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November 2023 Commercial Mortgage Report

The Quarterly Commercial Mortgage Report aims to inform the market about commercial real estate finance news. We focus on the following capital sources for commercial real estate: Conventional Mortgages, CMHC-Insured Mortgages, Commercial Mortgage Backed Securities (CMBS), High Yield Mortgages, Construction Financing, First Mortgage Bonds and Senior Unsecured Debt for real estate investment companies.

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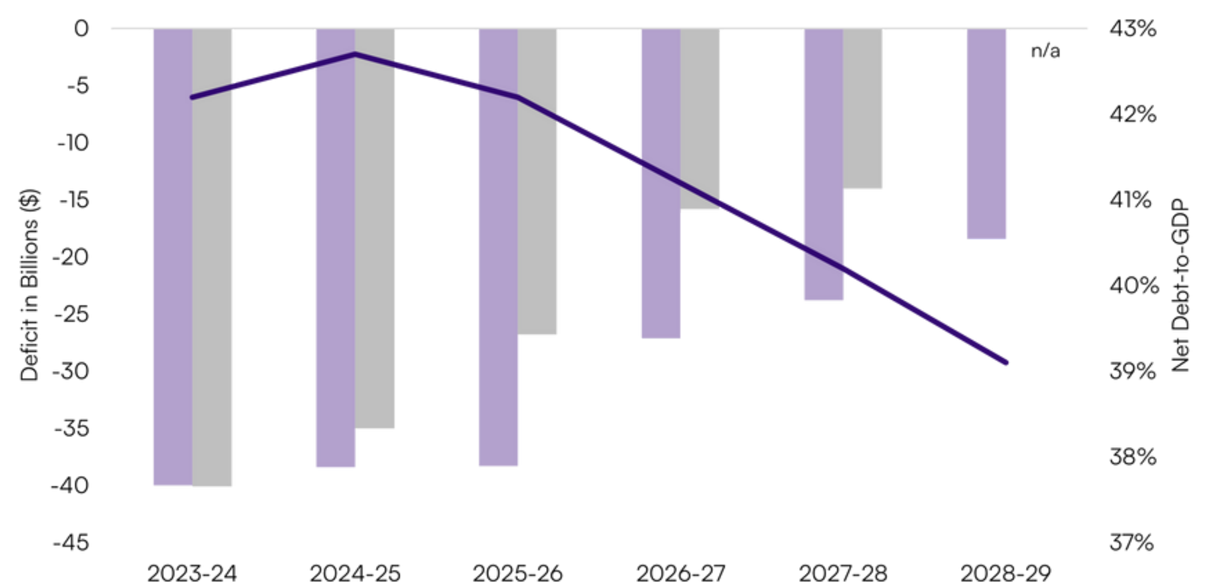
Making News

More Red Ink in Fall Economic Statement

The federal government delivered its 2023 Fall Economic Statement on November 21st, providing an update on its fiscal policy and financial position midway through the fiscal year. No surprise for the current government, the statement projected more borrowing, more spending, and no plans to balance the budget over the six-year forecast horizon. In total, the government announced $20.8 billion in new initiatives with a heavy emphasis on housing affordability.

The government is projecting a deficit of approximately $40.0 billion in 2023-24. In contrast to the 2023 Budget tabled in March, the deficit will hold slightly below $40.0 billion for two more years before stepping down to $18.4 billion by 2028-29 (see Chart 1). Despite billions more in deficits over the forecast period, the government is banking that economic growth will outpace the growth in debt, reducing the relative size of its total debt burden. Net debt as a percentage of gross domestic product (GDP) is expected to peak at 42.7% next year before steadily declining to 39.1%. Total net debt is expected to reach $1,282.8 billion at fiscal year-end and grow to $1,488.1 billion by 2028-29. The federal debt was $612.3 billion and the net debt-to-GDP ratio was 31.0% at the end of the 2014-15 fiscal year, prior to the Liberals taking office.

