Could a U.S.-Style Housing Meltdown Occur in Canada?

Description

Fears of a Canadian housing bubble and a U.S.-style housing meltdown continue to drive considerable short activity in Canada's major banks. **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is the most shorted bank on the TSX, while **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) is the fourth most shorted. Then you have **Royal Bank of Canada** (TSX:RY)(NYSE:RY), which is the most shorted Canadian bank on the NYSE.

There are signs that these fears are overblown and the risk of a U.S.-style housing meltdown is, in reality, extremely low to non-existent.

Now what?

There are significant differences between Canada's housing and mortgage markets in comparison to the U.S. real estate market in the run up to the meltdown.

Key among these is the lack of subprime mortgages.

You see, a primary cause of the U.S. housing crisis was the ease with which people could borrow to buy a home regardless of their credit worthiness, income, or assets. The volume of subprime mortgages more than tripled between 2001 and 2006, representing almost a quarter of all mortgages issued just before the meltdown occurred.

As a result, when U.S. housing prices began to decline, a large number of borrowers were unable to refinance their mortgages, causing existing mortgages to be reset to higher interest rates, which triggered a sharp increase in delinquencies.

It was the volume of delinquent subprime mortgages coupled with their securitization that caused the crisis to deepen, snowballing to the point where not only did the housing market meltdown, but the financial system was on the verge of collapse.

This wouldn't occur in Canada because of significantly stricter lending standards and a distinct lack of subprime mortgages. It is estimated that subprime mortgages make up a mere 5% of all mortgages issued in Canada at this time.

Furthermore, in response to growing concerns over a housing bubble and rising household debt, Canada’s banks tightened their lending standards.

It is also worth noting that banking regulation in Canada at this time is far stricter than it was in the U.S. in 2006.

As a result, any mortgage with a loan-to-valuation ratio, or LVR, of 80% or greater must be insured, and this creates a considerable safety net for the banks. In the case of Toronto-Dominion, just over half of its mortgages are insured, whereas it comes to 39% for the Royal Bank of Canada, and for Bank of Nova Scotia, it is just under half of all its mortgages.

Furthermore, the LVR of non-insured mortgages on average is well under 80%, creating considerable wiggle room for banks and borrowers should housing prices fall or financial difficulties arise.

Another factor that caused the U.S. housing crisis to deepen was the use of non-recourse mortgages. This meant that borrowers who found themselves in difficultly could walk away from their home and related debt, even if the value of the property was not sufficient for the lender to recoup the full value of the loan. This deepened the losses the banks were exposed to, especially in a market where prices were falling rapidly.

However, the mortgages issued by Canadian banks are recourse loans, which means that they can pursue the borrower for financial damages if the value of the home is not enough to extinguish the financial liability.

So what?

It is difficult to perceive how a U.S.-style housing meltdown could occur in Canada. Not only is the degree and type of regulation substantially different, as is the structure of mortgages, but the exposure of the banks is minimized through the use of mortgage insurance. Even if there was a protracted slump in housing prices, it is highly unlikely that it would take the banks to the brink of financial collapse.

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