Risks are Contained Within the Canadian Mortgage Market

By CAAMP Chief Economist, Will Dunning

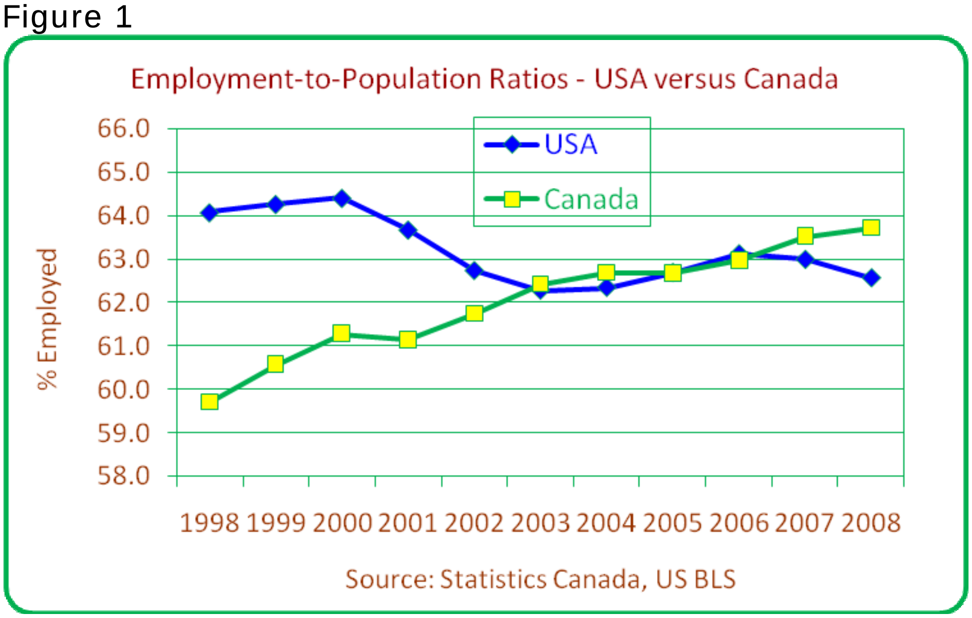
Recent media reports have expressed some concerns about potential risks for the Canadian housing and mortgage markets. One of the concerns being expressed is that Canadian consumers have been "over-extending" themselves through mortgage borrowing. And, it has recently been suggested that the Canadian housing and mortgage markets might fall into a downward spiral like the one currently underway in the United States.

Most Canadian economists, including CAAMP's Chief Economist, point to very substantial differences between the Canadian and US situations, which mean that the risks in Canada are considerably lower than they have been in the US.

The Canadian Economy is Much Stronger

During this decade the Canadian economy has been much stronger than the US economy. Figure 1 shows the percentages of adults that are employed (the "employment-to-population ratio"). The US economy peaked at the start of the decade. While it recovered somewhat during 2005 and 2006, the ratio has remained well below the prior peak. By contrast, the Canadian economy has shown increasing strength in this decade, and the employment-to-population ratio has set new record highs every year from 2003 to 2008. Moreover, to the extent that the US economy did improve at mid-decade, most of the growth was from the housing market – increased construction plus home equity take-out. There was a self-reinforcing bubble in the housing market. In Canada, on the other hand, economic growth has been diversified and much more durable. The Canadian economy has done a very good job of generating highly-qualified home buyers; in the US, slower job creation has meant that there have been fewer good mortgage candidates. Credit quality has remained very strong in Canada but slipped badly in the US.

