Economics
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Are Canadian households ready for higher rates?

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The market is turning hawkish, pricing in no less than 6 hikes by the Bank of Canada in 2022, starting as early as March, and an additional hike in 2023. The bond market is smelling blood, as 10 and 5-year rates have risen by 52bps and 68bps, respectively, over the past few weeks (Chart 1).

Market expectations and actual rate changes are of course two different things. Our own call is for a more gradual hiking trajectory, spread out over 2022 and 2023. But clearly, we have reached a point in which we have to assess the impact of any potential Bank tightening.

And here, of course, the focus is on heavily indebted Canadian households that saw their overall debt levels rise by close to 10% during the pandemic, to reach more than $2.53 trillion or 173% of disposable income. Seventy percent of that debt is mortgage debt, of which one quarter is variable rate mortgages (Chart 2).

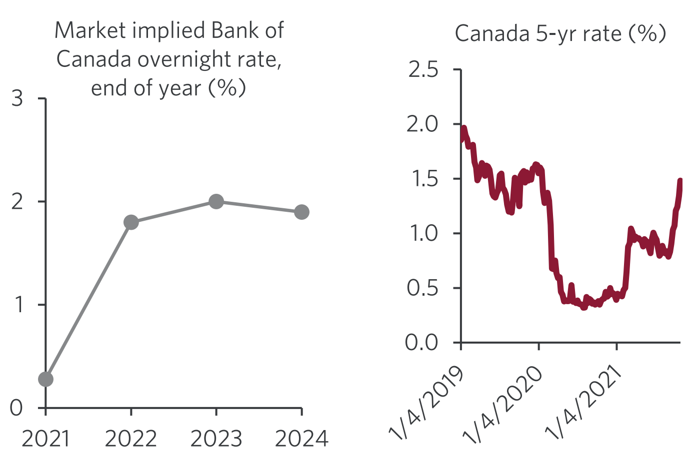
The mortgage portfolio

So how sensitive is that huge pile of debt to higher interest rates? Let's start with the mortgage portfolio.

Clearly, the rising size of new mortgages means increased sensitivity to higher rates. With the average size of a new mortgage having reached $450,000 (up by 20% during the pandemic), a one percent increase in mortgage rates from today's levels will cost an average new buyer $230 or 12% more in additional monthly interest payments. Assuming mortgage originations return to pre-pandemic levels, that translates into an additional $1.6 billion in annual interest payments relative to 2021 borrowers.

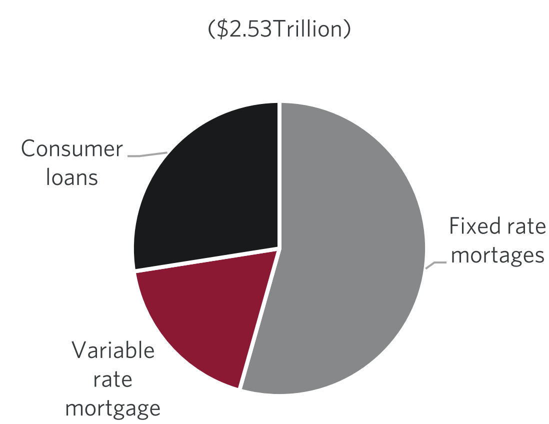
So higher rates can clearly slow down demand, but what about existing mortgage holders? How sensitive are they to higher rates?

