Canadian Mortgage Renewals Outlook
A Positive Update

Summary—Limited Financial Stress for Mortgage Holders, No Widespread Meltdown

- More mortgage holders facing renewal will feel financial pressure in the three years ahead, than in the last three.
- Mortgage borrowers will face an average 20% increase in monthly mortgage payments.
- The increase in mortgage payments is significant but better than anticipated 6–12 months ago, thanks to CPI inflation normalization and the ongoing normalization of short-term interest rates.
- Labour market conditions are expected to accommodate most borrowers to pay on time.
- After-tax real incomes are poised to improve at a solid pace, although the greater dedication of income to mortgage payments will require consumption adjustments.
- The slight rise of financial stress in the non-mortgage space points to an equally small increase in mortgage loan balances in arrears 90+ days.
- The percentage share of mortgage arrears is expected to remain below the highs reached during previous recessions.
- Only a very small percentage share of borrowers is expected to experience severe financial stress.

Busy Mortgage Renewals Period to Get Busier

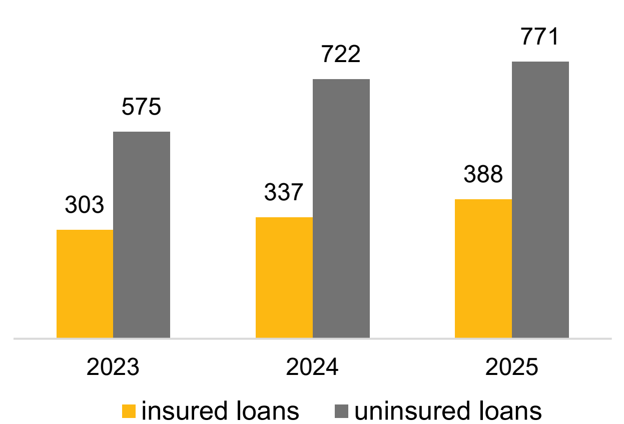
This report revisits the dynamics of mortgage holders facing higher payments at renewal. It continues to be a familiar topic during conversations Laurentian Bank Securities has with its investor base, across Canada.

Earlier this year, the Office of the Superintendent of Financial Institutions (OSFI) unsurprisingly identified mortgage renewals as a top financial risk. Of the mortgages outstanding as of early 2024, three quarters of mortgages are set to renew by the end of 2026, according to OSFI.

In the *2024 Financial Stability Report* (FSR) released last May, the Bank of Canada (BoC) reported approximately 37% of mortgage holders will renew in 2025 and 2026. It represents a significantly busier period relative to 2023 (9%) and 2024 (10%). Relative to the initial loan period, the BoC estimates the median monthly mortgage payment increase at 25% in 2025 versus slightly less than 20% this year, according to our calculations. The report also indicates a larger median shock slightly north of 30% for borrowers facing renewal in 2026, compared with origination.

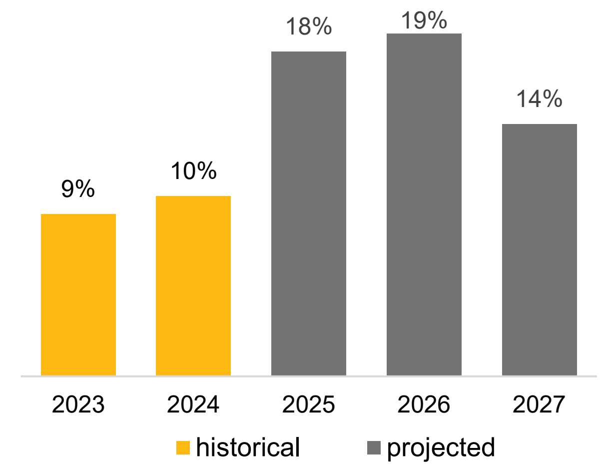
In late 2023, the Canada Mortgage and Housing Corporation (CMHC) predicted 1.2M mortgage holders will face significantly higher payments in 2025, up from 1.1M in 2024 and 0.9M in 2023. CMHC estimates average monthly mortgage payments could increase 30% to 40% in the coming years. This is broadly in line with the BoC FSR findings.