In a higher interest rate environment, interest costs will balloon to become one the largest expenses of the federal government. Interest costs are projected to reach $46.5 billion this fiscal year, climbing to $60.7 billion in 2028-29. Not only will Canadians be forced to cover the cost of the ever-growing federal debt, but the impact of this increased spending will further challenge efforts by the Bank of Canada (BoC) to tamp down inflation, meaning higher interest costs for consumers and businesses on their loans today. In a recent report by Scotiabank Economics, it is estimated that increased spending at all levels of government since 2020 has accounted for 200bps worth of tightening to the BoC's key policy rate.



Source: Department of Finance, Canada

CMB Program Stays, More Funds for Apartment Financing

Included in the Fall Economic Statement were two announcements to expand access to lower-cost financing for rental housing through the Canada Mortgage Housing Corporation (CMHC). Following several months of industry consultations, the government scrapped any plans to consolidate the Canada Mortgage Bond (CMB) program into its regular Government of Canada (GoC) borrowing program. The CMB program will remain as is and will see the limit on annual issuances lifted from $40 billion to $60 billion, with the additional $20 billion dedicated exclusively toward the funding of multi-unit residential mortgages. The government expects that this will help build up to 30,000 more rental units per year.

Additionally, the government announced its intention to start purchasing as much as $30 billion in CMB annually on the open market starting in 2024. The idea here is that the government would earn a higher rate of interest on the CMB it owns than the interest it pays on the GoC bonds borrowed to finance those CMB purchases. The difference in interest would be revenue to the government that could then be allocated toward affordable housing initiatives. A detailed summary of the CMB program, its role in financing multi-unit residential housing in Canada, and the government's initial consideration to consolidate the program can be found here.

The government also announced an additional $15 billion in funding for the Apartment Construction Loan Program, previously called the Rental Construction Financing Initiative. The program offers favorable terms and low-cost funding for the construction of standard rental housing. The additional funds will be available starting in 2025-26 and bring total funding to $40 billion. To date, the program has committed over $17 billion in financing to support the construction of 46,000 homes and is expected to finance the construction of 101,000 homes by 2031-32.

A Wave of Housing Affordability Measures

Housing affordability issues have weighed heavily on Canadians in 2023. The combination of rising interest rates, a structural housing supply shortage, and record immigration have priced many would-be buyers out of the housing market at the same time as they have sent rents soaring. As of October 2023, the national benchmark home price on the MLS Home Price Index was around $746,000, about 36% above its pre-pandemic level. Meanwhile, as per the latest Rentals.ca National Rent Report, the average all property asking rent was up 10% year-over-year in October. It now costs on average $2,872 to rent a 1-bedroom in Vancouver and $2,607 in Toronto, while surrounding markets have seen some of the most substantial annual rent increases. One-bedroom rents in cities like Burnaby, Oakville and Markham have climbed 15-20% over the past year and are nearly on par with traditionally more expensive central metropolitan areas. Even cities like Montreal, Calgary and Halifax more well-known for their affordability have seen double-digit rent increases in the range of 14-21%.

Support for the governing Liberal Party has plummeted through the summer and fall with housing affordability issues driving its dismal standing in the polls. This prompted the government to announce a suite of measures in recent months aimed at stimulating housing development and easing price pressures. As per a recent report by the CMHC, without a material increase in housing development, the country is looking at a shortfall of 3.5 million homes by 2030.

Central to the government's plan is the Housing Accelerator Fund (HAF), a $4 billion initiative to (Continues on next page)

remove barriers to housing development at the municipal level. The program saw its first agreement signed with the community of London, Ontario in September and has since seen $1.6 billion in funds announced through 10 agreements (see Table 1). The program offers municipalities (and the province of Quebec) direct federal funding to advance initiatives that increase housing supply. Some examples include as-of-right zoning for up to 4 residential units in low-density neighborhoods, as-of-right zoning for high-density residential near urban cores or transit corridors, the allocation of underutilized city-owned land for housing development, and investing in technology to speed up development approval times, among other things. All told, this could speed of development times and increase demand for multi-family mortgages.

In a bid to further reduce housing development costs, the government sales tax (GST) has been lifted on the construction of new purpose-built rental housing. The decision also prompted several provinces to follow suit by removing provincial sales taxes. The GST removal will apply to projects that begin construction between September 14th, 2023 and December 31, 2030, and which are to be completed by December 31st, 2035. The removal of GST alone would result in tax savings of $25,000 for a 2-bedroom rental unit valued at $500,000. The government rounded out these announcements with a flurry of additional measures in its Fall Economic Statement, the details of which can be found here.

