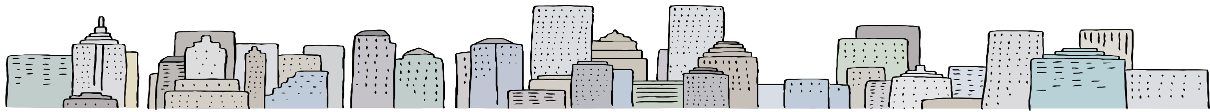

Kam's Mortgage Monthly

October 2008
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Questions I've heard a lot lately?

This month I'm going to do my best to address some of the most common questions and concerns that I've heard a lot over these crazy few weeks.

First off, "Who owns Canada Mortgage and Housing Corp. and can it go under?" CMHC was set up by the federal government just after the Second World War. It's primary purpose was to help deal with a massive housing shortage created by the huge number of soldiers returning home. It achieved this by helping finance home construction and provided funds for low-income housing. In the 1950s, when banks got more active in mortgage lending, CMHC started insuring "high-ratio" mortgages. With these mortgages, home buyers initially made only a small down payment to get into the housing market. As many of you know from reading my past newsletters, this summer, CMHC stopped insuring mortgages with zero down payments or 40 year amortizations.

Some other functions that CMHC performs are also subsidizing aboriginal housing, providing loans and grants for certain kinds of renovations, and gathering statistics on the housing market. It also buys mortgages from financial institutions, and repackages them as mortgage-backed securities, which it sells to investors. Because CMHC is a Crown corporation - unlike Fannie Mae and Freddie Mac which were private companies (until very recently), it is backed by Ottawa and could not really "go under", as this is simply something that the federal government would not allow to happen!

Another question that I've heard a lot recently is "Can our banks go broke and run out of money?" To better understand the answer to this question, we need to look at Tier 1 capital and how we can use it as a barometer to measure a bank's health. Tier 1 capital includes a bank's common equity - the value of the shares it has sold to the public - plus the value of its non-cumulative preferred shares, and its retained earnings. These are things that can't easily be redeemed by holders, so they are considered permanent.

Continued Page 2

Newsletter Highlights

Questions I've heard a lot lately

Page 1,2 & 3

Something to Ponder

A nickel ain't worth a dime anymore!
Yogi Berra

Questions I've heard a lot lately cont'd…

Tier 1 capital, as a proportion of a bank's overall assets, is a key measure of it's financial strength. There are international standards, set by the Swiss-based Bank for International Settlements, for this Tier 1 capital ratio. In Canada, the Office of the Superintendent for Financial Institutions sets the minimums. Most Canadian banks have Tier 1 capital ratios of around 10 per cent (meaning that Tier 1 capital represents about one-10th of overall assets), well above the OSFI minimum of 7 per cent. What does this mean in layman terms? Simply put, the lower this ratio, the greater the chances for a bank to have a financial crisis.

Another question is, "What is this "commercial paper" all about that is being shored up by the U.S. Federal Reserve, and does just about every company use it?" Commercial paper is normally issued only by the most credit-worthy companies, providing them with short-term cash to run their day-to-day operations. Issuers almost always need to have a credit rating on their commercial paper, because the buyers want assurance that their money is very safe, and will be paid back quickly. But since getting a credit rating is an expensive and time-consuming process that is conducted by bond-rating agencies, most commercial paper is issued only by large, stable companies, or entities such as utilities.

"What is this "spread" business that I keep hearing about in the news in relation to banks?" This is called the TED spread, and it's a measure of how much premium banks have to pay when they borrow from each other, and it is a reflection of worries over possible defaults. Originally, the TED spread was the difference in interest rates between three-month U.S. treasury bill contracts (the "T") and three-month Eurodollar contracts (the "ED"); hence the name "TED". Now, it usually represents the spread between risk-free three month T-bills and not-so-risk-free three-month LIBOR (the London inter-bank offered rate that banks use for interbank borrowing). When the TED spread goes up, that suggests bank lenders are worried their counterparties on interbank loans might default. In today's paranoid environment, the TED spread has increased to more than 400 basis points (a basis point is one-hundredth of a percentage point), from "normal" levels of around 30 basis points. Simply put, the higher this number, the harder for one bank to get money from another bank!

Another thing people often wonder about is, "Just exactly how do banks get money to lend to people who want to buy houses?". Banks have a wide variety of options for funding mortgages, from using money that customers deposit, to borrowing in the bond market. However, because of the credit squeeze, many of them have become prohibitively expensive.

Two of the relatively inexpensive ways of doings this for banks are CDs (Certificates of Deposit), where the saver agrees to park his/her money at the bank for a certain term and guaranteed rate of return. The bank in turn then lends those funds to people seeking mortgages, charges a higher interest rate, and voila, pockets the difference. The other way is in the form of mortgage-backed securities: mortgages that are packaged into bonds and sold to investors via CMHC. The Canadian Housing Trust, an arm of CMHC, issued $35.7-billion in Canadian Mortgage Bonds last year. Banks are increasingly looking at relying more and more on the CMHC/CHT to free up cash for other purposes (i.e. to lend to businesses and other banks).

Contd on Page 3

Questions I've heard a lot lately cont'd...

So who exactly owns Canadian mortgage bonds? Well, here is the breakdown from 2001-2007:

Canada: 65%
Europe: 17%
U.S.: 14%
Asia: 3%
Other: 1%

$119 Billon: The amount of Canadian Mortgage Backed Securities outstanding by the end of 2007.

As you can see, the bulk of them are held by Canadian's.

Just how large is CMHC? CMHC's current assets: $148-billion, with revenue: $9.7-billion for 2007

Canadian Housing Trust by the numbers:

Issues bonds ($35.7-billion in Canadian Mortgage Bonds in 2007), and as mentioned earlier, uses the proceeds to purchase mortgage-backed securities from "approved" sellers (a list that includes the banks as well as credit unions, trust companies and other regional lenders). Last year, the CHT generated revenue of $4.8-billion.

I know that I've covered a lot of territory here; my purpose in doing so is not to put you to sleep, but more importantly, to convey some information to you about the banking and credit environment in Canada. There is no doubt that we have felt the impact of this global credit squeeze, but from what I've read and heard, we are relatively well positioned in our banking sector to handle it. That's not to say there won't be some hardships as a result of this, but the sheer level of distress should pale in comparison to our neighbors south of us. As always, I'm here to answer any questions that you might have, so feel free to contact me anytime to discuss this or any other financial matter that may be keeping you up at night.

Referrals

Your referrals are always welcome, so if you can think of someone who may benefit from my services, please send me an e-mail to kam.brar@vericoselect.com or call me at **250-686-4246.**
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