Number of Mortgage Loans Subject to Renewal at Higher Interest Rates (in 000s)



Source: CMHC November 2023 Mortgage Report

Share of Mortgages Subject to a Payment Increase Relative to 2022



Source: Bank of Canada Financial System Report

Timely CPI Inflation Normalization; Timely Interest Rate Relief

Initial assumptions of the BoC FSR and CMHC report were based on expectations for a higher path of interest rates relative to what markets are pricing in today. About 6 to 12 months ago, for instance, market participants had priced in less than a 75bps cumulative reduction of the BoC policy rate by the end of 2024.

Interest rates on the yield curve are lower than last spring, thanks to solid evidence of CPI inflation normalization. We project total CPI inflation to stay close to 2% going forward, implying the 1.6% September figure was in our view a temporary dip. After reducing the overnight rate target by a cumulative 125bps to 3.75% on October 23rd, we forecast the BoC to cut its policy rate by an additional 75bps to 3% by March 2025. The 5-year fixed mortgage rates recently stood at the low- to mid-4% range. This is a notable drop from last spring when the rate was above 5%. Our renewal shock simulation, below, is based on a moderate uptick in the Government of Canada 5-year bond yield to 3.50% by mid-2025 relative to 2.90% today.

20% Average Mortgage Renewal Shock Ahead, Relatively Less Severe Than Previously Anticipated

We expect mortgage holders on fixed rates renewing in 2025 and 2026 to face an average monthly payment increase of 20% relative to their previous term. This constitutes a slightly lower renewal shock estimate compared to simulation findings previously made by the BoC and CMHC ranging between 25% and 40%. Twenty percent is still a significant shock at renewal.

This average estimate hides the fact that the renewal shock will be particularly large for those with 5-year fixed mortgages who benefited from extremely low interest rates in 2020 and 2021 and took on additional debt to afford rising home prices during the pandemic. Meanwhile, borrowers on variable-rate mortgages with variable payments will pay less each month. They will benefit from a relief offsetting 40% of the cumulative shock observed in 2022–23 when the BoC raised its policy rate by a cumulative 375bps.

Our findings corroborate the results of the most recent BoC 2024Q3 Canadian Survey of Consumer Expectations (CSCE), which was conducted after the back-to-back 25bps policy rate cuts announced in June and July. The probability of missing payments on all types of debt has edged down in our view relative to 6-12 months ago. The CSCE survey cited, "*fewer mortgage holders this quarter expect their mortgage payments to increase significantly at renewal, and those expecting higher payments have become more confident that they will be able to cope when they renew their mortgage contracts*." The CSCE survey also finds out fewer consumers are feeling worse off financially because of elevated CPI inflation, a trend poised to improve further.

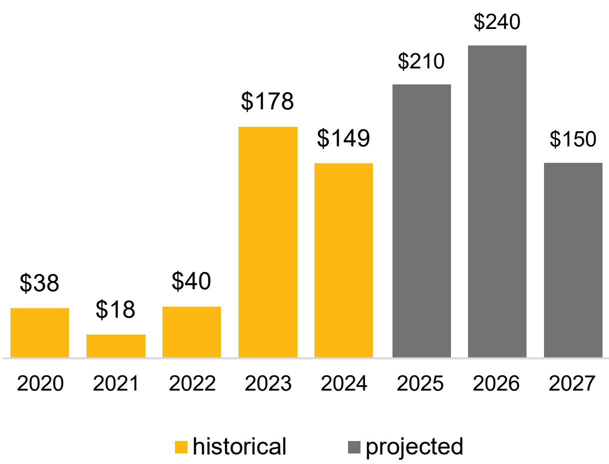
In a reverse engineering analysis, we found both the Government of Canada 5-year bond yield and the BoC policy rate would need to fall around 2% to maintain the renewal shock of 2025 and 2026 like 2024. This is an unlikely scenario in our view.

Renewal Shock to Lift the Average Monthly Payments on All Existing Mortgages

A different concept we look at, relates to the impact of renewals on the average monthly payment for all existing mortgages. In dollar terms, borrowers with a mortgage pay on average at $1700 per month as of 2024Q1. This compares to $1551 a year prior and $1373 in 2022Q1 when global central banks were on the verge of a coordinated hiking cycle. We expect average monthly payments on all mortgages to rise by another $210, to $1910, between 2024Q1 and 2025Q1. By 2026Q1, we forecast an additional increase of $200 per month.

