The dark side of the boom

Rock-bottom interest rates have made big mortgages look less expensive, lighting a fire under house prices. But for many homeowners, when rates start rising, it won't end well. Rob Carrick reports

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THE GLOBE AND MAILLAST UPDATED: MONDAY, DEC. 12, 2016 10:31AM EST

Through years of weak economic growth, up-and-down stock markets and miserable returns on cash savings, the housing market has delivered for Canadians by making them wealthier.

House prices used to more or less track the inflation rate, which was a feeble 1.5 per cent between 2008 and 2015 because of stunted economic growth. But in cities across the country, prices have jumped 5 per cent to 7 per cent annually over that same period. Prices in greater Vancouver have doubled in just a decade, while prices in greater Toronto have doubled since 2004. House prices have also risen sharply in mid-size cities such as Yorkton, Sask., Brandon and Thunder Bay.

Rising house prices make people wealthier on paper, but they also threaten to seriously damage the personal finances of those who borrow more than they can truly afford to buy a home. While most Canadians can handle their payments, the ranks of those suffering financial stress from oversized debt is growing, and quickly. The Bank of Canada says the proportion of indebted households that owe at least 3.5 times their gross income has doubled since before the financial crisis.

This cohort of the most heavily-indebted Canadian families represents 720,000 households, the central bank says – almost as many as there are in Manitoba and Saskatchewan. In some cases, their bloated mortgages have forced them into a financial high-wire act with no safety net. A recent survey by Manulife found that one-quarter of people have just $1,000 set aside for emergencies, a dismally inadequate amount by any standard of financial planning.

Credit lines and credit-card balances have surged since 2008, in part because some families must borrow to make ends meet.

In the longer run, high mortgage payments can crowd out retirement savings, forcing people to work longer or retire with a lower standard of living. Parents may not be able to save for their children's postsecondary education, which could lead to more student debt in the years ahead.

And yet it's difficult to persuade many Canadians that buying "too much home" can cause lasting harm to their financial health. "You're arguing with success on a huge scale," says Moshe Milevsky, finance professor at York University's Schulich School of Business and author of several books on personal finance and investing. "There's nothing that people could have done that would have resulted in a better return than housing over the past five years."

But a look inside the finances of Canadian homeowners shows there's a cost to this housing-generated wealth. Years of low interest rates have driven up house prices even as income growth has stagnated. That means people buying homes are devoting ever larger blocks of their take-home pay to their mortgages and other housing-related costs.

To afford a first home, people have always had to give up things such as restaurant meals, vacations, visits to the mall – and the list is growing. "Look around and you'll see all the things people are sacrificing as a result of their mortgage," Prof. Milevsky says.

In the near term, the biggest risk for people with big mortgage payments is that they will find it difficult to adjust to long-expected interest-rate increases that may just have begun with the mid-November uptick in mortgage rates. Even modestly higher rates might require families to curtail the consumer spending that has sustained the economy in recent years.

The credit-monitoring firm TransUnion reported recently that 718,000 people with debt would be seriously affected if interest rates rose just 0.25 of a percentage point, and one million people would struggle to cope with a rise of one percentage point.

Everyone who watches Canada's economy – from the Bank of Canada to global bond rating agencies – worries about the effect of rising rates of mortgage debt. But in all the excitement over ever-increasing house prices, many homeowners have overlooked these risks.

Here's a list of top-performing housing markets across the country between 2008 and 2015. Inflation averaged 1.5 per cent on an annual basis over this span

RANK*	MARKET	AVG. PRICE 2008	AVG. PRICE 2015
1	Greater Toronto	$379,943	$622,046
2	Thunder Bay (Ont.)	$132,470	$215,922
3	Yorkton (Sask.)	$104,693	$168,415
4	Swift Current (Sask.)	$133,743	$213,722
5	Hamilton-Burlington	$280,790	$442,493
6	SE Saskatchewan	$156,931	$246,922
7	Newfoundland & Labrador	$178,477	$275,579
8	Greater Vancouver	$593,767	$902,801
9	Oakville-Milton	$452,714	$685,431
10	Portage La Prairie (Man.)	$116,666	$173,236

RANK*	MARKET	AVG. PRICE 2008	AVG. PRICE 2015
11	Brandon (Man.)	$154,946	$224,535
12	The Battlefords (Sask.)	$148,179	$211,750

Source: Canadian Real Estate Association / *Out of 98 local markets / Ranked by percentage change

Stressed out

With prices rising in many places, it's getting harder all the time to buy a house. Our banking system decides if people can afford to buy by looking at their finances at the time they apply for a mortgage. It's a simplistic approach that compares gross income with the cost of mortgage payments, property taxes, heat and other debt payments (also 50 per cent of condo fees). If all of these costs total less than 40 per cent of your gross income (44 per cent if you have a great income and credit rating), and as long as you have the necessary down payment, your mortgage will be approved.

