



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



A More Prudent Society

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It has now been publicized around the world just how strong our banking system is in Canada. While our bank stocks are down over 50%, bank stocks in other countries have fallen by more than 70%. Indeed, our banks are oversold by any traditional valuation metric as we have been tarred by the same brush as American and European institutions.

Over the past 15 years, as the United States and Europe loosened regulations on their financial industries, Canadian regulators deemed the old rules to be useful shock absorbers. According to a well-publicized *Newsweek* article by Fareed Zakaria (February 7, 2009), "Canadian banks are typically leveraged at 18 to 1—compared with U.S. banks at 26 to 1 and European banks at 61 to 1. Partly this reflects Canada's more risk-averse culture, but it is also a product of old-fashioned rules on banking." Canadian tier 1 capital requirements are more stringent and limits on lending to individual companies and sectors are more restrictive.

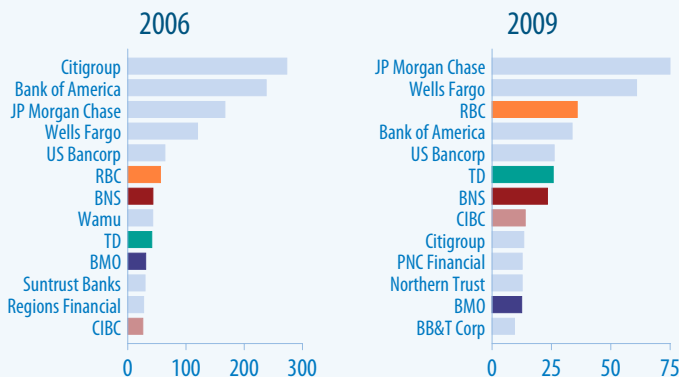
But possibly the most important difference and the one missed most often, is that our housing market has never been as leveraged as in the U.S. because of differences in the tax code. The U.S. tax code provides an incentive for overconsumption of housing and housing-financed consumption. Mortgage interest and property taxes on a primary residence are tax deductible in the U.S. at the borrower's top marginal income tax rate. As well, home loans in some states are nonrecourse loans, which means lenders may take the property pledged as collateral to satisfy a debt, but they have no recourse to the other assets of the

borrower. In Canada, there is no tax deductibility and mortgages are recourse loans—a personal liability of the borrower. Despite these built-in incentives in the U.S., the rate of Canadian home ownership is 68.4%, just above the U.S. rate. Canadians typically buy houses they can afford and try to pay back as much as possible before retirement.

Until the mid-1980s, interest on all consumer credit was tax deductible in the U.S. That was eliminated in an effort to slow excessive spending and inflation, which incentivized Americans to take home equity loans or mortgage equity extraction to pay for non-housing consumption. Americans literally lived

CANADA CLIMBS THE RANKS

North America's Biggest Banks by Market Capitalization (US\$ blns)



2009 = (as of February 27, 2009)

beyond their means, which increased explosively when mortgage rates fell and subprime lending boomed in the early '00s. Credit requirements were so lax in 2005 and 2006 that many borrowers didn't have to verify income and assets. No wonder the house of cards collapsed and many U.S. banks are on the brink of insolvency.

Only 5% of mortgages are subprime in Canada and none of those are as risky as the worst of the subprimes issued in the U.S. Canadians must put 20% down or pay CMHC insurance. Delinquency and foreclosure rates on Canadian mortgages are very low even in bad times and losses on defaults are negligible given large equity cushions. **So Canadian bank earnings are nowhere near as vulnerable to bad mortgages as in the U.S.**

The Obama administration is taking on the sacred cow by proposing to reduce the deductibility of mortgage interest and property taxes to a maximum rate of 28% compared to 33% or 35% for the high-income earners in the top two tax brackets. The national housing lobby is apoplectic. Let's see if Congress has the stomach to finally diminish this incentive for profligate spending that turned U.S. homes into piggy banks and U.S. households into massive net debtors. Of course, the housing lobby will argue that this is the worst time to take action with housing so weak. However, equally high home ownership rates in Canada show that tax deductibility is not a major long-term driver in the market. Canadians, unlike Americans, actually pay down their mortgages.

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