

# The Young and the Leveraged

Assessing the Impact of a Housing Market  
Correction on Canada's Homeowners

David Macdonald





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# The Young and the Leveraged

Assessing the Impact of a Housing Market Correction on Canada's Homeowners

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## Executive Summary

Concerns about Canada's overheated housing market and high household debt-to-income ratio raise an important question: what happens if the housing bubble bursts?

More than 70% of families in their 40s or older hold some real estate, whether it is their primary residence or perhaps also a secondary rental property or cottage. Housing is a popular asset and, for many Canadians, their most valuable.

Historically low interest rates have helped fuel the post-1999 real estate market frenzy, especially in British Columbia, Alberta and Ontario. As a result, house prices are up an average of 154% since 1999. In every major Canadian city, house prices have doubled (at least) over this period.

Canadian families are taking on disconcerting levels of debt to finance their real estate dreams.

The average debt-to-income ratio among thirtysomethings has almost doubled since 1999, hitting a new high of 4:1, the highest of any age group. Average debt-to-income ratios for families in their 40s and 50s grew by 64%

and 75% respectively since 1999, and doubled for homeowners in their 60s. The trend even applies to those in their 70s and older, whose debt-to-income ratios have risen by 56%.

The Bank of Canada predicts that housing prices are on average between 10% and 30% overvalued, which is the mid point of the range of private sector assessments. This paper examines several scenarios in which Canada's real estate market declines by various amounts, utilizing the recent Survey of Financial Security (1999 and 2012) as a micro-model to estimate the impact of changing real estate values on overall net worth across the population of Canadian families.

The results of a real estate correction of this magnitude on Generation X and Y homeowners would be devastating. Potential outcomes resulting from a 20% decline in the real estate market include the following:

- Homeowners in their 20s and 30s would quickly realize the result of overleveraging, with 10% of families in the first group and 8% in the second being underwater (i.e., owing more than they own).
- The net worth of homeowners in their 20s and 30s could drop by 39% even if real estate values only fall by 20%. As a general rule of thumb, young families would see twice the percentage decline in net worth as experienced in real estate prices.

The outcomes would obviously be worse if the real estate market declined by 30% and include the following:

- 294,000 young families (under 40 years old) would be plunged underwater, compared to only 44,000 today. One in seven young households (15%) would be underwater. In addition, a fall in real estate prices of 30% would yield a 61% fall in net worth for young families with real estate.
- Families in their 40s, 50s, 60s and 70s would also take a hit under a real estate market decline, but not as severely in relative terms, as they are not as overleveraged as Gen-Xers and Gen-Yers.

While these scenarios create the potential for future bankruptcies, it would also likely result in a sharp decline in spending to focus on debt repayment and deleveraging with a potentially substantial impact on economic growth. If, or more likely when, a real estate downturn occurs, we must recognize that young families are the most likely cohort to be plunged underwater.

This report concludes that the deleveraging of the household sector should be a top priority for governments. If young Canadian households' net worth is substantially reduced or eliminated, programs like those introduced in the United States during their real estate downturn may be necessary in Canada.

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## High Debt, Uncertain Assets

Real estate is one of the most widely held assets among Canadian families. Over 70% of families in their 40s or older hold some real estate, whether it is their primary residence or perhaps also a secondary rental property or cottage. This popular asset is also one of the most valuable asset classes for most Canadians. House prices have increased an average of 154% since 1999.<sup>1</sup> In every major Canadian city house prices have doubled (at least) in this time.

However, with substantial increases in real estate prices since the early 2000s, it requires a much bigger mortgage than ever before to get into the Canadian housing market. The result of those bigger mortgages is that Canadians with real estate have substantially increased their debt-to-income ratios. For most age groups that ratio has doubled, as shown in *Figure 1*.

For twentysomething families with real estate the ratios have increased marginally, although real estate ownership at this age is not as common. The average debt-to-income ratio for thirtysomethings has almost doubled since 1999, hitting a new high of almost 4:1 in 2012, the highest of any age group. Average debt-to-income ratios for families in their 40s and 50s grew by 64% and 75% respectively since 1999, and doubled for homeowners in their 60s. The trend even applies to those in their 70s and older, whose debt-to-income ratios have risen by 56%.

Despite these large increases in debt-to-income ratios, there were much smaller increases in debt-to-asset ratios. Broadly speaking, new debts (e.g., mortgages) were backed by new assets (e.g., houses).