Debt default data tell us that the number of people unable to pay what they owe is both low and fairly stable, although there are warning signs in provinces reliant on energy production. But what's missing from this analysis will be obvious to people who actually own a home: Households can struggle financially even while paying the mortgage on time.

There are maintenance costs to keep the house in good shape and discretionary spending on improvements and furniture. With daycare and car payments added, some families don't have enough money to cover their living costs and also save. In the worst cases, they're relying on new borrowing to get by.

To investigate, we invited Globe and Mail readers to try an online tool, which we developed with accredited financial planners. It looks at how much of their take-home pay is left after meeting a full range of household costs and putting some money away in savings. We call this measure the Real Life Ratio – a more realistic approach to house affordability than the gauges used by banks and other lenders. According to the RLR guidelines, a score of 86 and higher represents the point at which financial stress becomes extreme; a score of 76 to 85 indicates a household on the threshold of this level of stress.

RLR calculator generated more than 50,000 submissions within a few days of being published. Adjusted to remove multiple calculations by the same person, the data show an average RLR of 60.5, based on a total 1,318 responses from homeowners with mortgages (many prospective buyers also used the calculator). This tells us that households on average have a respectable 39.5 per cent of their take home pay left after accounting for major expenses. Buried in this average number are both homeowners in great shape and the house poor. Almost 7 per cent of homeowners with a mortgage were in extreme stress and 10 per cent were on the threshold.

Thirtysomethings were under a bit more pressure when households in financial stress or on the threshold were combined – 18.7 per cent over all. In households with daycare bills, a combined 22.1

per cent were under severe stress or on the verge. A surprise finding was that 17.4 per cent of the small sampling of 50-plus households using the RLR calculator were in severe stress or on the edge. A general rule for prospective home buyers and owners who want to be able to comfortably afford a house is to keep a maximum RLR score in the 60 to 70 range. That way, they'll have room to cover housing costs, save for the future and keep some financial flexibility.

The bank says the people most at risk as a result of high debt loads are under the age of 45. Heavily-indebted households – those with debts of at least 3.5 times their gross income – accounted for 8 per cent of all indebted households in 2012-14, up from 4 per cent before the 2008-09 global financial crisis. "That amounts to about 720,000 households holding close to $400-billion in debt, about one-fifth of the overall household debt," deputy Bank of Canada governor Lawrence Schembri said in a speech early this year.

The country's most-watched gauge of indebtedness is the debt-to-disposable income ratio, which at midyear showed Canadians owed a record $1.68 for every $1 in after tax income. These numbers reflect two worrying trends – rising debt levels and stagnant incomes. In the second quarter of this year, for instance, debt grew by 2 per cent while disposable incomes improved by just 0.5 per cent. The flaw in the debt-to-income ratio is that it lumps everyone together – people who take out mortgages after winning bidding wars in Toronto with seven-figure bully bids and seniors who long ago conquered their mortgage and other debts. Critics of this measurement of indebtedness also say it ignores the wealth being created by rising house prices. But as the Real Life Ratio numbers show, rising net worth does not help families pay their mortgages and other costs of home ownership.

Alyssa Gowing, 27, bought her Belgrave, Ont., home in July. While she's proud of being a homeowner, she worries about the new financial stress it brings.
DEBORAH BAIC/THE GLOBE AND MAIL

Paying old debt with new debt

Alyssa Gowing, 27, is an example of how driven millennials are to buy a house. She bought a house in the Southwestern Ontario town of Belgrave in July because she thought it was time to move out of her family home, and she had a sense that home ownership would be a smart financial move. “I’m proud about being a homeowner,” she said. “I’m single, I’m a female and I’m doing it all by myself.” But there are many sacrifices – she scrimps on groceries, drives a 2007 car with 350,000 kilometres on the odometer and isn’t putting money in a tax-free savings account or registered retirement savings plans. “I’m coming up to 30 years old the next couple of years and I’m going to have no savings. That’s something I lose sleep over.”