Table 1: Housing Accelerator Fund Tracker

Municipality	Amount ($MM)	Units	$/Unit
London, ON	$74	2,000	$37,000
Vaughan, ON	$59	1,700	$34,706
Hamilton, ON	$94	2,600	$35,962
Halifax, NS	$79	2,600	$30,500
Brampton, ON	$114	3,150	$36,190
Kelowna, BC	$32	950	$33,158
Province of Quebec	$900	n/a	n/a
Kitchener, ON	$42	1,200	$35,167
Calgary, AB	$228	6,800	$33,529
Moncton, NB	$16	490	$31,633
Totals/Average	**$1,637**	**21,490**	**$34,295**

Economic Environment

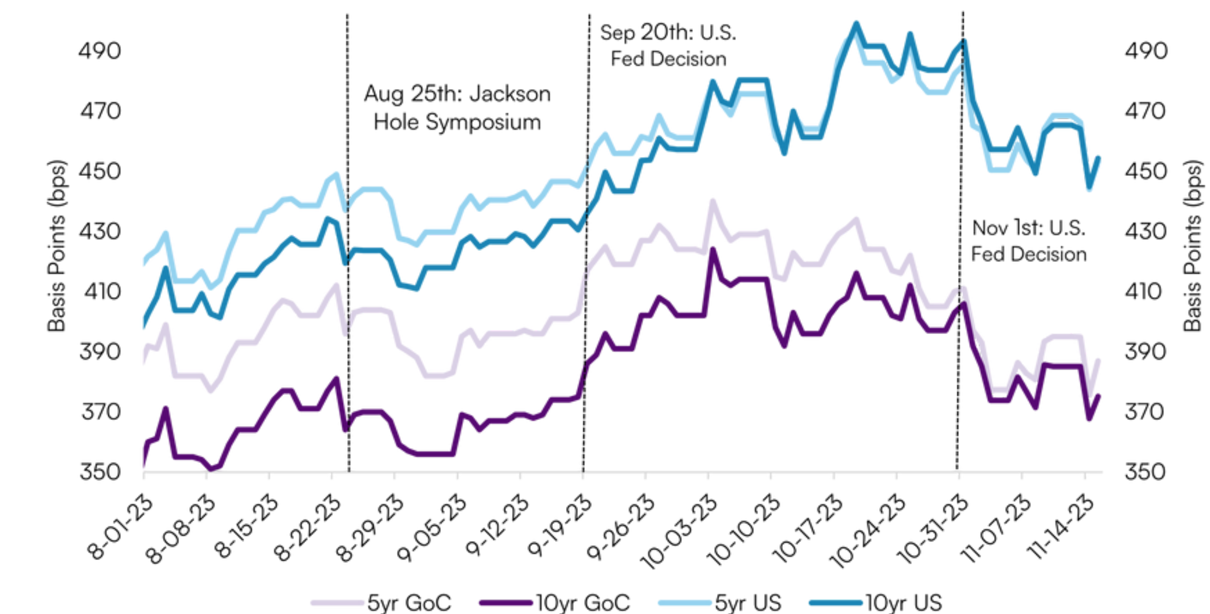
U.S. Fed Sends Bond Yields to 16-Year Highs

As the central bank of the world's most powerful economy, when the U.S. Federal Reserve (Fed) moves, the effects are felt across the global economy. While the Fed may have opted not to move its key policy rate at its last two interest rate decisions, sentiment out of the Fed in recent months has nevertheless had a significant impact on global bond markets. GoC bond yields and U.S. Treasury yields climbed in October to levels unseen since late 2007. Shortly thereafter, they plummeted even more abruptly than they had risen. Both events were triggered by remarks from the Fed with far reaching implications for commercial mortgage borrowers.

