

NORTH AMERICAN & INTERNATIONAL ECONOMIC HIGHLIGHTS

Dodging Innovation

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It seems that Mr Dodge is not a fan of mortgage innovation. In recent comments he warned that they help overheat the Canadian real estate market. And who can blame him given the experience south of the border?

In the eyes of many, the meltdown of the US subprime market has painted the mortgage market in black and white: Plain vanilla mortgages—good, all the rest—bad. It's true that the surge in exotic mortgages since 2004 created an artificial demand in the housing market south of the border, and was primarily behind the current mess in the subprime space. A sharp deterioration in underwriting standards in those years and extremely easy ways of passing on the risks were the main catalysts there.

But what's missing from the discussion is the fact that exotic mortgages in the US existed well before 2004— and back then the market was functioning just fine. What triggered the current difficulties in the US mortgage market was not the existence of exotic mortgages, but their overuse. For example, the share of interest only mortgages in new mortgages jumped from 5% in 2003 to 20% in 2006. Ditto for the share of subprime mortgages which reached 22% in 2006—more than double the level seen in 2003.

In Canada the exotic mortgage market that Mr. Dodge is so concerned about is still in its infancy. The subprime market, at 5% of originations, is only half the size seen in the pre-2004 US mortgage market (when the market was still functioning normally). Interest-only mortgages are only one percent of originations— clearly not a factor. And passing along the risk is not as common in Canada, with less than 20% of mortgages being securitized.

Another innovation that Dodge is concerned about is the recent use of mortgages with long-term amortizations. Indeed, we estimate that between 40% and 50% of new mortgages taken over the past year have an amortization term of more than 25 years. But it is far from clear that this trend has added to house price inflation in any meaningful way. If, as we suspect, the vast majority of these home buyers would have bought a similar house regardless of the availability of the increased amortization option, then this trend is not inflationary since it does not represent additional demand.

Not only are mortgage innovations important to a normally functioning market, but their role in Canada should, in fact, grow over time. Those new products are largely about serving under-served populations through more effective market segmentation and niche marketing.

Self-employment is currently the fastest growing segment of the labour market, rising by a dazzling 7.5% over the past year—six times faster than the pace of growth seen among paid employees. Many of those self-employed don't fit into traditional credit scoring matrixes and are heavy users of new mortgages products. Ditto for new immigrants, as well as professionals with high income volatility (due to increased reliance on commissions and bonuses). Limit mortgage innovation in Canada, and you shut-out those fast growing segments of the population from the housing market.