



The future of Canadian sub-prime

The term 'sub-prime' has become a dirty word in the US over the past few months – but are these negative connotations slowly creeping across the border? **Vanessa Chris** explores what went wrong in the US collapse and whether a similar fate could ever reach the Canadian sub-prime market

Although rumours of a possible sub-prime crisis in the US had been whispered for a while, it was the harsh numbers released by the Mortgage Bankers Association's National Delinquency Survey in early March that launched the issue into the public spotlight.

The survey revealed shocking results to a country that, until months earlier, had been in the midst of a real estate boom. The report noted delinquency rates in sub-prime loans had risen from 12.56% to 13.33% in the fourth quarter of 2006 – up 170 basis points from the previous year. Foreclosure rates were also on an incline – making up 1.19% of all outstanding loans in the fourth quarter of 2006, an increase of 14 basis points from the third quarter.

The drastic numbers sparked tales of major financial institutions going bankrupt, unethical lending practices and record foreclosure rates in the world's leading newspapers – including Canadian ones – giving the illusion that the US sub-prime market collapsed overnight.

The truth is – as many in the industry know – the current turmoil is the result of years of foreseeable risks that many just chose not to see. With the Canadian economy so closely tied to the US – and the Canadian mortgage industry just a few years behind its American counterpart's level of maturity – industry experts are torn as to what effect, if any, this could have on the Canadian sub-prime market.

What went wrong?

Most industry experts acknowledge a number of factors in the demise of the US sub-prime market – factors that, when combined, result in a unique situation that would be difficult to duplicate.

At the core is the personality of American homebuyers – consumers that are less conservative than Canadian homebuyers because US taxation laws encourage them to take on mortgages, since they are tax deductible.

"Mortgage debt is a very important part of American debts," says Benjamin Tal, a senior economist with CIBC World Markets. "Because Americans can write off their mortgages, they don't have motivation to pay off their debt. Some people say their mortgage is the best investment they ever made."

Combine that with the fact that, in the US, if a borrower defaults on mortgage payments, the lender's only two options are to sue the borrower personally or foreclose on the property. Since an individual who can't afford their mortgage payments isn't likely to pay the mortgage back in full, 99% of the time the lender opts to sell the property, says Ivan Wahl, president and CEO of Xceed Mortgage Corporation.

"If the proceeds aren't enough to pay off the loan, then the lender has no further recourse against the borrower," he says. "In most of Canada, it's the other way around. After they sell the property, if there's a \$10,000 deficiency, you have the right to garnish his wages and do what you need to do to get the money back. The courts are friendlier to the lender in Canada."

The Canadian policy not only lessens the lender's losses, but it also acts as a disincentive for borrowers to default on their mortgages.

"Not only do they have to sell their house, but they'll be forced into bankruptcy as well," Wahl says.

With American consumers hungry for homes and the housing market soaring, Wall Street analysts encouraged investors – namely pension funds, insurance companies, hedge funds and other institutions – to invest in mortgage-backed security sales in the sub-prime market. The mass amount of money – and the aggression of investors – fuelled the lenders' hunger for market share and led to the abuse of their products.

"There was a huge demand from investors to get high yields. Wall Street had huge amounts of money available and was literally throwing money at lenders and saying 'do more volume,'" says Wahl.

The abuse of affordability lending products

Many of the products that ended up causing the US sub-prime lenders' headaches – including adjustable rate mortgages (ARMs), interest-only mortgages, negative amortization and stated income loans – were introduced with good intentions.

Option ARMs, for example, offered low 'teaser rates' for the first months of a mortgage – sometimes as low as 1% – before jumping to a much higher rate. They proved to be an excellent product for new homebuyers.

"Original 'exotic' products didn't start out trying to take advantage of consumers," says Moe Forget, president and CEO of moneyconnect. "Teaser rates, for example, were used to help new homeowners move into their homes. It allowed them to afford new expenses... and pay a lower rate while they established themselves."