Fed Governor Jerome Powell's speech at the annual Jackson Hole Symposium in August, a closely watched event by financial markets, reiterated some common threads we've been hearing for awhile now — while there had been much progress on bringing inflation down from levels not seen in almost four decades, much work remained to be done. A few items of concern included stubbornly elevated prices for non-housing services, higher than expected GDP and consumer spending, and continued labor market tightness. The central bank confirmed that it would continue to monitor economic data carefully for signs of upward pressure on inflation and the need to raise rates further. Government bond yields didn't move sharply following the speech, but would climb 10-15bps in both the U.S. and Canada over the following three weeks leading up to the Fed's next interest rate decision (see Chart 2).

Building on sentiment from Jackson Hole, Jerome Powell's remarks at the September 20th interest rate decision struck a particularly hawkish tone that sent bond yields soaring. Most notably, the Fed's infamous dot plot, an outlook for the federal funds rate over the next several years, showed that a majority of the governing committee expected the key rate to reach 5.60% by year-end. This implied another 25bps hike in Q4. Additionally, Fed officials projected just 2 rate cuts in 2024, down from 4 at its previous forecast, signaling a higher for longer stance at the bank. Five-year and 10-year GoC bond yields rose 23bps and 38bps in the weeks following to a close of 4.40% and 4.24% on October 3rd — their highest level in 16 years. Five-year and 10-year U.S. Treasury yields climbed even more aggressively by 45bps and 63bps to near the 5.00% mark by October 19th.

The Fed again elected to leave the federal funds rate unchanged at the November 1st interest rate decision. Much of the questions posed to Governor Powell centered around comments he made on tighter financial conditions and whether higher borrowing costs for consumers and businesses might be a substitute for further rate hikes by the Fed. Powell acknowledged that this could be possible should government bond yields remain persistently high, but cautioned that he was not yet certain whether the federal funds rate was high enough to bring inflation sustainably back down to 2.00%. Nevertheless, markets broadly digested the announcement as a sign that the Fed was done hiking rates, which sent government bond yields plummeting as much as 35bps over two days. (Continues on next page)



Source: Bloomberg

The large swings in bonds yields in recent months are a continuation of the significant bond market volatility we've witnessed in recent years borne from the Covid-19 pandemic and aggressive tightening by central banks to quell near 4-decade highs in inflation. While Federal Reserve policy is not designed to steer the Canadian economy, policy decisions south of the border have serious implications for bond markets and commercial mortgage rates in Canada. As a result, commercial mortgage borrowers in Canada should keep an eye on the Fed, the U.S. economy, and progress on curbing U.S. inflation when considering the direction of commercial mortgage rates. However, as we will explore in the next article, there are several factors that could cause Fed and BoC policy to diverge in the months ahead, which would reduce the sensitivity of Canadian interest rates to Federal Reserve policy and U.S. economic developments.

What Factors Could Cause Fed and BoC Policy to Diverge?

