Notice to Brokers

FirstLine MORTGAGES

Consumer Watch Canada

February 7th, 2006

FirstLine Mortgages is committed to providing you with tools to help you grow your business. In keeping with this, we are pleased to present you with the following report, ***The Mortgage Market – The Long and Short of It.***

The Mortgage Market – The Long and Short of It takes a closer look at the shape and near-term prospects of the mortgage market - its momentum and composition.

The report focuses on:

- Mortgages outstanding,
- Arrear rates,
- Securitization,
- Refinancing, and
- ARM vs. fixed-term distribution.

Thank you.

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The Mortgage Market — The Long And Short Of It

Benjamin Tal

Short-term interest rates are on the rise and long-term rates are stubbornly sticky. The result is a flattening in the mortgage curve, with a possibility of yield inversion in the coming six months. What does this reality mean for the Canadian mortgage market? This report takes a closer look at the shape and near-term prospects of the mortgage market — its momentum and composition, while tackling the ultimate question: variable or fixed?

Mortgage Credit Outstanding — Starting To Slow

Growth in the mortgage market reached a peak in late 2004 and began a modest softening trend in 2005. However, as of November 2005, overall mortgages outstanding were still growing by just under 10% on a year-over-year basis — a very respectable pace. Given the recent increase in short-term interest rates and the inevitable leveling off in the housing market, the likelihood is that the downward trend in the growth of total mortgages outstanding will continue in 2006. Accordingly, we project that overall mortgage credit will grow by 8%-8.5% in 2006, following 9.9% growth in 2005 (Chart 1, left).

Reflecting its booming economy, Alberta's housing market is projected to continue to perform well above average. A 17% increase in the value of MLS resale

Chart 1
The Mortgage Market

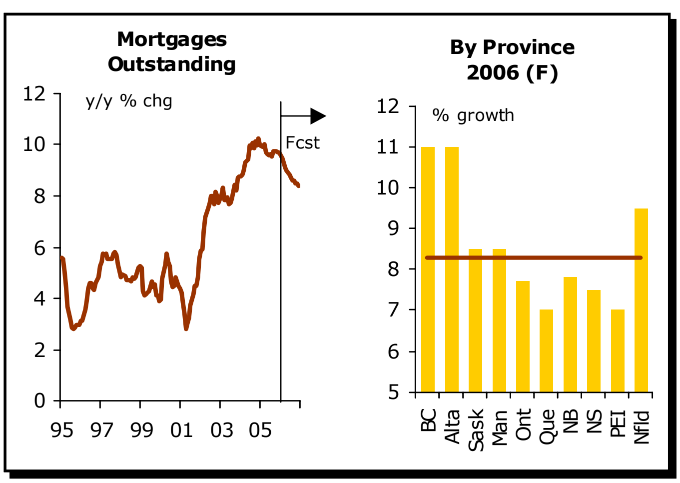
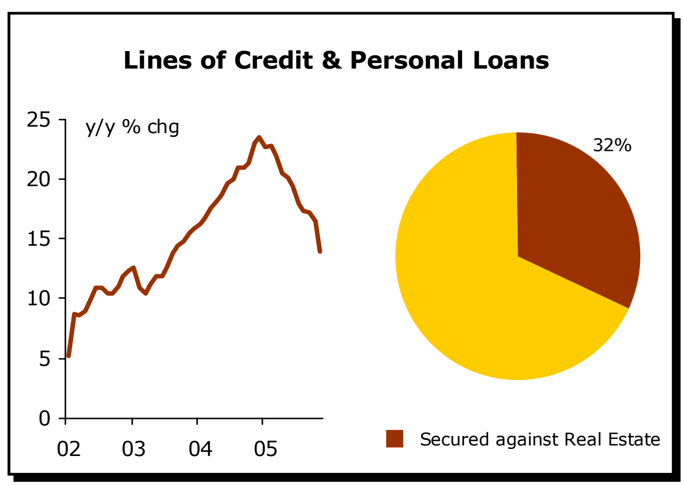


Chart 2
The Credit Cycle Is Turning



activity in 2006 will likely set the stage for an 11% increase in overall mortgages outstanding this year — almost three points above the projected national average. British Columbia, which is likely to register a 4.1% GDP growth in 2006, is expected to see another solid increase in overall mortgage credit. At the same time, with the negative impact of higher energy prices and a strong dollar, the Ontario economy is likely to under-perform in 2006, leading to below par 7.7% growth in mortgages outstanding. Ditto for the Quebec mortgage market, which is likely to slow notably from a surprisingly strong 2005 (Chart 1, right).

