Consumer Watch
October 30, 2012

Economics

Should We Worry About a US-Style Housing Meltdown?

by Benjamin Tal

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Every percentage point drop in housing activity in Canada raises the level of trepidation, both at home and among potential foreign investors, about an American-style real estate meltdown. To be sure, house prices in Canada will probably fall in the coming year or two, but any comparison to the American market of 2006 reflects deep misunderstanding of the credit landscapes of the pre-crash environment in the US and today's Canadian market.

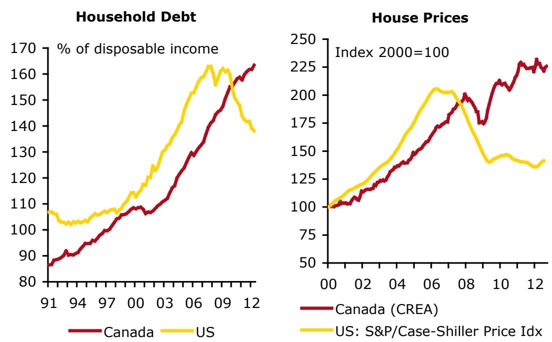
The Bad News

A glance at Chart 1 might cost you a good night's sleep. House prices in Canada continue to defy gravity while the new and improved household debt-to-income ratio is now above the level seen at the eve of the big American crash. No surprise then that the cocktail party conversation of the day is about the possibility that Canada will zig where America has zagged.

And admittedly, some of the lines of defense used to defy those fears are breakable. Many observers point to the extremely low mortgage delinquency rate in Canada as a measure of stability. But as the US experience teaches us, this sea of tranquility can turn into a violent storm overnight. In a short eighteen-month period in 2007-08, the serious mortgage arrears rate in the US surged by more than 300%. Ditto for the claim that the debt-to-asset ratio in Canada has been relatively stable. That was also the case in the US in the years leading to the recession, but it did little to prevent the ultimate crash.

Chart 1

It Doesn't Look Good



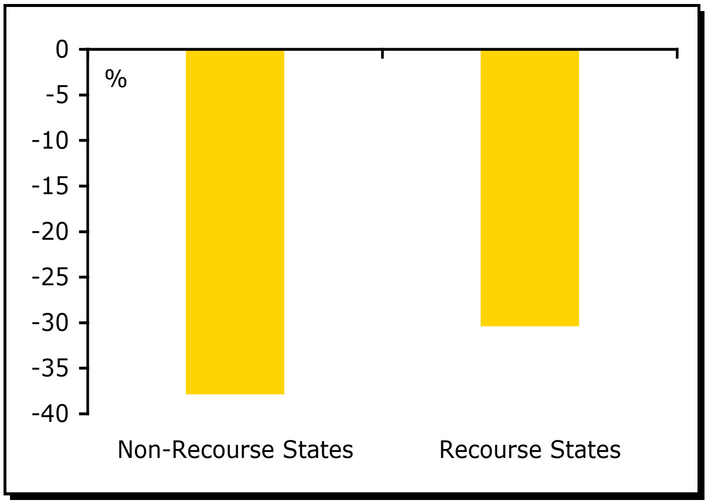
Source: StatCan, Federal Reserve Board, CREA, Standard & Poor's, CIBC

Another widely used feel-good assertion is that, unlike the US, Canada (with the exception of Alberta) is a recourse country—a situation wherein lenders can go after borrowers' other assets to pay down a mortgage. However, the reality is that only twelve US states are non-recourse states. What's more, there appears to be no significant difference in housing market performance between recourse and non-recourse states (Chart 2), suggesting that the recourse status of the Canadian market does not provide a full shield from a substantial fall in prices.

But perhaps the most widely used distinguishing claim is that as opposed to Canada, mortgage interest payments in the

Chart 2

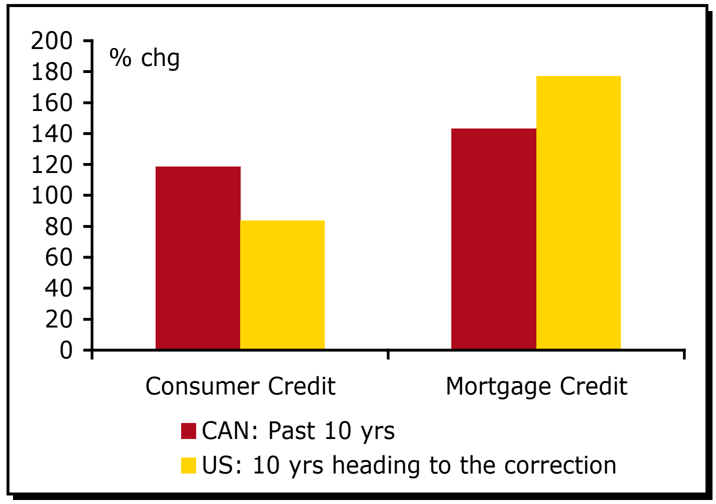
Change in US Average House Prices Since 2006



