

## Subprime mess spreads

The subprime lending crisis in the U.S. is far from over, and its impact on financial markets may continue to affect the cost of Canadian mortgages. In an American housing market trashed by the debacle, it remains to be seen whether or not the relief plan unveiled by President George W. Bush on December 6 will stem the tide of mortgage defaults, home foreclosures, and bankruptcies of mortgage lenders.

The Canada Mortgage and Housing Corporation defines subprime lending as programs that target borrowers who have weak credit and who could not secure a loan from traditional sources such as banks.

According to a UBC real-estate expert, a significant number of these loans, which offered "teasers" in the form of low-interest payments in the first two to three years, were made in 2005 and 2006.

"Those loans are starting now to have their teasers end," Tsur Somerville, an associate professor at the UBC Centre for Urban Economics and Real Estate, told the *Georgia Straight*.

With slumping house prices and loans taking on higher interest rates, it's not a pretty picture for the 1.2 million Americans that the Bush plan aims to bail out from financial distress.

"So people are now paying more interest on properties that are worth less," Somerville noted. "That's a bad combination."

Subprime loans aren't nearly as widespread in this country, accounting for roughly five percent of mortgages. This compares with the 22 percent share of subprime mortgages in the U.S., noted CIBC World Markets senior economist Benjamin Tal in his paper *Mortgage Risk—Canada vs. US* dated March 16, 2007.

Somerville noted that the problem is not the local subprime lending market. "The issue for Canada is the effect that the subprime crisis has on general financial markets," he said. "I think we've seen only one effect, which is that the spread between the Bank of Canada rate and mortgages has gone up."

Somerville explained that this spread is the difference between the overnight interest rate the Bank of Canada charges when it lends money to banks, and the rate charged by financial institutions on loans, including real-estate mortgages.

"When real estate is perceived as riskier, that spread grows," Somerville said. "One of the things that happened over the last five years is that spreads declined so that in general people were less worried about risks. The gap between the Government of Canada bond and other kinds of financial instruments and other kinds of loans declined over time. That's now going up."

Mortgages for Canadians have gotten more expensive because of problems in the financial markets stemming from the subprime issue in the U.S., Somerville added.

In December 2007, the British Columbia Real Estate Association released its mortgage outlook for 2008. A paper written by BCREA economists Cameron Muir and Bryan Yu stated that the "turbulence in credit markets contributed to the wider spread as investors moved away from riskier assets and into safer government securities".

"Since August, three-month treasury bills have dropped 70 basis points, while corporate paper yields jumped 25 points before reverting back near August levels," Muir and Yu wrote. "The re-pricing of risk has meant higher costs to raise capital in credit markets. This includes monies funding part of the mortgage loan market. Higher costs of capital on the part of some lenders have

been passed on to buyers through higher mortgage rates, explaining the rate bump in October, despite lower bond yields."

Muir and Yu projected that mortgage rates may decline slightly for the first half of this year because of domestic factors, but will "rise modestly during the second half of 2008".

"During the first week of December, the spread between one- and five-year mortgage rates and government securities of similar maturities reached 3.4 and 3.7 percentage points, which is well above the average spread observed over the past five years," they wrote.

Muir and Yu noted that financial-market conditions may worsen, creating a wider gap between government securities and mortgage rates.

When the Bank of Canada lowered its target for the overnight rate to 4.25 percent last month, it noted that credit conditions had tightened further—as anticipated losses on U.S. subprime mortgages worsened since October—and that they will persist for a longer period of time.