In the same sense, negative amortization loans – loans that charged a monthly mortgage rate that was lower than the mortgage's interest rate – were designed for purchasers who were not short on equity, but who temporarily could not afford their monthly mortgage payments.

"It was meant to be a product that could get you from A to B because you were going to sell your house, your income was going to increase or you were going to be able to buy down your mortgage somehow – you weren't going to have it forever," says Forget.

Interest-only loans were designed for a specific type of homeowner – one that typically did not fall into the 'sub-prime' definition.

"Interest-only is not something new – it's been around since the 1920s. Back then, they were given to a select few,"



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A broker's role

Although it seems everyone is getting blamed for the situation in the US – from lenders to borrowers – many feel that mortgage brokers played a large role in the sub-prime collapse.

Some were in cahoots with lenders, accepting a 'yields spread premium' – or extra compensation – if they could get an extra half of one percent on the yield of a mortgage. Others were not fully disclosing the dangers of certain products – either due to a lack of education or a desire to land commission – and were incorrectly suggesting products to people who could not afford them.

That is why it is important in Canada – as brokers help drive the growth of the sub-prime market – that they are fully educated on the sub-prime market.

"These products aren't for everyone, but they provide choice for people. The cost of housing has increased and these products help people into homes," says Jim Murphy, president and CEO of the Canadian Association of Accredited Mortgage Professionals. "Brokers should always look at particular circumstances of clients – look at the overall situation. Clearly brokers want to help people obtain a home, but they need to make sure communication is strong and they are constantly educating themselves."

Murphy says brokers should also ensure rigorous background checks and always look deeply into the situation of the borrower. That, combined with prudent lending practices and thorough underwriting, should ensure the right mortgages are going to the right people.

"As long as people are educated and aware of the strengths and weaknesses of a certain product, that is all a mortgage broker can do," he says. "Ultimately the borrower makes the decision."

says Tal of CIBC World Markets. "It's not totally insane if you're financially sophisticated and have assets on the side. It's almost advisable. Those people knew what they were doing and they were a small percentage of the population."

Tal says the mistake was making this type of loan accessible to everyone. "Those products were designed for specific people in specific situations – not everyone who wants to reduce their monthly payments," he says.

ARMs were also being offered in the sub-prime market and major lenders such as Freddie Mac – in an effort to compete with new private lenders that had entered the scene – started qualifying people with poor credit on the teaser rate. When the rate jumped, these borrowers could not afford it.

Negative amortization loans, in the same sense, were issued to people with no hope of ever affording a higher payment, with the expectation that housing values would increase and they could sell and make a profit. When the housing bubble popped – a housing bubble that had been growing by approximately 15% per year for the past few years – borrowers were left with mortgages that were greater than the value of their homes. So, knowing that lenders could not touch them, borrowers mailed in their keys and walked away.

"The lenders should have been using this product with prime borrowers, but to take that feature and offer it to the sub-prime sector was a mistake – you're taking customers who already have issues and putting them in a situation where they're owing more money than the month before," Forget says.

As more borrowers started walking away from their loans, investors stopped investing and lenders needed money to buy back the defaulted mortgages.

The Canadian perspective

Although a few of these affordability products are offered in Canada – namely the ARM and interest-only products – they have a much different look.

First National – which recently entered the sub-prime market in February – offers an ARM to its sub-prime borrowers, but it is a variation of the products available in the US.

"We have an ARM but we qualify our borrowers on fixed rates. We also don't offer teaser rates on our sub-prime products," says Stephen Smith, president of First National. "In the States, lenders were offering teaser rates for the first one, two or three years at 1.5% to 2.5% and then it would jump to 7%. With our ARMs, the rates adjust according to prime. It's not a huge payment shock – it only goes up or down a quarter of a point."

Xceed, which offers a stated income loan, will only offer 80% loan to value – compared to 100% in the US – and requires the borrower to come up with 20% upfront.

"Generally, we as a company have been a lot more prudent with stated income or low documentation loans," says Wahl. "We still look at every loan and make sure that we're comfortable that the borrower has a stable income that will allow him to make the monthly mortgage payments."