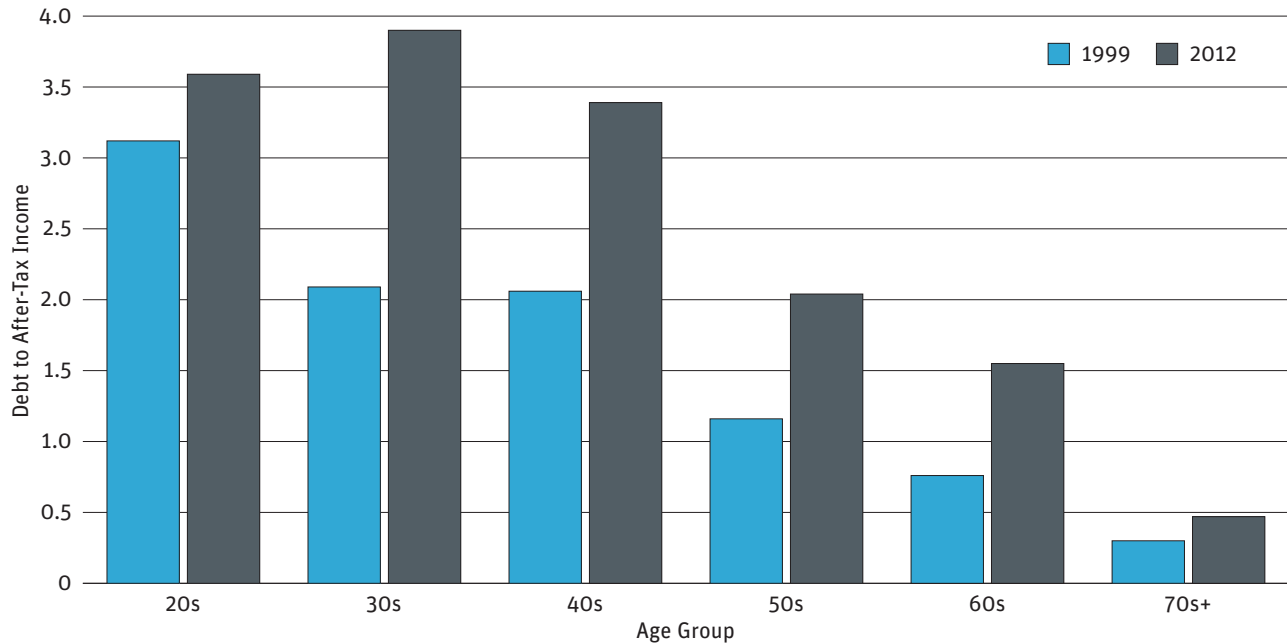
However, there is broad agreement that the house price increases seen since the late 1990s cannot continue indefinitely. Most observers now believe that housing price declines will occur, although there is a diversity of views on the timeframe and scale of those declines.

*Table 1* lists the diverse predictions of possible declines in Canadian real estate values. These estimates are heavily dependent on expectations of mortgage rates. For instance, if one expects that today's record-low mortgage rates are the new normal then real estate prices may be less likely to fall as families will be able to continue to afford their current monthly payments. However, if one expects mortgage rates to rise, the squeeze of higher monthly payments for today's expensive houses would likely cause real estate prices to fall.

A fall in real estate prices would not hit Canadian families equally. Some families have more debt, others more diversified assets, and some have already handsomely benefited from the substantial increase in hous-



**FIGURE 1** Average Debt-to-Income (After Tax) Ratio by Age Group (1999 & 2012)



Source: Survey of Financial Security 1999 and 2012 PUMF with author's calculations

ing prices since the late 1990s. The most at-risk families are those who are heavily leveraged, with all their wealth in their house, and who arrived late to the real estate party.

### Who Loses Most from a Housing Correction?

As we see in *Table 1*, the Bank of Canada's estimate falls in the middle of the pack of predictions (the median). The Bank estimates a possible decline in house prices of between 10% and 30%, with 20% being the mid-point. As such, this paper examines the implications of a 20% decline in real estate prices on the fortunes of Canadian families, assuming no other changes to family incomes or expenses, and recognizing the distributional conclusions would generally hold no matter the actual amount of the decline.<sup>11</sup>

In all likelihood, a fall in real estate prices would be caused by either an increase in mortgage rates or a decline in incomes (due to stagnant incomes or higher unemployment). However, these additional factors complicate the analysis of who would be hit hardest by falling real estate prices and so are excluded. This paper utilizes the recent Survey of Financial Security (1999

**TABLE 1** Possible Declines in Canadian Real Estate (Sorted by “Overvalued”)

Estimate From	% Overvalued	As of
Will Dunning Inc <sup>2</sup>	20% to 25% Undervalued	Mar-14
Canadian Mortgage and Housing Corporation (CMHC) <sup>3</sup>	0.03%	Jul-14
TD Bank <sup>4</sup>	10% to 15%	Aug-15
International Monetary Fund (IMF) <sup>5</sup>	7% to 20%	Jan-15
Bank of Canada <sup>6</sup>	10% to 30%	Jun-15
Fitch <sup>7</sup>	24%	Jul-14
Organization for Economic Cooperation and Development (OECD) <sup>8</sup>	31%	Jun-14
Economist Magazine <sup>9</sup>	32%	Mar-15
Deutsche Bank <sup>10</sup>	63%	Dec-15

and 2012) as a micro-model to estimate the impact of changing real estate values on overall net worth across the population of Canadian families. For a broader discussion see the Methodology section.