Source: CIBC calculations based on S&P/Case-Shiller and Loan-Performance

Chart 3

Consumer & Mortgage Credit: Canada vs US



Source: StatCan, Federal Reserve Board, CIBC

US are tax deductible, and thus worked to increase the home ownership rate to an undesirable level. This claim can be challenged in two ways. First, there is a growing body of research suggesting that mortgage interest deductibility (MID) played only a minor role in elevating US homeownership. Just over one-fifth of American taxpayers claim MID, and only 15% of them earn less than $50,000 per year. And for those, the average tax saving is less than $175 per year. Simply put, MID primarily benefits those who would choose to own homes anyway while encouraging them to simply buy bigger and more expensive homes. That goes a long way in explaining the fact that the homeownership rate in Canada today is not significantly different than the one seen in pre-recession US.

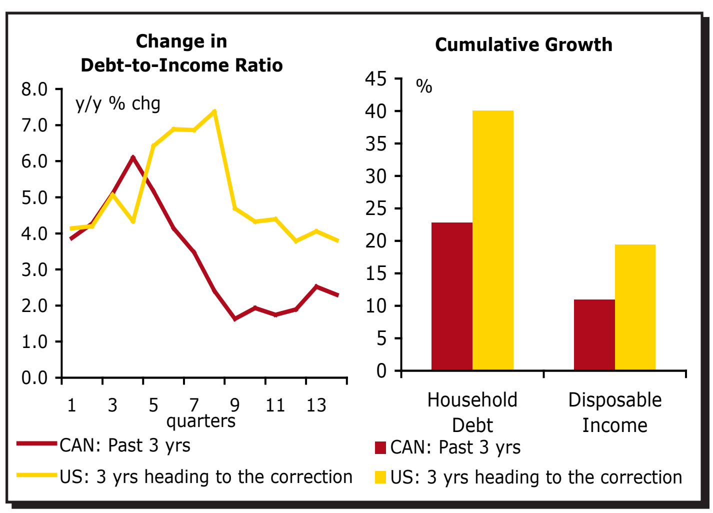
Second, even to the extent that the tax deductibility factor did work to increase mortgage borrowing in the US relative to Canada (say via the average size of mortgages), this growth probably substituted for alternative credit vehicles. No surprise then that when comparing the decade leading to the recession in the US to the past decade in Canada, we find that Americans relied more heavily on mortgage financing while Canadians borrowed proportionally more via non-mortgage loans (Chart 3).

The Good News

Fortunately, the Canadian housing market has more distinguishing attributes that separate it from the pre-crash US market. Yes, the debt-to-income ratio in Canada just broke the American record set in 2006, but as any economist knows, this ratio is more a headline grabber than a serious analytical tool. It compares the stock of debt to the flow of income, and the latter includes income of households with no debt whatsoever. There is a list of countries with comparably higher debt-to-income ratios, which did not experience anything remotely resembling the recent US experience. And while we should not completely ignore the level of that ratio, perhaps even more important is the speed at which it grows. And here the picture looks a bit less alarming. Comparing the three years heading into the US crash to the past three years in Canada reveals that the debt-to-income ratio in Canada

Chart 4

Debt-to-Income Ratio in Canada Rising Much Slower Than in Pre-Correction US



Source: StatCan, Federal Reserve Board, CIBC has been rising at half the speed seen in the pre-crash US market (Chart 4).

And that comparably strong growth in indebtedness in the US was no doubt helped by the fact that speculative activity south of the border was much more prominent than what we are currently seeing in the Canadian market. On average, over the past decade, housing starts in Canada exceeded household formation by only 10%—with most of the excess seen in cities such as Toronto and Vancouver. In the US, the gap during the decade leading to the crash was almost 80% (Chart 5).

