CAN CANADA PROVIDE ANSWERS TO AMERICA'S REAL ESTATE MALAISE?

Over Time, One Market Held Up, One Didn't

By Jonathan Glowacki, Ken Bjurstrom, and Eric Wunder

In recent years the residential mortgage market in the United States has become severely distressed. The downturn in the U.S. residential mortgage market spilled over into the global financial markets due to the explosion of mortgage securitization over the last decade ultimately leading to what is now known as the "Great Recession." Although there have been recent signs of a recovery, the economic malaise continues in the U.S. residential real estate market. Housing starts fell to an annual rate of 276,000 for August 2010, down from 310,000 a year earlier, according to the Department of Commerce. In addition, bank repossessions of houses topped 95,000 in August, up 25 percent from a year earlier, according to RealtyTrac, a research firm. These sour numbers continue to put downward pressure on future home price projections.

Canada, on the other hand, has maintained a relatively stable residential mortgage market during these difficult times. Canadian housing prices are rising, with average home prices hitting an all-time high in June 2010, up 14 percent over a 12-month period, according to a house price index developed by Teranet, a data firm and the National Bank of Canada. Canada's recession was also less severe. For Canada's two quarters of negative growth, its real annualized GDP fell 3.4 percent in the fourth quarter of 2008 and 5.4 percent in the first quarter of 2009, according to Statistics Canada, a government agency. (That compares with annualized declines of 6.2 percent and 5.7 percent for the same period in the United States). Why the stark difference in economic performance between the two neighboring countries? A brief comparison of the two countries' mortgage policies may provide the answer.

GOVERNMENT POLICY

One big difference between the two countries involves how each government shaped housing policy in the 20th century. The United States' current system had its origin in the National Housing Act of 1934, a law that was part of the New Deal legislation during the Great Depression. The law was passed in response to the collapse in the value of homes and a wave of subsequent foreclosures that swept the nation during the Great Depression. "Congress affirms the national goal that every American family be able to afford a decent home in a suitable environment," the law stated. The act created the Federal Housing Administration (FHA), whose goal was to provide an affordable home financing system to low income borrowers through governmental mortgage insurance. FHA Insurance requires a small down payment (just 3.5 percent of the purchase price) and removes borrower credit risk from the lender to the government. The National Housing Act added to what was already a favorable tax climate for investing in real estate: the mortgage interest deduction was introduced in 1913, allowing homeowners to itemize mortgage interest payments from their taxes. Real estate taxes were also made deductible.
The collection of these efforts allowed the government to encourage affordable housing for *all* Americans while giving less consideration to the borrower's ability to afford the home.

Subsequently to the National Housing Act, the government created government-sponsored enterprises (GSEs) to improve liquidity in the secondary mortgage market. Fannie Mae was formed in 1938, with the goal to expand the secondary mortgage market by securitizing mortgages. Mortgage securitization allows banks to move loans off the balance sheet and frees up capital, so the banks can provide buyers with more financing for home purchases. In 1970, Fannie Mae was authorized to buy private mortgages (those not insured by the FHA or another governmental agency), thus increasing the amount of mortgages that could be issued to borrowers who did not meet the FHA's underwriting guidelines. Freddie Mac was also formed that year to compete with Fannie Mae.

Canada took a different approach to home ownership. It formed the Canadian Mortgage and Housing Corporation (CMHC) in 1954, which, as its national housing agency, focused on maintaining housing supply and making home buying a practical option for those that had the means and desire to own a home. The CMHC was charged with promoting the construction of new houses, repairing and modernizing the current housing stock, and furthering the living conditions of Canadians. Its focus was on housing supply in the private markets, making owning a home a reasonable option and helping to reduce

the chance of mortgage defaults. So, while the United States focused on financing, Canada has a hand in directly helping citizens buy and stay in homes. CMHC mortgage insurance also has stricter underwriting standards: buyers must put 5 percent down, the CMHC has higher loan-to-value requirements for refinance loans, and debt-to-income ratios must use the average major lender-posted five-year rate as opposed to a current "teaser rate." Finally, Canada eschewed tax incentives for home ownership.