Thirty-three-year-old Andi Shallvari and his family of four are financially stressed by their housing costs, and they don’t even live in a house. They own a two-bedroom, 1,400-square-foot condo in Toronto’s north end. They don’t own a car, they’re not saving for retirement and outings as simple as a meal out at a restaurant have become an infrequent luxury. “It’s insane,” Mr. Shallvari said. “And I’m an accountant.”

People such as Ms. Gowing and Mr. Shallvari are examples of what we might call “house poor” homeowners – they may own an expensive house, but they spend so much money on their homes that there’s little left over after the bills are paid. In all the excitement over rising house prices, these people and their struggles have been overlooked.

Ms. Gowing said her father, a real estate agent, estimates that her house has already risen a little more than 10 per cent in value. But there’s no connection between the worth of her home and her day-to-day finances. When a property-tax bill came due recently, it was more than she expected and consumed all the money she had at hand.

She has also been forced to give up travelling and small pleasures such as spoiling her friends with gifts. “I used to be very generous with gifts – I have a lot of friends who are getting married, a lot of friends having babies. Now that I have this financial obligation, I can’t offer that same kind of generosity.”

Mr. Shallvari’s story shows how having children can add to the financial pressures on a family with major housing costs. He was in reasonably good shape with an RLR score of 67, but then he and his wife, aged 31, had a second child. With his wife on maternity leave, Mr. Shallivari says his score is closer to a sky-high 89. “My wife keeps saying, oh, we’re good, it’s fine,” he said. “I had to tell her, look at these expenses – housing and daycare – there’s nothing left after that.”

Daycare, which lenders don’t ask about when sizing people up for a mortgage, is a big strain on household finances. The RLR data shows an average monthly daycare cost for parents of $975, while payments by car owners averaged $570 and property taxes averaged $331.

“You buy a house and all you’re focused on is the mortgage payment,” said Doug Hoyes, a bankruptcy trustee with Hoyes, Michalos & Associates. “You’re not factoring in the property taxes, the condo fees, the repair and maintenance and all the other stuff. That’s the killer.”

You can see this financial pressure in the results of a poll recently issued by Manulife Bank in which about 25 per cent of the 2,372 participants had $1,000 or less set aside for emergencies and another 25 per cent didn't know how much they had in emergency savings.

Perhaps because house prices keep rising in some parts of the country people seem unwilling to blame their mortgages for their financial stress. In a survey done for The Globe and Mail by Nanos Research in September, 42 per cent of the 1,000 respondents said they were comfortable with their mortgages and another 28 per cent were somewhat comfortable. Just 11 per cent said they were uncomfortable.

Mortgage debt may be comfortable, but that doesn't mean it's a good fit. Other types of consumer debt have grown dramatically since 2008, which suggests people are using credit to supplement incomes that are depleted by housing costs. Data drawn from chartered banks by the Bank of Canada paint a worrying picture about the financial health of Canadians.

The amount of debt outstanding on personal loans more than doubled to $97.6-billion in September from $47.1-billion in the same month of 2008; over the same period the balances on personal lines of credit have surged to $276.4-billion from $162.9-billion, and credit card tabs have increased to $79.2-billion from $51.2-billion.

"Many Canadians have to go into debt to subsidize their living," said Bruce Joseph, a Barrie, Ont., mortgage broker who consults on the Canadian real estate market for investment fund managers. "You have people buying stuff with money they don't have."

Annie Kvick, a financial planner with Money Coaches Canada in Vancouver, says that 15 per cent to 20 per cent of the clients she sees are homeowners building up additional debts beyond their mortgage. "They say they're paying off their credit cards every month, but they're using their line of credit to do it. It's a false sense of security."

The danger down the road

Having trouble paying the bills is the short-term cost of being house poor. The long-term risk for house-poor families is a lack of savings for retirement and for their children's university or college. On the question of retirement savings, there seems to be some unease out there among homeowners. In the Nanos poll conducted on behalf of The Globe, 30 per cent of participants were uncomfortable with the amount they were saving for their retirement, and another 22 per cent were somewhat uncomfortable. Just 19 per cent said they were comfortable with their level of retirement savings.

Canadians over all are actually doing pretty well at saving. Despite low interest rates, the national savings rate has averaged 4.6 per cent since the global financial crisis, more than double what it was before the crisis. "We're saving a lot more than we used to save, even though people think we're saving less," said Fred Vettese, chief actuary at the benefits consulting firm Morneau Shepell. "It's kind of like crime – people always think crime is going up, and they always think that savings is going down."

