Plex Prices Temporarily Influenced by Recent Tightening of Mortgage Insurance Rules

In our previous Word From the Economist, we discussed the effect that the recent tightenings of mortgage insurance rules (see Box 1) had on residential sales in Québec. This month, we're examining whether these new rules had a temporary impact on prices in the period between their announcement and their implementation.

A Comparison of Sale Prices and Asking Prices

As our measure, we did not use the rate of price increases; rather, we used the percentage of sales transactions that were concluded at a price that was above the asking price. This normally occurs when many buyers are competing for the same property, resulting in multiple offers.

In recent years, even though it was a strong seller's market in most areas of the province, the percentage of transactions concluded at a price above the asking price remained low. Chart 1 shows the evolution of this percentage across the province since January 2005. It represented between only 2 and 3 per cent of transactions, with the exception of two periods[1]: 1) in the three months preceding April 2010, when the second tightening of mortgage insurance rules were implemented; and 2) in the three months preceding March 2011, when the third tightening of mortgage insurance rules were implemented. These periods are identified by the shaded areas on the chart.

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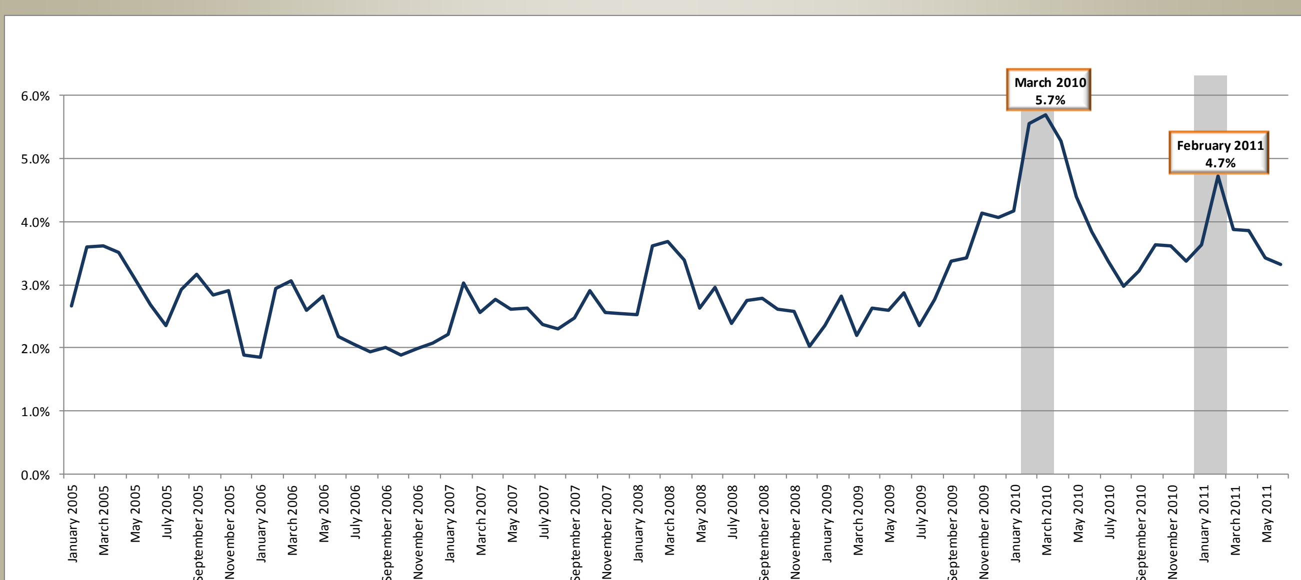
Using hypothesis tests[2], we examined whether the impact of the tightenings on the percentage of sales concluded at a price above the asking price was significant from a statistical point of view. In other words, can the announcement of a change in mortgage insurance rules mostly explain the peaks seen on the chart?

Chart 1: Percentage of Residential Sales in Québec Whose Sale Price Was Above the Asking Price



Source: QFREB by Centris®

1 No change was observed in the months preceding the first tightening in October 2008.
2 We conducted a hypothesis test based on a regression analysis. Binary variables were used to identify the periods preceding the tightenings (including the month of the announcement and the month of the implementation). We then tested the significance of the results for a confidence level of 2 per cent.

Tightenings Temporarily Exerted Upward Pressure on Prices

Our first result indicated that the announcement of the April 2010 and March 2011 tightenings had a significant impact, upward, on the percentage of sales concluded at a price above the asking price.

