

February 25, 2010

Memorandum to: John Kenward, Chief Operating Officer
Canadian Home Builders' Association

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Subject: Adjustments to Rules for Government-backed Insured Mortgages

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On February 16th the Government of Canada announced adjustments to the rules for government-backed insured mortgages. Among the adjustments was:

Require a minimum down payment of 20 per cent for government-backed mortgage insurance on non-owner-occupied properties purchased for speculation¹

CHBA asked Altus Group to provide an analysis of the meaning and implication of this rule change.

Principal Findings

- 1) If there is a problem with speculation in the residential real estate sector, this rule change will have little or no impact on these activities; but
- 2) The rule change will curtail investment in rental housing by small private investors, which could have broader negative repercussions.

In general, the change in rules will have little or no effect on any aspects of the market that could be considered "speculation". It will curtail, however, activity in an important component of the Canadian housing sector: contributions to the rental stock from small income investors. Generally, small income investors do not contribute toward market instability and are not speculators. However they do make an important contribution through the provision of rental housing.



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Thus all told, this change in the rules for government-backed insured mortgages will have little positive market effects and could have some negative effects through the curtailment of rental housing.

The following notes set out issues relevant to these conclusions:

1) Current Situation

The Canadian Bank Act (CBA) provides regulations on mortgage lending in Canada:

- The CBA prohibits most federally regulated lending institutions from providing mortgages without mortgage loan insurance for amounts that exceed 80% of the value of the home.²
- Mortgage loan insurance is provided by Canada Mortgage and Housing Corporation (CMHC) and also by private mortgage insurers. The insurance insures lenders against the risk of mortgage default. Consumers may purchase homes with a minimum of 5% down payment.
- The mortgage insurance is underwritten by a premium. The premium for insurance provided by CMHC ranges up to 2.75% of the mortgage principal for a standard borrower at 95% loan-to-value ratio. Premiums are higher in certain circumstances, up to 6% of the principal for certain self-employed borrowers.
- The minimum down payment requirements for mortgages from most federally regulated financial institutions in Canada, for single-family and two-unit dwellings is 5% minimum down payment, and for three- or four-unit dwellings is 10% minimum down payment.
- The CMHC Mortgage Loan Insurance program provides insurance on loans granted by approved lenders for the purchase, construction, renovation, or refinancing of single-family homes or multiple rental housing.
- Private mortgage insurers in the market, such as Genworth Financial Canada (Genworth), offer products under similar terms.
- Neither CMHC nor Genworth have criteria for “owner-occupier” status.



2) Property Types Affected by the Rule Adjustment

The rule change is set out in a press release and a backgrounder, both provided by the Department of Finance Canada. With respect to property types affected by the rule change, the following is noteworthy:

- The press release states “non-owner-occupied properties purchased for speculation”.
- There is certainly some ambiguity in this definition. With respect to the term “non-owner-occupied”, both CMHC and Genworth products are silent on the issue of owner occupation.
- The term “non-owner-occupied” is not defined within Section 2 (Definitions) of the CBA.
- In the Backgrounder document from the Department of Finance, a further definition of property types affected by this rule change is given: “small (i.e., 1- to 4-unit) non-owner-occupied residential rental properties”.
- Despite the ambiguity in definition, it is understood that any small property such as a single condominium unit, multiple selected condominium units within a larger structure, or single-ownership structures up to 4 units where all units are intended for rental will be subject to the rule change.

3) The Speculation Issue

- The term “speculation” in the property type definition provides little guidance.
- In the Merriam-Webster dictionary, ‘speculation’ is defined as:

Assumption of unusual business risk in hopes of obtaining commensurate gain

- The inclusion of the word “speculation” creates ambiguity, as most real estate transactions involving rental properties would not be considered speculative under the Merriam-Webster definition above.



- Typical rates of return on investment grade residential rental properties in Canada are about 8.5%, which is a combination of 6.1% income return on capital and a 2.3% per year capital gain³. This does not qualify as a high-risk, high-return investment.
- Moreover, there is evidence that investors in small properties or individual condominium units may face even lower returns than institutional investors in traditional rental properties. According to estimates by Will Dunning Inc., the estimated rate of return to a rental condominium investor in Toronto in 2006 ranged from 5% to 6.25%⁴. These returns represent modest investment returns.
- Thus, while being a small rental investor can be a sound modest investment strategy, these rates of return are certainly are not indicative of high-risk, high-return type of investments that could be considered “speculation”.

4) The newly-built condominium sales and finance process

It is important in assessing the effectiveness of the change in mortgage rules to understand the process by which newly-built homes are purchased and financed in Canada.

1. **Pre-construction sales.** For condominium apartment buildings, developers usually sell between 65% and 85% of units prior to embarking on construction (the remainder are sold through the construction phase or as “standing inventory” upon construction completion). In many cases, this “pre sale” criterion is imposed on the developer by the terms of their construction financing. Generally, pre-construction purchasers put down a small down-payment on the unit – about 5%, which is held in trust for the developer. Pre-construction purchasers are obligated by their agreements of purchase and sale to make additional payments to the developer in trust at certain milestone dates during the construction process. The sum total of the initial down payment and the additional payments is generally 15% of the purchase price, although this can vary from one developer to another. These payments are made on properties that are not yet registered to title, therefore these purchases do not have access to mortgage financing as a source for these funds. Purchasers may make use of other types of unsecured financing, draw on equity from other investments or make other arrangements.



