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Bank of Canada Financial System Review

BoC Cautiously Upbeat on Housing Sector

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The Bank of Canada released what is now its **annual Financial System Review** (FSR) and taking centre stage once again were financial vulnerabilities stemming from high household debt and housing market imbalances. While these two risks remain at the top of the list, they have eased slightly, with the Bank now sounding more optimistic that the housing sector will add to growth next year. And, while the risk to the financial system has increased overall, the financial system itself remains resilient.

The Bank sees **three main vulnerabilities** on the domestic landscape:

1) **Elevated household debt**. Though still listed as a "*significant*" risk, the one-two punch of tougher mortgage rules and past rate hikes have worked to slow household borrowing and improve the quality of mortgage lending.

2) **Housing market imbalances**. Toronto and Vancouver are highlighted once again with both markets appearing to "*be at different points in the adjustment*"—Toronto now stabilizing, while Vancouver still adjusting. Still, a healthy job market and strong demographic flows should support demand in both cities, with other regions broadly continuing with trend-like activity.

3) **Cyber Threats and Financial Interconnections**. This was introduced in the June FSR and remains a key structural vulnerability. The Bank stressed the importance of collaboration between governments and financial institutions in order to fortify the system and be better able to respond in the event of a cyber-attack.

Other notable vulnerabilities:

Fragile Corporate Debt Funding - Viewed as an emerging risk, the BoC will be closely monitoring developments as lower-rated firms take on more debt.

Climate Change - The BoC is now the first central bank to officially list climate change as a threat to the country's financial system.

Three key risk scenarios:

1) A **severe recession** caused by a negative foreign demand shock drives a "***large, persistent and negative foreign demand shock.***" The Bank rates this risk as: **elevated and increasing** given (1) global trade uncertainties, (2) a slowdown in Canadian GDP growth and (3) highly indebted households.

2) A **home price correction in overheated markets** with "*modest direct spillovers*" to the rest of the country. The Bank rates this risk as: **moderate and decreasing** given the cooldown in Toronto and Vancouver markets.

3) **A sharp increase in long-term interest rates driven by higher global risk premiums** which could be caused by an "*overreaction to economic or policy*

developments". The Bank rates this risk as: **moderate and increasing** now that trade tensions and geopolitical risks have ramped up.

Bottom Line: Housing and household debt were front and centre in the FSR once again, listed as significant vulnerabilities. But, with the impact of higher interest rates and stricter mortgage rules having the desired effect, these two vulnerabilities have been scaled back modestly. Overall, the FSR will likely not have much impact on monetary policy as the BoC is expected to sit on the sidelines for some time.