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U.S. Sub-prime Mortgage Problems

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Much has been written about the U.S. mortgage market and sub-prime mortgages, in particular, in recent months. Loans made to residential borrowers with poor credit, or no credit rating, are considered sub-prime and are charged a higher rate of interest to **compensate** for the higher level of risk. While there will likely be repercussions as a result of a slowing housing market in the broader U.S. economy, we do not believe the effect will be enough to cause a recession.

In the 1980s, the collapse of the Savings and Loan (S&L) industry eliminated a substantial source of residential mortgage loans. In the 1990s and 2000s, this gap was filled by mortgage brokers who originated mortgages and sold them to **investment** banks which, in turn, consolidated them into mortgage-backed securities (MBS). The **investment** banks then sold these to **investors**.

However, desperate for continued growth, the brokers kept lowering their credit standards, reduced or eliminated down payments, and relaxed their income verification requirements.

Marginal Mortgages

Borrowers only default if they can't make the payments and have no equity in their property. As housing prices continued to rise, borrowers who started with no equity in their homes ended up with equity. The flexibility afforded by this equity prevented defaults and, without defaults rising, the MBSs holding these marginal mortgages continued to sell well.

As prices leveled out, and even fell in some markets in 2006, many weaker loans began to default. Although brokers wash their hands of mortgages once they are sold to the investment banks, clauses in the sales contracts require them to buy back loans that default in the first few months. Sub-prime loans consolidated into MBSs in 2006 had extremely high default rates, often failing to make even the first few payments.

The investment banks, which funded the mortgage brokers' growth, pulled back as conditions deteriorated and demanded the return of their advances. Unable to cover their obligations and without money to originate new mortgages, spectacular broker bankruptcies resulted. Larger U.S. lenders which waded too far into the sub-prime mortgage market took substantial hits to their earnings. The vast majority of defaulted loans came from these mortgage brokers. In general, more disciplined banks and other lenders have not seen a substantial rise in defaults, even within sub-prime mortgages.

Quite Sudden

The bankruptcies of sub-prime lenders, while seemingly quite sudden, are not particularly surprising. Many of these brokers had neither the discipline nor the capital to withstand even a relatively slight downturn in the housing market. Consequently, they have not survived.

Other than residential mortgage brokers, the impact has been relatively muted to this point. The problem mortgages had no equity, poor credit, and little documentation of income. These mortgages should not have been made in the first place. Delinquency trends in prime mortgages, and even in sub-prime credit cards and auto loans, have not followed suit. The sub-prime mortgage situation has resulted in a tightening of lending standards which should improve the quality of all types of loans going forward.

Looking forward, the biggest risk is that the problems in sub-prime mortgages might result in lower housing demand fueling further declines in housing prices. This could erode consumer confidence causing a pullback in spending which could pull the economy down into a recession. While this is still a risk, there are already signs of stabilization in the housing market and the issues in sub-prime do

not appear to be enough to cause a recession. The bulk of defaults have been in the 2006 vintage sub-prime group, issued by specific mortgage brokers.

In the broader context, 57 per cent of homeowners have no mortgage at all and, by UBS estimates, the group of mortgages that are 'at-risk' represent less than one per cent of all homes owned. The conditions that led to these problems in the U.S. are not present in Canada. Consequently, it is unlikely that these problems will affect the Canadian market. ■

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