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SPECIAL REPORT

Economics and Strategy Group

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THE OIL-PRICE SHOCK AND THE CANADIAN HOUSING MARKET

Summary

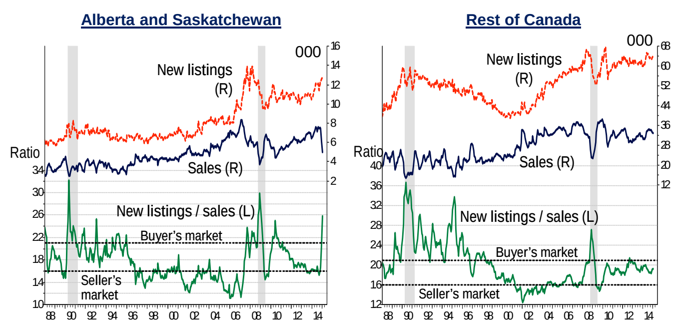
- The oil price slide has crimped the Alberta home-resale market. There is nothing to indicate that the weakness is about to spread to major markets elsewhere in Canada, such as Toronto and Vancouver.
- Uninsured residential mortgage loans in Alberta are generally non-recourse. There is fear in some quarters that a wave of strategic defaults could impair the profitability of Canadian banks to the point of triggering a severe contraction of credit in Canada as a whole.
- Since a borrower must make a down payment of at least 20% to obtain an uninsured mortgage loan, a strategic default is unlikely unless the home depreciates at least 20% from the purchase price.
- The mortgage loan delinquency rate rose sharply in Alberta in 1983 and 1984 when home prices fell more than 30%. It is likely that a wave of strategic defaults was a factor. Though there have been two recessions since then, the Alberta delinquency rate has never returned to a level near that of the early 1980s. Since in those two recessions the decline of home prices was much less pronounced than in the early 1980s, the opportunities for strategic default would have been rarer.
- Even if Alberta home values were to end up falling more than 20%, uninsured loans in that province account for only a modest portion of the mortgage loan portfolios of Canadian banks. Thus in the absence of some truly catastrophic turn of events, it is hard to see how a wave of strategic defaults in Alberta could shake the foundations of the Canadian banks to the point of triggering a severe contraction of credit.

Impact of the oil price slide

The oil price slide has made a serious dent in sales of existing homes in Alberta and Saskatchewan. The Canadian Real Estate Association reports that the seasonally adjusted number of homes sold in these two provinces in January was down 33% from November. Elsewhere in Canada the decline was 3%. In Alberta, January sales were the lowest since November 2010**;** in Saskatchewan, they were the lowest since August 2010. In just two months, Alberta's ratio of new listings to sales has soared from a tight-market reading to a buyer's-market reading. January sales were down 28% from a year earlier in Alberta and down 22% from a year earlier in Saskatchewan. In the rest of Canada sales were up 3.8% from a year earlier.

Chart 1

Canada: A home-sales plunge confined to the oil patch
Ratio of new listings to sales, seasonally adjusted



NBF Economics and Strategy, data from CREA

The oil-price shock will undoubtedly brake the economies of the three main oil-producing provinces (Alberta, Saskatchewan and Newfoundland and Labrador), but is generally likely to boost those of the other provinces, which are importers of oil. To date there is no indication that the hit to the Alberta and Saskatchewan housing markets has propagated to large centres elsewhere in Canada, such as Toronto and Vancouver.

Non-recourse mortgage loans

However, some observers think that a decline of Alberta and Saskatchewan home prices would entail systemic risk to Canadian financial institutions. Specifically, since a significant portion of mortgage loans in those provinces are non-recourse,[1] there is

[1] In the event of default, the creditor can seize the mortgaged property to dispose of it and thus recover the balance of the loan. In the case of a non-recourse loan, if the sale price does not cover the loan balance, arrears of

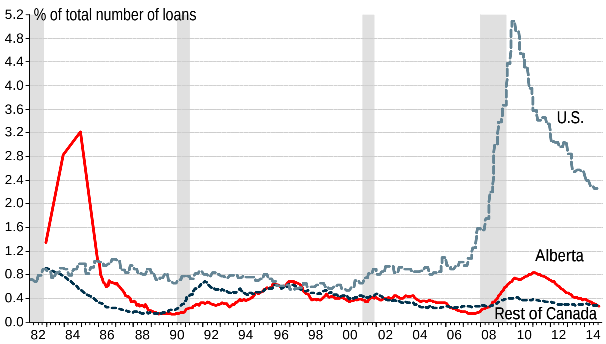
fear in some quarters that financial institutions could be hit by a wave of strategic defaulting. The ensuing financial losses would impair their Canada-wide ability to extend credit.

