Making sense of the U.S. subprime mortgage crisis

You've likely seen the doom-and-gloom headlines about the growing subprime mortgage mess in the U.S. A few months ago, most people had probably never heard of "subprime": an industry term used to describe mortgages that are written for clients with less-than-ideal credit histories. So what just happened… and why? And how is it affecting Canadian homeowners?

What happened – in short – is that in the past year, massive waves of U.S. borrowers began to default on their mortgages: leaving lenders and their investors bruised or even bankrupt. It's a complex situation, of course, but there are some key underlying factors.

Firstly, there was some unrealistic optimism in the credit markets in the U.S. In other words, there were mortgages that should not have been written without a more realistic look at the risks involved. The popular "2/28 ARM" mortgages, for example, offered cash-strapped homebuyers a very low teaser rate for two years, which were then re-set into a much higher long-term rate. These ARM mortgages have become rather infamous for the rates of default. Thousands of borrowers – completely unable to make payments at the higher rate or even refinance – were pushed into foreclosure and lost their homes.

Here in Canada, subprime mortgages represent a very small portion of our overall mortgage business. And mortgage brokers – the main sellers of subprime mortgages – have done an excellent and diligent job here in both protecting lenders from undue risk, and helping homebuyers avoid credit and payment pitfalls. We're just not experiencing the same wave of foreclosures as they are in the U.S. Our mortgage portfolios continue to exhibit strong credit performance with relatively low levels of arrears and losses, which are different from U.S. portfolios.

Still, we should expect to feel the economic rumblings of the mortgage mess in the U.S. There could be an economic slowdown in the U.S. that we could feel here in Canada. And some Canadian subprime lenders have temporarily pulled out of subprime lending while others have raised rates to justify the risk for these kinds of mortgages. This of course doesn't apply to conventional "A" mortgages that are available at the best rates to the typical or standard borrower.

As we've seen before, financial bubbles do occur that can shake the financial system for a short period of time. You likely remember the 1987 stock market crash, the 1997 Asian crisis that was followed by the Long-Term Capital Management / Russian debt crisis of 1998 and even the tech bubble. This particular crisis could result in downward pressure on interest rates in both Canada and the U.S. in order to keep the 2008 economy healthy.

You can watch for more ripples in the subprime mortgage market for a while yet. Until the dust settles, we should expect that these subprime mortgages are going to cost more. If you're shopping for a house or have a mortgage coming up for renewal, it may be a good time to call a mortgage broker for some advice on improving your credit rating to qualify for the best possible rate. Credit is part of the mortgage business and since mortgages are their only business, it's a great place to start. Mortgage brokers also have access to over 50 lenders including most of the major Canadian banks so you can be sure they can find the best mortgage for your particular situation.

Mark Goode AMP
Agent #M08003177
Mortgage Broker
180 Memorial Avenue, Orillia, ON L3V 5X6
T: 705.326.8523 TF: 1-866-326-8523
mark@markgoode.ca
www.markgoode.ca

Mortgage Architects™
Designed around you.™

Brokerage # 10287
Corporate Office: 6505 Mississauga Rd., Suite A/B, Mississauga, ON L5N 1A6
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