Note that the softening in the pace of credit growth is more evident in the lines of credit and term loans portfolios, which together have slowed from 23% (year-over year) growth in early 2005 to the current pace of 15%. Almost one-third of the combined credit in these portfolios is secured against real estate (Chart 2).

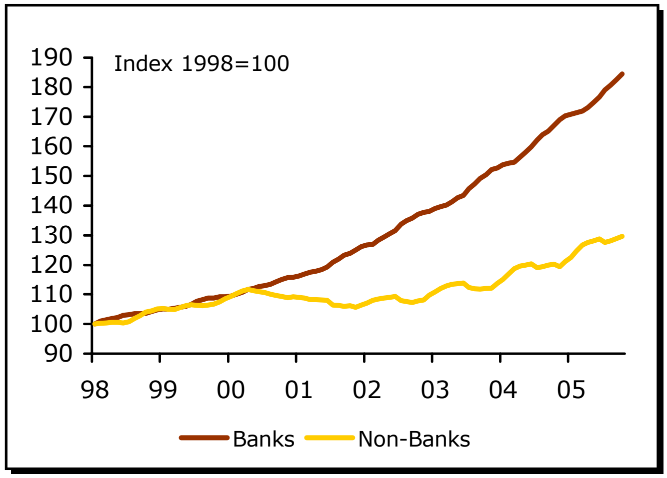
Growing Mortgage Securitization Market

A growing segment of the mortgage market is being securitized. In fact, the securitized portion of the mortgage market has doubled within five short years, from 6% of the total portfolio in 2000 to 14% today (Chart 3). As of November 2005, close to $100 billion in mortgages outstanding was in the form of Mortgage Backed Securities (MBS).

Banks continue to control the mortgage market, accounting for two-thirds of total activity. Loans originated by banks and trust companies account for more than 90% of the MBS market (Chart 4).

Chart 4

Mortgages Outstanding

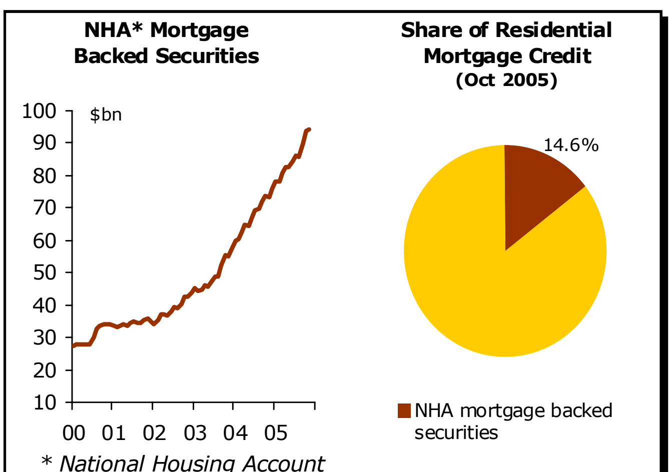


The Quality of the Mortgage Portfolio — So Far So Good

The quality of the mortgage portfolio has been remarkably strong despite the surge in mortgage activity in the past five years. The number of mortgages that are in serious arrears is now at only 0.26% of the total number of mortgages — a level not seen since the late 1980s. This ratio can change direction and accelerate rapidly almost overnight (Chart 5). But for that to occur, we need to see a 1991-type crash in the housing market — a scenario that is not in the cards at this point.

