

## **Making Sense of the Liquidity Crunch**

By Greg Holohan, CFP (September 2007)

The summer of 2007 may be remembered as the time when the financial services industry was not so gently reminded about the risk-return trade-off. The defaults in the US subprime mortgage market have, in the end, affected the Canadian market in the form of a liquidity crunch. In turn, mortgage borrowers now face a hesitant environment for new mortgages – particularly for higher risk, or subprime loans. In your role as a mortgage advisor you may welcome a primer on how the summer's events could affect you and your clients.

### *What happened?*

In a nutshell, rising rates and falling property values in the US caused defaults in the subprime market to soar. Some Canadian institutional investors were inadvertently exposed to the defaults through the commercial paper market, which – at least temporarily – created default fears and reduced the demand for these investment assets. The fallout appears to be a new risk premium for subprime mortgages and tighter credit from domestic lenders.

Arguably, it all started back in June 2003 when the United States Federal Reserve reduced its intended federal funds rate to 1%, an all-time low, to help combat a sluggish economy. Mortgage lenders flooded the market with teaser rate-offers, and accepted subprime borrowers into adjustable-rate mortgages who, in retrospect, were not qualified to be there.

The subsequent three years saw a steady increase in the Fed rate matched with a decrease in property values in many parts of the United States. Many borrowers faced substantially higher mortgage payments as adjustable rate mortgages were amended to match the new market conditions. Higher payments were coupled with an inability to refinance – since the loan outstanding often exceeded the property value. The credit conditions led to a distressing number of mortgage defaults.

In Canada, we faced no such deterioration of credit, and our interest rate increases have been more muted. The credit environment in Canada, by all accounts, has appeared to remain relatively stable with an acceptable mortgage default rate. “Let's not forget that the definition of ‘subprime’ in the US is very different than in Canada,” said Rob Galaski, Associate Director of Investor Economics. “In many ways it's not even fair to do a direct comparison between the two markets.”

Indeed, the impact of the US subprime mortgage situation, which caused the so-called liquidity crisis in August, mainly affected institutional investors in the commercial paper market.

These challenges, in Canada at least, have a lot to do with how some mortgages are funded. Over the past twenty years, many Canadian lenders have used a process of

securitization – which essentially means bundling and selling newly originated mortgages instead of actually holding them on their balance sheet. The main advantage for mortgage lenders is that securitization takes pressure off of managing their own balance sheet, and allows them to focus on their strengths – underwriting mortgages.

“Although the number of Canadian mortgage lenders who rely primarily on securitization is small,” says Galaski, “it remains a serious issue for those who do.”

Securitization agencies (most notably Coventree Inc.) packaged up hundreds of mortgages, credit card receivables, and auto loans into asset-backed commercial paper or mortgage-backed securities, which commonly received the highest debt ratings from the agencies like DBRS. It can be a wonderful arrangement for institutional investors – like pension funds, hedge funds, mutual funds, even publicly traded companies – who willingly invest their money into this paper in order to earn nominally higher rates of return.

However, as the credit problems in the US subprime market became more pronounced, the institutional investors finally began to question the extent to which their investments were exposed to the credit problems down south and decided to withhold future investments until they could get clarity on the underlying investments. Almost overnight, there was a liquidity crisis, as institutions cut off the flow of funds required to keep the market afloat. The other impact was an instant demand for a greater risk premium for acquiring subprime mortgages.

#### What next?

For mortgage brokers, the two most likely consequences are tighter access to credit and the threat of higher interest rates on non-conforming deals.

Indeed, by late August, a few lenders including MCAP and GMAC, announced that they were either tightening credit restrictions for subprime borrowers, or suspending new applications altogether. Certainly, a few foreign lenders may experience enough pressure south of the border that credit qualifications are tightened in Canada as well.

“Credit conditions have definitely tightened but these are the times that the cream will rise to the top,” said Elisseos Iriotakis, Vice President of Safebridge Financial. “Mortgage consultants who understand their clients’ needs – and their options – can sort through which lenders will accept these mortgage applications, under the new tighter guidelines.”

In the near future, much of the pressure will continue to come from the destabilization of the commercial paper market. Firms with a heavy reliance on the securitization market now face fundamental decisions about how to fund their mortgage portfolio moving forward. Assuming the commercial paper market fully re-stabilizes; lenders that rely on securitization revenue will, at the very least, face investors who demand a risk premium for these types of loans.

Likely, some lenders will choose to pass on the risk premiums in the form of higher mortgage rates to the subprime clients themselves. In essence, the market is facing a new risk premium for deals that only a few months ago may not have required one.

“We actually see this as a huge opportunity to educate our clients and real estate partners,” said Mr. Iriotakis. “The uncertainty gives us the chance to reinforce that we, as professional mortgage consultants, still have the resources to get the deal done.”

Educating clients will be even more important over the next year, as renewing borrowers could be facing significantly higher payments. One of the commonly cited reasons for the mortgage boom of this decade was that the low-rate environment and relaxed credit criteria from a few years ago allowed consumers to be converted from “renters to owners”. Given that the trough overnight rate from the Bank of Canada was three years ago (2.0% from April to September 2004), many borrowers are about to experience the pain of higher mortgage payments when fixed rate mortgage start to come due for renewal. Fortunately, unlike in the United States, Canada has not seen a corresponding decline in property values that would compound the problem.