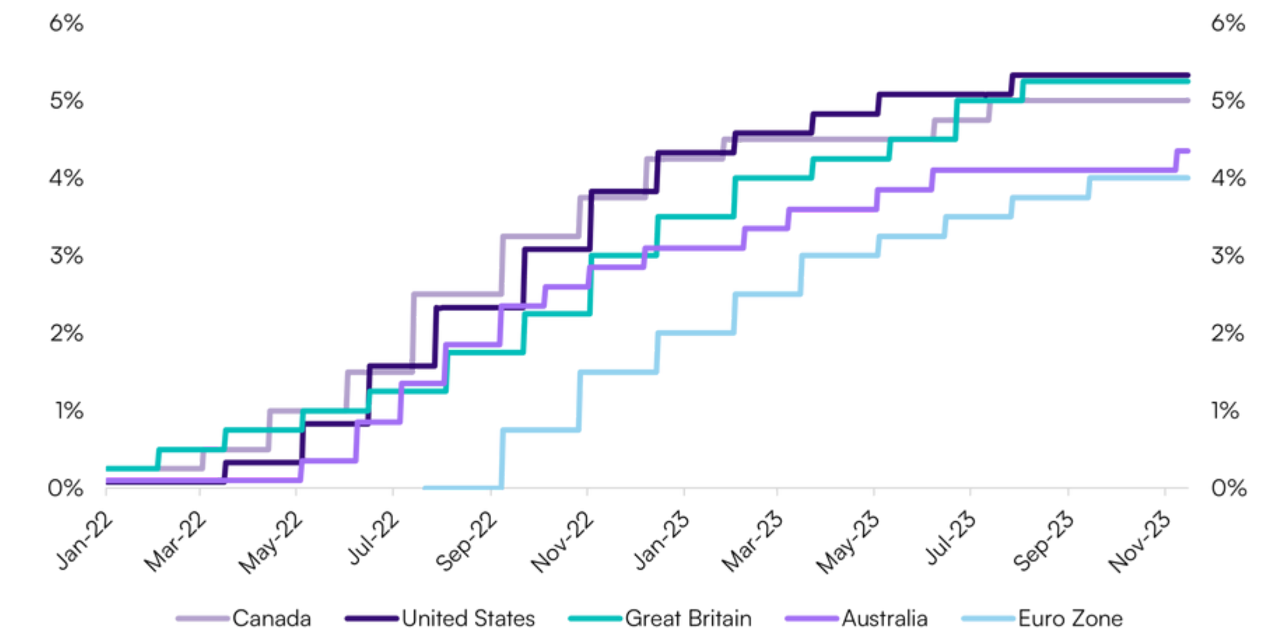
Central banks across developed economies have significantly tightened monetary policy since March 2022 in a bid to reign in the muti-decade highs in inflation borne from the Covid-19 pandemic and associated economic restrictions (see Chart 3). To date, the BoC has hiked its key policy rate by 475bps, marking one of the most aggressive tightening campaigns in its history. At 5.00%, its key policy rate is at its highest level since 2001. Barring an extended pause by the BoC through the first six months of 2023, the BoC and U.S. Federal Reserve have largely moved in lockstep throughout the rate tightening cycle. However, moving forward, there are several factors that could cause policy to diverge in 2024.

The first and most pressing factor is the sharp divergence in economic growth that is already underway between the two countries. The U.S. economy remains exceptionally strong and posted annualized GDP growth of 4.9% in Q3, its fifth consecutive positive quarter. Meanwhile in Canada, after a contraction of 0.2% in Q2, GDP continued to remain stagnant through the summer months. In a preliminary estimate, Statistics Canada projected that the economy contracted again in Q3 by 0.1%. This would put Canada in a technical, albeit mild, recession. Such sudden cooling has even caught the BoC by surprise. Back in its July Monetary Policy Report, the bank was projecting annualized growth of 1.5% in Q2 and Q3 of this year. Evidently, it appears that Canadian consumers and businesses are feeling the weight of higher interest rates.

