OPINION

How young adults and the whole country win with a tougher mortgage stress test for home buyers

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Almost everything in real estate has changed since the federal banking regulator opened the door early last year to easing a mortgage rate stress test applied to home buyers.

The pandemic arrived, interest rates plunged and the housing market entered a hyper-phase where prices routinely rise by double digit amounts over year-earlier levels. In the midst of all this, the Office of the Superintendent of Financial Institutions has proposed a modestly tougher stress test.

OSFI is seeking input on the proposal, which affects people with mortgages that have down payments of 20 per cent or more and thus aren't insured against default. Here's a comment from the point of view of what's best for personal finance as opposed to the enrichment of the housing sector: Good job, OSFI. A tougher stress test could help cool the overheated market in expensive cities, and keep the personal finances of buyers in balance in the potentially volatile years ahead.

The stress test makes buyers qualify at mortgage rates that are much higher than their actual rate. With home sales and prices on the boil in locations across the country, it's hard to argue the current stress test is bad for the market. But toughening the stress test will send more buyers to the sidelines to build up their down payments further.

A perfectly fair way to make the housing market more affordable and equitable in the near term does not exist. There's been a lot of talk about reducing or eliminating the capital gains tax exemption on the sale of a principal residence, which potentially hurts long-time owners like boomers the most. No doubt, a more intense stress test will cut some young people out of the herd of buyers, or force some into the hands of unregulated lenders where rates could be higher.

Those young buyers will be well rewarded for their forbearance if the froth in house prices disappears. The worst possible outcome for these buyers would be that housing is left alone and prices soar for another year or two as the pandemic ends, immigration resumes and cash on the sidelines finds its way into more home down payments.

A recent survey by Mortgage Professionals Canada shows that 48 per cent of first-time home buyers had a down payment greater than 20 per cent from 2018 through 2021. The current stress test for this group has required banks to qualify mortgage borrowers at the higher of: the market rate plus two percentage points, or the Bank of Canada's conventional five-year rate, currently 4.79 per cent. You can now get a five-year fixed rate mortgage for about 2 per cent, so there's already a lot of daylight between rates people pay and the stress test qualifying rate.

OSFI's proposal is to set the stress test for uninsured mortgages as the higher of: the mortgage contract rate plus two percentage points (as before), or 5.25 per cent. In early 2020, with the economy and housing growing sustainably, a move like this would have been overkill and a mild easing of the stress test, as was considered at the time, more appropriate.

But we're in a new world now, thanks to the pandemic. Buyers are spending more and more to buy houses at low rates that will almost certainly be significantly higher on renewal. Will they have to pay 4.79 per cent or even 5.25 per cent? It's doubtful, but we can't rule it out because inflation is lurking. A jump in living costs would push up the interest rates in the bond market that heavily influence mortgage rates.

A higher stress test rate is helpful even if rates never get close to stress test extremes. One thing we know about buying a house is that it puts you on a track of sustained higher spending. Add children, car payments plus home improvements and you can say goodbye to all the slack that was once available for higher mortgage rates down the line.

The entire country benefits if a tougher stress test helps people bear this financial load. We want households that aren't so tied down with mortgage debt that they can't juice the postpandemic economy with their spending, keep cash in a Plan B fund for the next pandemic and save for retirement in an economy that can't get enough of gig workers who get no work pension.

In a way, a more stressful stress test means less economic stress for the nation.

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