During these two periods, some buyers advanced their purchase and, as a result, the demand for properties became temporarily much higher than the supply, creating an inevitable upward pressure on prices. In addition, it is important to understand that the implementation of the new rules had a significant impact on some buyers' purchasing power. Before the implementation of the new rules, buyers were able to finance a larger amount of money, as shown in the example described in the box. In this example, a buyer who chose a five-year variable rate mortgage[3] was able to borrow a maximum of $327,500, but could only borrow a maximum of $213,500 after the implementation of the new rules. In a context of multiple offers, some buyers logically preferred to increase the amount of their offer a little in order to present their mortgage lender with an accepted promise to purchase before the implementation of the new rules, and thus be able to borrow a higher amount.

The implementation of the new rules had a significant impact on some buyers' purchasing power. Before the implementation of the new rules, buyers were able to finance a larger amount of money.

Example of the Financial Impact of the Requirement to Qualify for a 5-Year Fixed Rate Mortgage (new rule in effect since April 2010)

Hypotheses	
Five-year variable rate* (March 2010)	2.25%
Five-year fixed rate* (March 2010)	5,85%
Amortization period	35 years
Gross annual income	$60,000
Maximum monthly payment to qualify (25% of revenue)**	$1,250
Buyer's Scenarios	
Scenario 1: Maximum amount of loan with the variable rate (before the implementation)	$327,000
Scenario 2: Maximum amount of loan with the 5-year fixed rate (after the implementation)	$213,500
Difference between the two scenarios on the maximum amount that could be borrowed	-$113,500

Example of the Financial Impact of the Decrease in Amortization Period From 35 to 30 Years (new rule in effect since March 2011)

Hypotheses	
Five-year fixed rate* (February 2011)	5,44%
Gross annual income	$60,000
Maximum monthly payment to qualify (25% of revenue)**	$1,250
Buyer's Scenarios	
Scenario 1: Maximum amount of loan amortized over 35 years (before the implementation)	$236,234
Scenario 2: Maximum amount of loan amortized over 30 years (after the implementation)	$223,117
Difference between the two scenarios on the maximum amount that could be borrowed	-$13,117

* Based on rates posted by Canada's main financial institutions. Source: Bank of Canada.

** The Gross Debt Service (GDS) ratio, which is related to occupation costs, should not exceed 32% of gross monthly income. Because it also includes other occupation costs (taxes or property taxes, condominium fees, heating costs), we used a hypothesis in which the monthly mortgage payment (principal and interest) could not exceed 25% of gross monthly income.

Source: QFREB

3 Interest rates for variable rate mortgages were particularly low in the winter of 2010.

The Tightening of April 2010 Had a Greater Impact

Our second result indicated that, as we can see in chart 1, the tightening of April 2010 had a greater impact than that of March 2011. Thus, the announcement of the lowering of the maximum amortization period from 35 to 30 years had a lesser impact than the changes announced in February 2010, which introduced the requirement of having to meet the credit standards for a five-year fixed-rate mortgage. But the tightening of 2010 included another change in the rules that directly affected residential properties with one to four dwellings, meaning primarily plexes.

The announcement of the lowering of the maximum amortization period from 35 to 30 years had a lesser impact than the changes announced in February 2010, which introduced the requirement of having to meet the credit standards for a five-year fixed-rate mortgage.

Results Mainly Affected Plexes

At the same time, our results show that it was mainly plexes (two to five dwellings) that posted an increase in the percentage of sales transactions concluded at a price above the asking price (see chart 2). Three factors can explain this situation: first, plexes were the property category that already had the tightest market conditions, meaning that the supply was already much lower than the demand. Second, plex prices are generally higher than the other property categories, which implies that the amounts borrowed are higher and this makes their purchase (and their price) more sensitive to financing conditions . Finally, with regard specifically to the tightening of April 2010, the rule under which the minimum down payment increased from 5 per cent to 20 per cent for buildings in which none of the dwellings are occupied by the owner[4] is likely to incite another category of buyers to take action quickly. The jump in the percentage of plex sales concluded at a price above the asking price in the period preceding the implementation of this measure was probably fuelled by a number of buyers who were seeking a small revenue property for investment purposes and who chose to make their purchase just before the minimum down payment was increased.