In general, Canadian lenders boast more prudent lending practices. They pride themselves on better underwriting and keeping the needs of the borrower at the forefront of their practices.

"We're looking to get people homes – and homes they can afford

to pay. We're not in the collection business," says Barry Gollom, risk leader for GE Money Mortgages. "The lending mentality in Canada is very much focused on responsible, prudent lending."

Lenders pay a little more attention to the ethics of their lending practices because – like many other industries in Canada – the mortgage market is much smaller than the US and reputation is important.

"Canadian lenders have to get their money from somewhere," says Forget of moneyconnect. "We need to get a bond rating that rates the business we do and we have to convince [the bond rating agency] that it's a wise thing to do. After seeing the carnage in the US, I don't think we could get the bond rating agency to approve that type of lending."

The sub-prime market is also in its infancy – making up just 5% of Canadian mortgage originations last year as opposed to 20% in the US – and competition is much more sparse. This is a fact that Tal of CIBC World Markets expects to see change within the next few years.

"I think that the sub-prime market in Canada can continue to grow – and, in fact, might even double itself – without having a major impact on the overall risk profile," he says. "We might see some increased delinquency in the margin, but one could make the point that, given the extremely low delinquency rates in the mortgage market, maybe the market has been too conservative. When you're too conservative, by definition, there is a portion of the market that is underserved."

Tal says that, given the vast amount of room available in the sub-prime market, Canadian lenders should brace themselves for competition in the form of major US players.

"They're coming and they're one of the most important drivers of sub-prime growth in Canada," he says, adding that the number of US companies that choose to cross the border could either increase as a result of the collapse in the US (to make up for lost profits) or decrease as they cut their losses. "The experience in the US will provide us with a better-behaved market. I think they're now under the microscope in the US, and, when they come to Canada, the quality will be better."

Alistair Blackburn, director of mortgage services for HSBC Financial, says his company's practices have already tightened up due to the lost profit margins of the company's US chapter.

"One of the advantages we have over other players is that we

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have a giant business in the US," he says. "We have very close communication with our US operations. We certainly looked at our underwriting and tightened it up in areas where our US colleagues thought there was great risk."

The company is no longer offering standalone purchases on second mortgages, and it is focusing a lot more on data and analytics.

"Our business down there made mistakes like everyone else, but we can take advantage of that experience," he says. "The only big difference between [HSBC Financial Canada] and the US is that we underwrite every loan ourselves – we don't buy bulk mortgages from other originators. All mortgages are underwritten to meet our standards."

Warning signs

As long as the Canadian sub-prime market grows at an even keel and plateaus at 10% of annual mortgage originations over the next few years, Tal of CIBC World Markets believes Canada can stay out of trouble. If it grows higher than that, he believes things could get messy.

"I think if we're not careful and we let it go the way they have done in the US, then the sub-prime story will be a story in Canada for the next cycle. It's good that it'll continue to grow – we just have to make sure that we don't overdo it," he says.

But Michael Kent, director of Canadian operations for Accredited Home Lenders Canada, says the Canadian market is already five years away from a sub-prime crisis – and many of the warning signs are already staring the industry in the face.

"Interest-only mortgages are here. Some lenders are offering ARMs. Mix these products with stagnant or declining property values and you're in trouble," he says. "Any time you have a risky borrower and you mix that with a risky product, you're combining your risk."

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Michael Kent

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Kent, a US citizen who witnessed the hard hit Accredited’s US chapter took recently, says increased competition can have an unpredictable effect on a lender’s business standards.

“Lenders here are expanding their piece of the pie – which is fine if properties are solid, but what happens when they’re not?” he says. “There seems to be a ‘this can’t happen in Canada’ attitude that I don’t agree with.”

Kent says major signs to watch out for are equity lending – lending money based on the value of a property rather than an individual’s income – and the increased interest of Bay Street and Wall Street investors in the Canadian mortgage market.

