PRIVATE LENDERS REIN IN REAL ESTATE BORROWERS

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Mark Morris, Barrister & Solicitor,
at his office in Toronto ON

As financial pressures intensify, real estate industry professionals are keeping a wary eye on debt-burdened homeowners – particularly those who rely on cash from private lenders.

The credit that flowed so easily from private and alternative lenders when the Canadian real estate market was climbing is scarce, expensive and sometimes unobtainable when property values fall.

Mark Morris, Toronto-based real estate lawyer with LegalClosing.ca has a growing sense of foreboding as more problem files land on his desk. The steep climb in interest rates, combined with a slide in house prices, may be a major source of instability in the real estate market in the Greater Toronto Area and beyond, Mr. Morris says.

“The stars are aligned for a bloodletting,” he says.

Warnings from within the industry follow seven interest rate hikes by the Bank of Canada last year that took the benchmark rate to 4.25 per cent from 0.25 per cent. Low interest rates during the pandemic spurred many potential buyers to jump into bidding wars that sent prices soaring, but the central bank’s increases extinguished the market euphoria in 2022.

Mr. Morris says most homeowners have so far been able to cope with higher monthly expenses, but the duration of the increased rates is taking a toll. Some of those who borrowed heavily against the equity in their homes are struggling to make ongoing payments.

More inventory will hit the market, he believes, and he’s already seeing more homes listed under power of sale as lenders foreclose.

“People are hurting,” he says. “The truth is, it’s going to get worse.”

Mr. Morris sees the darkest storm clouds brewing in outlying communities where real estate prices spiked during the pandemic. Many of those areas are now facing the steepest declines in average price, and debt-laden homeowners are running into trouble.

“They just grabbed on to whatever they could get. They are in a world of hurt,” Mr. Morris says of those who bought near the peak.

Benjamin Tal, deputy chief economist at CIBC World Markets, believes homeowners in Canada have been handling the burden of rising interest rates well so far. But the number of distressed sellers is likely to increase in 2023, he cautions.

“I think you will see situations in which people are tested.”

So far, the 30-day delinquency rate on sub-prime mortgages – a good leading indicator of trouble ahead – has remained well-behaved, he says, but the data points to early signs of stress.

That stress will intensify, Mr. Tal predicts.

Homeowners who borrowed from alternative lenders are more likely to come under pressure, he adds. Alternative lenders account for about 8 to 10 per cent of the mortgage market in Canada, according to Mr. Tal. That figure includes mortgage investment corporations, private consortiums and so-called mom and pop investors.

Typically borrowers resort to alternative sources when they aren’t able to qualify for a mortgage with one of the traditional “A” lenders. The “B” lenders charge higher rates and fees to offset the risk.

While Mr. Tal expects an upward trend in delinquencies, he stresses that the magnitude will be nothing like the meltdown in the U.S. sub-prime segment that led to the 2008 global financial crisis.

“I suggest it’s not significant enough to derail the market,” he says.

Mr. Tal says some borrowers on the fringes will face significant hardship at the micro level, but housing in Canada remains stable at the macro level.

“This is not freefall. This is not a meltdown.”

Amongst the homeowners seeking advice from Mr. Morris, those who purchased in 2021 or early 2022 in areas of Ontario such as Barrie, Brampton, Caledon and Stouffville are feeling the greatest pressure.

Many who bought with a typical 20-per-cent down payment and a mortgage for the other 80 per cent have seen the value of their property slide more than 30 per cent, which puts the mortgage underwater Mr. Morris points out.

He has especially deep concern for people who took out a second mortgage from a private lender at a high rate of interest and are now finding that they are not able to renew.

Homeowners sometimes take out a second mortgage in order to consolidate debts with higher interest rates, to finance a renovation, or to invest in a second property. Typically such loans have relatively short terms of six months or one year.

Today, borrowers must meet tougher standards set by lenders who are aiming to limit their own exposure, Mr. Morris says.

“Now, if they want to renew, they can’t. Even if they can, the rates are atrocious,” he says, citing a recent example of 13 per cent interest plus another 2 per cent in fees.

Lenders are calling loans in tertiary markets because house prices have fallen more than 30 per cent in some cases and they are unwilling to renew for another term.

“There is no replacement for that money – that was already money of last resort,” Mr. Morris says.

There’s also less credit to go around after “mom and pop” lenders disappeared from the market all together, he says.

Mr. Morris points to the example of a client in a location he calls “Boonieville”. The homeowner owes $300,000 on a second mortgage with private lenders. Now, at the end of the one-year term, the lender is calling the money, and the house has fallen in value from about $900,000 in April to $700,000 today.

Mr. Morris acknowledged the lenders can force a sale if the homeowner doesn’t pay, but they would not be able to recoup the amount they are owed after the first mortgage is paid.

“Your only hope is that values go up,” Mr. Morris argued in successfully negotiating on behalf of the owner for more time.

The lawyer is taking several calls a day from homeowners facing similar scenarios.

Another snag at the moment is that so many sellers decided to lease their house or condo unit when it failed to sell, the rental market is becoming saturated.

“That out is collapsing too,” he says.

Andre Kutyan, broker with Harvey Kalles Real Estate Ltd., says prices in the Toronto market have held up better than those in rural and small-town areas, but some homeowners are crippled by the large amounts they owe to private lenders.

Lenders prefer not to foreclose, but they will after too many missed payments.

“There comes a point where a lender says ‘enough is enough.’”

Meanwhile, if borrowers stop making payments, the interest continues to accumulate and penalties tend to be steep.

“Sometimes they don’t see the money coming out of their bank account and they don’t grasp that the interest meter is still running,” Mr. Kutyan says.

In Toronto, the mezzanine financing segment is often providing loans to small builders and flippers, but those investors who pool their capital and lend to them are becoming far tighter with their money.

“In the past they would ask very little in the way of questions – they would lend the money.”

Those builders often need a short-term loan while they wait for the house to sell after pouring money into construction.

If the newly completed house doesn’t sell quickly, the builder may have to cut the price drastically.

“I’ve seen guys get burned like this,” Mr. Kutyan says. “Nine times out of 10 they have to reduce. It kills their profit margins.”

Mr. Kutyan says the potential for real estate prices to plummet has sent some private lenders fleeing to other asset classes.

“They have no idea where this is going – that’s the fear.”

Samantha Brookes, chief executive of Mortgages of Canada, says her clients are finding alternative lenders have become far more stringent.

Ms. Brookes points to the example of one elderly Ontario homeowner who borrowed against the equity in the property with a private lender.

The loan is up for renewal and the elderly owner faces exorbitant fees. Ms. Brookes says the senior faces losing the house because she doesn’t have the ability to repay the loan.

“There’s no equity left,” Ms. Brookes says. “It’s getting very, very tricky.”

Mr. Morris believes the market will regain strength in the long term. Meanwhile, he has tremendous sympathy for those caught up in the abrupt shift.

“We’re all taking our medicine for irrational exuberance,” he says. “We should be very, very sympathetic.”

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