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Canada's Sub-Prime Mortgage Time Bomb

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What do the mid-recession housing boom and the Harper Conservatives' rise in the polls have in common? Answer: the Canada Mortgage and Housing Corporation's massive sub-prime mortgage scheme that is keeping up the appearance of an economic recovery.

Reading the newspapers these days you have to wonder whether Canada was on another planet when the global credit crisis hit. House prices have actually increased in some provinces and now there is a shortage of houses for sale in southern Ontario. Credit is flowing everywhere.

Ottawa: The biggest sub-prime lender in the world

But what few Canadians realize is that the housing market has avoided collapse (prices are down 32 per cent in the U.S.) because the Harper Conservatives directed the CMHC to change the mortgage rules to effectively make the Canadian government the biggest sub-prime lender in the world. What's almost as alarming as this reckless policy is that no one in the financial media is talking about it, even though everyone knows the facts. I was alerted to the scandal by David Lepoidevin, a financial advisor with National Bank Financial, in a warning letter to his clients. (Blogger Jonathon Tonge has all the CMHC charts and graphs on his blog.)

The facts are that over 90 per cent of existing mortgages in Canada are "securitized" — that's the practice of pooling mortgages (or other assets) and then issuing new securities backed by the pool — MBSs, or Mortgage Backed Securities. That's what happened with the sub-prime mortgages in the U.S. which (because the whole pool was so diversified) received triple A ratings by the rating agencies. Losses around the world amounted to hundred of billions of dollars.

Credit is still tight in the U.S. because no private investor has the stomach for such risky MBSs. That's because those losses were private and not back-stopped by any government. In Canada, mortgages have been securitized for years. The Canadian-issued securitizations are called National Housing Act, Mortgage-Backed Securities. Unlike the failed U.S. pools, says Lepoidevin, "In order to find buyers for securitized mortgage pools, the Government of Canada has put guarantees on them" by directing CMHC to guarantee all Canadian mortgages.

So long as borrowing requirements were tight, the percentage of loans that were securitized remained modest. But in 2007 the Harper government allowed the CMHC to dramatically change its rules: it dropped the down payment requirement to zero percent and extended the amortization period to 40 years. In light of the mortgage meltdown in the US, Finance Minister Flaherty moderated those rules in August 2008 (it's now 5 per cent down and 35 years). But these are still relatively very loose requirements and securitization has taken off.

By the end of 2007 there were $138 billion in NHA securitized pools outstanding and guaranteed by CMHC — 17.8 per cent of all outstanding mortgages. By June 30, 2009, that figure was $290 billion, a figure Lepoidevin says "…exceeds the total value of mortgages offered by CMHC in its 57 years of existence!" CMHC's stated goal was to guarantee $340 billion by the end of this year and is on track to reach $500 billion by the end of 2010. Total mortgage credit in Canada will grow by 12-14 per cent of GDP in 2009

Keeping credit flowing: At what cost?

In an effort to prop up the real estate market in 2008 (when affordability nosedived) the Harper government directed the CMHC to approve as many high-risk borrowers as possible and to keep credit flowing. CMHC described these risky loans as "…high ratio homeowner units approved to address less-served markets and/or to serve specific government priorities." The approval rate for these risky loans went from 33 per cent in 2007 to 42 per cent in 2008. By mid-2007 average equity as a share of home value was down to 6 per cent — from 48 per cent in 2003. At the peak of the U.S. housing bubble, just before it burst, house prices were five times the average American income; in Canada today that ratio is 7.4:1 almost 50 per cent higher.

This high-risk policy actually prevents the natural playing out of the recession — that is, the purging of the excesses of the previous boom period. CMHC's easy-money resulted in a 9.3 per cent increase in Canadian household debt between June 2008 and June 2009.

Even bank economists admit to being concerned about a housing bubble. In a September research note, Scotiabank economists Derek Holt and Karen Cordes said, "…lenders have been scrambling to get enough product to put into the federal government's Insured Mortgage Purchase Program over the months, and that may have translated into excessively generous financing terms." Holt suggested that in two or three years — or whenever the Bank of Canada increases interest rates — many of these mortgages would be at risk.

The banks themselves have taken on virtually no new risk. According to CMHC numbers in the two years from the beginning of 2007 to January 2009 Canadian banks increased their total mortgage credit outstanding by only 0.01 per cent. Fully 90.5 per cent of all growth in total Canadian mortgage credit outstanding since 2007 has been accounted for by Mortgage Backed Securities. Of course, the banks have no interest in saying no if you have qualified for a securitized CMHC loan — because they bear no risk if you default.

If that sounds like sub-prime mortgages, it should. Sub prime is any loan below prime. If a bank refuses you a loan, and CMHC gives you one, the loan is sub-prime. As Lepoidevin says in his warning letter, "Every single U.S. lender specializing in sub-prime has gone bankrupt. The largest sub-prime lender in the world is now the Canadian government."

The high price of political cowardice

This is the ticking time bomb Prime Minister Stephen Harper has tossed at the Canadian taxpayer. Why? So that he can maintain the fiction that he is a good economic manager and win a majority in the next election.

The problem is no opposition political party wants to expose the looming disaster and risk being responsible for a dramatic fall in house prices. As Liberal finance critic John McCallum told the Globe and Mail: "I don't think we want the government to be rationing Canadian home-buying."

The price of political cowardice will be very high. And in the end the housing bubble will burst anyway, putting taxpayers on the hook for tens of billions of dollars in defaulted mortgages.

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