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Herd mentality rules in financial crisis

By Maggie Fox, Health and Science Editor

WASHINGTON (Reuters) - Herd mentality rules during a financial crisis because people are wired to follow the crowd when times are uncertain, experts say. Brain and behavior studies clearly show that when information is scarce and threats seem imminent, people often stop listening to their own logic and look to see what others are doing.

"People are afraid, and the reason they are afraid is there tremendous uncertainty right now in the markets," Gregory Berns, a neuroeconomist at Emory University in Atlanta. One clear pattern — the brain's "fear center" lights up when people are uncertain.

"When people are presented with a situation where they don't have information or the information is ambiguous, we see activation of the amygdala and insula portions of the brain".

"Then People begin to doubt their own judgment", Berns said in a telephone interview.

Mortgages: A very different story north of the border:

"Poor credit judgment, slack, substandard underwriting standards and a belief that a market increase will take care of a bad deal is at the very root of the U.S. subprime mortgage crisis".

— Bill Buterman, Access Capital

It is often said we Canadians are NOT as "progressive" as our American cousins in this case it has been to our benefit.

The Bank of Canada Governor, Mr. Mark Carney, gave a speech this past week in Montreal. Carney's comments reflected many beliefs that the process of de-leveraging and recapitalization is far from over and will continue to stem the flow of global credit.

However, his comments also emphasized that Canadian banks have avoided the problems currently facing many of their global counterparts. They are much better capitalized and have suffered fewer losses, putting them in a much stronger position to handle the fallout.

With all the focus on the housing market collapse in the U.S. and the recent fall in existing home prices in Canada, a considerable amount of attention has been given to the possibility that Canada's housing market will follow the U.S. into the abyss.

According to the World Economic Forum, Canada has the soundest banking system out of 134 countries, as stated in an article in the Calgary Herald on Friday, October 10, 2008. Basically, we can cash our cheques.

The U.S. housing market collapse was brought about by a loosening of lending standards and the explosion of subprime mortgages at the height of the U.S. housing boom. In other words, lenders failed to underwrite loans in accordance to the long standing credit rules.

Recent media reports have expressed some concerns for the Canadian housing and mortgage markets, in part based on a belief that Canadian consumers have been "over-extending" themselves through mortgage borrowing.

Many Canadian economists, including CAAMP's Chief Economist, point to very substantial differences between the Canadian and U.S. situations, which means that the risks in Canada are considerably lower than they have been in the U.S. While there are risks to the Canadian housing market, it is important to keep a few key facts in mind on the differences between the two.

The housing collapse and astronomical rise in U.S. home foreclosures can be broken down into three stages:

1. At the first stage, investors (who made up close to 10% of mortgage originations and had little to no equity in their purchases) simply turned over the keys when prices turned down, adding to excess housing supply and pushing prices down further.
2. The second wave came last year as resetting adjustable rate mortgages given in 2005 reset to higher rates and lower prices made it impossible for borrowers to refinance.
3. The current stage is where negative equity (10% of mortgage holders owe more on their home than it is currently worth) combined with job losses or insufficient income (lower than what was stated) has caused borrowers to simply walk away from their mortgages.

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The Wall Street market crisis and the mortgage crisis are NOT one and the same. They have some related roots and issues but are quite different in nature.

The financial melt down (crisis) is primarily due to lack of liquidity (cash) and with a lack of trust between the major U.S. investment firms and banks. This is combined with the American public and many foreign countries having a lack of confidence in these firms, their management and their underlying assets.

This lack of confidence is based on the fear that these firms, banks, investment banks and insurance giants may not have sufficient assets or liquid assets (assets from which they can create ready cash) to cover their financial obligations and promises if or when called upon.