DIFFERENT POLICIES, DIFFERENT OUTCOMES

The government policies helped shape how citizens in each country approached home buying. The United States used lower down payments and tax incentives to reinforce its policy of every American owning a home. Canada instead shunned incentives and emphasized higher down payments focusing on quality housing for Canadians with the means to purchase a home. Since Canadians tended to have more equity in their houses due to the higher down payments, they also had a lower probability of default. The difference in policies meant a divergence in risk on the table for the financial industry. Mid-decade, about 22 percent of outstanding mortgages in the United States had a loan-to-value ratio (LTV) of 80 percent or higher, and 7 percent ranged from 90 percent to 100 percent. That compared with 16 percent of mortgages in Canada having an LTV of 80 percent or above, with 1.5 percent in the 90 percent to 100 percent range. The more equity (and inversely, lower LTV) an individual has in their home, the lower the default probability. American society seems to encourage stretching one's money which led to lower down payments and consequently a greater percentage of loans with high LTV ratios. This in turn corresponds to higher probabilities of default and inflated home prices as the demand for higher-priced homes artificially increased.

SECURITIZATION AND UNDERWRITING

Another key difference between the United States and Canada is their approach to securitization and underwriting, which were closely linked to the collapse of the residential real estate market in America.

The United States expanded the use of mortgage securitization in the 1980s, offering investors a steady stream of income. Issuance of "mortgage-backed securities" (MBS) took off in the 1990s, growing in popularity each year, reaching nearly $2.7 trillion in 2003, up from $318 billion in 1995. By the mid-2000s, the banks, thrifts and mortgage finance companies faced unprecedented demand for the securities by investors. MBS issuance represented 54 percent of all originations in 2000. By 2007, the percent of mortgage financing from securitization jumped to 81 percent. Another significant change involved the amount of non-agency—or private—debt being securitized. Non-agency debt includes loans that don't conform to the standards of Fannie Mae and Freddie Mac, such as subprime, Alt-A, and jumbo loans. Non-agency securitized debt represented just 12 percent of all originations in 2000; by 2006, that number ballooned to 42 percent of all originations or equivalently $1.1 trillion of originations.

Many U.S. originators began to issue riskier loans because they were more profitable, and the originators found fewer buyers with high credit ratings, leaving them to either crimp lending or move downstream to lower credit scores. The riskier loans included subprime lending, which made up 21 percent of all RMBS issuance in 2005, up from 7 percent in 2003. Meanwhile, so-called Alt-A loans also grew rapidly over the same time period. These included interest-only loans, those with little or no documentation (no-doc), no-down payment loans, and teaser loans that would reset to a higher interest rate at a later date. Alt-A loans securitization grew to 17 percent by 2005, up from 2.7 percent two years earlier. Debt-to-income ratios used for adjustable-rate mortgages (ARMs) historically were measured at the current floating rate, rather than the highest possible rate over a longer period of time, such as five years. This allowed riskier borrowers to pass the litmus test.

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As loans moved off the originators' balance sheets, so did the risk: for the most part, investors assumed the liability. Rising demand for the private-label MBSs continued, and originators went with riskier borrowers to help satiate the appetite of the investment banks, which packaged the bonds. Investment banks earned lucrative fees and were often able to structure the securities in such a way that they could still obtain a high credit rating from the rating agencies regardless of the collateral backing the security. Often MBSs laden with subprime loans received the highest possible rating, allowing large institutions around the globe to invest in what were deemed to be some of the safest fixed-income securities.

Loose underwriting, helped by low interest rates, meant credit was cheap and readily available. Both subprime and Alt-A lending increased the demand for homes by making credit available to borrowers who previously were not able to obtain financing. Meanwhile, the increase in the supply of homes could not keep pace with the increase in demand. This disconnect between supply and demand contributed to the rapid increase in property values. Furthermore, the artificial spike in demand was encouraged by the belief that home prices in the United States would not decline since they have not done so since the Great Depression. However, a slowing economy in 2006 eventually lead to falling prices leaving deeply leveraged home borrowers high and dry, precipitating record defaults and a wave of failures of financial institutions and mortgage originators.

