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THE NEXT MOVE

# Real estate market storm clouds are gathering

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A home for sale in Toronto’s Annex neighbourhood on July 18.

FRED LUM/THE GLOBE AND MAIL

Real estate industry professionals who help homeowners grapple with rising interest rates and crushing debt are trying to keep up with the volume of new business these days.

“We’re aware that the storm is brewing and likely to get worse,” warns Toronto-based real estate lawyer Mark Morris.

Today credit has tightened, extensions are rife and defaults are rising, says the principal with LegalClosing.ca. The process of buying and selling was "very clean" when there was an abundance of money flowing through the system, Mr. Morris explains, but now that stream has slowed to a trickle.

Some buyers appeal to sellers for more time to come up with the financing they need to close a deal, and defaults are also rising, says the lawyer, who has 15 to 20 problem files on his desk on a given day. Purchasers planning to rely on a home equity line of credit, or HELOC, to buy an additional property are finding that avenue closed.

Mr. Morris is carefully watching the new build segment, where he sees peril ahead. He points to the many people who signed a contract with a builder before construction on a new project began. A number of those buyers count on being able to sell the contract to another party without ever taking possession of the property.

When prices were rising rapidly, speculators often made hefty profits on so-called assignment sales.

He sees complications on the horizon because many of those original buyers cannot afford to finalize the purchase when the unit is finished – especially in today's economy.

In order to rein in inflation, the Bank of Canada has raised its benchmark rate four times since March to its current level of 2.5 per cent.

Few people will be surprised to learn, Mr. Morris says, that lenders were often lax in extending financing to builders without requiring strong proof that their buyers in the pre-construction market were property qualified.

Investors on shaky financial ground are facing the completion of their units without the ability to trade in the unregulated assignment market.

"That market is now illiquid," Mr. Morris says. "Buyers will find they cannot assign the product away if they can't afford it."

In the current environment, Samantha Brookes, chief executive of Mortgages of Canada, is advising prospective buyers they cannot skip any steps in applying for a mortgage pre-approval. Lenders have become much more stringent about making sure a borrower is creditworthy.

“They want documents up front,” she says. “Consumers have to know they have to have their information ready.”


While interest rates have been far higher in previous decades, the debt levels consumers carry today swamp those of the past, Mr. Morris says.

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In some cases, Ms. Brookes is seeing three or four people from one family applying for one mortgage in order to buy a property.

“The parents and the kids are all on title just to buy one home,” she says. “They’re trying to make it work.”

Ms. Brookes urges buyers in the current market to make sure that their offer is conditional on financing.

“Do not waive any type of conditions on financing, no matter what anyone tells you,” she says.

Ms. Brookes also recommends that buyers have a short closing period of four or five weeks in order to avoid the problem of the property declining in value before the appraisal is complete.

As rates have shot up, Ms. Brookes says, her firm has had to cut back on its marketing because they are overwhelmed with clients who need to refinance an existing mortgage or they run into problems when the loan is up for renewal.

“A lot of people are looking for solutions.”

In the most dire cases, a homeowner may have had a fixed-term mortgage with an interest rate of 1.89 per cent, for example, only to have the lender present them with a rate of 5.89 per cent at renewal.

“A lot of them already have sticker shock,” she says of the consumers renewing today.

Ms. Brookes can often find a resolution for borrowers by extending the amortization period, which can stretch to as long as 40 years, she says.

“We stop bankruptcies quite frequently.”

Some homeowners have let things slide to the extent that they have defaulted on mortgage payments, received letters from the lender, and eventually had the bank foreclose.

“We have people come to us who have already been locked out of their house by the sheriff,” she says. “They leave it until the last minute.”

Ms. Brookes says mortgage brokers can help some borrowers in such a predicament refinance, pay the arrears and pay the fees and penalties that pile up on a daily basis.

She figures that more homeowners are going to be facing financial challenges as rates continue to climb and more mortgages come up for renewal.

“I do believe by September or October we’re going to see a lot of people jump ship.”

Mr. Morris sees significant risk in the heavy debt loads that many Canadians have accumulated in recent years. People have borrowed against their home equity to pay for major expenditures in the past, but the practice of drawing HELOCs for everyday expenses has accelerated in recent years, he says.

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"People started using houses as bank accounts five or six years ago," he says, pointing out that people who borrow to maintain their lifestyle continually need to borrow more. "I'm not certain people appreciate how much homes have become part of salary," Mr. Morris says.

Household budgets are already becoming stretched, he says, and the Bank of Canada is likely to raise rates again at upcoming meetings.

Many Bay Street economists are expecting the central bank's key rate to end up at 3.25 per cent or 3.5 per cent this year as policy makers try to tame runaway prices. Inflation in Canada reached an annualized rate of 8.1 per cent in June to mark a four-decade high.

The central bank has identified lofty levels of household debt and rich home prices as the top two vulnerabilities in the country's economy. Bank of Canada governor Tiff Macklem says his primary focus is getting inflation back to target.

While interest rates have been far higher in previous decades – rising above 20 per cent in the early 1980s – the debt levels consumers carry today swamp those of the past, Mr. Morris adds.

Mr. Morris fears that higher debt-servicing costs could lead to a tipping point that forces a wave of people to sell their homes at the same time real estate prices are in decline. The combination can lead to a downward spiral, he warns.

Meanwhile, the buyer's remorse that saw real estate deals falling apart before closing has calmed down after the tumult of early spring, he says.

At that time, buyers who purchased in the heady days of February and March were sometimes distressed to find that prices had fallen in the two to three months between the time the agreement was struck and the deal closed.

"Suddenly people were caught in the shift because they had no knowledge of what was coming," he says.

The transition was painful for people who had purchased a new home before selling their existing property, he says.

"That type of deal has largely worked its way through the system," he says, because most sales that took place when prices were at their peak have already closed.

Now he is dealing with the upheaval of tighter credit and higher rates.

"Rising interest rates are really, really really, starting to bite."

A wave of listings is already here, he says, adding that the wave is likely to swell.

At the same time, borrowers who need to go to private lenders for a second mortgage are facing interest rates of 18 per cent or more, Mr. Morris says.

Mr. Morris has harsh criticism for Mr. Macklem and his assurances to Canadian businesses and consumers in July, 2020 that interest rates would remain low for a long time to come.

"People relied on it," Mr. Morris says. "It was extreme negligence to give the assurance, even with the storm clouds brewing."

Mr. Macklem recently reiterated his view that a soft landing is possible for the Canadian economy.

Mr. Morris believes that the only scenario that might save the real estate market is a recession. A contraction in the economy may already be underway, he adds, and that in turn could lead the central bank to lower interest rates once again.

Still, he is not hoping for that grim outcome because it would cause severe economic pain.

“It brings hardship on people. It’s going to be very difficult for many Canadians.”

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