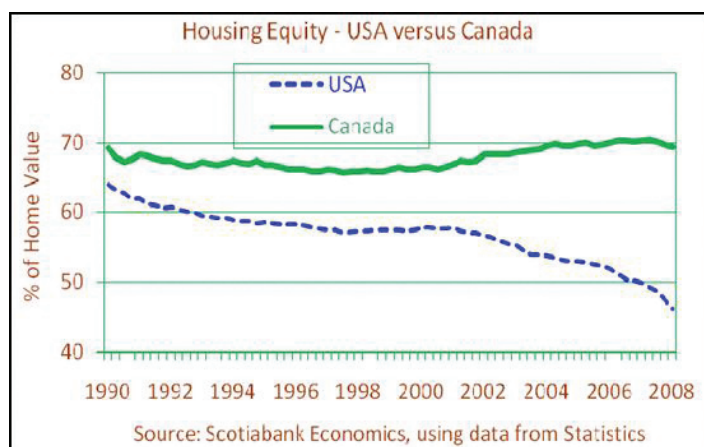
In short, they wrote a postdated cheque two years ago or more and today they do not have sufficient cash to cover that cheque. They gambled that the future would be better.

The postdated cheque is the similarity to the mortgage crisis.

In contrast, the Canadian residential mortgage market subprime mortgages have not exceeded 6% of the market. Resetting adjustable-rate mortgages are non-existent. Most of the subprime mortgage lenders in the U.S. were small lending companies and not large banks and credit unions that typically provide mortgage financing in Canada.

Canadians have a significantly higher level of equity built up in their homes (see Figure 1) than their U.S. counterparts. While there are markets in Canada where home prices have overheated, such as here in Alberta (where we will likely continue to see further corrections over the next several months), this is in no way comparable to the kind of declines or financial losses that we have seen south of the border.

Figure 1:



The Canadian housing market has not followed the U.S. into the same quagmire in a large extent that our lending industry and practices are structured differently, examples of this include:

- Most Canadian mortgages remain on the lenders' books, unlike in the U.S. where they are sold off in packages. Thus, if you lend it here, you have to collect it here, providing strong incentive to maintain credit standards. There is nothing like collecting your own mistakes to make you NOT want to lend like that again. **At Axxess Capital we have said time and time again; exit, exit, exit!**

- In the U.S., subprime mortgages were never really affordable and the majority of them were given with initial teaser interest rates that reset after two years or less. Upon renewal the interest rates were pushed up, and monthly mortgage payments increased on average by 50% or more for buyers who had no equity, little to no other assets/savings, nor the income to make the higher payments. Only about 6% of Canadian mortgages are held by special purpose corporations and non-deposit lenders who booked "subprime" mortgages.
- In the U.S., widespread securitization (the selling off of mortgage bundles) eventually caused a breakdown in the incentive to control risk.
- When it became apparent that mortgage originators would not have ultimate accountability for credit quality, the underwriting standards and credit quality was thrown to the wind. (aka: Responsibility; "Not my job to worry about the deal after I book it").

The Canadian economy, despite its sound macroeconomic fundamentals, is experiencing a growth slowdown due to falling U.S. demand and a considerable appreciation of the Canadian dollar in recent years. Domestic demand, however, remains sturdy and core inflation low, which provides a good basis for recovery.

The U.S. is a huge influence around the world and Canada will not be exempt from the various economic fall outs. The U.S. retail, manufacturing and warehouse sectors will have significant slowdowns over the next three quarters due to a lack of consumer confidence and spending due to less credit available to that consumer.

That in turn will bring that economic slowdown home to our manufacturing and export segments which will cause a further slowdown of our economy.

During this decade the Canadian economy has been much stronger than the U.S. economy. Figure 2 shows the percentages of adults that are employed (the "employment-to-population ratio"). The U.S. economy peaked at the start of the decade. While it recovered somewhat during 2005 and 2006, the ratio has remained well below the prior peak.

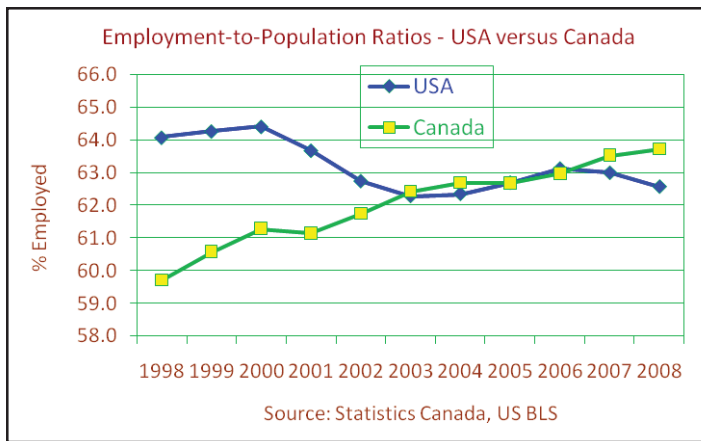
By contrast, the Canadian economy has shown increasing strength in this decade, and the employment-to-population ratio has set new record highs every year from 2003 to 2008.

