What the Changing Fundamentals of Canada's Mortgage System Means for Investors

Description

With new mortgage rules now in effect in Canada, borrowers looking for a traditional mortgage now must comply with stricter stress test rules to qualify for loans from federally regulated lenders, such as Canada's largest banks. With interest rates rising following recent hikes from the Bank of Canada exacerbating these new stress test rules, a significant percentage of new home buyers have been forced to seek mortgage loans from alternative lenders that are not bound by federal regulations but are provincially policed.

The Office of the Superintendent of Financial Institutions, an independent agency tasked with regulating Canada's federally registered banks, recently put in place a stress test for Canadian borrowers, requiring such borrowers to qualify for mortgages at significantly higher interest rates than the rate borrower would actually pay. These rules were put in place as a safeguard to protect the Canadian financial system from the potential downside effects of too many consumers borrowing too much money in a rising interest rate environment — a situation which could lead to a significant housing correction if not accounted for by lenders.

Reports cited by various mortgage brokers that upwards of 20% of all new loans being generated are being generated by credit unions or alternative lenders, which do not need to follow the federal stress test rules, is something that is currently shaking up the mortgage mix in Canada's housing market. With more borrowers, who would otherwise be investment grade if not for the new regulations, seeking loans from alternative lenders such as **Home Capital Group Inc.** (TSX:HCG) or **Equitable Group Inc.** (TSX:EQB), a potential boon could be in store for these lenders in the short term, if they are able to compete with other provincially regulated financial institutions, such as credit unions, on mortgage rates.

The argument that the overall risk portfolio of alternative lenders may improve in the short term is an attractive thesis to pursue for investors looking to pick up shares of Home Capital or Equitable Group. With a higher percentage of credit-worthy customers seeking loans from companies that would otherwise be forced to lend to non-prime or sub-prime borrowers arriving in the alternative lending space, I would expect to see fundamentals improve at companies like Home Capital and Equitable

Group, at least in the short term.

That being said, the stress tests which have been put in place by OSFI are there for a reason, and with Canadian borrowers now largely looking outside Canada's large banks to buy houses, concerns that a correction could potentially hit the alternative lending sector harder than before are real. Other lenders outside Home Capital and Equitable Group have also experienced issues with mortgage documentation , so the ultimate effects of a correction have yet to play out. That being said, I would caution investors to stay fully diversified in the financials sector, holding a variety of equities in this space to avoid over-allocating funds to alternative lenders at this point in time.

Stay Foolish, my friends.

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