Chart 1: Markets are pricing in an aggressive Bank of Canada



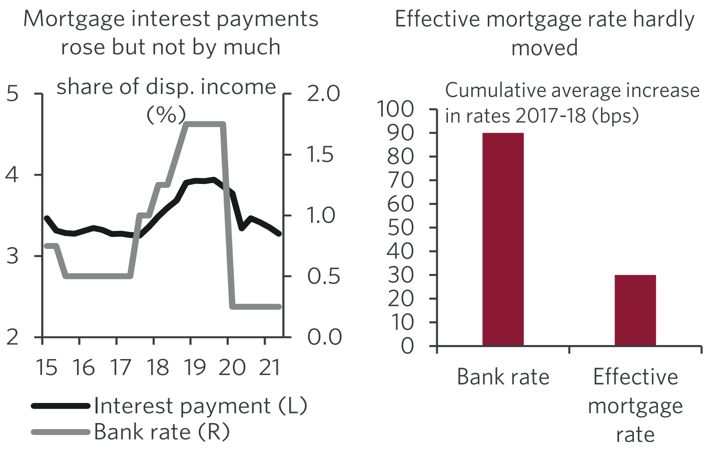
Source: Bank of Canada, Bloomberg, CIBC

Chart 2: The market



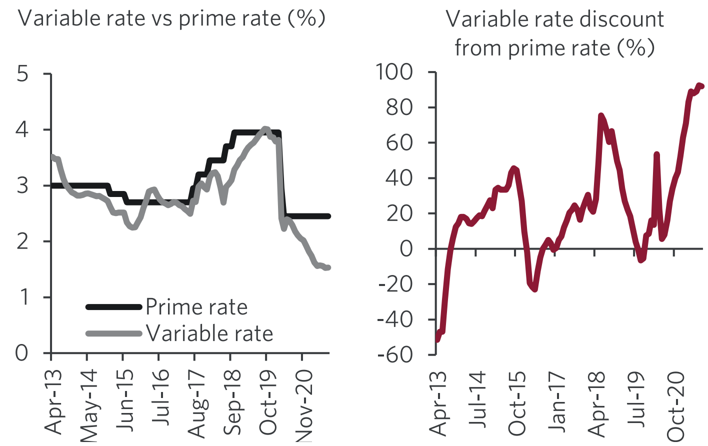
Source: Statistics Canada, CIBC

Chart 3: The 2017-18 hiking cycle



Source: Bank of Canada, Statistics Canada, CIBC

Chart 5: Rising discount from prime rate



Source: Bank of Canada, Statistics Canada, CIBC

Exposure

First, we assess the share of mortgage holders that will be exposed to higher rates. The vast majority of non-fixed rate mortgage debt is variable, meaning that during the term (usually 5 years), payments don't change due to higher rates, but amortization does. For fixed-rate mortgages, only about one-fifth reset in any given year. We estimate that roughly $350 billion of mortgages will be repriced in the coming year. So, not a trivial segment of the mortgage market will be repriced when the Bank makes its move. But repriced to what?

Repricing

To get a sense of the potential impact of rate hikes, we can start by examining the impact on the mortgage market of the Bank of Canada's 2017/18 hiking cycle, which saw the overnight rate rise by a cumulative 125 basis points.

Chart 3 tells the tale. Yes, overall mortgage interest payments in 2017 and 2018 rose in response to the Bank's hiking, but a closer look reveals that the increase amounted to only 0.5% of disposable income — hardly a macro story. Reflecting that, the effective interest rate on mortgages (the ratio of actual interest payments to mortgages outstanding) rose by only 30 basis points during that hiking cycle.

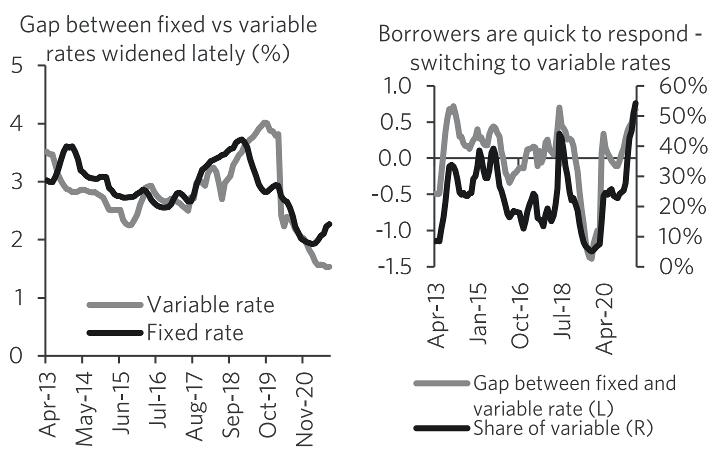
What was behind that muted response was not only limited exposure, but also the fact that those who had to reprice in 2017 and 2018 did it at a rate more or less similar to what prevailed five years earlier — so the interest rate change they faced was minimal.

Fast-forward to today's situation. As illustrated in Chart 4, both fixed and variable rates fell notably during the pandemic, with the gap between fixed and variable rates reaching record territory due to the recent increase in the five-year rate. Note the quick response by borrowers to that shift, with the share of variable rate mortgages in origination rising notably.

Importantly, the variable rate trajectory is impacted not only by the prime rate (which dances to the tune of the overnight rate), but also by the discount from prime offered by lenders. And as illustrated in Chart 5, that discount has widened notably recently.

