The New Mortgage Rules Don’t Change Much

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We’ve been hearing a lot about the new mortgage rules. In June 2021, these rules state that banks must verify whether a borrower will be capable of making their mortgage payments using a rate of 5.25% instead of the actual rate on their mortgage (or the applicable rate plus 2% if it is higher).

Some believe that this protects us against an increase in interest rates.

Here's why this doesn't change much:

The debt service ratio can completely compensate for these new mortgage rules.

The banks base their systems on *the debt service ratio* in order to determine how much they can lend you. The debt service ratio is equal to the borrower’s monthly mortgage payment divided by the borrower’s monthly disposable income (gross income minus income taxes).

For example, if you have $4,000 of disposable income per month (this represents a gross annual salary of $70,000) and the bank uses a debt service ratio of 36%, you will be able to borrow an amount for which the monthly mortgage payment is equal to $1,440. Therefore, you will have $2,560 left per month to pay for food, electricity, your car, clothing, activities, etc.

As I wrote above, the new mortgage rules force the banks to check whether a borrower will be *capable* of making their mortgage payments in a situation where interest rates rise. Here’s the problem: the definition of *capable* is determined by the banks; it is determined by the debt service ratio that they decide to use.

If we come back to our example (with a monthly disposable income of $4,000), assuming an interest rate of 1.59%, the mortgage granted by the bank could give you the ability to purchase a house for $400,000 (with a down payment of $40,000 and a monthly mortgage payment of $1,455).

This means if you are a couple and each of you make $70,000 a year, you could potentially purchase a house for $800,000.

So, what happens now that the new rules are in place?

The bank calculates your monthly mortgage payments with the minimum interest rate of 5.25%. This results in a monthly payment of $2,150 versus $1,455, which now represents a debt service ratio of 54%. If the bank accepts this hypothetical ratio, you pass the test! In other words, the choice is still up to the bank. This doesn't change much.

Between April-May 2020 and April-May 2021, monthly rents only rose by 4% in the Montreal area. This is much more representative of the real increase in the value of real estate. The difference between the increase in rents and the increase in house prices is probably due to financing games and the fact that interest rates are much lower than they used to be.

If interest rates increase and your monthly payments begin to represent a large percentage of your income, the banks may feel better by thinking that you will cut down on your other expenses in order to pay for your home.