M Hanson Advisors – Real Estate, Finance & Credit

Tier-1 Client Services -- Foreign Housing – *June 17, 2012*

Weekly Wrap ending 6-17-12
by Ben Rabidoux

1) **As good as it gets? Q2 Canadian bank NIMs decline Y/Y for 5 of 6 big banks. Banks set to lose mortgage market share to alt lenders.**
2) **First sign of a crack? New listings surge 20% Y/Y in Toronto. Anecdotes suggest cooling condo market**
3) **Lessons in reflexivity and pro-cyclical Canadian bank lending**
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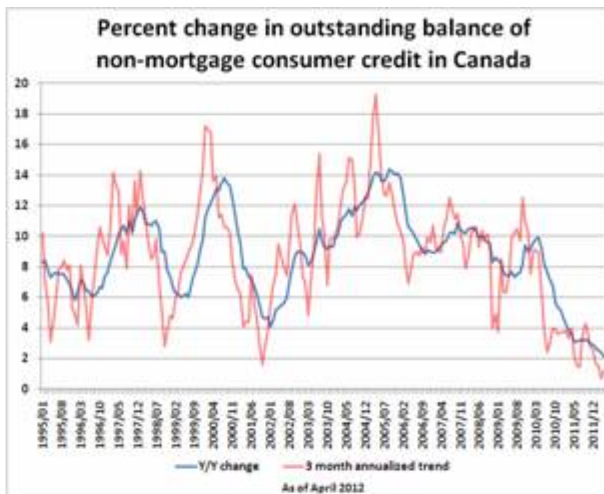
1) As good as it gets? Q2 Canadian bank NIMs decline Y/Y for 5 of 6 big banks. Banks set to lose mortgage market share

Q2 bank results reveal a decline in net interest margins at 5 of the 6 big Canadian banks. Only TD saw its NIM rise on a Y/Y basis. The problem is that after essentially treading water for a couple of years, a break lower is the last thing investors wanted to see.

Bank	Change in NIM on Y/Y basis
RY	-7 bps
TD	+10 bps
BNS	-2 bps
BMO	-12 bps
CM	-13 bps
NA	-17 bps

Lower margins in the quarter were offset by higher loan volumes as the big Canadian banks engaged in a well-publicized “mortgage war”. We remain of the belief that earnings off the big bank domestic retail operations have peaked and are set for a secular decline as Canadian consumers retrench and delever. Already we are seeing significant slowing in credit growth that will only worsen as house prices roll over, confidence wanes, and the economy weakens. Add in Europe woes, new capital rules and pending regulations that prevent banks from driving profits in other divisions

and the stage is set.



While bank domestic lending will slow simply as a result of high household indebtedness, regulatory changes will also slow loan volumes. From the Financial Post:

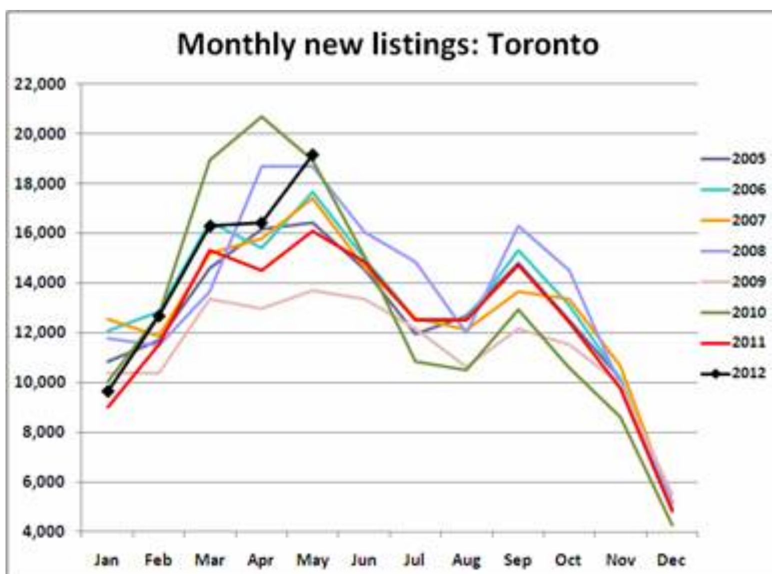
> Housing bubble fears a boon to alternative lenders
> Pressure on Canada's big banks from Ottawa and the Bank of Canada to tighten mortgage lending practices is benefiting the country's alternative lenders.
>
> […] "They are filling the void left by the Big Six banks…The country's largest lenders have "reduced lending to self-employed borrowers and lending through the mortgage broker channel due to reduced availability of mortgage insurance from CMHC and increased regulatory scrutiny from OSFI, among other things."