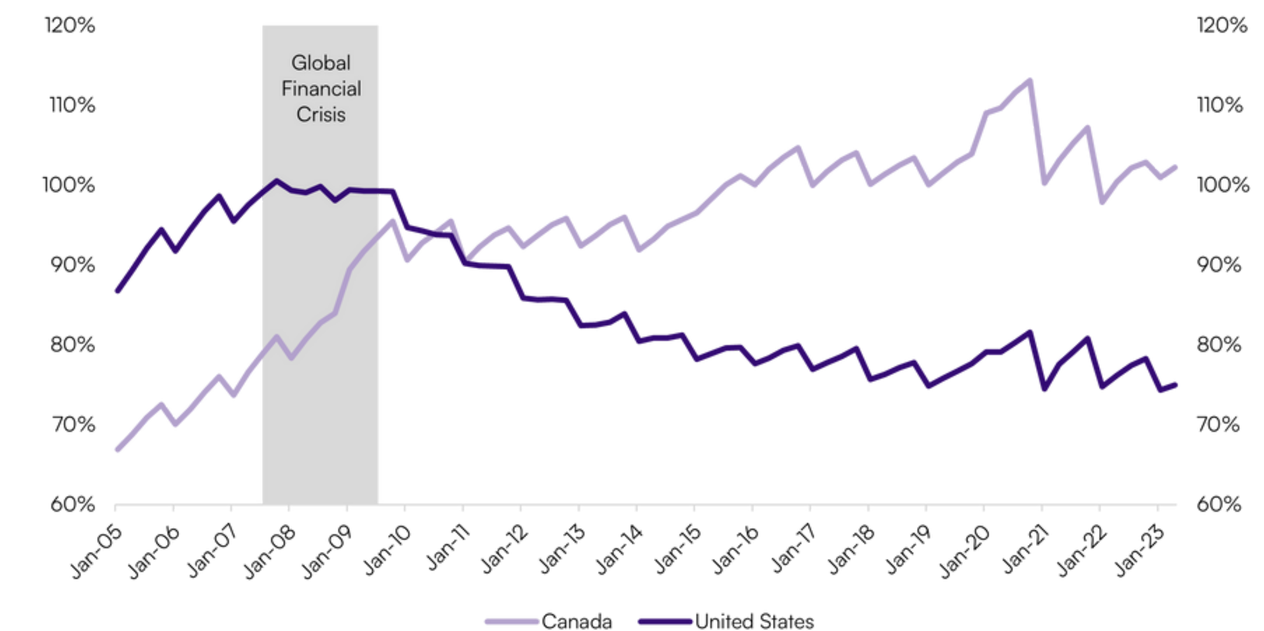
Further contrasting Canada's economic performance to the U.S. is that the economy has been contracting for over a year when accounting for record population growth. In the 12 months ending July 1st, Canada welcomed 1.2 million immigrants, a growth of 3.0% that marks the highest level since 1957. RBC Economics reported in September that, on a per capita basis, the Canadian economy declined by an annualized rate of 3.5% in Q2, far lower than the 0.2% decline in absolute terms. Given continued softness in Q3, we are staring at the 5th consecutive quarter of per capita economic decline.

Economists can point to many reasons for the diverging economic performances of Canada and the U.S., but one of the more clear explanations lies in the size of Canada's household debt. Since the Global Financial Crisis of 2007-2009, Canadian households have gone on to become one of the most indebted among developed nations. As per Chart 4, a shorter and shallower recession, a resilient banking system, and a more stable housing market encouraged Canadians to continue taking on debt in the aftermath of the crisis. The situation in the U.S. was much the opposite with American households undergoing a significant deleveraging through the 2010s. Today, this means that the American consumer is relatively less sensitive to interest rates than in Canada, which may in part explain why consumer spending and economic output in the U.S. have fared so much better in recent quarters.

Finally, differences in the structure between Canadian and U.S. residential mortgage markets is another factor that has and will continue to put pressure on Canadian households in the years ahead should rates remain elevated. In Canada, the most popular mortgage product is the 5-year fixed rate mortgage, whereas in the U.S. most households lock-in a 30-year fixed rate mortgage. The prevalence of longer-term fixed rates in the U.S. provides American households (Continues on next page)



Source: Bloomberg



Source: Federal Reserve Bank of St. Louis

with greater predictability and payment security. In an environment of rapidly rising interest rates, Canadian households are more exposed to prevailing mortgage rates, which adds an additional layer of interest rate sensitivity to the Canadian economy. A recent report by RBC Capital Markets estimates that some $900 billion worth of residential mortgages in Canada are expected to mature between 2024-2026. These borrowers, which account for approximately 60% of total outstanding residential mortgages, will be renewing at rates substantially higher than when they were issued during Covid-19 pandemic years — a period of historically low mortgage rates and exceptional mortgage activity. RBC estimates that, should mortgage rates remain at elevated levels, the average household would see payment shocks of approximately 30% in 2024 and 2025 when $186 billion and $315 billion worth of mortgages are expected to mature. The bank expects that figure to climb to 48% in 2026 when $400 billion in mortgages are expected to mature.

Conventional

Lenders Behind on Origination Targets Heading into Q4

As per our Expected Origination Index, it appears that the weight of higher mortgage rates and general economic uncertainty have had a significant dampening effect on commercial mortgage origination in 2023. The index is derived from responses to our Quarterly Lender Sentiment Survey, which polls approximately 30 of the largest commercial mortgage lenders in Canada. We ask lenders on a quarterly basis whether year-to-date origination is higher than, in line with, or lower than expected for mortgages across different risk categories to construct the below index (see Chart 5).