Chart 3

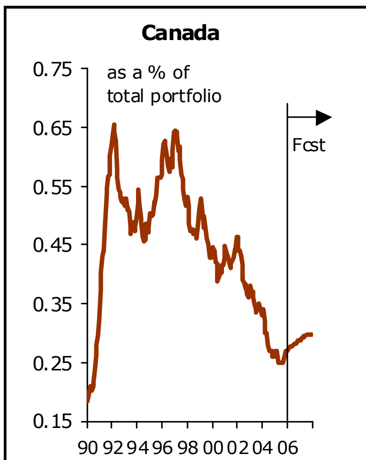
Mortgage Backed Securities Are Rising Fast



* National Housing Account

Chart 5

Mortgage Arrears



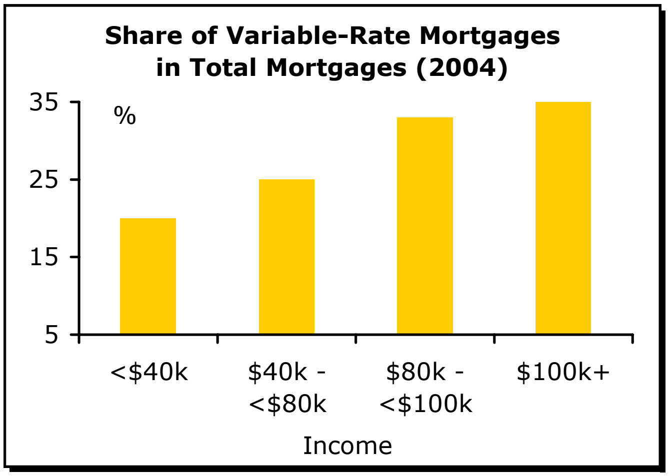
By Province
Nov 2005

as a % of total portfolio	
Atl	0.41
Que	0.16
Ont	0.27
Man	0.40
Sask	0.31
Alta	0.32
BC	0.18
Canada	0.26

Also note that the practice used by many financial institutions, in which those who take a variable-rate mortgages (VRM) are qualified based on a 3-year fixed rate, provides another layer of security. It is interesting to note that, as opposed to the US, where the majority of those who choose adjustable rate mortgages are low-income individuals, in Canada, variable-rate mortgages are more popular among households with relatively high incomes (Chart 6).

Chart 6

Variable-Rate Mortgages More Popular Among High Income Households



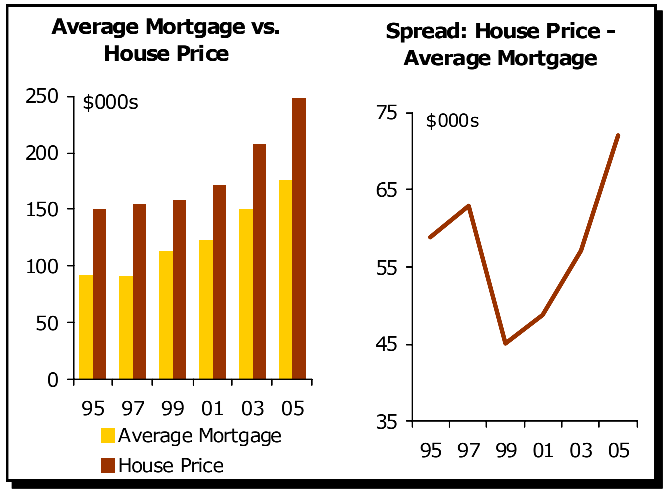
Overall, the combined impact of higher interest rates and some softening in the pace of job creation is likely to put a modest upward pressure on mortgage arrears during the course of 2006 and 2007. We expect the arrears ratio to rise to close to 0.3% by mid-2007.