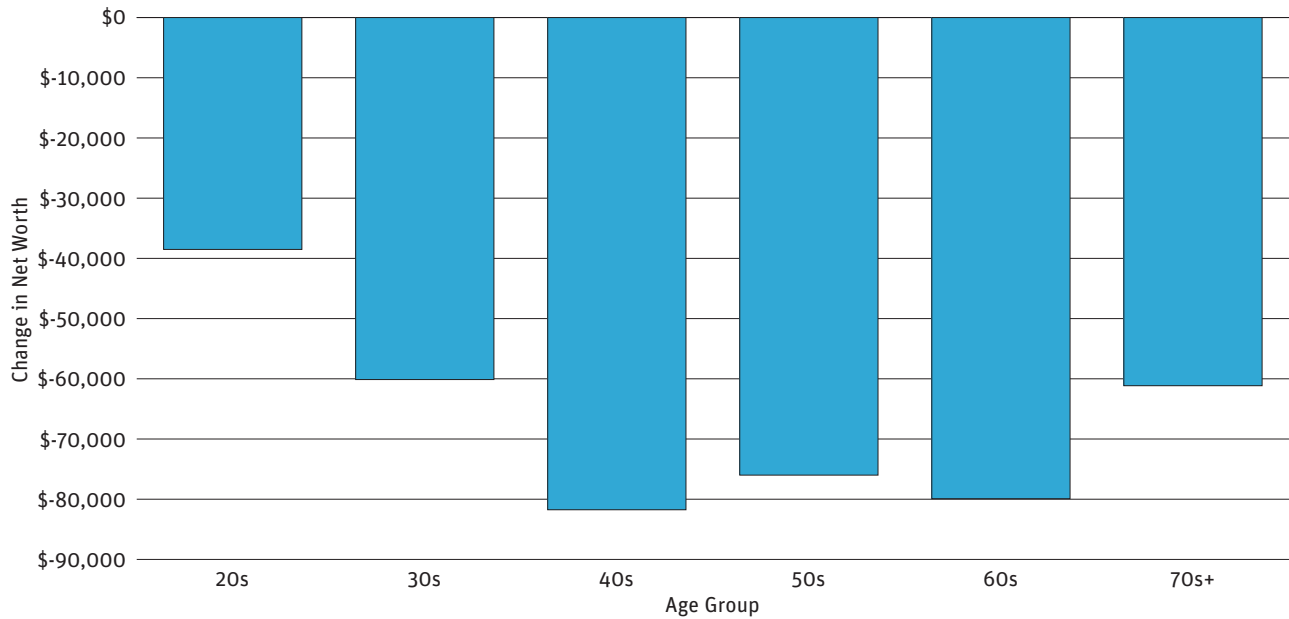
As shown in *Figure 2*, among those who own property, middle-aged families (in their 40s, 50s and 60s) would lose the most money from a real estate decline. They would see their net worth fall, on average, by \$70,000 to \$80,000. Families in their 70s and 30s would see smaller dollar losses of \$60,000 on average. Younger families in their 20s would see declines of \$40,000 in net worth, as their real estate holdings are worth less, on average, to begin with.

But focusing on dollar-amount losses misses the full picture. Middle-aged families typically have more assets. They also have paid down their mortgages and likely benefited from the increase in real estate prices since the late 1990s. In other words, while this group might lose more in dollar terms, those losses may not be as significant to overall net worth.

To get a better idea of the impacts of a 20% fall in real estate prices, it is instructive to examine it as a percentage decline in net worth. *Figure 3* illustrates how a 20% correction in the housing market would be much worse, on average, for families in their 20s and 30s, who would see declines in net worth of 45% and 39% respectively. Those in their 40s and older would see much smaller declines in net worth (23% or less).

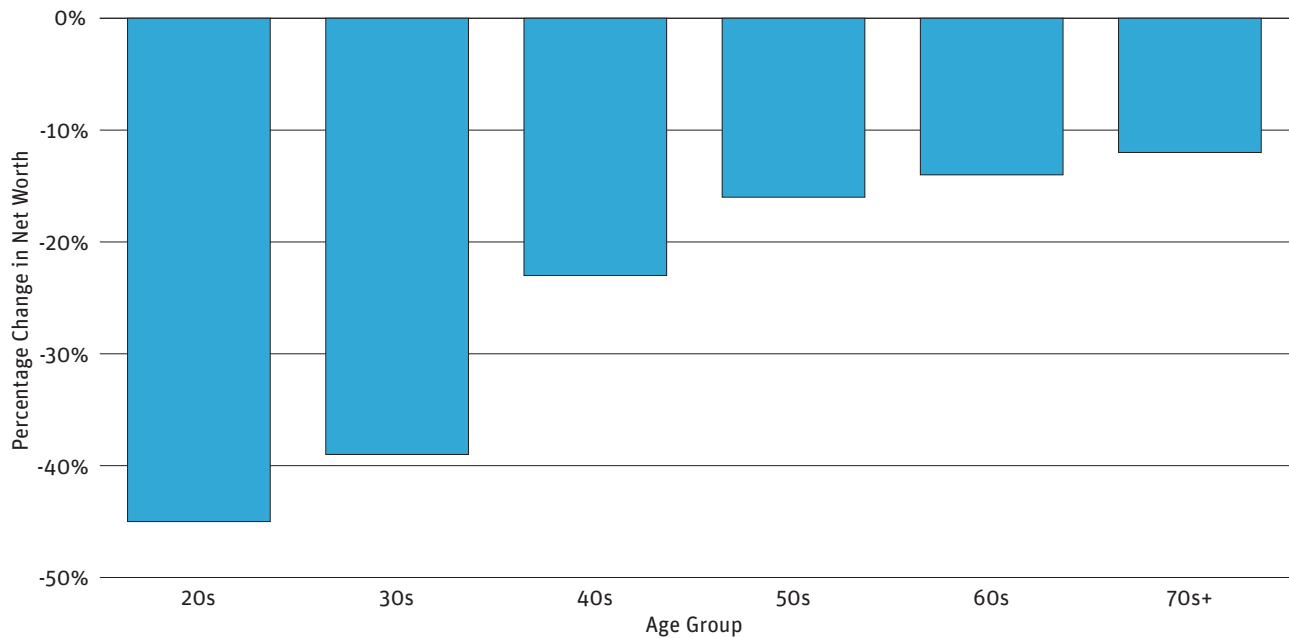
As seen in *Figure 3*, high leverage magnifies real estate losses for those in their 20s and 30s, cutting net worth for those families by 40% when real estate values fall by only 20%. As a general rule of thumb, young families