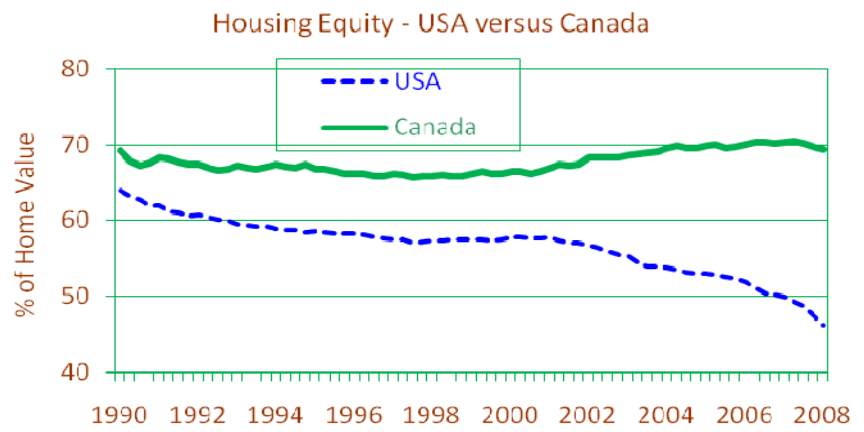
Figure 1



Housing Equity is Substantial in Canada

Some very interesting estimates from Scotiabank's Economics Department (see Figure 2) show that Canadians have retained strong equity positions in their homes. Scotiabank estimates that in Canada, home equity is equal to almost 70% of the values of residential property – **in other words, total mortgage debt is only about 30% of the total value of Canadian homes**, and the equity position today (almost 70%) is stronger than it was a decade ago (about 66%). In the US, on the other hand, there has been sharp erosion of home equity, which began during 2001/02. By 2004 – well before the onset of the current US troubles - the equity position had already seriously eroded.

Figure 2



Source: Scotiabank Economics, using data from Statistics Canada, US BEA

Low Debt Service Ratios in Canada

Most Canadian home owners have housing costs that are very well within their comfort zones. Data from 2006 (shown in the table below) indicates that more than 90% of Canadian home owners have GDS ratios below the traditional 32% threshold.

Table 1

Canadian Home Owners by GDS Ratios, 2006		
GDS Ratio	Number of Home Owners	As % of Total
<20%	5,709,000	70.9%
20-21.9%	417,000	5.2%
22-23.9%	306,000	3.8%
24-25.9%	304,000	3.8%
26-27.9%	225,000	2.8%
28-29.9%	181,000	2.3%
30-31.9%	139,000	1.7%
32-34.9%	145,000	1.8%
35-39.9%	166,000	2.1%
>=40%	455,000	5.7%
Total	8,048,000	100.0%

Source: Adapted from Statistics Canada, Survey of Household Spending PUMF, 2006. Cat. No. 62M0004XCB

Scotiabank has estimated that consumers' total debt service burden in Canada (as a percentage of after-tax income) has not worsened during the past decade, with the burden staying close to 8%. **In the US, by contrast, the debt service burden is almost twice as high (about 14%)** and the burden has increased significantly, from about 12% a decade ago.

Very Few Canadians are in Arrears

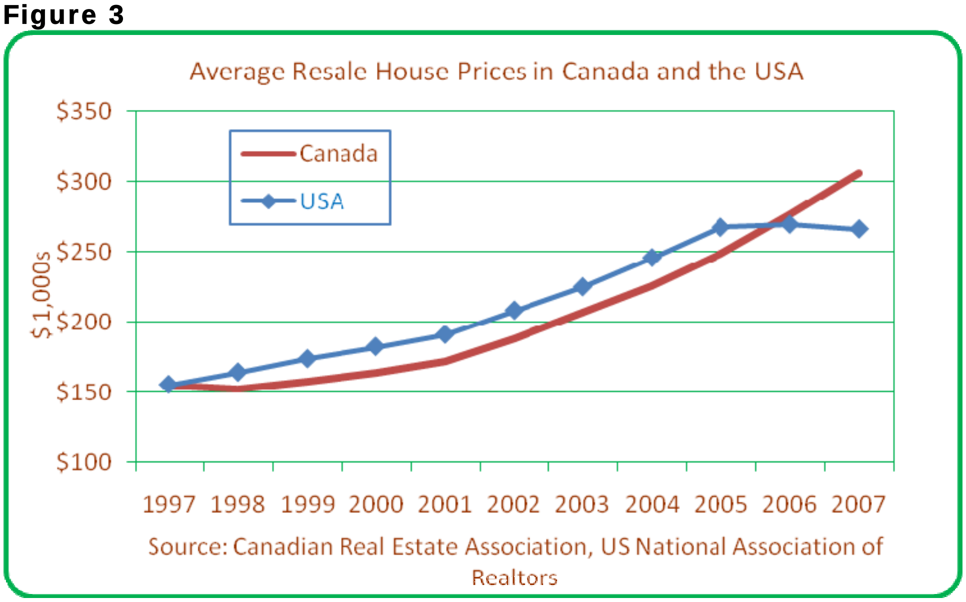
The most recent data from the Canadian Bankers Association – which covers 7 major banks – shows that just 0.27% of residential mortgages were in arrears (three months or more, as of June 2008). This amounts to about 10,300 out of 3.85 million mortgages. This data from the Canadian Bankers Association covers about 85% of all residential mortgages in Canada - it is possible that there is a different rate of arrears in mortgages from other lenders. The Bank of Canada estimates that about 2% of sub-prime mortgages in Canada may be in arrears or foreclosure. In total, 20,000 to 25,000 Canadian home owners might be in arrears, a very small fraction of the 8.05 million home owners in Canada.