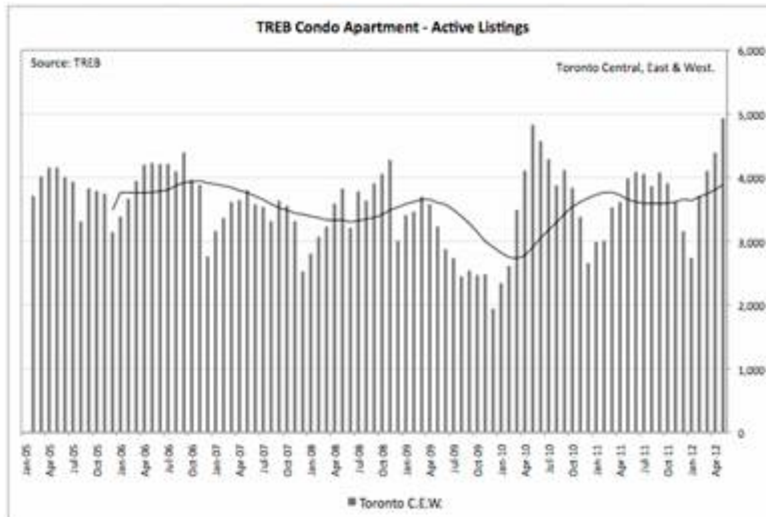
[…] Alternative lenders such as Equitable and Home Capital Group are poised to continue to benefit as the banks tighten underwriting rules at the behest of policy-makers and regulators, said Stephen Boland, an analyst at GMP Securities.

Tightening of income and credit screening at the big banks will mean more business for the alternative lenders, he said.

2) First sign of a crack? New listings surge 20% Y/Y in Toronto. Anecdotes suggest cooling condo market

The Vancouver macro report from last week highlights how quickly markets can go from bidding war frenzy to hard stop. We expect momentum and low inventory in the Toronto market to propel prices higher through Q3, though we believe this market will follow in Vancouver's footsteps before long. For the time being, the resale data continues to show strong demand in Toronto as sales remain near record levels in May while total MLS inventory remains low.
However, new listings surged to all time highs for May and registered as the second highest monthly total ever, an interesting and unexpected development. Central Toronto condos listed on the MLS also rose to levels not seen in over a decade:





Resale prices remain strong with the average house price in the Greater Toronto Area rising 6.4% year over year. The median single family home rose 8.5% while the median condo price rose 4.2%.
Despite price stability in the resale market, there is mounting evidence of a slowdown in the new condo market. We've previously noted the decline in the three month rolling average of new condo sales which industry representatives argue is simply a reflection of fewer big launches:

Nevertheless, the fact that new condo prices are now falling Y/Y suggests that there may be more to the story. A recent Globe story also adds some insight:

Signs of sanity in Toronto's condo craze- Globe and Mail
Ottawa's efforts to cool off Toronto's red-hot condominium market

> appear to be having an impact, as **prices begin to ease and developers pull back on projects and bidding for land**.
> In recent weeks, **prices on existing units have been softening, while some developers have abandoned or rewritten their plans for new condo projects**, industry experts and insiders say. Prospective buyers are also increasingly cautious in a market where prices have shot up about 50 per cent since 2005.

While a reduction in the pace of construction would seem bullish on one hand, we'd remind readers that **there are currently 58,000 residential dwellings under construction in Toronto, 45,000 of which are condos**:

The potential for a major inventory overhang is high and rising.