**FIGURE 2** Dollar Loss Due to a 20% Decline in Real Estate Values



Source: Survey of Financial Security 1999 and 2012 PUMF with author's calculations. Restricted to those who own real estate.

**FIGURE 3** Percentage Loss in Net Worth Due to a 20% Fall in Real Estate Prices



Source: Survey of Financial Security 2012 PUMF with author's calculations. See the Appendix for a more detailed discussion.

**TABLE 2** Example of Leverage Magnifying Real Estate Declines

	Original Value	After 20% Fall in Real Estate Prices	% Decile After 20% Fall in Real Estate Prices
Home Value	\$300,000	\$240,000	-20%
Mortgage	\$200,000	\$200,000	0%
Net Worth (assets-debts)	\$100,000	\$40,000	-60%

see twice the percentage decline in net worth as is experienced in real estate prices.

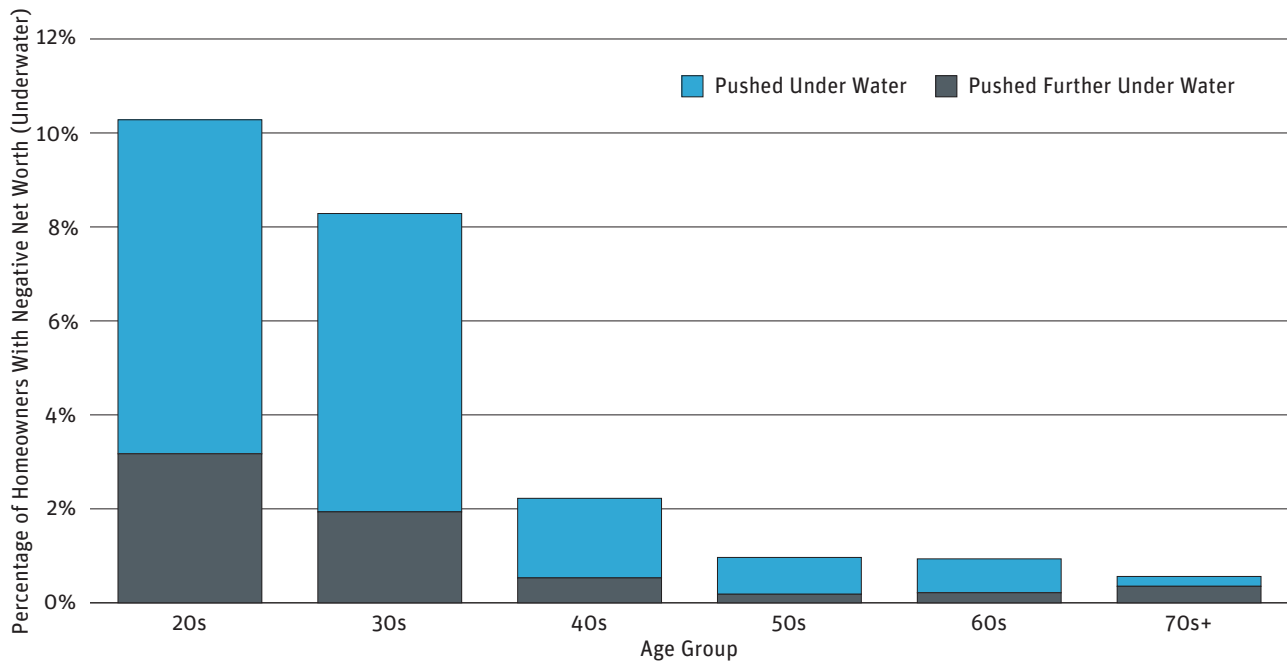
The effect of a decline in real estate prices would be less severe for older families. For instance, for families in their 40s, a 20% house price drop translates into a 23% decline in net worth. At higher ages, the effects of real estate declines on net worth are more muted, even if the dollar value of those declines may be greater, as shown in *Figure 2*. By the time families reach their 60s and 70s, a 20% decline in real estate translates into slightly more than a 10% decline in net worth.