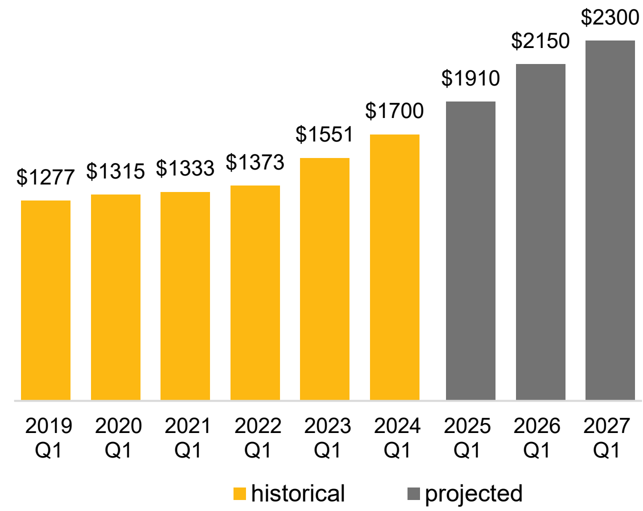
Those renewing in 2022 are likely to see a smaller shock based on our interest rates projected path. Also, CMHC's *2024 Mortgage Consumer Survey* highlights a shift towards shorter-term fixed rates at the 1-to-3 years horizon in recent years. These borrowers should be able to reduce their payments when renewing at lower rates in 2027. Altogether, these forces should translate into a relatively lower increase of average monthly payments relative to 2025-26 at $150, or similar to the uptick observed between 2023Q1 and 2024Q1.

Annual Increase in Average Monthly Payment Obligations for Existing Mortgage Loans



Source: CMHC; LBS Economic Research Projections

Average Monthly Payment Obligations for Existing Mortgage Loans



Source: CMHC, LBS Economic Research Projections

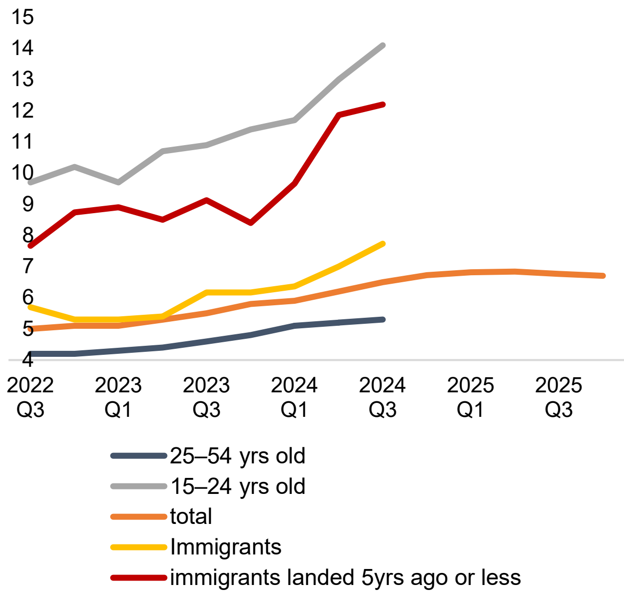
Unemployment—Still an Ally for Mortgage Credit Performance

Borrowers' ability to make payments on time depends largely on the job market. Canada's unemployment rate increased from 5.0% in early 2023 to 6.5% in September 2024—the highest level since 2017, excluding the pandemic period.

Although job market conditions have been softening, mortgage holders remain largely insulated. The rise in unemployment has disproportionately affected youth and recent immigrants, who usually rent, rather than own. The jobless rate for both these demographics unfortunately stands above 10%, while unemployment among the 35–54 age group remains firmly under the 6% mark, so far in 2024. This 35–54 age group is the most important for mortgage credit performance because they have more debt than other groups in dollar terms and as a percentage of disposable income.