Mr. Vettese doubts young homeowners are doing much saving at all, and he's okay with that. In his forecasting, he expects people to start putting money away for retirement only at the age of 35. "As long as people save fairly diligently between 35 and 65-ish, they're going to do fine. It's when they start saving at 50 that they have a problem."

Among those who are optimistic that the house poor of today will eventually find money to save for retirement is Carlos Cardone, senior managing director of the financial data-analysis firm Investor Economics. He sees today's young homeowners getting their finances in order as they move ahead in their careers and use their rising salaries to pay down debt.

Mr. Cardone is not as hopeful that parents will be able to save for their children's postsecondary education. "That's probably where we're going to see savings impacted over the next decade or so. It's not visible yet."

There are two reasons to question whether today's young homeowners will easily be able to catch up later on their retirement savings. One is that people entering the work force today are less likely to benefit from a company pension plan than previous generations. The percentage of people covered by a company pension has been creeping lower for the better part of 15 years and in 2015 reached 38.1 per cent.

The rise of temporary work – the so-called gig economy – puts pensions further out of reach for young workers. They'll be under pressure to save for retirement on their own, even while facing higher living expenses because they lack company benefit plans to pay for dental bills, eyeglasses, and other expenses.

The other problem for young people hoping to catch up later on their retirement savings is that financial markets may not co-operate. The same economic pressures that are keeping interest rates low are also expected to depress returns from stocks and bonds, said Benjamin Tal, deputy chief economist at CIBC World Markets. He expects people retiring 30 to 40 years from now to have incomes that are smaller relative to their working-age salaries than did previous generations. The only way for them to make up the shortfall is to save more.

Mr. Tal is like many economists in believing that interest rates are the biggest risk to the financial health of today's heavily indebted homeowners. Today, low rates are the borrower's best friend. At the end of last year, the cost of interest alone for homeowners accounted for a record low 19.9 per cent of their monthly wages (it's the principal portion of mortgage payments that has been rising). But rates will rise – it's only a question of when and by how much. The reaction to Donald Trump's victory in the U.S. election in early November is a reminder of this inevitability. Investors, looking ahead to the measures a Trump presidency might take to stimulate the U.S. economy, have been bracing for increased inflation. The resulting rise in interest rates has already been sufficient to feed a small but noticeable rise in mortgage rates.

The more indebted people are, the more vulnerable they are to this and future rate increases. "Interest rates will rise and people will be spending more on interest payments and less on other things," Mr. Tal said. "That will lead to a recession or a slowdown in economic activity, and that will lead to defaults. I'm almost positive that the next recession will be a consumer-led recession."

So far, the only signs of debt stress in the country can be seen in provinces where the economy has been hurt by low oil prices. Nationally, data from the credit-monitoring agency Equifax Canada says the delinquency rate on non-mortgage debt – where payments are overdue by 90 days or more – has remained in the low 1-per-cent range since 2013. Equifax's mortgage data show that the share of mortgages with payments overdue by 90-plus days has been edging lower in the past few years and in the third quarter of this year stood at 0.22 per cent.

Low and stable debt-default rates are seen as proof that people are managing their debt loads well. But Mr. Hoyes, the bankruptcy trustee, says some people are surviving only because rising prices are giving them more equity in their homes. This allows them to sell with enough profit to pay off their debts, or refinance their mortgage to pay what they owe. "Even if you bought way too big a house and bad things happened – you got divorced or you lost your job – you can still sell your house and get out close to even. Or, refinance and live to fight another day." House prices don't need to fall to shut down what Mr. Hoyes calls "the real estate ATM machine." They just need to stop rising.

Recent measures introduced by the federal government to cool down the housing market will also have an effect on refinancing. Mortgage broker David Larock said the rules will make it more expensive for lenders to offer refinancings, which means higher rates for borrowers. He said the premium so far been around 0.25 of a percentage point on five-year fixed rates.

York University's Prof. Milevsky said the effects of being house poor go beyond rising debt levels and a lack of savings. He wonders how young buyers will be able to maintain the value of their homes through maintenance and improvements over the years. He also notes that young buyers are limiting their ability to move to a different city to take a better job.

"My concern is that people are sacrificing liquidity and emergency funds and the ability to respond to situations in life," he said. "But with prices going up year after year, it's tough to argue against housing."