For older families, diversification and lower leverage blunt the impact of declines in real estate prices. As families reach their 50s and older, they are likely to have other assets as well as real estate, like retirement savings or a pension. By holding more diverse assets than younger families, older families are better able to weather a decline in value in any one asset class. Older families with real estate also likely gained substantially from the run up in real estate prices in the 2000s. Finally, older families tend to have lower debt levels, having paid down their mortgages over time, which reduces the leveraged impact of falling real estate prices.

*Table 2* illustrates how large mortgages can magnify real estate losses. A family owns a \$300,000 home with a \$200,000 mortgage. If they have no other assets or debts, the family's net worth is \$100,000 (home value minus mortgage). If the value of their house falls by 20% (or \$60,000), from \$300,000 to \$240,000, their net worth will be cut to \$40,000 from its original \$100,000. The fall in net worth for this family is 60% even though the value of their house only fell by 20%. The family's large mortgage magnified the real estate price effects on their net worth.

The substantial decline in net worth, particularly for young families, will result in many real estate owners finding themselves underwater – with more debts than assets. This problem is acute for younger families, particularly those in their 20s and 30s, as shown in *Figure 4*. A 20% decline in real

**FIGURE 4** Who's Underwater After a 20% Decline in Real Estate



Source: Survey of Financial Security 2012 PUMF with author's calculations

estate prices would put 10% and 8% of families in these age groups respectively underwater.

Families in their 40s or older are generally less leveraged, have more assets, and those assets are more diversified. As a result, these families are much less likely to end up underwater, even after a 20% decline in real estate prices.

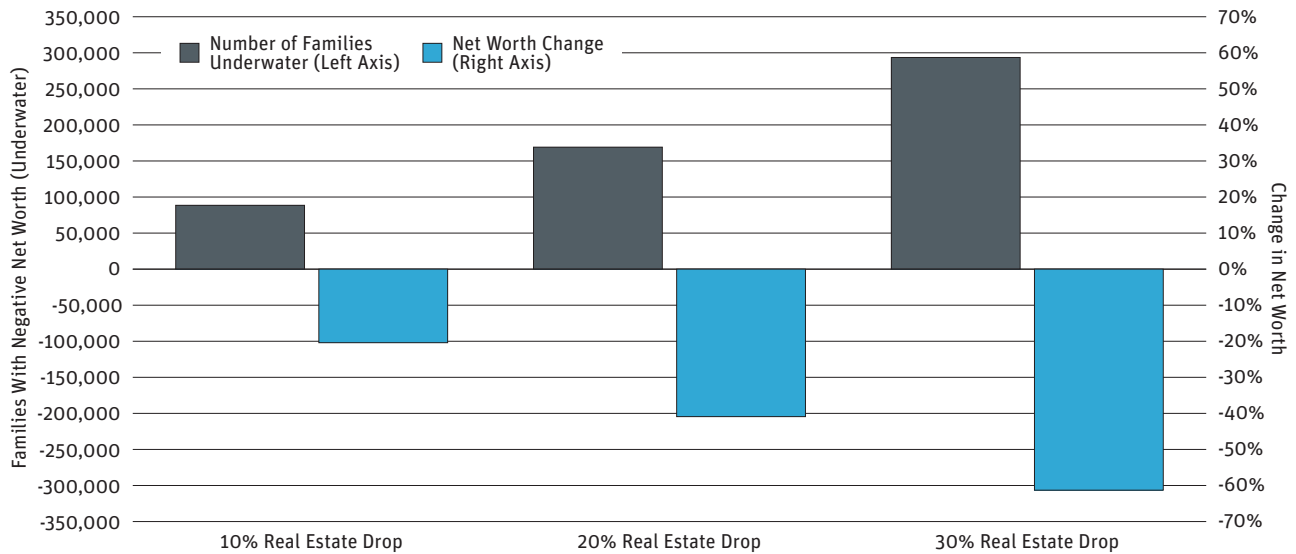
Across all age groups, 260,000 families would end up underwater after a 20% decline in real estate prices, and more than half (169,000) of those families would be in their 20s and 30s.

### Young Families at Highest Risk

As you would expect, a larger decline in real estate prices would plunge more families underwater and yield larger declines in net worth. This is particularly true for young families where the oldest person in that family is under 40.

*Figure 5* examines the impact on home-owning families under 40 that several scenarios of declining real estate prices would have. For instance,

**FIGURE 5** Effect on Young Families (Under 40) of Falling Real Estate Prices



Source: Survey of Financial Security 2012 PUMF with author's calculations

if real estate prices dropped by 30%, 294,000 young home-owning families would be underwater (owing more than they own), compared to only 44,000 today. Put another way, one in seven young homeowners (15%) would be pushed underwater by a 30% correction, and they would see their net worth drop by 61%.

In the middle of the range, a 20% fall in real estate prices would put 169,000 young homeowners (in their 20s and 30s) underwater, up from 44,000 today — a four-fold increase. For perspective, that is one in 10 young families who own real estate. A 20% fall in real estate prices, magnified by high debt, would produce an average 41% decline in net worth for this age group.