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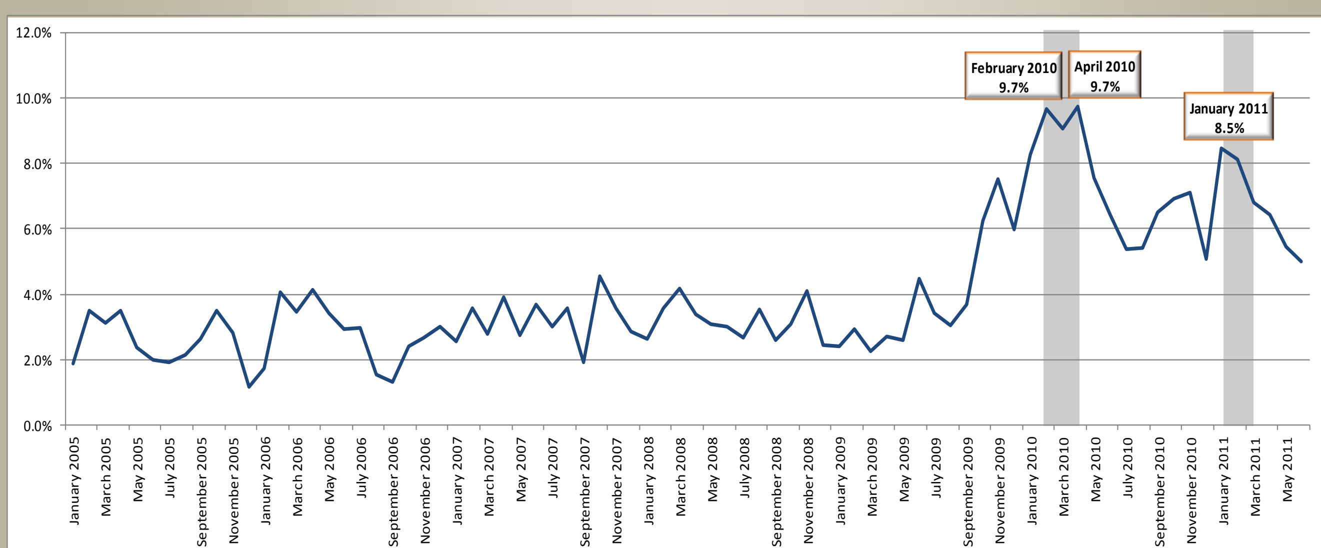
Chart 2: Percentage of Plex Sales in Québec Whose Sale Price Was Above the Asking Price



Source: QFREB by Centris®

4 For example, because the median price of a triplex on the territory of the City of Montréal was $400,000 in March 2010, the minimum down payment, for a non-occupying owner, increased from $20,000 to $80,000.

Phenomenon was Noticeable in the Areas of Montréal, Québec City and Gatineau

Geographically, we tested each of the metropolitan areas to determine whether the tightenings had an impact on the percentage of sales concluded at a price above the asking price. We noticed that the impact was significant in the Metropolitan Areas of Montréal, Québec City and Gatineau, and this applies to the tightening of April 2010 and that of March 2011. Conversely, the impact was not significant in the Saguenay, Sherbrooke and Trois-Rivières Metropolitan Areas.

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Because it is mainly plexes that are subject to multiple offers, it is not surprising that the markets in Montréal, Québec City and Gatineau were the most affected. In each of these areas, we noticed that the central neighbourhoods were the most affected.

Chronology: tightening of the rules for federal government-backed insured mortgages

① **October 15, 2008** (measures announced on July 9, 2008)
- The maximum amortization period for new loans is reduced from 40 to 35 years
- The minimum down payment increased from 0 to 5 per cent

② **April 19, 2010** (measures announced on February 16, 2010)
- Borrowers must met the standards for a five-year fixed-rate mortgage
- The maximum amount that can be borrowed during a mortgage refinancing is lowered from 95 to 90 per cent of the value of the property
- The minimum down payment increased from 5 to 20 per cent for loans associated with buildings with 1 to 4 dwellings, in which none of the dwellings are occupied by the owner

③ **March 18, 2011** (measures announced on January 17, 2011*)
- The maximum amortization period for new loans is reduced from 35 to 30 years
- The maximum amount that can be borrowed during a mortgage refinancing is lowered from 90 to 85 per cent of the value of the property

* On this same date, the government also announced that, as of April 18, 2011, it would stop offering lenders insurance backing on lines of credit secured by homes, such as home equity lines of credit, with a loan-to-value ratio (LVR) of 80 per cent or less. This measure did not have a direct impact on consumers.

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