Average Mortgage vs. Average House Price

While the cumulative 55% growth in total mortgage debt since 2000 appears excessive, in fact, it did not keep pace with the rise in the price of an average house. Between 2000 and 2005, the average size of a mortgage rose from $120,000 to $175,000. At the same time, average house price in Canada has risen from $164,000 to $250,000 (Chart 7). This fact is behind the well-documented real estate wealth effect, as increases in net real estate wealth paved the way for increased consumer spending. This is a logical and a reasonable response to rising wealth. But our concern is that the heavy reliance on real

Chart 7

Average Mortgage vs. House Price



estate-based wealth has turned Canadians away from "active" savings (by way of putting money aside) to "passive" savings (by using real estate wealth as a saving vehicle). For more information on that, see our previous issue of Consumer Watch, *"The Negative Personal Savings Rate: Is It Just A Statistical Mirage?".*

Mortgage Refinancing

The past few years have seen a significant acceleration in the pace of mortgage refinancing and renegotiation. For example, during the course of 2004 and 2005, no less than one-third of mortgage holders renegotiated their mortgages, and more than half of them did so well before the mortgage terms were up. In fact, we estimate that close to 60% of all existing Canadian mortgages were negotiated in the course of the past two years. Furthermore, despite the fact that interest mortgage payments in Canada are not tax deductible, as is the case in the US, Canadian households have shown almost the same appetite to borrow against home equity as their counterparts south of the border. We estimate that mortgage refinancing in Canada amounted to a record high of $29 billion last year alone (Chart 8).

But mortgage renegotiation is like a drug. In order to renegotiate, one needs not only low interest rates but, in fact, lower rates. The gradual increase in short-term rates along with the relative stability in long-term rates has largely removed the motivation to renegotiate. What's more, if the housing market

Chart 8

Home Equity Withdrawals

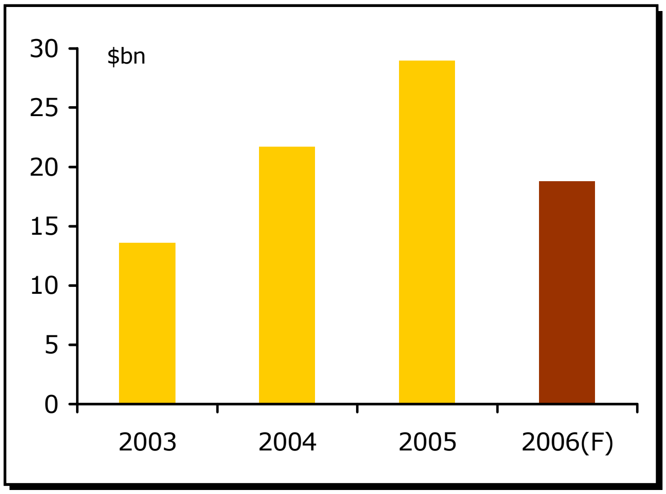
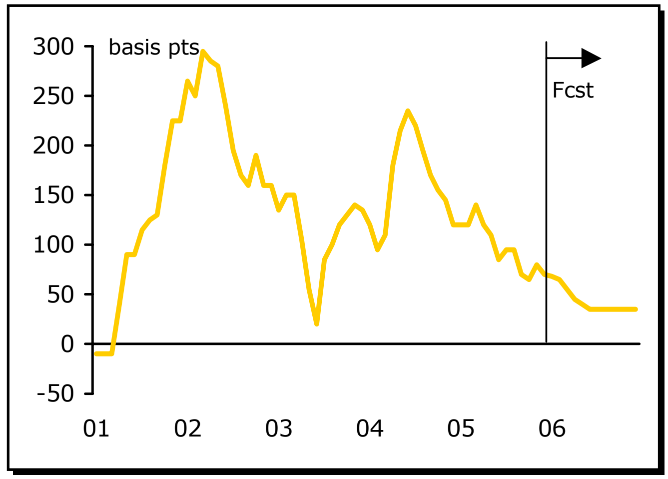


Chart 9

Spread: 5 Year minus Prime (including discount)



indeed levels off in the coming 12 months, home equity withdrawals will be much less of an option than it was in the previous four years. This process is already evident in the US, with mortgage refinancing now contributing less than 40% of total mortgage originations, down from 70% of two years ago. Overall, we project that home equity withdrawals in Canada will fall by 35% in 2006.

