

In June, Scotia Capital launched Research coverage of three alternative mortgage lenders (Home Capital, First National, Equitable Trust), and consequently prepared a 110-page report on the state of the mortgage industry.

The report, entitled “Canadian Non-bank Mortgage Lenders: Compelling Opportunities in Out-of-Favour Sector” is ultimately designed to highlight the investment prospects for the three firms. In doing so, author Phil Hardie provides an expansive look at the mortgage industry in general.

As we head into the summer months, you may find it helpful to hear an outside opinion about the current and future prospects for the mortgage industry.

REPORT HIGHLIGHTS

Canadian mortgage industry remains healthy, but rate of growth to moderate

“Following a five-year period of accelerated growth that averaged 10% annually, we anticipate the Canadian housing and residential mortgage industry to return to more sustainable levels with the rate of growth slowing over the next two years. Our thesis assumes (1) continued low unemployment, and (2) a moderating economic backdrop, but with the Canadian economy avoiding being pulled into recession by its U.S. neighbour.”

The differences between the US and Canada

“Many are concerned that the collapse of the Canadian non-prime market is just around the corner as the Canadian housing markets cool and return to more sustainable levels following the recent boom. We believe that these assumptions are flawed, given that the two markets are fundamentally different. The contrasts include:

- Weak U.S. housing market
- More conservative products and underwriting in Canada
- Secondary market fuelled demand
- Limited lender recourse in some U.S. states
- Competition weakened financial health and eroded profitability
- Non-recourse securitizations in Canada

“The Canadian mortgage markets tilt the risk towards borrowers, creating a more conservative borrowing culture in Canada. This likely explains historically lower mortgage default rates in Canada, and enables Canadian mortgage lenders to better weather a downturn in the housing markets than their U.S. peers. We believe that investments in Canadian mortgage lenders have lower risk than their U.S. peers, a fact we do not believe the market fully appreciates.

“Canada’s mortgage and housing markets remain healthy with delinquency rates near 20-year lows. We expect the housing market to moderate over our forecast period and return to more sustainable levels. We view this positively as it reduces the risk of a housing bubble bursting similar to what has taken place in the U.S.”

Mortgage spreads

“We view the wider spreads on conventional mortgage loans to be transitional and likely to narrow over the coming quarters. The prime mortgage market remains competitive, with banks continuing to dominate the space. However, we believe that spreads will remain relatively high in the non-prime sector. We view the regulatory costs and burdens of operating a deposit-taking institution as a significant deterrent for new entrants, and therefore do not expect an influx of new entrants increasing competition in the industry.”

Funding sources matter

“Reduced competition in the non-prime segments has benefited the remaining lenders that fund mortgages through deposits or have diverse sources of funding. The exodus from Canada’s non-prime market is likely a reflection of changes in the capital markets that impact access to mortgage funding, rather than a change in the outlook for the performance of Canada’s mortgage market. Companies such as Home Capital Group (HCG) and Equitable Group (ETC) that fund mortgages through deposits, and have diverse sources of funding, stand to benefit considerably from reduced competition in the sector. Reduced competition has enabled lenders to (1) regain pricing power, and (2) originate greater volume of loans from better-quality borrowers.”

Securitization and secondary mortgage markets

“Longer U.S. terms led to introduction of securitization and secondary mortgage markets, shifting interest rate risk to the lender (investor). Securitization in Canada accounts for only 20% of mortgage credit outstanding and is still in its early stages following its introduction by CMHC in 1986. In the U.S., 55% to 60% of mortgages are securitized.”

The impact on the non-prime market

“Reduced competition in the non-prime sector creates an estimated \$4.7 billion in unclaimed market potential for remaining lenders over the next five years. Almost a dozen firms have retreated or exited entirely from Canada’s non-prime mortgage market since August 2007. The volume of non-prime loan originations has decreased from about 8.5% of total loans originated through the broker channel in the first eight months of 2007 to roughly 5%. The mortgage broker channel accounted for 33% of mortgage originations for home purchases in 2007, and remains the primary distribution source for non-prime lenders. We believe that the drastic reduction in the volume of non-prime loans originated in Canada has created significant opportunities for the remaining lenders.

