December 17, 2009

A tricky dance of debt for home buyers

By KERRY GOLD
From Friday's Globe and Mail

Low rates have made high-priced homes affordable for many - for now

For anyone who got carried away and purchased a house by mortgaging it to the max, at an unbelievably low floating interest rate, it's like the hangover after the party.

The Bank of Canada delivered the sobering reality check last week that interest rates are bound to climb in the next couple of years.

These last few months in Vancouver, the market has picked up so much there has been bidding wars over bungalows. One house on the city's east side sold for $320,000 above asking, symptomatic of the sudden activity that has erupted. An estimated one-third of recent purchasers are people who've been long shut out of the market and are eager to snap up houses at recessionary prices and interest rates as low as 3.69 per cent for a five-year fixed rate.

In a Royal Bank of Canada report released in November, senior economist Robert Hogue observed of the Vancouver market: "the turnaround has been nothing short of breathtaking."

There were 3,083 sales through the Multiple Listing Service in November in Vancouver, compared to only 874 sales that same month in 2008. The benchmark price rose more than 12 per cent in the same time frame.

It isn't a bubble, says Helmut Pastrick, chief economist for Central 1 Credit Union, the umbrella organization for credit unions in B.C. and Ontario. Mr. Pastrick has also analyzed the B.C. housing market for the Canada Mortgage and Housing Corporation.

"It's a market pick-up, a resurgence. Market activity is up in response to low rates and the attractiveness of home ownership," says Mr. Pastrick.

"This run-up is going to lose steam for a variety of possible reasons, but for the year as a whole, I think that [sales] volumes will be higher in '10 than '09 and prices will be higher in '10 than '09, too."

Interest rates are also certain to climb, which is part of a return to a healthy, normal economy.

"That 'normal' might not appear for two or three or four years," says Mr. Pastrick. "But before we reach that normal, interest rates will be rising."

Historically, the relationship between interest rates and housing sales and prices has been a complicated one. But generally, when interest rates go up, house prices go down and when interest rates go down, house prices go up. Statistics that compare house prices to interest rates demonstrate this negative relationship in a rudimentary way. More importantly, numbers of housing sales are also affected by interest rates. In 2007 there were record sales in B.C. and not coincidentally, an extremely low interest rate, according to data supplied by Landcor Data Corp.

"Probably the single most important variable that affects sales is interest rates," says Mr. Pastrick.

"Like many markets, it tends to be the result of a complex set of factors, and putting it down to one over-simplifies it," he says. "But certainly, if you have to choose one, interest rates are the single most important variable given that, for most people, financing is a big part of the equation."

For the consumer, an up-tick in interest rates of just a few points can be the difference between being a homeowner

and a renter. For example, a typical east side Vancouver bungalow that is purchased for $800,000 with $600,000 in financing and a five-year fixed rate with a 35-year amortization currently requires a household income of $82,500, according to information supplied by mortgage broker Rob Regan-Pollock's Invis Team. If the rate goes up just three percentage points, the borrower would be required by the lender to earn $112,500 a year. And those amounts only apply to someone with a platinum credit rating.

If the homeowner makes less than that amount, they suddenly couldn't afford to buy their own house, which means they stay put and the market potentially stagnates, says Rudy Nielsen, owner of Landcor Data, which collects the most comprehensive statistics on real estate in B.C.

It means that many first-time buyers would again be shut out of the housing market. As for anyone who's just eking out mortgage payments at the current rates, higher rates would mean major financial stress.

Mr. Nielsen believes there are two scenarios that could play out. If the market doesn't stagnate, the other side of the coin is a lot of activity, with people who are unable to afford their payments having to downsize to condos or unloading real estate entirely. People with more money could then snap up the available housing stock, says Mr. Nielsen.

"A lot of people are working their salaries right to the limit," he says. "Our standard of living got so high, we are used to low rates and spending, and soon we'll have to come back to reality. You might have to give up the TV set and the car. 'You gotta start saving some money, people.'"

Mr. Pastrick is hopeful that the majority of people did their homework and chose not to leap into risky debt, such as taking on the maximum amount of mortgage at a variable rate.

"On a variable rate mortgage, I would presume there is caution on the part of some borrowers and lenders, that they recognize that the current and extremely low rates will probably not prevail in year two or three.

"I would hope lenders and borrowers, instead of using today's rate, they used something more appropriate for the next two to three or four years.

"But maybe not," he adds. "The market is what it is, and some do want to take greater risks than others.

"But I think most people are going for fixed terms. Most people are rational. Anybody who's been following the market or economy can grasp the attractiveness of these low rates and that locking in for five years is a darn good deal. If they have to go to the maximum and take advantage of the lower variable rate to max out, those are situations that are certainly likely to experience some problems.

"But I would have to think those are in the small minority of cases."