Year-to-date origination volumes for conventional and high yield mortgages have come in well below target through the first three quarters of 2023, while CMHC insured volumes have hovered around expected. As of Q3, nearly half of conventional lenders responding to our survey reported that origination was lower than expected, while 75% of high yield lenders reported the same. The only time that the index offered a more depressed view of origination levels for these risk buckets was in the latter half of 2020 when the Canadian economy was still emerging from severe pandemic lockdowns.

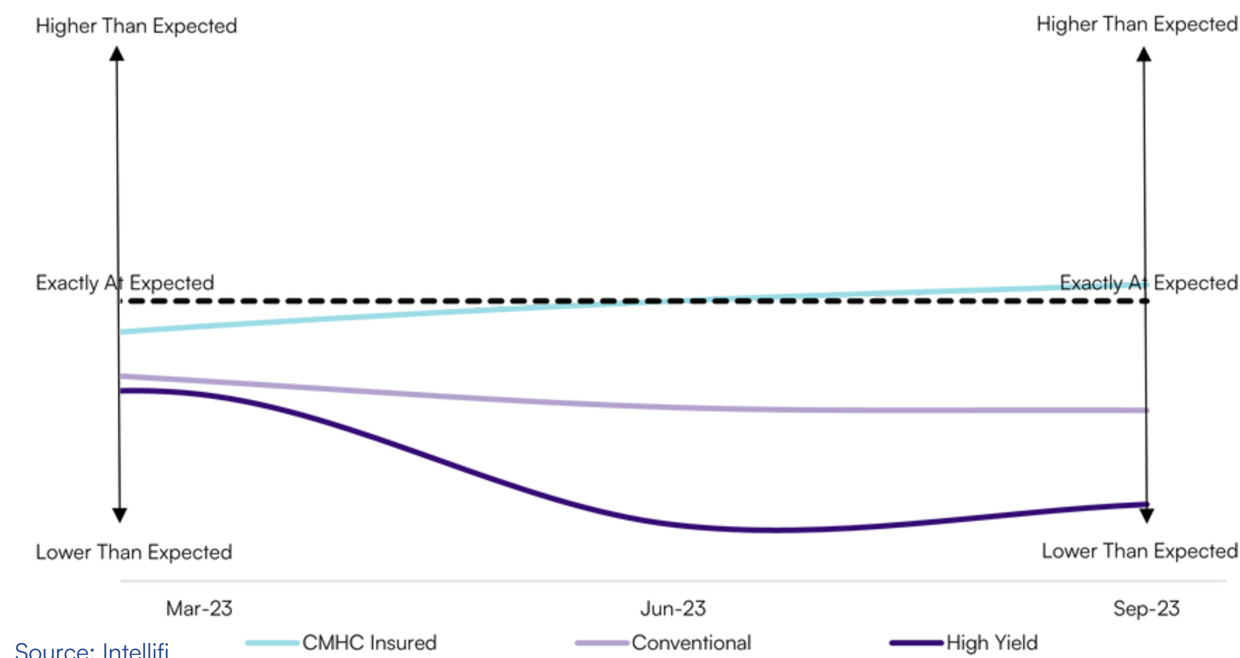
The figure for conventional lending is especially concerning given its relative market size. As per our 2022 Canadian Commercial Mortgage Survey, conventional mortgages (including top tier, conventional, and conventional plus subcategories) accounted for 60% of total origination, followed by the CMHC insured space at 37% and high yield at 3%.

While the index provides a guide as to how successful lenders have been at deploying capital, it is difficult to predict how the results will translate into total dollars originated in 2023. We will have a firmer grasp on origination volumes when we release the results of our 2023 Intellifi Commercial Mortgage Survey next spring. The survey, the only of its kind in Canada, is an annual endeavor that seeks to measure the size and composition of Canadian commercial mortgage origination and outstanding balances. Last year, we estimated that origination climbed ~3% year-over-year to $77.2 billion. You can find the full summary of our 2022 Intellifi Commercial Mortgage Survey here.