“We believe that negative investor sentiment towards mortgage lenders has resulted in depressed valuations that do not reflect the strong growth profile or long-term underlying fundamentals of these companies. Reduced competition in Canada’s non-prime mortgage market has benefited the remaining lenders. As a result of a number of major competitors exiting the segment, we anticipate the non-prime mortgage lenders will experience a growth rate of 15% to 20% over the next five years, even with an expected slowdown in the overall mortgage market.”

Changing competitive landscape - competitors not expected to return

“Large, well-capitalized competitors such as GE Money (a subsidiary of GE) and GMAC RFC that were once poised to expand aggressively in the Canadian market have either decided to sell off their divisions or exit the market entirely. The significant losses these companies took in the U.S. subprime market and seizing of the non-bank ABCP market were likely causes of their exit strategies. Many other smaller mortgage originators that relied almost entirely on securitization as their sole source of mortgage funding were literally forced out of the market..

**Reduced Competition in Canadian Non-prime Mortgage Market
(List of companies that have recently exited non-prime market)**

Accredited Home Lenders	MoneyConnect
Abode Mortgage	MyNextMortgage
GE Street Capital	N-Brook
GMAC RFC	Resmor
MCAP Subprime	Xceed Mortgage

Source: Scotia Capital

Mortgage Insurance Companies Becoming More Aggressive to Fill Gap

“Growth in the scope of mortgage insurance poses a threat to the non-prime lenders because it is a substitute product. An insurance company willing to insure higher-risk or non-conforming loans (particularly in the Alt-A segment) would provide an alternative for borrowers unable to get approved by traditional financial institutions or meet the criteria to be eligible for CMHC insurance. The Canadian mortgage insurance industry has historically been dominated by just two players, CMHC and Genworth. Recently, a number of U.S.-based mortgage insurers have either entered or announced their intention to enter the Canadian market.”

The Government of Canada may intervene

“Bank of Canada governor Mark Carney has recently expressed public concern with increased prevalence of very long amortization and higher loan to value mortgage products, as has Finance Minister Jim Flaherty. While neither has stated any specific proposal, we believe one option being considered is limiting the scope of the current government guarantee of mortgage insurers. The Department of Finance is currently conducting a review of the government guarantee of mortgage insurers and is examining how a number of key issues impact risk.”

Anticipated home prices

“We expect home price appreciation to slow in 2008 and 2009 to more normal levels as affordability becomes an increasing concern. With that said, we do expect variations through regions, with the western provinces experiencing higher growth in home prices than central and eastern Canada.

“In the five years leading up to the beginning of the collapse of the U.S. subprime market, housing prices increased an average of 9% year over year. Innovative mortgage products aimed at affordability coupled with looser lending standards likely fuelled the

bubble in the latter years. In 2006, the median price of existing homes cooled to just 1% and fell an average of 1.4% in 2007 with a year-over-year decline of 7.7% in the fourth quarter of that year. In contrast, the Canadian market remained healthy, and CMHC forecast housing prices to increase 5.2% and 3.8% in 2008 and 2009, respectively.”

What might happen if home prices decline?

“The most significant risk to domestic non-prime lenders is a significant downturn in the Canadian economy that leads to falling home prices and a weaker consumer credit environment. A drop in home prices reduces the value of collateral backing the mortgage loan and limits the amount of home equity a borrower can draw on to provide additional funding if their financial situation unexpectedly changes. Further, borrowers are more likely to default on loans with little (or negative) home equity, increasing the probability of default.”

Greg Holohan, CFP, is a Wealth Advisor with ScotiaMcLeod and specializes in helping mortgage professionals maximize and protect their wealth. Greg can be reached at greg_holohan@scotiamcleod.com or 1.800.447.5854 ext. 8238. This article is for information purposes only. You should not undertake any investment or portfolio assessment or other transaction on the basis of this publication, but should first consult your investment advisor. ScotiaMcLeod is a division of Scotia Capital Inc., Member CIPF.

Report Highlights

- Canadian mortgage industry remains healthy, but growth is expected to slow
- Strong underlying fundamentals for Canadian mortgage lenders despite being in an "out-of-favour" sector
- Reduced competition in non-prime is creating an opportunity in a significantly under-served market
- "Balance sheet lenders" like Home Capital are benefiting most through this transition phase
- Spreads on conventional mortgages are expected to decline, while non-prime spreads have likely fundamentally been altered
- Mortgage insurance companies will likely continue to aggressively expand
- Concern from the federal government may limit the expansion of product categories (i.e. long amortizations, high LTV)