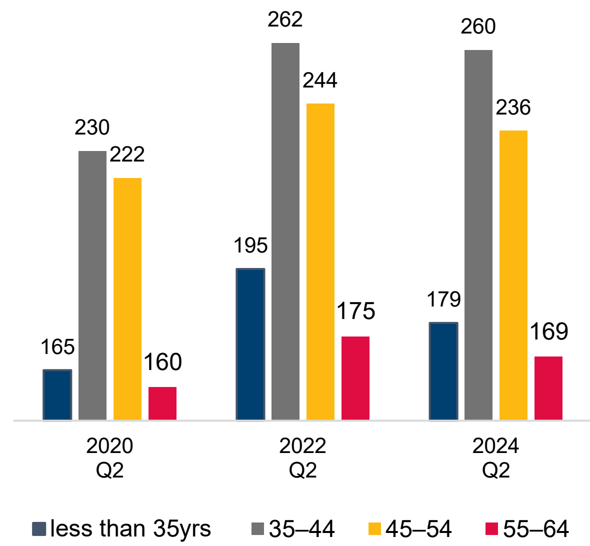
To properly assess the credit performance through mortgage arrears, it is worth describing our labour market assumptions too. We forecast unemployment will rise gradually from the current 6.5% figure but to stay slightly below the 7% mark. The federal government will slowly reduce the share of non-permanent residents in the population and plans to welcome 22% fewer permanent residents in 2025-26 than anticipated a year ago. These measures should realign labour force growth with modest employment growth, leading to a gradual decline in the unemployment rate to 6.7%, by the end of 2025. While the job market is rebalancing, strong corporate earnings and a high percentage of companies reporting skilled labour shortages (see CFIB's September 2024 Monthly Business Barometer) should mitigate the risk of widespread layoffs going forward.

Unemployment Rate by Selected Groups (%)



Source: Statistics Canada; LBS Economic Research Projections

Q2 Comparison Debt-to-Income Ratio by Age Group of Major Income Earner (%)



Source: Statistics Canada

Moderate Wage Growth—To Accommodate Most Borrowers to Make Payments on Time

The low level of unemployment among mortgage borrowers—particularly Canadian millennials and Generation X carrying higher debt burdens—will lead to further solid wage growth. A simulation exercise done by BoC staff in late 2023 used a 2.4% wage growth estimate to show that higher incomes can partially—but not fully—offset the effects of rising interest rates on debt repayment. The report concludes most mortgage borrowers will not face severe financial stress from rising payments if their wages continue to grow.

We think the 2.4% assumption used is overly prudent. Workers seek higher pay to restore purchasing power in response to the high inflation years of 2021–23. Average hourly earnings reported in the *Survey of Employment, Payrolls and Hours* (SEPH) are up 3.6% year-to-date. The *Labour Force Survey* (LFS) reports a 5% increase in average hourly earnings year-to-date. The current wave of new labour union settlements incorporating solid wage growth agreement and sufficient duration, particularly in the public sector, is expected to last through the critical mortgage renewal period of 2025 to 2027.

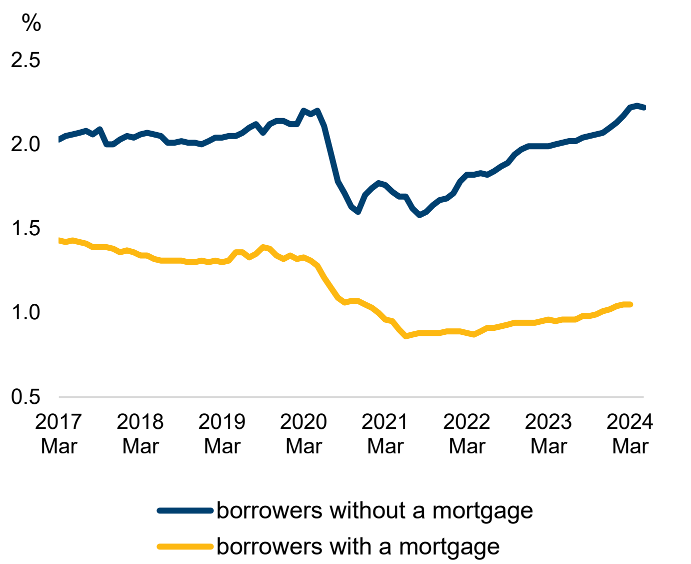
We assume a conservative 2.8% average annual wage increase over the 2025–27 period. In percentage terms, this appears—at first glance—to be insufficient, compared to our estimate of an upcoming 20% median shock at renewal in 2025–26. However, in dollar terms, the situation appears more manageable. The average before-tax income for homeowners was $136K in 2022, and it has been rising since. A 2.8% wage increase would translate into an after-tax labour income boost of $180 per month, allowing most mortgage borrowers to meet their payments.