WITH COOLER TEMPERATURES, A COOLER RECEPTION TO RISK

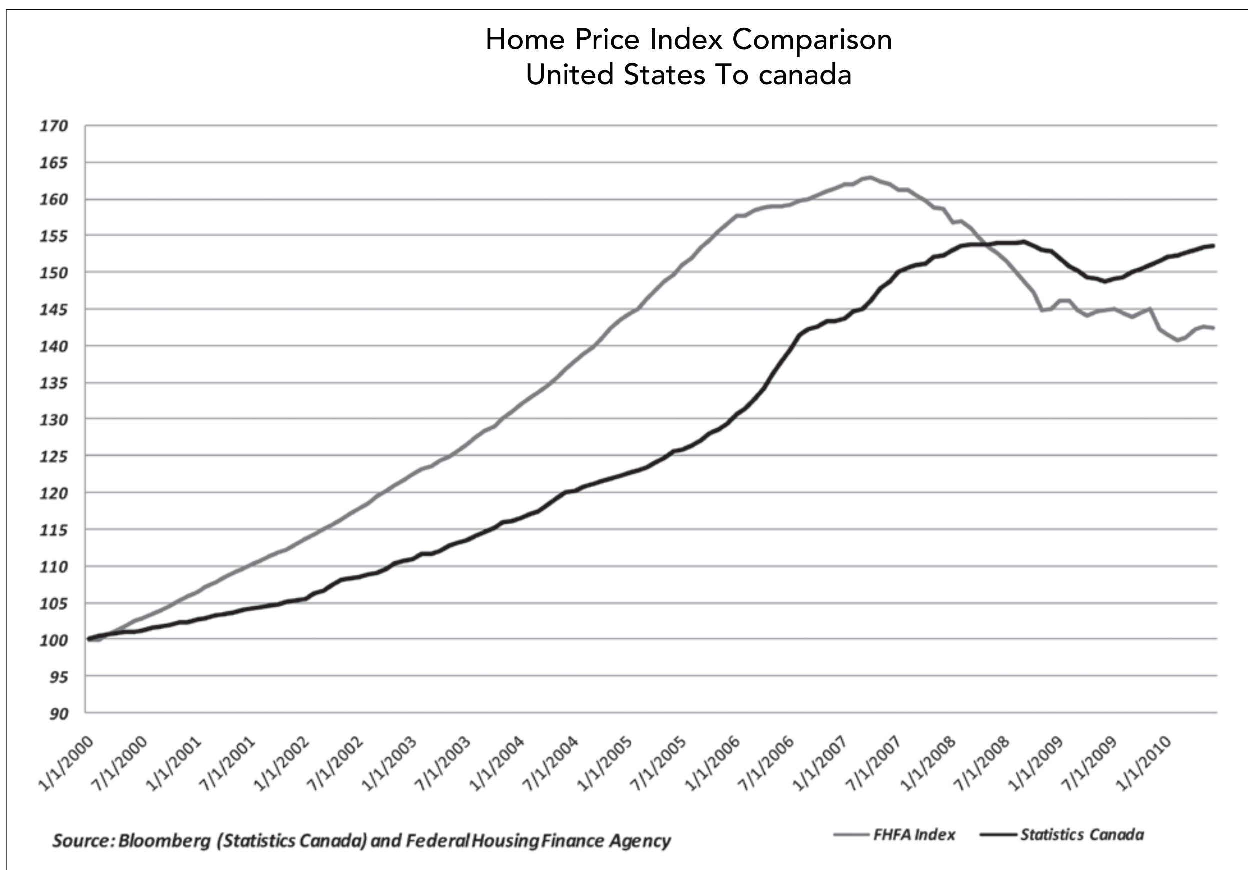
In Canada, securitization was much slower to catch on, and never reached the fever pitch it did south of the border. About $267 billion of outstanding loans have been securitized, representing 29 percent of all loans, according to a report by the International Monetary Fund.[1] Moreover, only $24 billion of those were private label (meaning they did not have a governmental guarantee), compared with $3 trillion in the United States from 2005 to 2007. This means Canadian banks tend to retain mortgages on the balance sheet for the life of the mortgage, instead of selling them to investors and jettisoning the risk.

