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# Bank of Canada warns of steep jump in mortgage payments

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Governor of the Bank of Canada Tiff Macklem speaks following the Bank of Canada's release of the 2024 Financial Stability Report in Ottawa on May 9.JUSTIN TANG/THE CANADIAN PRESS

Homeowners who are due to renew their mortgages over the coming years will face steep jumps in payments, according to the Bank of Canada, with the median monthly payment increasing by more than 60 per cent for those with a variable rate mortgage.

So far, many homeowners have been able to weather the sharp rise in interest rates, with residential mortgage defaults remaining below 0.5 per cent across Canada, the central bank said in its annual Financial Stability Report, published Thursday.

But the report warns that the ability of households and businesses to service their debt has become one of the main risks to the stability of the country's financial system.

“If more Canadians lose their jobs, the unemployment rate goes up, all of a sudden that stress, that vulnerability is really at risk of crystallizing,” Governor Tiff Macklem said in a press conference about the report.

“More households won’t be in a position to pay that mortgage, particularly given the larger reset. So it is a vulnerability. And the point here is households and banks need to get ahead of that. We know what’s coming.”

Since the central bank started aggressively hiking interest rates in March, 2022, about half of the country’s outstanding mortgages have renewed at higher rates. This process has gone relatively smoothly, according to the bank, as income growth, accumulated savings and a pullback in spending has helped homeowners handle the higher rates.

Indeed, the report showed that renters are facing greater financial stress than homeowners, and have been increasingly missing payments on car loans and credit cards.

The next phase of mortgage resets, however, could be more painful. Many people whose mortgages are scheduled to renew over the next two years purchased their home early in the pandemic, when the bank’s policy interest rate was at an emergency low of 0.25 per cent. It has since risen to 5 per cent.

Most Bay Street economists expect the central bank to begin cutting rates this summer. But Mr. Macklem has warned that interest rates will likely decline slowly, and not back to levels seen either during the pandemic or in the decade before it.

Those that will shoulder the largest payment increase are homeowners who have a variable rate mortgage with a fixed monthly payment, where the monthly payment has remained the same throughout the term of the mortgage. For those mortgage holders, the steepest rise will occur in 2026, with the median monthly payment rising by more than 60 per cent, according to bank estimates. In 2025, the median increase is more than 50 per cent; this year, about 30 per cent.

For those with a fixed-rate mortgage, where the interest rate does not change over the loan term, the shock at renewal time will not be as great. Fixed-rate mortgages are based on longer-term bond yields, which have fallen since the autumn. The bank estimates that the sharpest rise will occur in 2026, with the median increase being more than 20 per cent.

Despite warning about rising mortgage payments, the report generally had a more optimistic outlook than the one published last year. At that time, financial markets were fragile after the collapse of Silicon Valley Bank in the U.S., the emergency takeover of Swiss bank Credit Suisse and the near meltdown of British pension funds.

That said, the central bank is becoming more concerned about certain corners of the financial system. Canadian hedge funds and pension funds have added considerable amounts of leverage over the past year. And the prices of riskier assets such as stocks

and corporate bonds look overstretched and susceptible to a correction, especially if there's a change in market expectations about the path of interest rates.

The report says the office real estate market is under pressure with office vacancies rising in major cities. That includes Toronto, the country's financial capital, where the vacancy rate is nearing 20 per cent.

Small to medium-sized banks had the highest exposure to the commercial real estate sector with their loans accounting for 20 per cent of their portfolio, according to the report. For large banks, commercial real estate loans made up 10 per cent of their portfolio.

As a whole, the banking sector is in fairly good shape to handle potential losses, the report says. Canada's large banks have sizeable liquidity and capital buffers, and they've built loan-loss provisions, which provide a buffer if borrowers default.

The report did note, however, that smaller banks are in a tougher spot. Some of them specialize in lending to higher-risk clients and tend to issue shorter-term mortgages. That means more of their loan portfolios have rolled over at higher interest rates already, and the share of mortgages in arrears is greater for these institutions.

A similar divide appears to exist between smaller and larger non-financial businesses. The report says large companies are handling their debt fairly well. In contrast, small business insolvencies have risen sharply over the past year. This is likely the result of both higher borrowing costs and an end of pandemic-era government support programs, the report says.

The report did flag one area of mounting concern within the financial system: Asset managers, such as pension funds and hedge funds, are taking on significantly more leverage for certain trading strategies. Most of this borrowing is happening in repo markets, where financial institutions borrow money on a short-term basis against high-quality collateral.

Canadian asset managers have increased their repo borrowing by 30 per cent over the past year, with hedge funds up 75 per cent and pension funds up 14 per cent. This is mostly to conduct a "cash-futures basis trade," where investors use a mix of short and long-positions to profit from price discrepancies in the bond market.

This increase in leverage exposes investors to a sudden shift in bond prices, which could occur if there's a change in expectations about the path of interest rates. This could spark a fire sale for bonds that would reverberate through the rest of the financial system.

"Leverage is usually there to amplify profits, but it works the other way around too. It amplifies losses, it amplifies volatility," said Carolyn Rogers, the Bank of Canada's senior deputy governor.