“Soon we’ll see Wall Street players coming up here. It’s the next stage of development in Canada,” he says.

Hot markets, such as that in Calgary, could top out down the road and cause problems for lenders because Alberta is one of the few provinces that does not offer personal recourse for lenders.

And insurance companies penetrating the sub-prime market could also lead to some desperate practices.

“More insurance companies coming onto the scene are shrinking people’s piece of the pie. Less risky transactions are being taken by the insurance companies, which leaves only the more risky transactions to go around to other lenders,” he says. “Fannie Mae took the cream of the crop sub-prime loans and that move pushed everyone else towards borrowers with worse credit.”

The increased number of insurers entering the market has also caught the attention of Bob Ord, chairman and CEO of Mortgage Architects.

Sub-prime regulation

Regulators in the US mortgage industry did little to curb the unethical lending practices that led to the sub-prime collapse. Although some states are now taking steps to remedy the problem – including doing away with yield spread premiums and forcing irresponsible lenders to relax their policies so homeowners can keep their homes – many say it is too little too late. So, what are Canada’s regulators doing to avoid a similar problem?

“In Canada, there’s less regulation than in the US,” says Wahl of Xceed. “In terms of specific practices being part of the regulation, there are less regulatory constraints.”

Superintendent Al Clark of the Financial Institutions Commission of British Columbia (FICOM) says different mortgage lenders are regulated by different governing bodies. Banks, for example, are federally regulated, while an institution such as a trust company can be locally, provincially or federally regulated.

FICOM regulates credit unions and trust companies as well as mortgage lenders that lend their own money.

“From a financial institution’s viewpoint, sub-prime lending is regulated the same way as all financial institution business. We ask: ‘What risk are you taking on?’” he says.

In BC, it is a rule that mortgage lenders in the sub-prime market must

have at least \$5,000 of their own capital to lend out. Since they are lending their own money, lenders can sell the mortgage to investors without any problem.

“As long as there’s proper disclosure, if a company wants to lend the funds, they can. But they should always ask themselves, ‘Does the individual have the ability to pay it back?’” he says.

Clark believes that questionable affordability products such as teaser rates could find their way into Canada, although he would try to prevent anybody FICOM regulates from doing so. How successful FICOM would be at this is another question.

“I’m old enough to know that it takes quite a while for things that happen in the US to happen in Canada – but they usually do,” he says.

Many in the industry believe the sub-prime market should not have to rely on regulators, but regulate itself instead.

“We have to count on the common sense of the players,” says Forget of moneyconnect. “Most lenders in Canada securitize their mortgage products and, in order to securitize them, you need to keep up a good rating.”

Ord of Mortgage Architects agrees. “The sub-prime arena in Canada is monitored by investors, rating agencies and insurers. You’re not going to get these products through if you can’t sell them,” he says.

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“If I do have a concern, it’s with the number of insurers who are entering the non-conforming space. I just wonder how many we can support in Canada,” says Ord.

Ord worries that an increased number of insurers on the scene could lead to a loosening of criteria as lenders compete for business.

“Before, loans that were above 75% loan to value had to be insured, but now those restrictions are being raised. Eighty percent loan to value can now be uninsured, so the insurers are losing 5% of their business and left to play in the space between 80% and 100% loan to value,” he says. “Their other option is to get into the non-conforming market. You reduced the size of the sandbox, but increased the number of kids. I think that’s a recipe to look at – there are concerns there.”

Some lenders also have concerns with companies such as Deutsche Bank entering the market. While much of the industry’s prudent practices come from the fact that most sub-prime lenders keep their risk on their own balance sheets rather than selling it, the introduction of Deutsche Bank will now offer lenders the option of selling their whole loans.

Like many of the subtle warning signs, it is something the industry must keep an eye on.

“This type of thing [in the US] doesn’t happen overnight. It happens day-by-day, inch-by-inch,” says Forget of moneyconnect. “It took many years for these lenders to lower their standards. They didn’t move to 125% lending in one day.” **CMP**



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