At the lower end of the range, if real estate prices dropped only 10%, the number of young families underwater would double from 44,000 to 89,000. A 10% real estate drop would, on average, cut the net worth of young families with real estate by 20%.

In short, declines in real estate prices would have a strongly disproportional impact on young families with real estate, the effect of which would be substantial decreases in net worth — generally twice as severe as the percentage fall in real estate prices themselves, caused by high leverage. The associated effect would be to substantially multiply the number of young families that would be underwater, holding more debt than assets.

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## Policy Options

If, or more likely when, real estate prices fall, the resulting tidal wave will drown those closest to the proverbial ground floor — younger families just getting into the market — first. Families in their 20s and 30s can expect to lose a substantial portion of their net worth and could find themselves owing more than their house (and other assets) are worth. This worst-case scenario has already been put in motion: young families with real estate are already at risk.

The substantial downturn in real estate in the United States may provide hints as to the types of programs that could be useful in Canada in the event of a real estate correction. In the United States real estate crisis, the primary reason for mortgage difficulties was due to either reduced income or unemployment.<sup>12</sup>

One of the more successful programs in the U.S. was the Home Affordable Refinance Program (HARP).<sup>13</sup> While interest rates fell in the U.S. following its housing crisis, many homeowners could not refinance their mortgages, since they were underwater due to falling real estate prices (i.e., their mortgages were worth more than their homes). Despite being current on mortgage payments, being underwater ruled out refinancing in order to lower monthly payments.

The HARP program allowed for refinancing for homeowners pushed underwater, resulting in lowered mortgage payments. After some early setbacks, a 2.0 version of the HARP became one of the more successful of the U.S. housing programs.<sup>14</sup> The Canadian situation differs in that mortgage rates are already at record lows, with most Canadian mortgages at those low rates and refinancing not a problem. As such, this type of refinancing program would likely not be particularly helpful.

The Home Affordable Modification Program (HAMP) allowed homeowners pushed underwater to modify their mortgages in order to avoid “imminent default.”<sup>15</sup> These modifications could include extending the term, reducing the interest rate, or allowing for delayed payment.<sup>16</sup> Loss of income was the main reason the vast majority of people received HAMP support,<sup>17</sup> but the program had more limited success, with fewer than half of those applying actually receiving modified mortgages.<sup>18</sup> Applicants without HAMP modification likely had their houses foreclosed. A situation of rising mortgage rates and/or higher unemployment in Canada may make a Canadian equivalent to the HAMP program helpful to young homeowners at risk of default.

The only U.S. program to actually reduce the principal on troubled mortgages was the Federal Housing Administration Refinance for Borrowers with Negative Equity program (FHA Short Refi).<sup>19</sup> This program allowed homeowners pushed underwater by the crisis, but who were current on their payments, to reduce the principal on their mortgage to better align its value with the reduced price of their house.

However, only 4,600 mortgages had their principal reduced on over a million qualifying households.<sup>20</sup> The lack of take-up was entirely due to the rejection of the program by the largest mortgage insurers in the U.S. A Canadian version of the FHA Short Refi could assist young homeowners who are up to date in their mortgage payments to modify the principal on their mortgages to better align with lowered house values. This would require the buy-in of the Canadian Mortgage and Housing Corporation (CMHC), the largest insurer of Canadian mortgages, if we hope to avoid the terrible performance of this U.S. program.

Smaller-scale programs such as the U.S. Home Affordable Unemployment Program (UP) and the Home Affordable Foreclosure Alternatives (HAFA) may be worth investigating.<sup>21</sup> The UP suspends mortgage payments until a new job is found for up to 12 months following job loss.<sup>22</sup> In Canada, if the decline in real estate prices were the result of lowered incomes due to higher unemployment, creating a Canadian version of the UP might help those unemployed to keep their homes.

The HAFA allows homeowners pushed underwater to walk away from their mortgage with a less negative effect on their credit score than a foreclosure.<sup>23</sup> A HAFA-equivalent program in Canada could help more extremely affected young families get a fresh start following a downturn.

In general, the deleveraging of the household sector should be a priority for governments. A badly managed downturn in real estate prices could wipe out the wealth of a large number of Gen-Xers and Gen-Yers. We need to recognize that young families are the most likely group to be plunged underwater by a nasty housing correction. Lessons learned during the U.S. real estate crisis may be helpful in Canada. There is still time to plan for that tidal wave.



# Methodology

FAMILY AGES IN this paper are represented by their oldest member. This is in contrast to other research examining the Survey of Financial Security, which utilizes the age of the oldest earner. The latter approach may result in families with the oldest earner in their 20s appearing to have substantial net worth due to a non-earning member of the family being in their 70s. Assigning an age to families by finding the oldest member avoids this issue.

