Experts wonder if mortgage rule changes are "the last nail in the coffin?"

While some in the mortgage industry are praising the response to the federal government's latest rule changes as "swift and profound," others, with memories of the US housing meltdown, wonder whether the changes represent a crisis for the average home homeowner or if it a "misguided attempt to slow down a potential real estate bubble in locations such as Toronto with minimal impact," in the words of some industry experts.

One of the major changes to the new rules is those applying for mortgages will now need to qualify at the Bank of Canada's five-year fixed rate currently at 4.64 per cent on all mortgages to pass what is being called the "rate stress test." Previously, if qualifying on a five-year fixed term, mortgagees could qualify at the lenders best rate, approximately half the posted rate.

"The logic behind the change is that homeowners should have some wiggle room in terms of future affordability in the event of interest rate increases," Bruce Smith of Casb Management Group Inc., explains. Smith say that while this makes sense in some respects, the change will also reduce the number of Canadians – perhaps as many as 15-20 per cent of buyers and especially first-time homebuyers that can now qualify for mortgages, especially first time home buyer. "Supply and demand suggest housing prices will drop with fewer people eligible for purchase," Smith says.

Bruce Smith

There will also be restrictions on low ratio mortgage insurance. Currently, all mortgages with less than a 20 per cent down payment are subject to government-backed insurance, such as provided by the Canada Mortgage and Housing Corporation. Many lenders currently purchase bulk insurance from insurers for mortgages with a greater than 20 per cent down payment, and it is these low ratio mortgages that will be affected.

"In theory, reducing this reliance on insurance makes sense, as with 20 per cent equity in a property, lenders should be expected to take some risk in the lending process and not expect the government to bail them out on any bad deals they underwrite," Smith says.

Smith also says, however, that this could create multiple issues, including fewer deals being approved and higher interest rates for uninsured deals to offset the additional risk. Smith notes rental properties in particular are likely to be most affected. He adds there could be "an exodus of non-bank lenders from the marketplace which would be of particular concern as completion is essential for keeping mortgage rates low. Non-bank lenders who don't raise funds from deposits must securitize or essentially sell their book of mortgages to third parties, in order to replenish the coffers, so they can underwrite new mortgages."

The end result of a lack of insurance or increased cost of insurance will make the process more difficult as either these costs will be passed on to consumers, or the current business model for the lender no longer works, Smith explains. He believes the situation could mirror what happened during the U.S. housing meltdown where the resale market for mortgages simply dried up, and many lenders ceased operations in Canada. The net result is potentially higher mortgage rates, fewer mortgage approvals and a subsequent drop in home prices.

One final issue regarding the new mortgage ruling surrounds the primary residence capital gains exemption. Currently, any financial gain from selling a primary residence is tax-free. However, what has led to an issue are both foreign investors and house flippers/landlords not reporting capital gains on the sale of homes, when the homes are not used as their primary residence. "Tighter Canada Revenue Agency reporting procedures will hopefully help close this loophole and enforce the tax rule, as it was intended," Smith says.

Smith says there are many issues stemming from new rules. He adds that time will tell if the rule is "the final nail in the coffin as some have been suggested, or simply prudent/misguided fiscal policy that Canadians will simply have to accept, as it impacts on their ability to purchase homes and finance mortgages?"

Bruce Smith, of Casb Management Group, consults on financial topics, including investments, mortgagees and real estate. Find him at www.casbmanagementgroup.com.