#### **Diversification Tips for Mortgage Brokers**

- **Consider that occasionally the market actually does experience “the worst case scenario”.** When contemplating an investment in private mortgages, try to conceptualize how “the worst case scenario” might feel. Invest accordingly, to the point where you could sustain a full-scale default without it becoming a major life event.
- **Work with an investment advisor who understands the role of private mortgages.** It’s imperative that your advisor be able to account for the different investment risks you’re taking. Have an advisor you trust complete a proper risk assessment to ensure that the portion of your wealth in private mortgages is not excessive.
- **Insist that your wealthy investors do the same.** Ensuring that you and your investors have done their homework could prevent a lot of heartache for both of you in the event of a default.
- **Remember that diversification is your friend.** Just as a diversified portfolio of bank stocks is not truly diversified, a “diversified” pool of mortgage investments still exposes you to significant mortgage market risk.
- **Don’t neglect your RRSPs.** These accounts exist to help you eventually lead a comfortable retirement. A well-built, diversified investment account should be expected to return 8-10 percent over the long run. In a passive, long-term account, focus on blue chip companies with reliable earnings and solid growth prospects.
- **Diversify your business, not just your portfolio.** While there is a strong argument for specializing in certain areas, remember that your income is susceptible to shocks too. Ensure that you’re not overly reliant on one referral source, business strategy, or mortgage lender.

#### *The role of private lending*

The factors that have affected the US market do lead to a question of whether borrowers at the margins of the Canadian mortgage market will be forced into the sphere of private lending if the risk premiums become too significant, or credit criteria become too strict.

Understanding the evolving private lending market may prove to be critical over the next few years for mortgage brokers seeking to build business in the subprime market. By very definition, “private” lending can be opaque and difficult to navigate; even the size of the private mortgage market has proven difficult to estimate. Commonly, sources of funds are either consortiums of private capital (such as Mortgage Investment Corporations – or “MICs”) or wealthy individuals, who provide access to funds in exchange for higher rates and fees. However, be aware that the risks for brokers, wealthy investors, and borrowers themselves have almost instantly become more pronounced.

Certainly, many brokers are already well aware of the private lending market - in many cases loaning their own money or raising capital from wealthy clients or associates. Indeed, it is not uncommon to find brokers who invest a significant portion of their personal investment assets into private mortgages.

Private lenders are well established as “lenders of last resort”. Particularly in an anxious credit environment, homeowners forced to borrow money privately should be made explicitly aware that they should not expect much leniency on missed payments.

If property values in the real estate market ever do recede, aggressive investors may find themselves without sufficient collateral to recover their investment. Brokers involved in promoting investments in mortgages should insist that clients undergo a proper risk assessment prior to making an investment decision. Rates of return of 12-18 percent may sound enticing, but if the threat of losing capital becomes realized, it will not be an enjoyable experience for either broker or investor.

Lastly, protect yourself by revisiting your strategies for growing your business as well as your personal investment portfolio. After all, your income is already dependent on the fluctuations in the mortgage and real estate markets; too much focus on the subprime mortgage market could not only be an emotional roller coaster but potentially damaging to your income as well. Look for diverse sources of income beyond the subprime market.

Similarly, be cautious about your own personal exposure to private lending and make sure you are well diversified beyond mortgage investments. If nothing else, the liquidity crunch was a reminder to all of us that effective use of diversification is a terrific form of protection against the surprises the marketplace has to offer.

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### **What may be in store for interest rates**

“Scotia Economics has lowered its forecast for U.S. output growth this year and next to 1.9% and 2.2% respectively. The spreading financial fallout in the wake of the subprime mortgage crisis will exacerbate the housing-induced slowdown already underway, forcing additional downward adjustments in consumer expenditures and ‘big-ticket’ purchases. The pace of U.S. activity should be materially weaker later this year and through the first half of 2008, with household spending power further constrained by the slide in both home and equity values.

The tightening in financial market conditions stemming from the repricing of risk, the widening in interest rates spreads, and the implementation of more cautious lending practices in the United States will have a moderating effect on business spending as well. Exports to an expanding global economy, along with continuing service sector growth, will underpin the U.S. economy’s slower momentum.

We expect the Federal Reserve to cut rates three times — 25 bps at each of its Sept. 18th, Oct. 30/31st, and Dec. 11th FOMC meetings — in response to the recurring financial market volatility, tightening in lending standards and credit conditions, and spreading economic weakness.

The Bank of Canada has indicated that it will keep its overnight rate steady at 4.5% in view of the financial headwinds sweeping the globe and the changing economic conditions which should relieve some of the upward pressure on Canada’s core inflation rate. While the C\$ has lost some ground during this period of exceptional financial market volatility, the loonie is likely to resume strengthening against the backdrop of a renewed weakening in the US\$, and continued support from relatively high commodity prices and ongoing fiscal surpluses.”

	Current	'07Q4	'08Q1	'08Q2	'08Q3	'08Q4
Bank of Canada Overnight Target Rate	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
US Fed Funds Target Rate	5.25%	4.50%	4.50%	4.50%	4.50%	4.75%

Source: Scotia Economics, Sept 6, 2007