Non-Mortgage Delinquencies—Softer Rise for Mortgage Borrowers Than Renters

Delinquency on other credit types constitutes a key measure of financial pressure. A valuable breakdown shared by the BoC shows auto loan delinquencies among borrowers without a mortgage are at a 10-year high (1.3%), while only 0.2% of mortgage holders are behind on their auto loans. This discrepancy in non-mortgage credit performance can be attributed to relatively larger holding of liquid assets among homeowners with a mortgage than renters, in addition to the diverging performance observed within the job market favouring homeowners relative to renters.

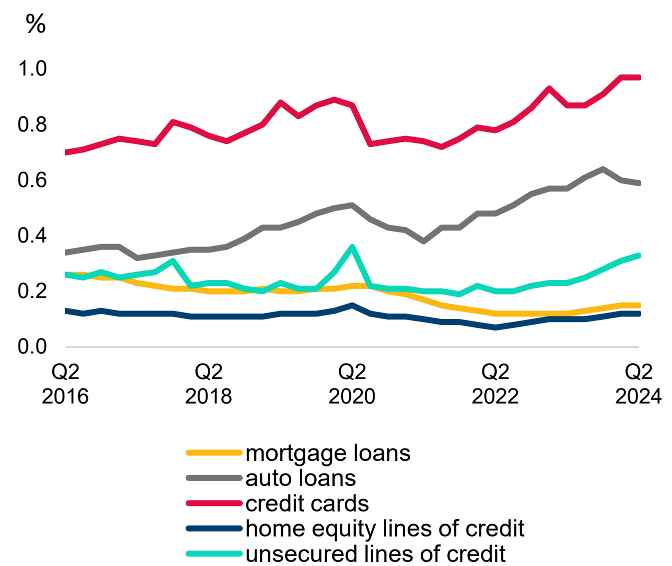
Data compiled by the BoC also shows the share of payments overdue by 60 days or more has risen faster for non-mortgage holders (renters, homeowners without mortgages), than for mortgage holders. This rate was 2.2% in early 2024—twice that of mortgage borrowers (1.1%). But financial stress among mortgage borrowers is rising, albeit softly. A BoC's staff report released last July indicates mortgage holders with unpaid credit card balances are twice as likely to miss mortgage payments than those who pay off their credit cards. The main conclusion to draw here is simple: we cannot call for an imminent peak in mortgage arrears until financial stress in other types of credit among mortgage borrowers peaks. One big silver lining increasing the odds of softening the burden of households under pressure came from the most recent BoC CSCE: the median probability of missing a payment edged down from 1.6% in 2024Q2 to 1.5% in 2024Q3, also moderately lower than the peak of 1.9%.

Borrowers with Credit Card Products in Arrears (60+ Days)



Source: BoC Annual Financial System Report, May 2024

Rates of Loans in Arrears by Product Type (60+ Days)



Source: BoC Indicators of Financial Vulnerabilities

Recent Trend—Mortgages Arrears Softly Increasing, Still Very Low

Mortgage delinquency rates remain extremely low, according to statistics.

First, the percentage of all mortgages in arrears 90 days and over (insured and uninsured) has been edging up to 0.19% for most of 2024. This compares to 0.15% in early 2023 when unemployment hit a cyclical trough and to 0.12% in mid-2022, before floating rates began to rise sharply as the BoC started its jumbo hike campaign. In comparison, UK mortgages in arrears stand at a 7-year high, near 1.5%. In the U.S., the delinquency rate stands at 0.74%.

Second, CMHC's latest quarterly results for 2024Q2 highlight strong credit performance among insured mortgages. The share of arrears for insured mortgages has been stable during the last year (0.29% in 2023Q2, versus 0.28% in 2024Q2).

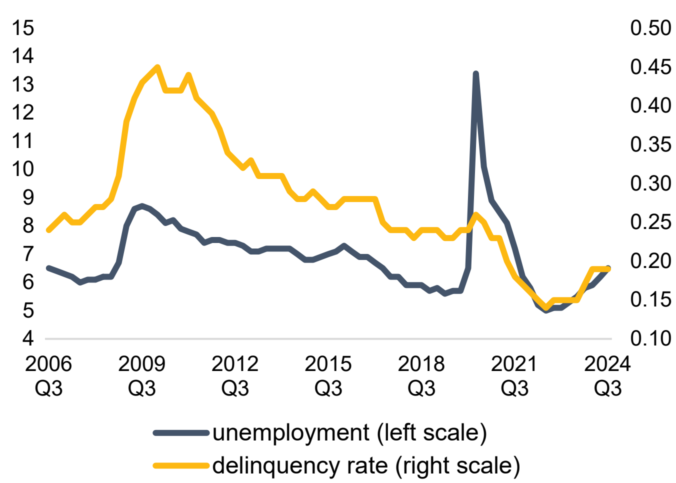
Outlook—Mortgages Arrears Poised to Rise Slightly and Stay Below Previous Highs

