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Understanding The Sub Prime Mortgage Market Crisis

Despite the fact that the U.S. sub prime mortgage market has gained much media attention, only some of us know what this means while many are worried about it's affect on our market. In this article we shed some light on this issue and it's effects on the Canadian market.



What is a sub prime mortgage?

A sub prime mortgage is a loan that is risky in nature. If the borrower has poor credit or a low income, then he/she would not typically qualify for a mortgage. This is why sub prime mortgage was created. Sub-prime mortgages are mortgage loans to borrowers who have bad credit history. While the terms and conditions of sub-prime mortgages can vary, an introductory two-year term interest rate before resetting to a much higher interest rate, which is the combination of the index rate plus a margin is always offered.

If the borrower in subsequent years couldn't meet their financial obligations, the higher property prices would largely insulate or negate losses for the lender. The lenders usually offload these sub prime mortgages to institutions who would package them as mortgage backed bonds. The high returns offered by these bonds make them very attractive for investment funds as there is always an incredible amount of money flowing into them largely from Canada, Europe, and Asia.

Many consider this a profitable business like brokers who sell the

Term	NATIONAL MORTGAGE RATES	
	Posted Rates*	Best Rates*
6 Month	6.80%	5.40%
1 Year	6.95%	4.90%
2 Year	7.00%	5.50%
3 Year	7.00%	5.25%
4 Year	6.85%	5.50%
5 Year	6.99%	5.45%
7 Year	7.40%	5.90%
10 Year	7.75%	6.15%
	Variable Rate	4.15%
	Prime Rate	4.75%

* last updated: May 12, 2008

bonds and the debt rating agencies who receive substantial fees for making the bonds appear to be solid investments.

The market crisis!

The countdown began on June 2004, when the Federal Reserve (the central bank in the US) began a cycle of interest rate hikes that raised the cost of borrowing from the lowest levels registered since the 1950s. It increased the interest rates seventeen times and paused only in June 2006 when the borrowing cost touched 5.25 percent.

The US housing market began sliding in August 2005 and that continued through 2006 when building rates and housing prices tumbled.

The high spending of the American government on the war in Iraq and many other factors played major role in the shrinking of the U.S. economy and affected the employments rate. This combined with the high interest rates and low home values have left many of those borrowers unable to meet their mortgage obligations and led to a crisis in the sub prime mortgage market.

By the end of 2007, the number of foreclosures went up 93 percent comparing to 2006. Some lenders have been forced out of business because of the unconquerable losses.

What affect will this have on Canada?

Canadian sub-prime mortgages represent less than 5 per cent of mortgage origination's, and less than one in four of them have more risky variable rates. While US home prices are falling on average, home prices in Canada continue to rise. The economic fundamentals in Canada remain strong. Lenders here in Canada may tighten up lending practices globally which would not be immune to the Canadian marketplace. Also, if the US is heading into a recession, it may have an impact on the Canadian economy.

Are there similar risks to the market in Canada?

In Canada, a prime mortgage is known as a conventional mortgage. A home-buyer with a down payment less than 20 percent (high ratio mortgage) needs to secure mortgage insurance like the kind provided by Canada Mortgage and Housing Corporation (CMHC). Conventional and high ratio mortgages in Canada and the United States use similar underwriting practices.

There are some key differences between the sub prime markets in Canada and the United States. In Canada, there is less emphasis on gaining market share for the risky sub prime mortgage business. In the U.S., clearly the war for the sub prime mortgages, may have been a reason for some careless and reckless loan granting.

Also, the lending practice in Canada is not to use option adjustable rate mortgages for the sub prime borrower. This usually reduces the risk with any loan. The Canadian housing market has been less speculative than the U.S. market. A strong job market and lower interest rates will help sustain the Canadian real estate market.

Furthermore, mortgage interest is tax deductible on an American principle residence. This is another significant reason why Americans are encouraged and motivated to buy a home (sometimes prematurely). The U.S. housing affordability is at its worst level in two decades. In Canada, affordability is still very much present as the overall real estate picture is better than the 1989 period when there was a significant spike in prices. Currently, the U.S. household debt is a staggering 25 percent higher per capita than that of the Canadian household.

The real estate market in Canada has been going strong for 9 years. It is difficult to predict when the market will show signs of a slowdown. Given the demand for real estate in our current market, the low unemployment figures and the availability of affordable housing, the market will continue to flourish despite the struggles of our southern neighbour.

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