Variable-Rate vs. Fixed-Rate Mortgages

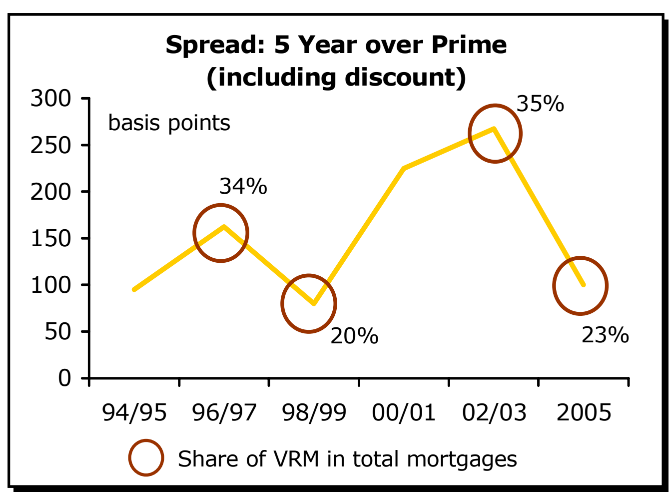
The shape of the yield curve is the chief factor that determines the distribution between variable-rate and fixed-rate mortgages. As indicated earlier, short-term rates in Canada are on the rise but long-term rates are relatively stable. Since mid-2004, the Bank of Canada's overnight rate (and by extension the prime rate) has risen by a cumulative 150 basis points. During the same period, the five-year rate has hardly changed. As a result, the spread between the five-year mortgage rate and the prime rate (after accounting for discounts) has fallen from 200 basis points in mid-2004 to only 70 basis points today. With the Bank of Canada likely to raise rates by additional 25-50 basis points in the coming few months, and our forecast that the five-year rate will remain relatively stable, look for this spread to narrow even further (Chart 9).

Note that mortgage holders have been very responsive to the changing interest rate environment. As illustrated in Chart 10, in 1998-99, when the spread between five-year rate and the prime rate had fallen to an average of 70 basis points, only 20% of those who took out a mortgage during this period went the variable route. In contrast, in 2002-03, when the five-year/prime spread averaged 250 basis points, the share of those who took variable-rate mortgages surged to 35% of the total number of new mortgages. In 2005, with the spread shrinking back to average only 100 basis points, the ratio of variable-rate mortgages has fallen to an estimated 23% of all new mortgages.

This on-and-off love affair with variable-rate mortgages over the past decade appears logical given the changing interest rate environment. But

Chart 10

The Relationship Between Mortgage Rate Spread and VRM Ratio



the reality is that staying in a variable-rate mortgage for the past few years was probably the best move. Consider an individual who took a $200,000 mortgage in 2001: by choosing variable-rate mortgage vs. a five-year fixed rate, this individual saved a cumulative total of $17,400 in mortgage payments during the five years to 2005 (Table 1, column 1). That represents an annual average savings of close to $3,500. Note, however, that the average annual savings as a result of choosing a variable-rate over a fixed-rate mortgage has been diminishing over the past few years (Table 1, column 2). But even for a mortgage taken in January 2005, the savings were close to $1,400.

Table 1

Savings: Variable vs. Fixed Rate

$200,000 Mortgage
(25 years amortization)

	Cumulative Total To 2005	Annual Average
2001	$17,421	$3,484
2002	$11,226	$2,807
2003	$5,948	$1,983
2004	$3,278	$1,639
2005	$1,372	$1,372

That's the past. What about the future? If you take a $200,000 mortgage today, how much will you save (if at all) by choosing a variable-rate mortgage over a five-year fixed-rate mortgage? Table 2 presents two scenarios. The first is a situation in which the Bank of Canada raises rates by 50 basis points in the coming few months (and stay on the sidelines for the remainder of 2006 and 2007), while the five-year rate remains relatively stable. In this case, one would save just over $600 in the coming two years, or an annual average of just over $300. Another scenario, in which the Bank rate and the five-year mortgage rate rise by 100 and 50 basis points respectively, will generate $760 in savings over two years. Many of those who currently choose fixed-rate mortgages might say that such a "price" is worth paying for a good night's sleep.