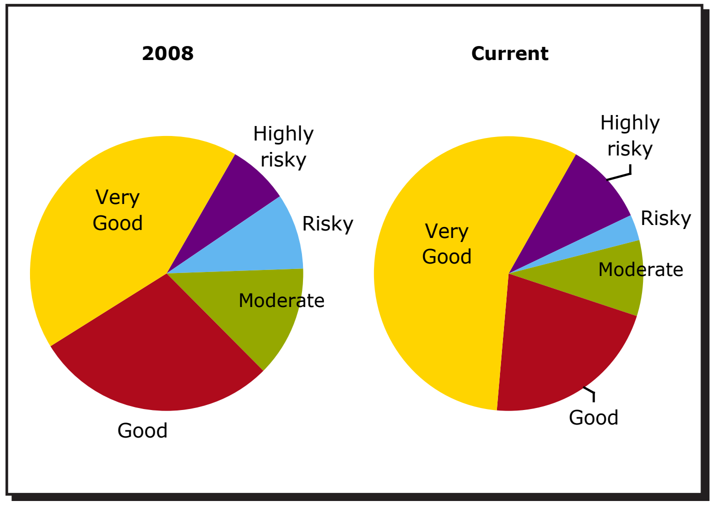
The Quality Factor

Even more important than the amount of debt is its quality. A quick glance at Chart 6 reveals that the distribution of the credit score in Canada has not changed dramatically in the past four years with some increase in the relative proportions of both sides of the risk spectrum. That is very different than the experience seen in the US in the four years heading into the recession. The proportion of the risky category rose by no less than ten percentage points and accounted for 22% of the market.

But credit score does not tell the whole story. Many of the troubled mortgages in the US were sold to borrowers with an acceptable credit score. Alt A mortgages, for example, were underwritten to borrowers of good credit quality that did not satisfy the underwriting rules for prime loans because they were unable or unwilling to provide full documentation on their mortgage applications. In 2006,

Chart 6

No Notable Deterioration in Credit Score Distribution in Canada



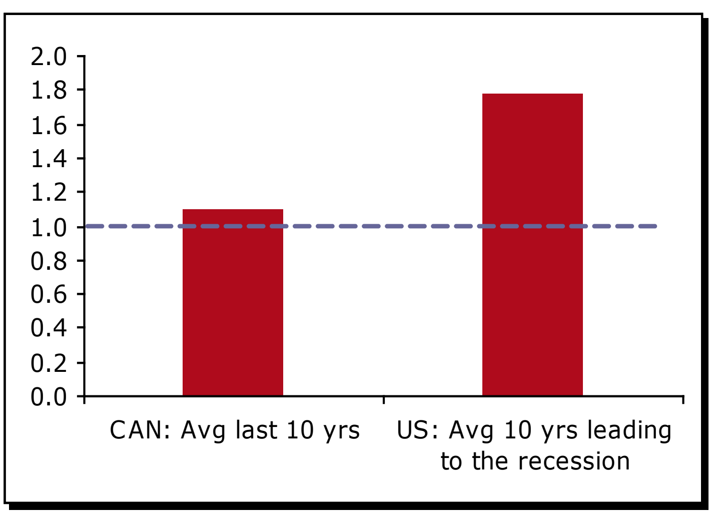
Source: Equifax, CIBC

non-conforming mortgages (subprime + Alt A) accounted for no less than 33% of originations and close to 20% of outstanding mortgages. What's more, an astonishing one-third of mortgages taken out in 2005 and 2006, before the drop in prices, were in negative equity position, and more than half had less than 5% equity, making them highly exposed to even a modest decline in prices.

In Canada, the negative equity position is nil, and only 15-20% of new originations have an equity position of less than 15%. Furthermore, we estimate that the non-

Chart 5

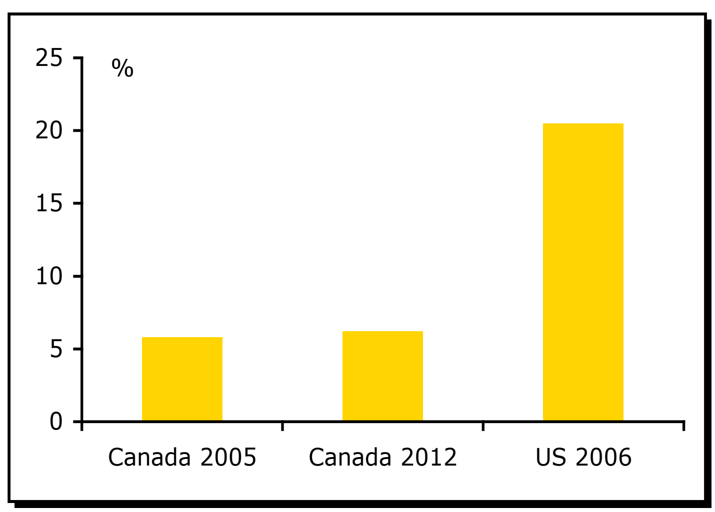
Ratio of Housing Starts to Household Formation



Source: StatCan, Conference Board, US Census Bureau, CIBC

Chart 7

Non-Conforming Mortgages as a Share of Total Outstanding



Source: CIBC calculations based on Filogix, Financial Monitor and Loan-Performance conforming market is currently at around 7% of mortgage outstanding, up from 5% in 2005 but dramatically below the level seen in the US at the eve of the crash (Chart 7).