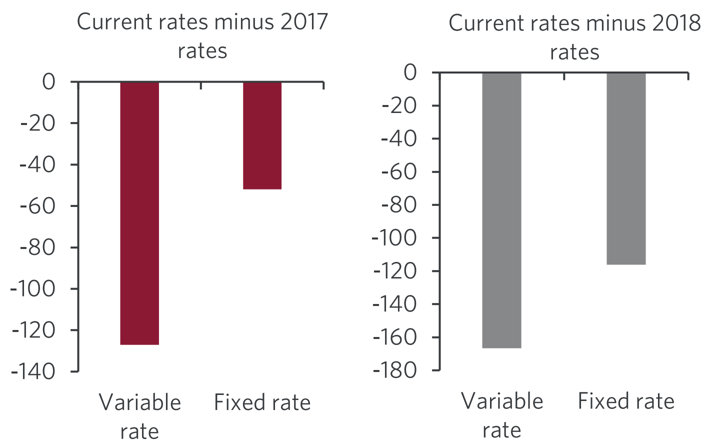
Given the above, we can now compare the current rate environment to the one that prevailed when mortgages that face resetting in the coming two years were originated. So, the only thing we need to do is look at the rate environment in 2017 and 2018 which happened to be, as discussed earlier, the last hiking cycle. That clearly makes the comparison more favourable. Charts 6 illustrates exactly how favourable. In 2017,

Chart 4: Variable vs fixed rate



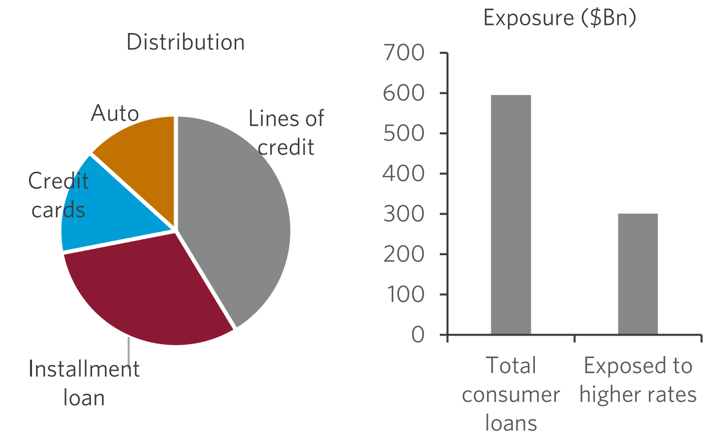
Source: Statistics Canada, Bank of Canada, CIBC

Chart 6: Gap between current rates and five years earlier



Source: Bank of Canada, Statistics Canada, CIBC

Chart 7: Consumer loans



Source: Equifax, CIBC

the five-year fixed rate stood at 2.84% while the variable rate was at 2.74%. Compare those rates to today's rate (Chart 6, left), and you see that today's variable and fixed rates are 127 bps and 52 bps lower, respectively. In other words, the five-year rate will have to rise by an additional 50 bps to start costing more, while the overnight rate will have to rise by close to 130 bps before starting to cause any damage. And with interest rates having risen in 2018, the comparison to 2023 is even more favourable (Chart 6, right). In fact, with rates remaining elevated in 2019, the borrowing cohort of 2024 is also relatively protected.

So the structure of the mortgage market and the rate hikes in 2017 and 2018, along with elevated rates in 2019, provide current mortgage holders with some immunity against rising rates. That immunity will cover borrowers that reprice in 2022 through 2024. But without a booster (lower rates in 2025/2026), that immunity will fade for borrowers that entered into mortgages during the pandemic. And given that in the past two years mortgage originations rose by more than 60% relative to their pre-crisis level, that might be a significant shock.

Consumer loans

As for the $660 billion consumer loan portfolio, the sensitivity to Bank of Canada rate hikes varies widely across credit products. For direct loans, roughly half of those outstanding are variable and are adjusted once a year. Lines of credit, of course, fully adjust to changes in prime. However, while in theory interest rates on credit cards are adjustable, rates would have to rise significantly more than we expect during this cycle before actual borrowing costs would even budge.

Accordingly, we expect roughly half of the current outstanding consumer debt to be repriced due to increases in the overnight rate (Chart 7). We estimate that a 100bps hike would lead to an increase of half a percent in interest payments as a share of disposable income.

Bottom line

Elevated and rapidly rising household debt levels mean increased sensitivity to higher interest rates. The good news is that existing borrowers whose mortgages originated in 2017 through 2019 will not be exposed to the full impact of potential rate hikes in the coming years.

That, however, is not to say that higher rates will not bite. Potential buyers will face a higher interest payment trajectory, leading to reduced demand for new and existing units, potentially resulting in some slowing in the important construction industry. Current variable rate holders might choose to keep their principal payments untouched and thus will absorb the full impact of higher rates — potentially at the expense of other spending. And the sizable lines of credit in the loan portfolio are fully exposed to any rate hikes, resulting in a direct impact on consumption. Furthermore, if rates stay elevated into 2025, the massive borrowing undertaken during the pandemic will feel the full bite of higher rates.

Accordingly, despite the protection enjoyed by existing mortgage holders, higher rates will still be effective in slowing economic activity. Moving too fast (as the market suggests now) is therefore inadvisable.

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