Moreover, to the extent that the U.S. economy did improve at mid decade, most of the growth was from the housing market – increased construction plus home equity take-out.

There was a self-reinforcing bubble in the housing market. In Canada, on the other hand, economic growth has been diversified and much more durable. The Canadian economy has done a very good job of generating highly-qualified home buyers; in the U.S., slower job creation has meant that there have been fewer good mortgage candidates. Credit quality has remained very strong in Canada but as mentioned slipped badly in the U.S.

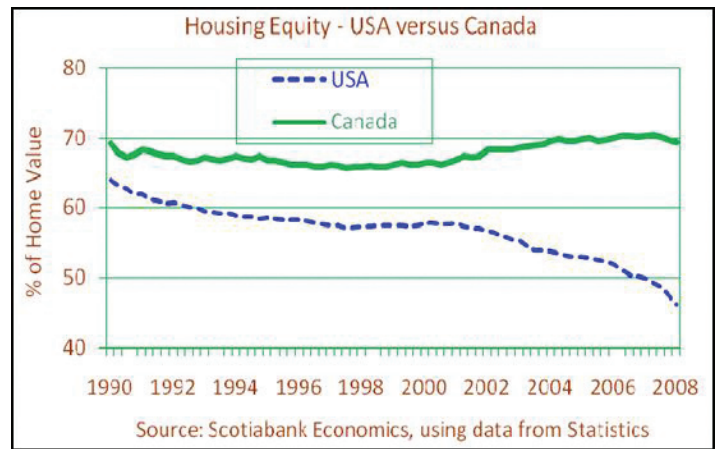
Figure 2

Housing Equity is Substantial in Canada



Some very interesting estimates from Scotia bank's Economics Department (see Figure 3) show that Canadians have retained strong equity positions in their homes. Scotiabank estimates that in Canada, home equity is equal to almost 70% of the values of residential property – in other words, total mortgage debt is only about 30% of the total value of Canadian homes, and the equity position today (almost 70%) is stronger than it was a decade ago (about 66%). In the U.S., on the other hand, there has been sharp erosion of home equity, which began during 2001/02. By 2004, well before the onset of the current U.S. troubles, the equity position had already seriously eroded.

Figure 3:



Low Debt Service Ratios in Canada

Most Canadian home owners have housing costs that are very well within their comfort zones. Data from 2006 (shown in the table below) indicates that more than 90% of Canadian home owners have GDS ratios below the traditional 32% threshold.

Canadian Home Owners by GDS Ratios, 2006

GDS Ratio Number of Home Owners as % of Total Income

GDS Ratio	Number of Home Owners	% of Total Income
<20%	5,709,000	70.9%
20-21.9%	417,000	5.2%
22-23.9%	306,000	3.8%
24-25.9%	304,000	3.8%
26-27.9%	225,000	2.8%
28-29.9%	181,000	2.3%
30-31.9%	139,000	1.7%
32-34.9%	145,000	1.8%
35-39.9%	166,000	2.1%
>=40%	455,000	5.7%
Total	8,048,000	100.0%

Source: Adapted from Statistics Canada, Survey of Household Spending PUMF, 2006.

Scotiabank has estimated that consumers' total debt service burden in Canada (as a percentage of after-tax income) has not worsened during the past decade, with the burden staying close to 8%.

In the U.S., by contrast, the debt service burden is almost twice as high (about 14%) and the burden has increased significantly, from about 12% a decade ago.