Mortgage Rates Comfortably Eclipse 6%

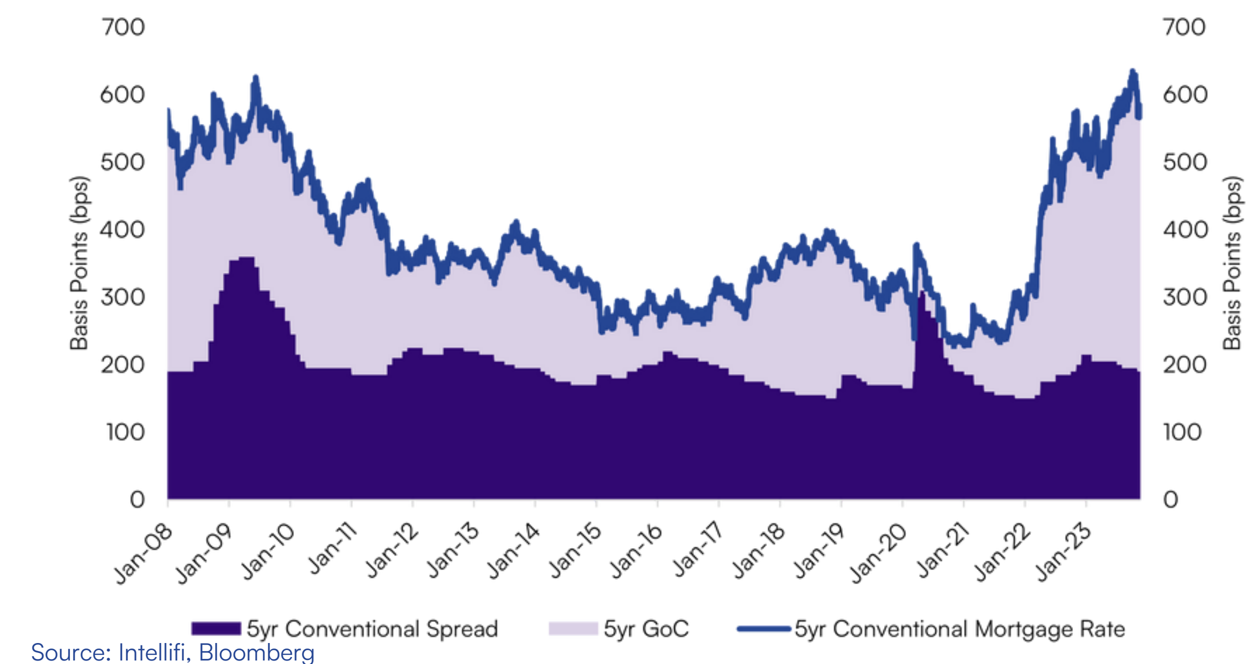
Conventional mortgage rates continued their march upwards into the fall thanks to the surge in government bond yields. As mentioned in the Economic Environment section, a flurry of hawkish sentiment out of the U.S. Federal Reserve and uncertainty on the trajectory of inflation and monetary policy prompted government bond yields to climb to their highest level in 16 years. The 5-Year Conventional Mortgage Index, our proxy for the rate on a typical conventional mortgage, averaged 6.05% through the first month and a half of Q4. As per Chart 6, commercial mortgage borrowers have not seen rates this high since 2009 when mortgage spreads tightened considerably in the fallout of the Global Financial Crisis. For context, the index averaged about 3.50% through the 2010s.

Chart 5: Expected Origination Index



Source: Intellifi

Chart 6: 5yr Conventional Mortgage Index



Source: Intellifi, Bloomberg

About Intellifi

Intellifi provides scalable, bespoke, end-to-end solutions for established and emerging lenders. By combining data, people, and technology, we meet the demand for faster, simpler solutions and ensure usability, flexibility, and scalability for your business.

As pioneers in the Canadian mortgage industry, we bring decades of experience to our clients' businesses. We are passionate about spearheading innovative, creative lending solutions that create competitive advantage in the digital age.

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Risk Reviews
Spread Matrix License
Market Intelligence

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LMS360 Commercial Servicing Software
Target Asset Management Software

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Mortgage Servicing
Back up Underwriting
Back up Servicing
Securitization Administration

Software

Crystal Automated UW Engine
LMS360 Servicing Platform
LMS360 Underwriting Platform

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