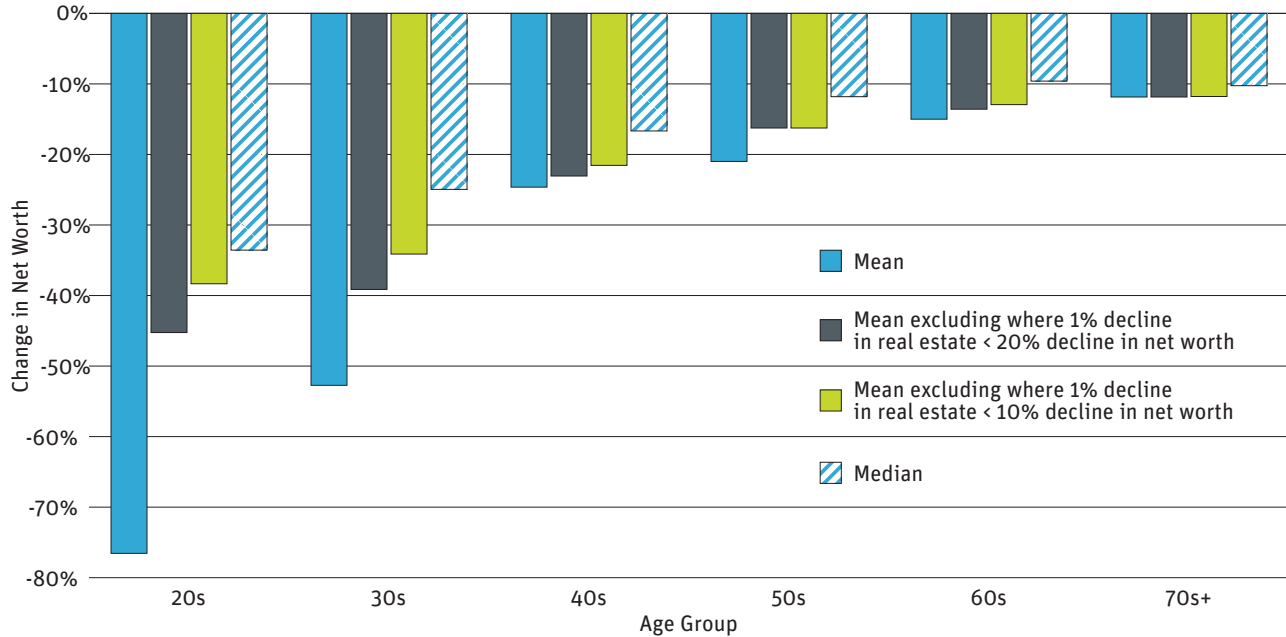
The Survey of Financial Security's unit of analysis is the economic family, which is any grouping of people in the same household who are related by blood, marriage or adoption. This can result in extended families being grouped together as one economic family. For instance, an elderly couple living with their adult children, who themselves might have young children, would count as one economic family with all assets and debts grouped together.

Unless otherwise stated, all graphs and calculations in the paper are restricted to those who own real estate.

Representing the central tendency of the percentage decline in net worth given, say, a 20% decline in real estate prices poses a challenge. Particularly in younger age groups there is quite a variety of experiences around whatever central tendency measure is used. The decision of which central tendency measure to use will always face these types of difficulties. However, for the percentage change in net worth this is a special problem. The issue is that low net worth households and/or highly leveraged households can see dramatic swings in net worth given much smaller changes in real estate values.

In the most extreme case a household with a net worth of \$1 and a house value of \$500,000 (with a mortgage of \$499,999) would see a dramatic fall

**FIGURE 6** Central Tendency Measures for the Fall in Net Worth from a 20% Fall in Real Estate Prices



Source: Survey of Financial Security 2012 (PUMF) with author's calculations

in percentage net worth given only a 1% fall in house value. Under such a scenario, house value would fall by \$5,000, as would net worth. However, net worth would fall by 500,100%  $[(-5000-1)/1]$ . While such an extreme value doesn't exist in the micro-data the implications are obvious. Any average including that percentage fall in net worth would be heavily skewed.

Figure 6 outlines four measures of central tendency to show a range of options across the various age groups by decade. The options presented include an unrestricted mean, two means that restrict the larger value, and the median. It is immediately clear that, as age increases, there is much less difference between the measures. However, in one's 20s and 30s, higher leverage ratios and smaller net worth conspire to provide a wider range of values, particularly at the high end of decline in net worth. The other broad conclusion from Figure 6 is that, as noted above and irrespective of the measure, young homeowners see a larger decline in net worth for a given decline in real estate prices than older homeowners.

To avoid the largest percentage changes, the second measure is used in the report, i.e., the mean excluding all values where a 1% decline in real estate results in a higher-than-20% decline in net worth.

