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Why should I care about the credit crunch?

A spoonful of sugar won't help

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Chris Wattie/Reuters

Forget tomorrow, Canadians are already getting hit in the pocketbook by the debt-market crisis, and it could get a lot worse.

David Dodge, governor of the Bank of Canada, said this week "Mr. and Mrs. Jones on Main Street" could ultimately be "pulled down" as banks scramble to come up with a deal to save the debt market and prevent the unwinding of \$300-billion worth of leverage, in a worst-case scenario.

But the reality is, the cost of debt has already risen for consumers. "It could get a lot more difficult for consumers to get any type of mortgage loan or any type of personal loan," as debt markets tighten up," says Fred Lazar, a professor at the Schulich School of Business at York University in Toronto, sounding a wake-up call for consumers dulled by the big numbers and ugly acronyms of the steadily escalating credit-crunch story.

And that's just the tip of the iceberg. If the worldwide credit crisis deepens, we could be looking at a global recession, which would have dire consequences for consumers.

"I would compare what's going on now with the onset of the Depression period in the late 1920s and early 1930s," says Steven Hochberg, chief market analyst with Atlanta-based Elliott Wave International. "The potential is for it to be a lot worse simply because of the amount of credit outstanding." The total credit-market debt as a percentage of gross domestic product is more than double what it was during the Great Depression, he says.

"You know debt is forever. It has to be serviced or it has to be paid off. In some cases it has become so large that in order to service it, it becomes onerous, it starts taking away from other areas of the economy just to service the debt," Mr. Hochberg adds.

That doomsday scenario aside, the debt crisis may already be dipping into your wallet. Herewith, a consumer's guide to the credit crunch:

WHAT WILL HAPPEN TO MY MORTGAGE?

Already, some people in the industry are musing privately that the banks may consider moving the yardstick for qualifying for a mortgage. Your monthly mortgage debt is not supposed to be more than 32% of your monthly gross household income and your total debt should not be more than 40% of total income.

"I've heard some talk about those numbers moving," says one industry veteran, who asked not to be named.

For about two months now, the banks have been quietly reducing the discount they provide on mortgages. Canadians now negotiating a variable rate mortgage can get .60 percentage points off the prime rate. Two months ago they were getting .90 percentage points off.

With prime at 6%, the difference between a mortgage rate of 5.4% versus 5.1% could mean almost \$15,000 extra in interest on an average Canadian home over 25 years (based on a 10% downpayment.)

The spread on long-term loans -- the difference between Bank of Canada government bonds and mortgage rates -- has also been widening as the perceived risk increases. The gap is now 184 basis points compared to 115 basis points in June, says Vince Gaetano, of brokerage firm Monster Mortgage.

COULD IT IMPACT THE VALUE OF MY HOUSE?

There are reports that appraisals on property, which are conducted in conjunction with a mortgage, are erring on the side of being more conservative.

"We are looking at everything now," says Frank Scavo, owner of Appraisal 2000. "I would say there is a little more caution than there used to be." The risk for appraisers is a purchase default on mortgage and when defaults start happening the banks will be taking a closer look at loans to be make sure an appraisal represented the true market value. The conservatism in the market has led to some appraisals being less than the purchase price.

That's a bit of worrisome sign, says Don Lawby, chief executive of Century 21 Canada. "Appraisers are saying, 'I don't want this to come back at me.' If the appraisal comes in under purchase price, the purchaser says 'I'm paying too much, I want out,'" he says.

SHOULD I BE BUYING THAT NEW CAR I WANTED?

Mr. Hochberg is calling for a return to a time when consumers saved for purchases rather than just financing them with debt.

The last thing you want to do is expand your debt obligations. "This means hard times. It remains a reduction in the standard of living as everybody gets their house in order. It's going to be the way it used to be," says the market analyst.

ARE MY MUTUAL FUNDS AT RISK?

Canadian mutual fund unit-holders have little to fear from the escalating credit crisis, industry insiders say. Joanne De Laurentis, president of the Investment Funds Institute of Canada says, "very few of our mutual funds seem to have been affected. They held little or none [ABCP] in their portfolios; those that did are taking measures to deal with it."

Initial concerns revolved around money market mutual funds. Morningstar Canada found only small proportions of ABCP in them. The few that owned significant amounts, such as National Bank, were quick to issue statements they would backstop affected funds. Any funds with ABCP "off-loaded the paper to their parent company sponsors," says Windsor-based fund analyst Dan Hallett.

Money-market fund sales have recovered from the summer scare, "so there is no general loss of confidence," says

Rudy Luukko.

One fund category where one might expect to see problems is in high-yield bond funds. But the industry also downplays this threat.

