Canada Bubble Seen as IMF Risk With Record Low Rates: Mortgages

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By Doug Alexander and Sean B. Pasternak

Jan. 17 (Bloomberg) -- Kevin Lau, a Toronto-based technology consultant, says he can't wait to take advantage of the lowest mortgage rates in Canadian history to buy a second condominium and rent his current home.

Lau, 28, plans to get another mortgage and refinance his C$160,000 ($157,000) home loan after Bank of Montreal, Toronto- Dominion Bank and Royal Bank of Canada cut borrowing costs last week.

"It's always tempting when the credit is available at much lower rates than they ever have been," said Lau. "The fact that house prices have been going up and continue to go up much faster, you need to really take advantage of it."

Banks are competing to offer mortgages at rates as low as

2.99 percent as their funding costs drop on investor demand for the relative safety of Canadian bonds amid Europe's fiscal crisis. That's fueling real estate purchases, potentially inflating a housing bubble and adding to record household debt, which the International Monetary Fund says poses a risk to the nation's economy.

"It could increase the housing bubble," said Sheryl King, head of Canadian economics at Bank of America Corp., who estimates the country's housing prices are overvalued by about 10 percent. "The lower interest rates are, the more speculative demand you will have in the market."

Credit easing by central banks and commercial lenders around the world is sparking a household debt surge in haven countries such as Canada and Norway, which escaped the last housing crisis by steering clear of subprime mortgages that escalated the U.S. slump.

Bank of Canada Rate

The Bank of Canada is expected today to leave its benchmark lending rate at 1 percent, according to forecasts from economists compiled by Bloomberg, extending a record period of unchanged rates to counter economic risks posed by Europe. The central bank will probably maintain the key overnight rate at 1 percent until the first quarter of 2013, the forecasts show.

At the same time, record-low bond yields have prompted the country's commercial lenders to drop mortgage rates to entice borrowers ahead of the spring home-buying season. Canadian bonds have rallied as investors are drawn to the country's AAA rated debt after France, Spain and other European nations were downgraded by Standard & Poor's.

Bank of Montreal, Canada's fourth-biggest bank, dropped the rate for a five-year fixed-rate mortgage by 50 basis points, or

0.5 percentage points, to 2.99 percent on Jan. 12, the lowest in its 195-year history. Toronto-Dominion and Royal Bank, Canada's two-biggest lenders, followed suit the next day with the same rate on a fixed four-year loan.

Market Correction

"This type of pricing obviously makes headlines, so you're starting to see other lenders now jockeying for position," Rob McLister, a mortgage broker who runs the Canadian Mortgage Trends website from West Vancouver.

The heads of Bank of Montreal and Royal Bank warned as recently as last week that housing markets in Toronto and Vancouver are at risk of a correction, particularly for condominiums.

"Investor-owned condo properties have got to be a cause for concern, just because of supply and demand," Bank of Montreal Chief Executive Officer William Downe said Jan. 10 at a banking conference in Toronto. Royal Bank CEO Gordon Nixon said "there's no question" that the condo markets in Vancouver and Toronto are the most vulnerable in the country.

Canadian home sales last year increased 9.5 percent to

C$166 billion, the Canadian Real Estate Association said yesterday, as home prices rose 7.2 percent. Toronto-Dominion Bank estimated in a Dec. 22 report the average Canadian home is overvalued by about 10 percent.

Price Gains

The average resale price rose 0.9 percent in December from a year earlier to C$347,801, the smallest monthly increase since October 2010, the real estate group said.

Other reports last week showed strength in the housing market, with new home construction increasing 7.9 percent in December and residential building permits rising 6.9 percent in November.

Canadian home prices fell by 8.5 percent between August

2008 and April 2009, but have since increased by 22 percent, according to the Teranet Home Price Index. By comparison, U.S.

home prices fell by 33 percent between July 2006 and March 2011, and have since increased by 1.9 percent, according to the S&P/Case-Shiller Composite-20 Home Price Index.