Interest Rates Contribute to Sustained Affordability

One of the major risks faced by mortgage borrowers – a factor that has clearly contributed to the US crisis - is that their monthly mortgage payment might increase when their mortgage comes up for renewal. Interest rates for 5-year fixed rate mortgages (after lender discounts) are currently 5.25% to 5.5%, almost identical to the average for the past five years (5.2%). For variable rate mortgages, typical discounted rates are now 4.25% to 4.5%, similar to the average of the past 5 years (4.3%). For most Canadian home owners, future renewals will not result in increased mortgage payments. What's more, most Canadian households have experienced income growth since they took out their mortgages, with the consequence that over time their ability to cover their mortgage payments has improved.

In many respects the Canadian and US housing markets have followed similar paths during the past decade – until late 2006 (see Figure 3). In both countries strong demand resulted in rapid growth in property values. In the US, however, a strong growth cycle turned into a bubble, and like all bubbles, it eventually burst.

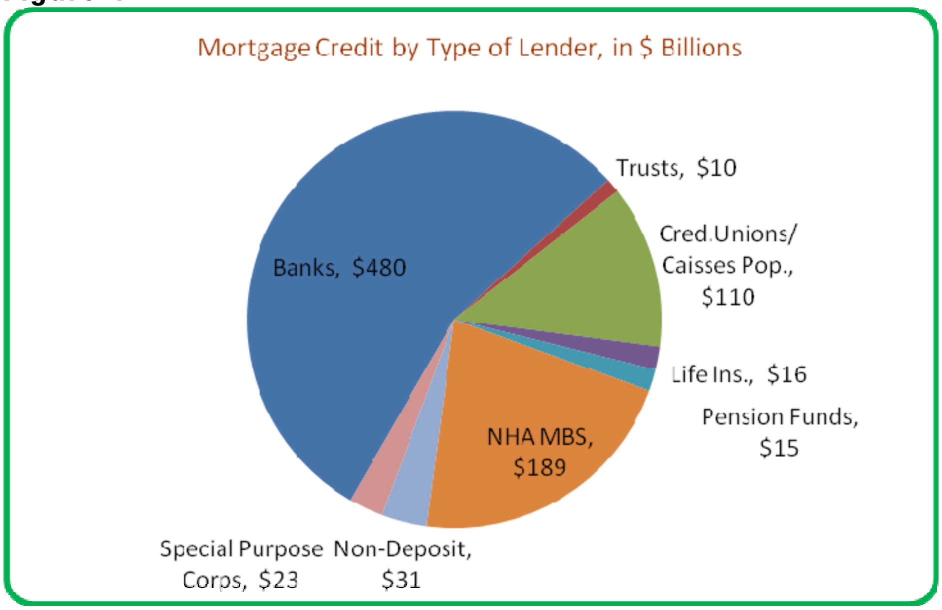
Figure 3



The key reason that the Canadian housing market did not follow the US into the same quagmire is that our lending industry and practices are structured differently:

- In particular, most Canadian mortgages remain on the lenders' books, and there is strong incentive to maintain high credit standards. As is shown in Figure 4, only about 6% of Canadian mortgages are held by special purpose corporations and non-depositary intermediaries.
- In the US, on the other hand, widespread securitization eventually caused a breakdown in the incentive to control risk. When it became apparent that mortgage originators would not have ultimate accountability for credit quality, credit quality was abandoned.

Figure 4



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