Economic slowdown hits the alternative lending business

RACHELLE YOUNGLAI

PUBLISHED JULY 26, 2020

The coronavirus pandemic is hitting alternative lenders hard, with business down substantially, a handful of mortgage investment corporations stopping investors from redeeming their funds and others trying to offload their portfolios of home loans.

In Ontario, mortgage registrations by private lenders fell 26 per cent in June over the same month last year, according to Teranet, which operates the province's electronic land registry system. That followed a 45-per-cent decline in May and a 29-per-cent drop in April, when real estate sales plunged and private lenders halted loans to assess the economic rout.

Industry experts say the downturn will reveal where the weaknesses are in the sector.

"The tide is going out right now. We'll see very quickly who was naked this whole time in the private mortgage world," said Dustin Van Der Hout, investment adviser with Richardson GMP Ltd.

In contrast, banks, credit unions, trusts and insurance companies weathered milder declines over the same period. Mortgage registrations at the major Canadian banks fell 3 per cent in June over the same month last year. That followed single-digit-per-cent declines in May and double-digit gains in April, according to Teranet. (Mortgages are registered after the lender provides the loan to the homeowner.)

Alternative lenders include mortgage investment corporations, or MICs, which pool investor funds to provide mortgages. They lend to self-employed workers and a higher-risk segment of the population, as well as to homeowners facing an unwelcome turn of events such as a sudden job loss, divorce or health problems.

They grew quickly over the past decade as house prices jumped and policy makers toughened mortgage rules to prevent homeowners from loading up with debt, putting traditional mortgages beyond the reach of some borrowers.

But when the pandemic struck in March and millions of Canadians lost income, it put pressure on lenders.

Banks have set aside more funds to cover loan losses and have seen a steady increase in demand for mortgage deferrals. As of the end of June, banks provided mortgage deferrals of up to six months for more than 760,000 homeowners. That represents about 16 per cent of their residential loan book, up from 10 per cent in April, according to their industry group, Canadian Bankers Association.

Meanwhile, weakness is surfacing among private lenders and MICs, where the loan's interest rate can be three times higher than the bank's.

"If the bank is seeing 16-per-cent arrears on quality mortgages that paid 2-per-cent to 3-per-cent interest, what's the arrears rate on someone paying 12 per cent to 15 per cent through a private lender?" Mr. Van Der Hout said.

Unlike the banks, private and alternative lenders don't typically defer payments.

As a result, some are facing headwinds from their borrowers, investors or both – that is, homeowners who lost income and cannot make their mortgage payments and investors who want to take their money out of the fund.

Westboro Mortgage Investment LP and Morrison Laurier Mortgage Corp. halted redemptions in the early days of the pandemic.

At the time, Westboro told its investors: "It was determined that the temporary suspension will protect the long-term interests of all unitholders during this period of economic uncertainty and limit the effects of the pandemic." Morrison Laurier said it "had no choice but to suspend dividends, redemptions and new purchases at this time for a period of 90 days." Both did not reply to a request for comment.

Meanwhile, smaller troubled alternative lenders have tried to offload their mortgage portfolios to their more established peers, such as RiverRock Mortgage Investment Corp.

"A lot of these people have no experience in lending. They weren't lenders before they started this business. They have no institutional experience or executive experience in lending," said Nick Kyprianou, chief executive officer with RiverRock, which agreed to buy some of their portfolios. "They have all been around for 10 years. But the problem is, the last 10 years the market has been very good and corrected any mistakes you have made. You don't even know you made the mistake," he said.

Mr. Kyprianou said some MICs often don't fully understand the risks associated with providing a borrower with a second or third mortgage. The most recently available data show the largest MICs have been increasing their exposure to those second and third mortgages, according to Canada Mortgage and Housing Corp. If a borrower defaults on their debt, the original or first mortgage will get paid before the second and third.

It is not clear precisely how large the alternative lending market is. CMHC estimates there are about 200 MICs in the country, though some mortgage brokers say there could

be hundreds more. The federal housing agency estimates that it makes up about 1 per cent of the total national mortgage market, which was equal to between $13-billion and $14-billion in 2018, compared with between $8-billion and $10-billion in 2016. (However, that only covers the two dozen largest MICs. There is no comparable data for 2019.)

In Ontario, MICs and private lenders play a bigger role, with a 6.7-per-cent share of the market in 2018 compared with 4.4 per cent in 2012, according to the most recently available data from Teranet. In the eight largest cities in the province, private lenders had 7.2 per cent of the mortgage market in 2018, and in Toronto they had 8.9 per cent of the market.

The default rate from private borrowers is not available, but it was heading higher prior to the pandemic. The default rate for MICs was 3.12 per cent in the third quarter of last year compared with 2.79 per cent in the second quarter, according to a CMHC spokeswoman. In comparison, the default rate at banks was 0.24 per cent in February.

Economists and housing experts predict more pain in the market as the pandemic continues. The country's household debt was already at a record high and mortgage holders were spending a higher share of their after-income on just the interest on their debt when the economy was robust.

Although jobs have started to come back and economies are reopening, the unemployment rate is 12.3 per cent, businesses continue to suffer and many government programs are set to expire in the fall. As well, banks' mortgage-deferral programs are due to end soon.

"We are in a state of total illusion, an economy experiencing a psychotic episode," said Ron Butler, manager with his family-run Butler Mortgage, who has been brokering mortgages for more than two decades. "No question that there is trouble in MIC land. It is really opaque right now who will be in the most trouble."

There is a dearth of timely, regular and countrywide data on the entire mortgage market, especially alternative mortgages. CMHC and Statistics Canada recently started to issue reports on alternative mortgages, but much of the data are inconsistent and lag by at least six months.

While there is no known default rate for alternative lenders, those that lend have observed an uptick.

Mr. Butler said more homeowners are defaulting on their payments since the pandemic started. His brokerage also helps facilitate some private lending between investors and borrowers. In the past year, he said no one defaulted on their payments. Now, there are defaults. "There are more people having trouble making payments today," he said.

Fundamental Research Corp., which provides CMHC with MIC data, said the largest MICs were collecting more than 90 per cent of their revenue from their borrowers earlier in the pandemic.

For now, the real estate market's rebound in many major cities means that, even if homeowners default and lenders sell their homes, the high prices will protect the lenders. The real crunch for them will come if real estate prices fall in major markets.

"As soon as the borrower stops payments, the MICs can get the property. If property [prices] go down 30 per cent, that is when they will start having problems," said Siddharth Rajeev, who heads Fundamental's research department.

But the research company said: "We remain wary of the long-term impact of the pandemic, as a prolonged period of high unemployment will be catastrophic for the real estate market."

https://www.theglobeandmail.com/business/article-economic-slowdown-hits-the-alternative-lending-business/

© Copyright 2020 The Globe and Mail Inc. All Rights Reserved.globeandmail.com and The Globe and Mail are divisions of The Globe and Mail Inc., The Globe and Mail Centre 351 King Street East, Suite 1600 Toronto, ON M5A 0N19 Phillip Crawley, Publisher