The picture that emerges is clear. The current interest rate environment (a flat and flattening yield curve) is working to narrow the variable-rate premium over fixed-rate mortgages. And under reasonable rate scenarios for the coming 12 months, the premium will narrow even further, thus reducing the "cost" of a fixed rate.

But if you refer back to Chart 10, a similar situation occurred in 1998-1999, when the fixed/variable spread fell to only 70 basis points. That led to an exodus from variable-rate mortgages, which fell to 20% of all new mortgages — down from an average of 34% in the previous two years. But was it a smart move? Note that those who switched from variable-rate mortgage to five-year fixed-rate mortgage in January 1998 "lost" a cumulative $8,300 during the subsequent five years (on a $200,000 mortgage).

So the key question is: To what extent is it reasonable to assume that within the coming two years the mortgage curve will go back to its "normal shape" — with a healthy 150 basis points spread between the five-year rate and the variable rate? Clearly, no one can foresee with any degree of certainty where rates will be 2 or 3 years down the road. But, we can make a directional call based on the information we have today. In all likelihood, we are in the eighth inning of the Bank of Canada's tightening cycle. Within the next few months, the Bank rate will peak (probably around 4% give or take 25 basis points). And if the Bank of Canada is right, and 2007 turns out to be a challenging year for Canadian economic growth, then the likelihood is that in 2007 (or 2008) the Bank will, in fact, start an easing cycle — probably resulting in a widening spread between the five-year rate and the variable rate. So, those who are switching now from variable to fixed rate might find in two years' time that it was not an optimal move from a financial standpoint.

In fact, since the 1970s, variable-rate mortgages outperformed a five-year rate mortgage 88% of the time. Does this mean that we all have to take a variable-rate mortgage? The answer would be yes if we all acted like robots. But of course, we make choices differently, allowing the uncertainty regarding the volatility in short-term rates influence our decision. The varying degrees of risk aversion among individuals (be it due to personal inclinations

Table 2
Savings: By How Much?

SCENARIO A

PRIME	↑ by 50 basis points	
5 YEAR FIXED	No Change	
$200,000 mortgage as of now: (25 years amortization)		
Total Savings of using VRM By End-2007		**$ 634**

SCENARIO B

PRIME	↑ by 100 basis points	
5 YEAR FIXED	↑ by 50 basis points	
$200,000 mortgage as of now: (25 years amortization)		
Total Savings of using VRM By End-2007		**$ 760**

or objective circumstances) largely accounts for the fact that Canadian households, as a whole, act in a way that might be found as sub-optimal by a computer program.

While it is impossible to make a blanket statement regarding the choice between variable and fixed rates, we can make the following general remarks:

- For a young or first-time homebuyer with a large mortgage (relative to income), a reasonable course of action at this point might be to take a fixed-rate mortgage (say 3-5 years). The relatively flat mortgage curve suggests that his/her potential "loss" might not be significant enough to notably offset the "benefit" of stability of payments.
- For homeowners with a small mortgage (relative to income) and some financial investment outside their home equity, taking a variable-rate mortgage at this point is still a reasonable course of action. These individuals can afford taking the risk, and in fact, can hedge against it by investing some of their financial assets in interest-bearing instrument such as GICs.

Data sources: CMHC, CREA, Statistics Canada, 2005 CIBC Homeownership Poll, CIBC World Markets*

** The 2005 CIBC Homeownership Poll was conducted by The Strategic Counsel between January 25th and February 1st, 2005 and was based on a randomly selected sample of 2,150 English and French speaking Canadian household decision-makers (2,003 current homeowners, 147 current renters who are potential homebuyers). With a sample of this size, the results are considered accurate to within ±2.11% percentage points, 19 times out of 20, of what they would have been had the entire Canadian adult population of homeowners and renters who are potential homebuyers been polled. The margin of error will be larger within regions, Census Metropolitan Areas, and for other sub-groupings of the survey population. The sample of household decision-makers is representative of the regional and age distribution produced by Statistics Canada. Percentages may not sum to one hundred due to rounding or the acceptance of multiple mentions.*