In fact, in Alberta and Saskatchewan, only uninsured mortgage loans (which require a borrower down payment of at least 20%) are non-recourse. In Saskatchewan, moreover, even uninsured loans become full-recourse when renegotiated.[2] This means that before a borrower can think of strategic default, the market value of his or her home must fall at least 20% below the purchase price, and more than that if the borrower has had time to repay some of the capital.

Chart 2

Delinquency rate of residential mortgage loans

Mortgage in arrears 90 days or more, chartered banks

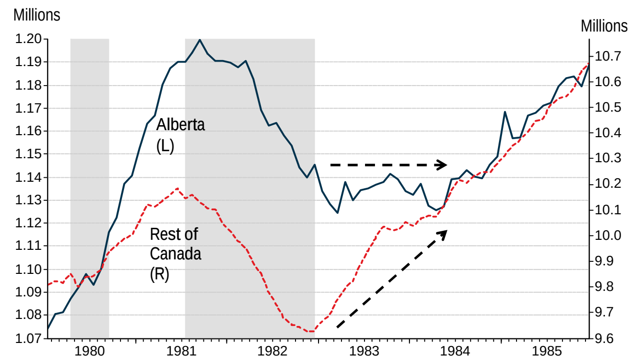


NBF Economics and Strategy, data from Canadian Bankers Association and U.S. Federal Reserve

In the early 1980s, the percentage of mortgages in arrears 90 days or more rose sharply in Alberta, reaching 2.8% in December 1983 and 3.2% in December 1984. That spike had no counterpart in the rest of Canada. True, employment stagnated in Alberta in 1983 and the first half of 1984, while elsewhere in the country employment growth was making up the losses of the 1981-82 recession. But more than this divergence of employment trends (see chart 3), the high delinquency rate in Alberta at the time was laid to a wave of strategic defaults prompted by the fall of home prices. For example, from January 1982 to January 1985 the average sale price[3] of a Calgary home fell 32%. In Canada excluding Alberta, the average sale price rose 5.8% over the same period.[4] The likelihood that the province was struck by a wave of strategic defaults is reinforced by the reversal of Alberta's balance of interprovincial migration to a net outflow in 1983. For homeowners who wanted to leave Alberta, strategic default was an alternative to selling their home for less than the remaining balance of their mortgage.

Chart 3

Alberta jobs stagnated after the 1981-82 recession



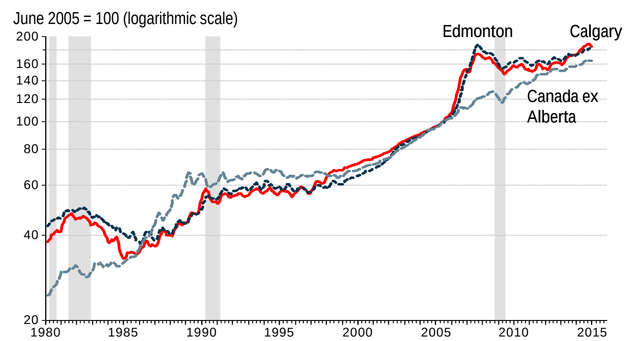
NBF Economics and Strategy, data from Statistics Canada

Chart 4

Home prices: Calgary, Edmonton, rest of Canada

Before 1999: average sale price reported by CREA

1999 to date: Teranet–National Bank House Price Index[MD]



NBF Economics and Strategy, data from Canadian Real Estate Association and Teranet–National Bank House Price Index

In the recession of the early 1990s, Calgary home prices fell 11.5% from the peak of April 1990 to the trough of January 1991. That percentage is well below the 20% down payment required for an uninsured mortgage loan. This would be the reason there was no material wave of defaults in Alberta during that period.