We anticipate the share of mortgages in arrears for 90 days and more to rise slightly above the pre-pandemic high of 0.25% by the end of the challenging mortgage renewal cycle in 2027— moving closer to 0.30%. Our expectation is based on the higher number of renewals, the larger shock in percentage terms in respect to monthly payments, the additional softness of job market conditions and signals of growing financial stress in the non-mortgage space. A study released last May, by CMHC, projected mortgages in arrears to reach 0.25% by the end of 2024. We think the 0.25% figure will be eventually reach, but by late 2025 instead.

In our view, previous macroprudential housing finance regulation will prevent the percentage share of mortgage arrears during the 2025–27 period to reach the 0.4%–0.5% range observed during the 2008–09 recession and some longer episodes of the 1990s.

Our mortgage delinquency rate estimate assumes a moderate 5% average annual appreciation in Canadian home prices. We also expect further adjustments from households taking the form of a moderate cutback in discretionary spending on a per capita basis. According to the CMHC 2024 Mortgage Consumer Survey, over 40% of mortgage holders report they have cut expenses. Furthermore, the 2024Q3 BoC Canadian Survey of Consumer Expectations shows close to two thirds of consumers plan to reduce their spending in response to interest rate expectations. This figure is better than in previous quarters but well above results recorded post-pandemic (45%–50%). We also think liquid assets won't save the day for long. The May 2024 BoC FSR shows homeowners with mortgages carried the equivalent of approximately two months of after-tax income in liquid assets as of early 2024, versus slightly more than 2 months in early 2023. Such a small liquidity buffer offers only temporary relief in the event of unexpected job loss. As of 2024Q2 middle-class households and those with below-average incomes are still dipping into savings to cover expenses according to Statistics Canada, even though CPI inflation normalized.

Unemployment Rate and Mortgage Delinquency Rate (3 Months or More)



Source: Statistics Canada, CMHC, Canadian Bankers Association

Takeaway—Limited Severe Financial Stress, No Widespread Meltdown

More mortgage holders will feel financial pressure in the three years ahead than the last three. This pressure will also be relatively more significant but better than anticipated 6–12 months ago. The return of low CPI inflation and the ongoing normalization path of short-term interest rates are welcome developments pointing to a 20% average shock for those renewing in 2025 and 2026. Real incomes are poised to improve markedly although the greater dedication of income to mortgage payments will require challenging consumption adjustments particularly since households cannot rely on past savings. Altogether, only a very small percentage share of borrowers is expected to experience severe financial stress, according to our projection of mortgage loan balances in arrears 90+ days.

We want to hear from you

Sales & Trading

Robert Sforza, CFA
Head of Distribution, Money Market & Repo
SforzaR@vmbl.ca | 514 350 2905

Etienne Bisaillon, CFA
Vice President, Trader
BisaillonE@vmbl.ca | 514 350 2905

Kacper Jurga, MS
Vice President, Trader
JurgaK@vmbl.ca | 514 350 2905

Benoit Martineau, MS
Vice President, Trader
MartineauB@vmbl.ca | 514 350 2907

Jean-Philippe St-Laurent, CFA
Vice President, Sales
StLaurentJP@vmbl.ca | 514 350 2904

Laura Chelaru, CFA
Vice President, Sales
ChelaruL@lb-securities.ca | 416 865 5811

Debt Capital Markets

Benoit Lalonde, CFA
Vice President & Head DCM
LalondeB@vmbl.ca | 514 350 2904

Massimo Morabito, CFA, FRM
Director, Debt Capital Markets
MorabitoM@vmbl.ca | 514 350 2904

Zakaria Hammama
Associate, Debt Capital Markets
HammamaZ@vmbl.ca | 514 350-2904

LBS Economics

Sébastien Lavoie
Chief Economist
LavoieS@vmbl.ca | 514 213 4571

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