decides the prices. It is the case for interest rates; it is the case for other products too."

The Canadian mortgage market, however, is not exactly free and open. The Canada Mortgage and Housing Corp. insures roughly half of outstanding mortgages in Canada against default. Genworth Canada, backed by a federal guarantee, covers another 25%. So for the great majority of the Canadian mortgage market, the risk of default is shouldered not by the banks, but by taxpayers. "For the banks, it's fantastic," Andrew says. "They get their money and they don't have any of the hassle of the foreclosure process. It's pretty much an ironclad guarantee."

Whereas default risk is a natural disincentive to loose lending, from the banks' perspective, the risk of issuing mortgages is minimal, which helps to explain why they're willing to loan money at such low margins. It also helps to explain why the government wants to have a say in how mortgages are priced. "The more people take on debt, the bigger the contingent liability the government has, the riskier it gets," Routledge says.

Of course, the government can always tighten regulations to effectively limit the availability of mortgages. While he has no control over mortgage rates, Flaherty does have the power to further reduce the maximum amortization or increase the minimum down payment on insured mortgages. But there are competing concerns emerging about the Canadian economy, aside from housing, and Flaherty has given no indication he intends to resort to further regulation. Mortgage tightening effectively pushes marginal borrowers out of the market, reducing the size of the pool of first-time homebuyers. And it's that cohort driving much of the demand for condos and suburban starter homes, Andrew says. The government can't afford to unduly impair the construction sector. Rather, it wants to slowly let some air out of the housing bubble without triggering anything severe.

Given all of that, the big question is whether rates will sag even lower in the months and years to come. It could indeed happen if the Bank of Canada keeps the overnight rate where it is right now, while a slowing housing market puts even more pressure on the banks to cut their profits as they battle for share in a dwindling market.

As for the first condition, outgoing governor Mark Carney announced on April 17 that the Bank of Canada was yet again keeping its overnight rate at 1% and said the bank was pushing back its own projections for the economy's recovery to "full capacity" to mid-2015. "This is later than was anticipated by the Bank in January," Carney said. In other words, the target interest rate looks likely to remain at its current rock bottom through 2014—and perhaps even longer.

The second condition for declining rates will likely be satisfied too: housing unit sales have now been declining for months, unemployment has remained stubbornly high, and economic growth is still sluggish. All these factors further constrict the number of mortgage-worthy homebuyers; as banks scramble to court them, cutting into their profit margins looks ever more likely. That could conceivably take variable rates as low as 2.2%—perhaps even lower.

For the moment, Manulife and BMO have fallen back in line by reducing the visibility of their mortgage rates. But nothing has changed in terms of the mortgage contracts being signed. Roberts, the Toronto mortgage broker, is advising all of her existing clients that if they are currently locked in mortgages at rates of 3.59% or higher, they need to consider breaking their contracts and refinancing, depending on the penalties and time to maturity. The lure of a bargain is hard to resist, and it looks like more bargains are on the way—just don't tell the finance minister.