Mortgage rates have also plunged in the U.S., with the average rate for a 30-year fixed loan dropping to 3.89 percent last week, the lowest in records dating to 1971, Freddie Mac said in a statement.

Household Debt

"While the expectation is that housing will stay strong, it could slip out of control if the Canadian economy's growth falters due to a new U.S. recession," said Scott MacDonald, head of research for MC Asset Management Holdings LLC in Stamford, Connecticut.

Canadian household debt rose to a record 153 percent of disposable income in the third quarter of 2011 as borrowing increased, Statistics Canada said Dec. 13. That contrasts with

146 percent in the U.S., and a projected 204 percent this year for Norway.

Norway, whose oil wealth is attracting investors to its government bonds, may suffer a collapse in its housing market that would be "dangerous" to the economy, Robert Shiller, the co-creator of the S&P/Case-Shiller home-price index said Jan. 12 in an interview in Copenhagen.

"It looks like a bubble to me, so the collapse of that bubble, that's dangerous to any economy," said Shiller, who is also an economics professor at Yale University.

Economic Risk

The Bank of Canada said last month that consumer debt is the main domestic risk to financial stability, predicting the burden will keep setting records as income growth lags behind borrowing.

Finance Minister Jim Flaherty tightened lending rules a year ago, shortening the maximum amortization period for government-insured mortgages to 30 years from 35 years, and lowering the maximum amount homeowners can borrow against the value of their homes.

He may be forced to take additional steps to ensure banks don't bloat household debts that are threatening the recovery, said King at Bank of America.

"If we are in a competitive environment like this, rates are going to continue to go lower," King said in a telephone interview from Toronto. "There is no other way to control it other than more regulation of the mortgage market."

IMF Report

The IMF agrees, saying Canadian authorities may need to take more measures to rein in household debt, which along with high house prices pose a risk to the nation's economy.

"Adverse macroeconomic shocks, such as a faltering global environment and declining commodity prices, could result in significant job losses, tighter lending standards, and declines in house prices, triggering a protracted period of weak private consumption as households reduce their debt," IMF staff wrote in the annual assessment of the country's economy last month.

The commercial banks say the low rates are a reflection of falling bond yields, and will help consumers pay off debt faster. The 10-year yield touched 1.837 percent on Dec. 16, the lowest level in data compiled by Bloomberg going back to 1989 as Europe's crisis drives demand for Canada's AAA rated bonds. The premium to equivalent-maturity U.S. Treasuries is seven basis points, compared with 32 basis points on Sept. 5, the most in 2011.

"Low rates are absolutely not an invitation for Canadians to overextend themselves," Farhaneh Haque, director of mortgage advice at Toronto-Dominion, said in an interview from Toronto.

"If you look at the low rates, you could look at them for the interest savings that will help you get debt-free faster."

25-Year Loans

Bank of Montreal's mortgage offer is limited to 25-year amortizations to ensure consumers pay off their loans faster, the lender said. About 22 percent of Canadian mortgages have amortization periods of more than 25 years, according to a survey by the Canadian Association of Accredited Mortgage Professionals.

"We're giving a low rate with a shorter amortization to help people reduce their debt quicker," said John Turner, Bank of Montreal's national director of specialized sales and investment lending. "It's about doing prudent things for customers that want to be debt-free sooner."

Part of Bank of Montreal's motivation may be to reduce risks by drawing more people into fixed-rate mortgages, where the rate is guaranteed for the full term, King said. About 60 percent of mortgages in Canada are for fixed terms, according to the CAAMP survey. The remainder are adjusted and so-called variable, tied to the prime lending rate, which rises and falls with the Bank of Canada rate.

Aware of Risks

"Variable has been the story for the last couple of years," King said. Banks "are worried about the fact that households are taking on too much risk."

Lau says he's aware of the risks, yet can't resist the low rates to add to his real estate investments.

“I read that the three banking chiefs are saying that housing prices have to go down, and now here they’re offering the lowest mortgage rates we’ve seen in a long time, which sparks people to actually want to purchase more places,” Lau said. “I don’t know what to believe.”

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