"I don't think there is much to worry about," says fund analyst Philip Lee. "Frankly, I don't think high-yield bond funds would have had too much exposure to these."

Toronto fund analyst Dave Paterson says many bond fund managers steered away from ABCP because they "didn't understand what it was."

AGF has two high-yield bond funds (one Canadian, one global), but only 2% or 3% was allocated to these type of credit products.

Fund manager Tristan Sones says those small allocations are comprised of asset-backed securities, commercial mortgagebacked securities and collateralized debt obligations or loan obligations. She notes, however, that asset-backed securities are different from ABCP. The former are "longer term, more than one year, and backed by things like personal lines of credit or credit cards. Most of it is Canadian-domiciled and not exposed to the U.S. where the problem resides."

IS MY PENSION SAFE?

The impact of the credit crunch on Canada's pension plans has been minor so far, says actuary and pension consultant Malcolm Hamilton, worldwide partner with Mercer. "Most pension plans are patient, long-term investors. They are not terribly concerned about liquidity and not too worried if they have to wait a little while to get their money back."

In fact, if ABCP assets become available at fire-sale prices, "I suspect some of the better-run pension plans will be lining up to buy," Mr. Hamilton adds.

That being said, some fallout from the ABCP crisis has already been felt with the \$1.2-billion University of Western Ontario pension plan for 6,300 faculty and staff restricting redemptions on some of its

funds in early November.

The real risk to pension plans may be their indirect exposure through the stock market. If credit concerns cause markets to collapse or a recession, "then pension plans will suffer as the stock market retreats," Mr. Hamilton says.

"The recession scenario is particularly worrisome as interest rates often decline when the economy is weak and this would increase pension liabilities just when pension assets were following the stock market down."

However, Washington-based pension consultants Watson Worldwide issued a release on Thursday that stated "despite recent market volatility in asset values and discount rates, pension funds are expected to again fare well when final 2007 numbers are known."

But Moshe Milevsky, finance professor at York University's Schulich School of Business, says any Canadian with mutual funds or pension funds that held credit-sensitive paper or their derivatives "has already seen the impact."

The credit crisis will indirectly impact almost every Canadian's personal balance sheet, on both the asset and the liability side, Prof. Milevsky says.

"On the assets side, anyone with bond funds, especially corporate bonds, has already seen a drop in net asset values due to the increase in default risk."

WHAT WILL HAPPEN TO MY LINE OF CREDIT OR LOAN?

Benjamin Tal, a senior economist with CIBC World Markets, says it's a little too early to be looking at doomsday scenarios, but he says consumers are definitely paying for the crisis with higher rates. "The Bank of Canada is trying to ease the pain of the increase in credit spreads by cutting rates," he says.

Another long-term effect of the crisis could be fewer lenders at the end of the day, says Nick Kyprianou, president of Home Capital Group Inc. Lenders that securitize their debt -- package the debt and then sell it into the market -- will have to change their model.

"They were doing alternative lending with high ratio mortgages -- that part of the business might dry up," he says, referring to people with little equity and lots of debt. And the market to buy that securitized debt is disappearing.

All of this is not that new. In the early 1990s, it was difficult to get credit. Rates were high, people didn't have equity and lenders were going bankrupt or closed down by regulators.

"People were taking big hits and lenders were tightening up conditions," says Mr. Kyprianou. "Back then, if people missed a couple of mortgage payments, the banks would tell them they are not renewing."

The fears of Armageddon might be a little overstated, says Century 21's Mr. Lawby, who has witnessed a few down cycles in the economy.

"The credit granters are being more selective. People are being squeezed out with marginal credit, people who don't have good histories of employment. Lenders are saying 'I want to be careful'," says Mr. Lawby. But the market always seems to find a way around. In the 1980s, when credit was tight, vendor take-back mortgages became popular. Back then a seller would agree to provide a mortgage on the property to complete a deal. "It was the only way a buyer could get credit," says Mr. Lawby.

WHAT ABOUT MY SAVINGS?

Ultimately, even savings could be jeopardized as some banks falter under the weight of their bad loans, says Mr. Hochberg. Northern Rock PLC, one of the five largest lenders in the United Kingdom, saw a run on its accounts in September before the Bank of England guaranteed deposits.

Most Western democracies have some sort of deposit insurance like Canada, where your first \$100,000 is insured. Mr. Hochberg wonders whether you'll actually see that money. "The question of whether these banks are going to be around is on the table. It doesn't take many of them to go under to realize [government insurance corporations] don't have money to insure all this. They'll have to go back to the taxpayer to pay the taxpayer who went bankrupt," he says. "You'll get the money but how long will it take?"

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