2. **Occupancy.** At some point, the condominium apartment unit is ready for occupancy. The purchaser is then permitted to move occupants into that unit; these occupants may or may not be related to the purchaser. Occupancy often occurs well before the building, and the units within, are registered to title, so the unit is still technically in possession of the developer. The purchaser remunerates the developer during this period through a “phantom mortgage”, or other arrangements, tantamount to renting the unit from the developer. Depending on the size of the building, and other factors, the time between a pre-construction purchase and occupancy can range from several months to several years.
3. **Closing.** When the building and the units within are all completed and title is ready to be transferred to the purchasers, then this is known as closing. At this point, the purchaser is responsible for transferring the remaining funds to the developer, and most purchasers will at this point draw those funds from a mortgage. The date of closing is generally several months after occupancy. In some cases this can be up to a year or more later.
4. All mortgages, including insured high-ratio mortgages, are engaged only upon closing. If purchasers made unsecured (or other) financing arrangements with their lenders to cover the payment obligations through the construction and occupancy phases, then the mortgage funds will in part be used to discharge these other loans.

4) Who are the purchasers of non-owner-occupied properties?

This is an area for which there is little solid data in Canada to provide precise guidance. More generally, it may be instructive to consider what sorts of individuals may be purchasers and owners of non-owner-occupied properties, how “speculative” their purchases may be, and how effective the change in the mortgage rule will be in addressing such speculation:

- **Small income investors.** These investors often own only one or a small number of rental properties. These investors are holding properties primarily for the on-going rental income and expectations of capital gain. The typical time-frame for holding properties is unknown, but is likely several years. Small investors are very likely to leverage their investments using mortgages on the investment property. Down payments may be made from savings, drawing on equity in other investments, or in drawing equity out of their primary residence.



In general, small income investors would likely benefit from using high ratio mortgages as the increased leverage would be beneficial to their capital returns, and the ability to spread a fixed amount of equity over more properties reduces risk through diversification. Small income investors may be attracted to both new construction and existing properties.

Are these small investors “speculators”? No. These investors are seeking safe, relatively modestly-paying income investments. Generally, small income investors look for a positive cash return from their investment, and this objective self imposes significant discipline on purchase transactions. Small income investors are unlikely to be a driving force behind a housing bubble, in large part due to this cash return discipline.

The proposed rules will have a significant effect on this type of investor. The curtailment of access to high-ratio mortgages will limit the options for this important pool of investors.

This class of investor is likely very prevalent, and is also a major contributor to the stock of rental apartment units in Canada. If the options available small income investors become more limited, then it is reasonable to assume that this class of investor will contribute less to the stock of rental apartment units in Canada.

- **Offshore investors.** There is considerable anecdotal evidence of property transactions, especially in the Toronto and Vancouver condominium apartment markets, taking place by offshore investors. These investors may be holding Canadian real estate for diversification reasons and/or as a place to “park” money in a relatively safe investment. There is some evidence that transactions of this nature became more prevalent over the past two years during a period of shaky international financial conditions.

Are offshore investors “speculators”? Perhaps. Offshore investors will clearly be looking for capital return on investment and thus will be more willing to accept larger risks. In reality, there is likely a wide array of motivations within this group of investors, however, so it is difficult to generalize.

It is unclear how large this class of investors is and what component of the market they comprise. Anecdotal evidence suggests that offshore investments are focused in a very limited number of markets, so, overall, offshore investors are likely a very small component of the total Canadian new housing sector. A recent report on the Vancouver market



suggested that up to one-quarter of that market (or 6,000 units per year) are investor-owned condominium units that are not-rented⁵. Many of these could be accounted for by offshore investors. Thus, even if some offshore investors introduce some “speculative” behaviour to specific market, it is not likely to be widespread.

Offshore investors do not finance these investments through high-ratio mortgages. Whether or not offshore investors are responsible for the “speculative” behaviour that the rule change is attempting to curtail, the proposed change to the mortgage rule will not have an effect on this type of investor.

- **Change of Plans.** It is possible that a number of owners of non-owner-occupied properties are simply people whose plans have changed. They may, for example, be people who intended to move, purchase and occupy a condominium apartment and made a purchase in a pre-construction period, but faced a change of plans by the time the unit was ready for occupancy. Their options at that point would be to sell the unit, or to rent it.

Some buyers in this situation might have originally planned on financing the unit through a high-ratio insured mortgage. The proposed changes in the mortgage rules could affect this type of investor. This situation also raises an unanswered question about the change in rules. Will this investor still have access to high-ratio financing at closing? If not, then the change-of-plans individual investor will quickly become a forced (pre-closing) seller, which in some cases could put them in violation of purchase and sale agreements with developers.