In the aftermaths of the recession that began in late 2008, the Alberta delinquency rate was the highest of any province, but was modest compared to that of the early 1980s. From the peak of September 2007 to the trough of June 2009, home prices fell 15% in Calgary and 17.5% in Edmonton[5]. These being averages, it is quite possible that the market value of some homes fell 20% or more and motivated some strategic defaults. Yet Alberta's higher delinquency rate could also be explained by its greater job losses during the recession – 3.6% versus 2.4% in the rest of Canada.

Thus it seems that a wave of defaults of early-1980s magnitude is unlikely to strike Alberta if the fall of home prices remains less

interest and legal costs, the creditor has no recourse against the borrower to recover the difference.

[2] In Canada, residential mortgage loans are negotiated for a period generally not exceeding five years.

[3] In the absence of a resale price index covering this period, we draw on the average sale price reported by the Canadian Real Estate Association.

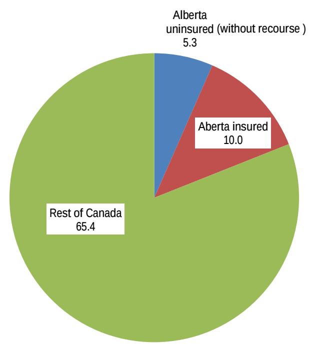
[4] Despite a 16% drop in B.C.

[5] This time, according to the Teranet-National Bank House Price Index[TM].

than 20%, as in the recessions of the early 1990s and the late 2000s. At this point, the Teranet–National Bank House Price Index shows Calgary prices down 1.9% over the last three months and Edmonton prices still rising over that period. But account must also be taken from the fact that in the nine preceding months, prices were up 9.2%, on top of gains of 6.5% in 2013 and 4.1% in 2012. Inasmuch as a dwelling was acquired before the beginning of 2014, one can consider that a price drop susceptible to trigger strategic defaults would rather be at least 30%. If the property was acquired towards the end of 2012, then it would take depreciation of at least 36%, and of at least 40% if it was acquired one year earlier.

Chart 5

Big 6 banks' residential mortgage loans
Regional breakdown of outstanding in Canada



NBF Economics and Strategy, from annual reports data.

In any case, the rise of home prices since 2005 has made it increasingly difficult for a first-time homebuyer to obtain an uninsured loan. By an estimate based on recent data from the six large Canadian chartered banks, 5.3% of the value of their aggregate portfolio of residential mortgage loans in Canada was non-insured loans in Alberta[6]. Assuming that the province's share of the number of loans is representative of its share of the outstanding[7], a delinquency rate of 5.7% on uninsured loans in Alberta would be necessary to raise the delinquency rate for Canada as a whole by 0.3 percentage points (which was Alberta's contribution to the Canada-wide delinquency rate of the six banks in December 1984). By way of comparison, the U.S. delinquency rate peaked at 5.1% in the wake of that country's housing-bubble collapse.

Conclusion

There is no doubt that the oil price slide has crimped the Alberta home-resale market. A sharp drop in sales has turned a tight market into a considerably oversupplied market. It is also true that uninsured residential mortgage loans in Alberta are generally non-recourse.

A homeowner with an uninsured mortgage had to put up a down payment of at least 20%. A wave of strategic defaults would thus occur only when home prices fell more than 20%. This happened in Alberta in the early 1980s, but even after two subsequent recessions has not happened since then.

In any case, even if Alberta home prices were to fall more than 20% in the wake of the oil-price shock, the delinquency rate on uninsured loans in Alberta would have to be higher than the peak rate reached in the wake of the U.S. housing-market collapse just to raise the banks' cross-Canada delinquency rate by 0.3 percentage points. Thus in the absence of some truly catastrophic turn of events, it is hard to see how a wave of strategic defaults in Alberta could shake the foundations of the Canadian banks to the point of triggering a severe contraction of credit.

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[6] And 35% of their residential mortgages in Alberta.

[7] As an indication, according to Canadian Bankers' Association, Alberta accounted for 12.2% of the number of Canadian banks' residential mortgage loans in Canada, while according to Statistics Canada, it accounted for 14.3% of total banks' outstanding in Canada.

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