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Risks to financial stability largely unchanged, household vulnerabilities remain key concern

OTTAWA, ONTARIO — The overall level of risk to Canada's financial system remains largely unchanged from six months ago, the Bank of Canada said today in the *Financial System Review* (FSR). The Bank continues to highlight two key vulnerabilities related to Canadian households: high levels of indebtedness and housing market imbalances. A third ongoing vulnerability is the potential for fragility in fixed-income market liquidity.

Nonetheless, the Canadian financial system remains resilient as the nation's economy improves and financial reforms in Canada and worldwide progress.

Since June, the proportion of highly indebted households has continued to rise in many cities, notably in the Greater Toronto Area. Nationally, house prices continue to increase relative to income, although significant regional divergences persist. Imbalances in some regional housing markets make it more likely that adverse economic shocks could cause large declines in prices.

This buildup of vulnerabilities will be mitigated over time by new federal housing finance rules and other housing sector policies, which will dampen activity in the sector and improve the quality of new mortgages. While the impact of these measures will be concentrated in regions where house prices are the highest relative to income, such as Vancouver, Toronto and Calgary, they will also have important effects at a national level.

"These macroprudential policies will raise the underlying quality of household indebtedness over time, as well as financial institutions' capital requirements and pricing criteria, which will make them more resilient to future shocks," Governor Stephen S. Poloz said. "Accordingly, these policies will help mitigate financial stability risks over time."

In view of the household vulnerabilities identified in the FSR, the most important risk remains household financial stress and a sharp correction in house prices, triggered by a large and persistent nationwide rise in unemployment. The likelihood of this risk materializing, however, remains low.

Other key risks are a sharp increase in long-term interest rates driven by higher global risk premiums, stress emanating from China and emerging-market economies, and prolonged weakness in commodity prices.

The December issue also features three reports written by Bank of Canada staff:

- Monitoring Shadow Banking in Canada: A Hybrid Approach
- The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities
- Toward More Resilient Markets: Over-the-Counter Derivatives Reform in Canada