

# A CREDIT CRUNCH PRIMER

## Q: What is a sub-prime mortgage?

**A:** It's a mortgage given to a home buyer with less than perfect credit, or a home buyer who lacks the paperwork to prove an income that can support the mortgage payments. While these mortgages may not seem like a good idea to begin with, lenders in the United States with liquid assets, or investment money were making loans to almost anyone who asked, and charging a little more interest for these "riskier" loans. The assumption was that constantly rising house prices in the U.S. would compensate for any lending mistakes. The companies doing this included specialty finance firms such as American Home Mortgage (which filed for bankruptcy in August 2007) as well as big well-known banks such as HSBC PLC.



## Q: How did this U.S. lending crisis start?

**A:** When U.S. housing prices started to slide and U.S. interest rates began to rise, many mortgage borrowers ended up in trouble and defaulted. Mortgage lenders, in turn, started to run into troubled waters as far as their profit statements were concerned, and a number have gone bankrupt or closed. Many of the companies making the sub-prime loans were also not holding onto the loans, but instead sold them to other companies such as hedge funds and pension funds who in turn looking for higher profits. Often, the loans were packaged together (think of a mutual fund holding thousands of individual loans) and sold to investors.

As more and more consumers defaulted and the mortgage loans started going bad, suddenly lots of people all across the financial world were affected. Concerned about losses, investors and lenders started demanding higher interest rates to make loans, or stopped making loans entirely. That initiated the credit crunch.

The confusion over what the sub-prime market is has caused many Canadians to panic unnecessarily. They think the so-called sub-prime crisis in the United States will spread to them because their mortgage is at a floating rate below the bank's prime lending rate (hence sub-prime)

## Q: What is the commercial lending paper referred to by the media as part of the crisis ?

**A:** Commercial paper is short-term debt issued by companies, usually coming due in under a year and often in as little as a month. The buyers of these "papers" tend to be institutional investors, including money-market mutual funds, or low-returning funds where investors invest in the belief that the money is safe. As a result, only highly rated companies with strong balance sheets can generally issue commercial paper, limiting the size of the market.

But because of the demand of the growing fund industry for more commercial paper, financial companies such as American Home Mortgage and National Bank of Canada set up trusts that issue commercial paper backed by assets such as car loans, mortgages and credit-card receivables. This asset-backed commercial paper alone is estimated to be worth \$120 billion. About two-thirds of that paper is sold by trusts run by banks, and that segment of the market is holding up. About another third, or \$40-billion, is issued by trusts created by non-bank financial companies such as American Home Mortgage, which no one will now buy.

Suddenly money-market mutual funds are questioning investing in commercial paper that is backed by assets such as mortgages when the housing market is slowing, and prices dropping. As a result, the trusts can't find buyers for their paper, leaving them short of cash. They are turning to banks that had agreed to provide loans in a situation where the market flounders, but some of the banks are now balking. So far it's only a segment of the market that's in trouble, and not every money market fund holds paper issued by the troubled trusts.

In March 2007, one of every eight U.S. sub-prime loans was in default. Projections are this number will double by June, 2008.

**Q: How is all this affecting the U.S. housing market now?**

**A:** Consumers in the United States are finding mortgages have become more expensive and tougher to get, and that has had an impact on housing sales. The number of sub-prime mortgage lending has all but disappeared, so that has eliminated a level or layer of consumer who was previously active in the real estate market. In essence, tougher credit terms are slowing purchases and that's slowing the economy and hurting the stocks of companies involved in lending, or in housing. That includes home renovation, builders, and furniture retailers – the impact reaches into various aspects of the economy.



**The bottom line:**

Unlike the U.S., the Canadian housing market has not been artificially driven by bad lending practices. Our long-term fundamentals are solid. Canada has a growing population. Our energy and commodities are in high demand, and job creation is strong. Consumer confidence remains high. However, there may be an impact on the overall Canadian economy, which may affect the Canadian housing market. For example, the drop in housing starts in the U.S. will mean lower demand for Canadian softwood lumber products.

By June 2007, more than 21% of U.S. mortgages were sub-prime compared with only 5% in Canada (all Canadian mortgages are insured).

According to the Canadian Bankers Association a record low number (0.24%) of Canadian mortgages were in arrears by July 31/07.

The MLS® sales forecast published quarterly by The Canadian Real Estate Association says that with these economic factors taken into consideration, 2007 will represent a record or near-record year for the sale of re-sale housing in Canada, but the pace of sales will slow in 2008. The detailed MLS® forecast is available on the [www.crea.ca](http://www.crea.ca) web site.

Any questions or comments about the service or products CREA provides?  
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