Very Few Canadians are in Arrears

The most recent data from the Canadian Bankers Association — which covers 7 major banks — shows that just 0.27% of residential mortgages were in arrears (three months or more, as of June 2008). This amounts to about 10,300 out of 3.85 million mortgages. This data from the Canadian Bankers Association covers about 85% of all residential mortgages in Canada — it is possible that there is a different rate of arrears in mortgages from other lenders. The Bank of Canada estimates that about 2% of sub-prime mortgages in

Canada may be in arrears or foreclosure. In total, 20,000 to 25,000 Canadian home owners might be in arrears, a very small fraction of the 8.05 million home owners in Canada.

Access Capital has .012% or 2 files in default, both with substantial equity.

Interest Rates Contribute to Sustained Affordability

One of the major risks faced by mortgage borrowers, a factor that has clearly contributed to the U.S. crisis, is that their monthly mortgage payment might increase when their mortgage comes up for renewal. Interest rates for 5-year fixed rate mortgages (after lender discounts) are currently 5.25% to 5.5%, almost identical to the average for the past five years (5.2%). For variable rate mortgages, typical discounted rates are now 4.25% to 4.5%, similar to the average of the past 5 years (4.3%).

For most Canadian home owners, future renewals will not result in increased mortgage payments. What's more, most Canadian households have experienced income growth since they took out their mortgages, with the consequence that over time their ability to cover their mortgage payments has improved.

Access booked files at the existing rates of 10%-12% and has not increased the rates on renewal. Our policy on renewals is not to increase the rate, and to renew if the borrower is making the payments as agreed.

In many respects the Canadian and U.S. housing markets have followed similar paths during the past decade until late 2006. In both countries strong demand resulted in rapid growth in property values. In the U.S., however, a strong growth cycle created "new and innovative ways of financing deals. In Canada we stayed with the traditional lending criterion.

At Access we have stayed with our course we charted when we originally began underwriting mortgages for our investors. This course was based upon many years of lending experience in good and bad times. Exit of a file has always been first and foremost, while keeping the LVR's lower. (LVR= the mortgage loan / the current value of the project = %).

The LVR's for the Access Capital portfolio (last quarter report for Greentree) sits below 64%.

The real estate we have mortgaged at Access Capital is "normal" in regards to location, style, use and value ranges.

As many of you know, we believe that the mortgages underwritten have the inherent ability to fail, thus we continued to underwrite the mortgage loans on the basis that we would have to collect them. If so,

we want to have to the ability to divest of that product them in a slow market. Or at the very least hold on and retain it at little or no costs.

This is contrary to so many other real-estate investments that solely rely upon a market increase to provide a large promised return, in some cases advertised at 90% plus.

Our underwriting is based upon a normalized market, not one heated; as such we constantly look for reasonable logical exits on our files. Access Capital continues to focus real estate to lend on in our known economic/geographic region. We do not seek to lend or invest in locations where we are not familiar with the economics, the pitfalls of that micro-market or where we are the new guys on the block.

Western Canada has a history of solid economic fundamentals; these are required for a supply of mortgage investment opportunities which can meet our standards. The strength of these regional economic fundamentals continues today. The current supply of appropriate mortgage investment opportunities is more than sufficient to meet the growth needs of Access Capital and our investors.

We live here thus we know and understand our back yard, as do you. Our back yard is one of the safest and strongest places to invest in real estate in the world.

In conclusion we at Access we believe that the "dirt", as we so fondly call it (mortgage investments), is as good today as it was when we originally funded the deal. We continue to believe in the exit strategies perceived when the file was underwritten. The quantified risks have not changed since we presented those files for your investment consideration.

Do we know more then others? Do we know where the market is going? Emphatically no, yet given our experience, using the underwriting tools, common sense and experience to keep your investment dollars safe and secure while providing an above average return, our plan is to stay the course we set and trust in our underwriting and lending judgment.

We trust that this has been informative in these turbulent economic times. We may not have answers with regards to markets, but we can speak to any concerns you may have with regards to your mortgage investments with Access Capital, we invite you to come by and meet with our experienced staff to discuss any of our files. The coffee is always on.

Thank your for your continued support!

The management and staff at Access Capital,

Wm J. Buterman, MBA Trevor Stott, CA

Sources: CAAMP Chief Economist, Will Dunning, CMHC, Scotiabank, Alberta Economic, Canadian Real Estate Assn., U.S. National Assn of Realtors.

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