Canada avoided a collapse in part by maintaining its historically tighter underwriting standards, which call for higher down payments, short- to medium-term fixed rate loans with a longer amortization period of 25 to 30 years following the fixed rate period (after which the rate resets to the market rate), and other enhanced underwriting requirements when compared to more recent U.S. subprime and Alt-A lending. Subprime lending remained a fraction of the U.S. pace, accounting for roughly 5 percent of the market in 2006, compared with 22 percent in the United States.[2] Its Alt-A segment remained small this decade, and the debt-to-income ratios used to underwrite ARMs assumed the average major lender-posted five-year rate as opposed to the U.S. method of using a current "teaser rate." While standards started to loosen somewhat prior to the U.S. subprime crisis, Canadian lenders were able to curtail lending in the category once they saw the disturbing outcome in the United States.

RETENTION OF RISK PROVIDES A SAFETY VALVE

When loans can be packaged and sold as bonds to investors, it creates more liquidity in the secondary market. Yet that benefit presents a weakness for the system. In the escalation of MBS volume, once the loans were securitized, they were removed from the balance sheet of the banks that originated them. In essence, U.S. banks and other originators could write very risky loans and not actually retain the risk, so long as they were able to securitize the debt. Banks earned money through origination fees and spreads above the interest paid on the securities. On the other hand, Canadian banks tended to retain the mortgages on the balance sheets. By carrying the risk, banks tend to be more responsible in their underwriting since the banks were exposed to the credit risk of the mortgages.

> THE UNITED STATES USED LOWER DOWN PAYMENTS AND TAX INCENTIVES TO REINFORCE ITS POLICY OF EVERY AMERICAN OWNING A HOME. CANADA INSTEAD SHUNNED INCENTIVES AND EMPHASIZED HIGHER DOWN PAYMENTS …



While the U.S. system created a property bubble and set the stage for a real estate crash, Canada's more conservative approach allowed it to avert a collapse itself. Its lag behind the United States in loosening of lending practices gave it a looking glass into the unraveling of the subprime market in America. By extending less mortgage credit to those with questionable income and credit Canada avoided skyrocketing property values, and the inevitable unwinding as was the case in the highly leveraged American market. The figure above summarizes the outcome of the two approaches to housing. The Canadian market did not appreciate as quickly as the United States' housing market from 2000 to 2006; however, the Canadian market also did not fall as hard as the United States' housing market and has resumed steady increases in property values.

CONCLUSION

Major differences between the U.S. and Canadian residential mortgage market range from the overall government policy and societal values to the drive of bankers to increase revenue. Given these differences, it appears very unlikely that there is a quick fix to the U.S. problems in the residential mortgage market. On the other hand, Canada's market strength during a global economic slowdown gives insight into adjustments that can possibly be made over time to the U.S. market.

Potential changes to the U.S. residential mortgage market could include a change in government policy away from the idealistic stance that every American should *own* a home; rather the United States may want to focus on ensuring every American has a place to live—either through ownership or rent. No doubt, strict and consistent underwriting standards—much of them back in place today—will help. Prudent securitization would also help preserve a more conservative approach, or at least minimize the chances of another period of writing loans—no matter what their risk—solely for the sake of securitizing them. Some of these issues are being partially addressed by the Dodd-Frank Act. The Dodd-Frank Act focuses on more prudent underwriting criteria and requires companies selling securities to retain 5 percent of the risk under certain conditions. In the longer term, a potential beneficial change could also involve a shift in social mindset in American borrowers that values maintaining less debt by putting down a higher down payment.

END NOTES

1 IMF Working Paper: Canadian Residential Mortgage Markets: Boring But Effective? June 2009. p. 5.
2 "Why Didn't Canada's Housing Market Go Bust?" Federal Reserve Bank of Cleveland. December, 2009.

Jonathan Glowacki, ASA, CERA, MAAA, is project manager for Milliman, Inc. He can be contacted at jonathan.glowacki@milliman.com.

Andrew Fisher, FIAA has recently joined Sunsuper as a Portfolio Analyst in Strategy and Risk, following a tenure as a Financial Risk Management Consultant at Milliman. He can be reached at andrew_fisher@sunsuper.com.au