3) Lessons in reflexivity and pro-cyclical Canadian bank lending

As a personal anecdote, Canadians to whom I speak are absolutely convinced that credit will always be as readily available as it is currently. The past decade has shaped Canadians' expectation of what normal bank lending looks like. As the saying goes, a frog in a well can only believe it's swimming in an ocean.

Yet we know bank lending is notoriously pro-cyclical, particularly once government mortgage guarantees are removed from the picture. Even the Bank of Canada noted this in its semi-annual Financial System Review:

> "**Price corrections in important segments of the housing market can have adverse effects on the financial system**

> **through contagion, which could arise, for example, from a retrenchment in market confidence or a reduction in the availability of credit as financial institutions come under increased stress**. The initial decrease in house prices may be amplified by the links with the real sectors of the economy as lower confidence and lower household net worth lead to reduced household spending and employment.
>
> These interrelated factors would reduce economic activity and increase strains on household balance sheets. A sharp and persistent rise in the unemployment rate would reduce aggregate income growth, making it more difficult for some households to meet their debt payments. The resulting increase in loan-loss provisions for financial institutions and the reduced quality of the remaining loans would lead to tighter credit conditions and, in turn, to mutually reinforcing declines in real activity and in the overall health of the financial sector."

It's a pretty safe bet that as the housing market continues to weaken, Canadian banks will make credit increasingly difficult to obtain, exacerbating the trend. This will particularly be the case for low ratio mortgages which are now very difficult to insure after-market through CMHC.

Already we're seeing signs of this pro-cyclical credit tightening:

> Banks go on appraisal alert in a volatile housing market- Globe and Mail
> Several Canadian banks have been quietly re-evaluating their appraisal strategies **amid increased worries about the accuracy of property values in a market deemed at risk of overheating**. […] Banks are emphasizing on-site visits to value properties, especially those above a certain price or in rural areas. They are also paying closer attention to who does the appraisal. **The higher level of diligence aims to get more accurate values amid fears of an overheated housing market. If standards tighten or appraisals become more conservative, it could result in a decrease of the amount of mortgages that banks lend**.
>
> Condo clients losing 'lender of last resort'- Mortgage Broker News
> The lender of last resort may be no longer, at least not for condo clients, as **B lenders pull back from financing owner-occupieds, amid fears of a correction**. "If a borrower can't find

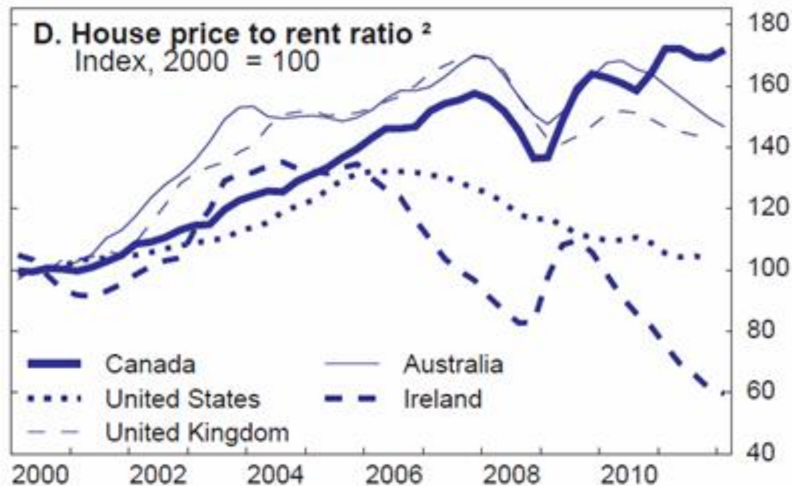
an A lender to offer a second or refi on their mortgage, they're likely not going to find a private to do it anymore – at least not at a rate they would find acceptable," said Yan Gurevich, owner of Verico Mortgage Canada in Toronto. "But **they may not find a lender to take it, period.**"