# Notes

- 1** Based on the Teranet - National Bank House Price Index™ between March 1999 and June 2015. <http://www.housepriceindex.ca/default.aspx>
- 2** Will Dunning proposes Canadian housing prices may be fairly valued “and they may even be undervalued.” See “How to Dissect a Housing Bubble,” Will Dunning Inc., March 12, 2014, Pg. 2. Last accessed October 26, 2015: <http://www.wdunning.com/docs/Bubble-report-2014-03-12.pdf>.
- 3** Tamsin McMahon, “House of cards: Deconstructing Canada’s housing market valuations,” *The Globe and Mail*, April 28, 2015. Last accessed *October 26, 2015*: <http://www.theglobeandmail.com/report-on-business/economy/housing/house-of-cards-deciphering-canadas-housing-market-numbers/article24152245/>.
- 4** Diana Petramala, “Canadian Regional Housing Outlook: the power of low interest rates,” TD Economics, August 2015, Pg. 3. Last accessed October 26, 2015: [https://www.td.com/document/PDF/economics/special/RegionalHousing\\_August2015.pdf](https://www.td.com/document/PDF/economics/special/RegionalHousing_August2015.pdf).
- 5** International Monetary Fund, “Canada: 2014 Article IV Consultation — Staff Report; Staff Statement; and Press Release,” January 2015. Last accessed October 26, 2015: <http://www.imf.org/external/pubs/ft/scr/2015/cr1522.pdf>.
- 6** Bank of Canada, “Financial System Review,” June 2015. Last accessed October 26, 2015: <http://www.bankofcanada.ca/wp-content/uploads/2015/06/fsr-june2015.pdf>.
- 7** McMahon, “House of cards: Deconstructing Canada’s housing market valuations.”
- 8** OECD, “Focus on House Prices,” June 2014. Last accessed October 26, 2015: <http://www.oecd.org/eco/outlook/focusonhouseprices.htm>.
- 9** The Data Team, “Location, location, location: Global house prices,” in *The Economist*, October 7, 2015. See tag “Prices against average income” in chart. Last accessed October 26, 2015: <http://www.economist.com/blogs/dailychart/2011/11/global-house-prices>.
- 10** Andy Kiersz, “Deutsche Bank reveals 7 reasons why ‘Canada is in serious trouble,’ starting with 63% overvalued in housing market,” *The Financial Post*, *January 8, 2015*. Last accessed

October 26, 2015: <http://business.financialpost.com/business-insider/deutsche-bank-reveals-7-reasons-why-canada-is-in-serious-trouble-starting-with-a-63-overvalued-housing-market>.

**11** Barring unforeseen threshold effects.

**12** Making Home Affordable, “Program Performance Report Through March 2013,” Pg 9 (Homeowner Characteristics). Last accessed October 26, 2015: <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/February%202013%20MHA%20Report%20Final.pdf>.

**13** See <https://www.makinghomeaffordable.gov/steps/Pages/step-2-program-harp.aspx>

**14** See: Tara Siegel Bernard, “Hope and Frustration in New US Efforts to Help Homeowners,” *The New York Times*, May 25, 2012. Last accessed October 26, 2015: [http://www.nytimes.com/2012/05/26/your-money/mortgages/harp-2-o-stirs-hope-and-frustration-for-homeowners.html?\\_r=0](http://www.nytimes.com/2012/05/26/your-money/mortgages/harp-2-o-stirs-hope-and-frustration-for-homeowners.html?_r=0); and Nick Timiraos, “Mortgage Program Pans Out: revamped after early stumbles, initiatives to stem foreclosures proves success in helping homeowners,” *The Wall Street Journal*, Dec 31, 2013. Last accessed October 26, 2015: <http://www.wsj.com/articles/SB10001424052702304753504579282853217912132>. For a more thorough evaluation of the HARP and HARP 2.0 programs see: Federal Housing Finance Agency, “Home Affordable Refinance Program: a mid-program assessment,” Office of the Inspector General, August 1, 2013. Last accessed October 26, 2015: <https://origin.www.fhfaog.gov/Content/Files/EVL-2013-006.pdf>

**15** See <https://www.makinghomeaffordable.gov/steps/Pages/step-2-program-hamp.aspx>

**16** For a more detailed historical examination see: Breck Robinson, “An Overview of the Home Affordable Modification Program,” Consumer Compliance Outlook, 3<sup>rd</sup> Quarter, 2009. Last accessed October 26, 2015: [https://consumercomplianceoutlook.org/2009/third-quarter/q3\\_02/](https://consumercomplianceoutlook.org/2009/third-quarter/q3_02/)

**17** Making Home Affordable, “Program Performance Report Through March 2013,” Pg 9 (Homeowner Characteristics). Last accessed October 26, 2015: <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/February%202013%20MHA%20Report%20Final.pdf>.

**18** See ProPublica, “The State of the Government’s Loan Modification Program,” June 2012. Last accessed October 26, 2015: [http://projects.propublica.org/bailout/loan\\_mods/list](http://projects.propublica.org/bailout/loan_mods/list)

**19** See <https://www.makinghomeaffordable.gov/steps/Pages/step-2-program-fha-short.aspx>

**20** Lisa Prevost, “Scant Interest in F.H.A. Program: the F.H.A. Short Refi program has helped few,” *The New York Times*, July 10, 2014. Last accessed October 26, 2015: <http://www.nytimes.com/2014/07/13/realestate/the-fha-short-refi-program-has-helped-few.html>

**21** The UP had only 32,000 successful applicants and the HAFA 126,000 out of 1.6 million successful applicants for the broader HAMP. See Making Home Affordable, “Program Performance Report Through March 2013,” Pg 2. Last accessed October 26, 2015: <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/February%202013%20MHA%20Report%20Final.pdf>.

**22** See <https://www.makinghomeaffordable.gov/steps/Pages/step-2-program-up.aspx>

**23** See <https://www.makinghomeaffordable.gov/steps/Pages/step-2-program-hafa.aspx>





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