The change in the mortgage rules eliminating the high-ratio mortgage option for investors could have painful consequences for some change-of-plans purchasers.

In terms of market destabilization, the change of rule could actually introduce additional market destabilization (by creating a situation of forced sales) rather than curtail it in these circumstances.

- **Pre-construction short term investors.** There is anecdotal evidence that some investors find purchasing new condominium apartment properties during the pre-construction phase and selling those units upon occupancy or closing dates can be effective investments. Under normal conditions, the market price for such units may have risen between the time of purchase and the time of occupancy or closing. It is also possible that newly-built but never-



occupied units may fetch a certain market premium, and, if so, that would also provide an incentive for this type of investment. This is the form of small non-owner-occupied property investment that could most be described as “speculation”, as some investors of this type may expect relatively healthy returns on relatively small initial investments.

The prevalence of this type of investor is not fully known, but is likely a reasonably large share of the pre-construction sales of condominium apartment projects. In Toronto, for example, developers and other industry watchers suggest that “investor” buyers of condominium apartment units can account for anywhere from 50% to 70% of the market in recent years and similar estimates have been made about the Vancouver market. However, CMHC data suggest that net additions to the rented condominium stock have accounted for only some 20% of occupancies in the past five years⁶. Although the two data sources are not fully comparable, the large gap between the prevalence of investors upon pre-construction sale and the post-closing universe is suggestive that many of those pre-construction investors are ultimately selling units to owner-occupiers upon occupancy or closing.

Inasmuch as these investors are taking relatively large risks (i.e., they are betting on a strong market for newly-completed, never-occupied units) and are looking for commensurate returns, many could be considered speculators. In addition, inasmuch as these investors are contributing toward the supply of condominium apartment units (i.e., by purchasing at pre-construction, they enable developers to move forward with projects), their actions could contribute to adverse supply situations. Adverse supply situations, such as an oversupply of new condominium apartment units relative to the market, can lead to adverse price effect. Pre-construction short-term investors, therefore, could contribute toward price bubbles and market destabilization, particularly at the local level.

New condominium apartment buyers do not borrow through a mortgage until the time of closing. Investors of this nature plan to sell the unit upon the units closing date (or in some cases, where allowed, upon occupancy date, which is even sooner), thus, generally, these investors are not using mortgages and certainly not high-ratio mortgages. It is possible that some of these investors depend on the ability to take out a mortgage on the unit in the event that market conditions at the time of closing are not favourable to a sale. Even in these circumstances it would be more likely that these investors would avoid high-ratio mortgages due to the extra costs (through the premium) which would be spread over such a short time frame.



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In those cases where pre-construction short-term investors are relying on the ability to obtain a high-ratio insured mortgage at time of closing in the event that market conditions are sour, then the rule changes will certainly add additional risks. But this circumstance is likely to apply to a pretty small component of the overall investor market.

Even though this type of investor could be considered “speculative”, and has the possibility of introducing adverse supply and price situations, the proposed changes will have little affect on this type of investor, and, therefore, be generally ineffective in addressing these market destabilization situations.

5) Household Debt

The rule changes for insured mortgages were introduced as “part of the Government’s policy of proactively adjusting to developments in the housing market that could take root and cause instability.” The announcement does not detail what the nature of these developments in the housing market are, but some clue to the Government’s thinking may be found in recent discussions in the Canadian media that suggest that the Minister of Finance was becoming progressively more concerned about the level of debt taken on by Canadians, and concerned about homeowners taking on mortgages they won’t be able to afford once interest rates rise⁷.

In its January, 2010 *Monetary Policy Report*, the Bank of Canada reported that: “Borrowing costs for households also remain at very low levels by historical standards, and household credit has continued to grow at a brisk pace, pushing the debt-to-income ratio of Canadian households to a historic peak.”

The change in rules will not likely have a significant influence on credit growth and debt burden among Canadians. The vast majority of new mortgage debt continues to be among owner-occupied purchasers. Among the non-owner-occupier purchasers detailed in the section above, only the small income investor (and the change-of-plans purchaser who becomes a small income investor) uses mortgage financing to a large degree. Inasmuch as these small income-investments are generally well disciplined and the debt service obligations are set against the income generated from the investment, it is difficult to conclude that curtailing this activity will address the core of the perceived problem of increased debt across Canadian households.



¹ Ministry of Finance: www.fin.gc.ca/n10/10-011-eng.asp

² Canada Bank Act (1991) 418. (1)

³ IPD Index, All Residential, Total Returns, Income Returns and Capital Growth Indexes. Data are 3-year average on standing properties, 2009.

⁴ Will Dunning Inc., "The Condo Investor", Toronto Area, Fourth Quarter 2006.

⁵ City Space Consulting, "Vancouver Condominium Rental Study", December 2009.

⁶ Calculated using data on occupancies in the GTA from RealNet Canada Inc., and from CMHC, "Rental Market Report – Greater Toronto Area", various editions.

⁷ See, for example, "Feds should cool house market" Globe and Mail, Feb. 15, 2010 p.B5