And at its core, the US meltdown is a non-conforming story. Average house prices in cities with above-average non-conforming exposure fell by 40% from the June 2006 peak—double the decline in cities with below average exposure (Chart 8). And in the US market of 2006, below average non-conforming exposure does not necessarily mean low exposure, as this category included cities such as Dallas and San Diego with well over 15% in non-conforming exposure. Eradicate subprime from the US housing market and, instead of the most severe house price meltdown since the great depression, you get a soft landing.

Sensitivity to Higher Interest Rates

On paper, the fact that a typical mortgage in the US is for 30 years compared to a typical 5-year term in Canada makes Canadian borrowers more sensitive to the impact of interest rate hikes. But the key word here is typical. And in the years leading to the crash, there was nothing typical in the US housing market.

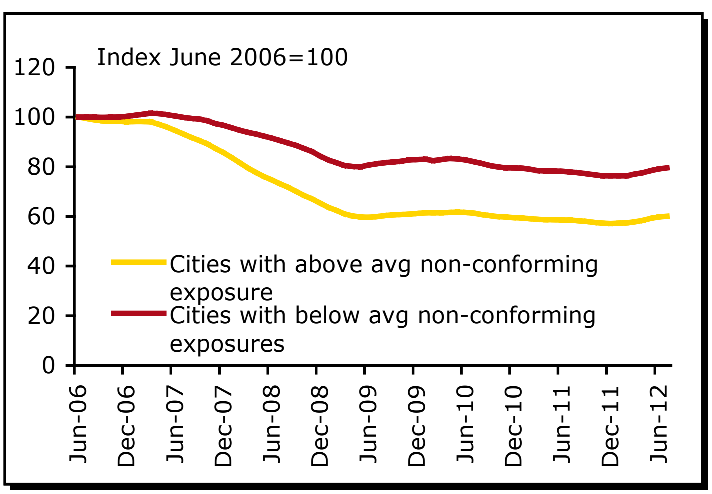
In Canada, borrowers are already curbing their rate sensitivity by reducing the share of variable rate mortgages in new originations to a multi-year low (mainly among more risky mortgages) whereas in the pre-crash US, the opposite was the case (Chart 9). The share of adjustable rate mortgages (ARM) remained elevated until the bitter end, with no less than 80% of non-conforming originations being ARMs.

And those mortgage gymnastics did not end here. The introduction of the teaser rate, a low introductory rate for a period of two or three years that would adjust upward at the end of the initial period, worked to effectively neutralize US monetary policy. Between mid-2004 and mid-2006, the Fed Funds rate rose by more than 400 basis points, but in part due to the impact of the teaser rate, the effective mortgage rate rose by only 30 basis points. The practical implication of that was that when the teaser period expired, millions of Americans felt the full impact of two years' worth of monetary tightening virtually overnight. The reset of no less than $2 trillion of mortgage debt in 2006 and 2007 was no doubt the trigger to the US housing crash. Such a potential trigger does not exist in Canada with mortgage rates likely to rise gradually, allowing borrowers to adjust over time.

In a final analysis, not all is well in the Canadian housing market. Home prices are overshooting their fundamentals, mainly in large cities such as Toronto and Vancouver. The recent slowing in sales activity will probably be followed by price adjustments in many cities across the country. But the Canada of today is very different than a pre-recession US, namely as far as borrower profiles are concerned. Therefore, when it comes to jitters regarding a US-type meltdown here at home, the only thing we have to fear is fear itself.

Chart 8

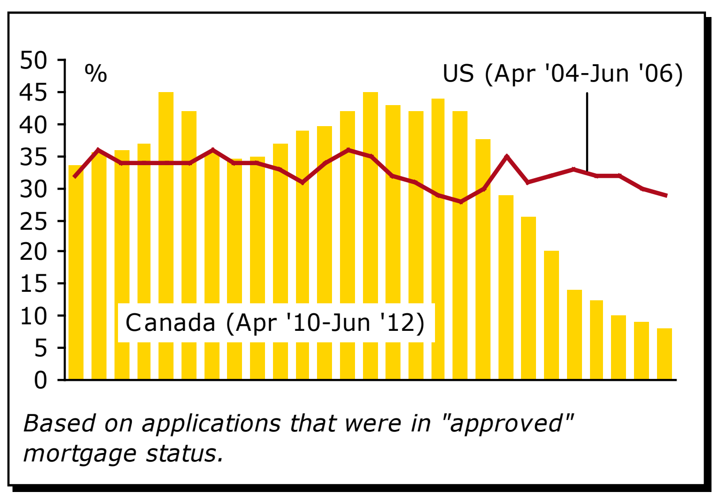
US Average House Prices by Non-Conforming Exposure



Source: CIBC calculations based on S&P/Case-Shiller, Loan-Performance and MBA

Chart 9

Share of Variable Rate Mortgages in Originations



Source: D+H: Lender Insights' Market Share Report 2012Q2 (broker channel) , Federal Reserve Board, CIBC