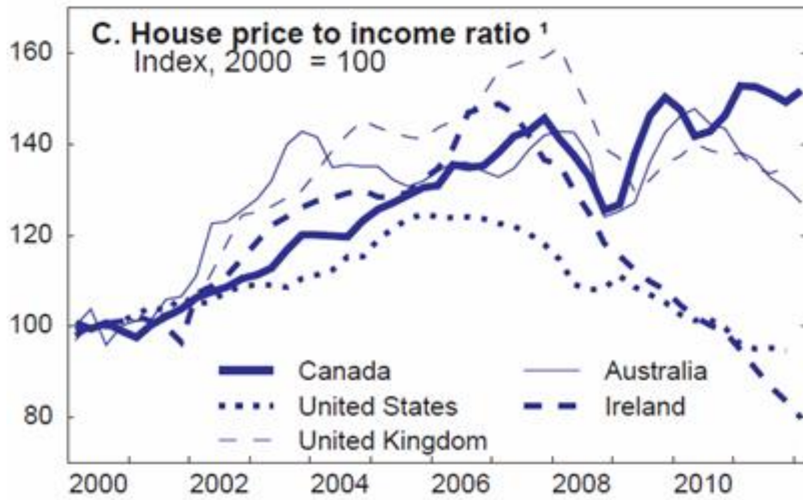
The comments are backed up by a growing number of seasoned specialists who have seen some alternative lender as well as privates pull back from condo lending in key markets.

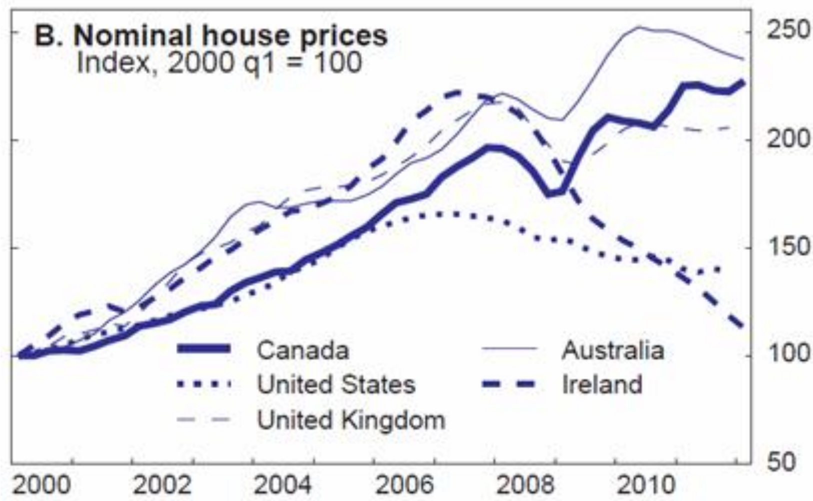
Fears about a correction, especially in Toronto, have precipitated the collective move, although several lenders continue to offer financing, having reduced their maximum loan to values on condo financing.

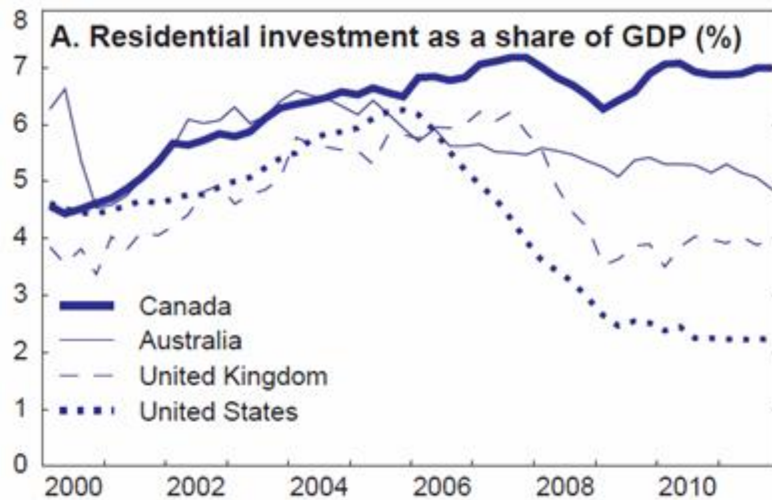
4) Some telling charts from the OECD

Taken from the OECD's Economic Survey of Canada. Presented without commentary:









Best Regards,

Ben Rabidoux
Ben@MHanson.com

Mark Hanson
Mark@MHanson.com

***Data for this report provided by M Hanson Advisors unless where otherwise noted**

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