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A WORD FROM THE ECONOMIST

October 2016

RAINSTORM OF NEW MORTGAGE RULES: A COLD SHOWER FOR THE QUÉBEC REAL ESTATE MARKET

On October 3, Finance Minister Bill Morneau announced three new preventative measures to ensure that the Canadian housing market remains stable, competitive and healthy. The objective is, of course, commendable. However, in the context of the Québec real estate market, which has already successfully achieved a soft landing and in which first-time buyers play a major role, there is a real possibility that Ottawa's latest intervention is too drastic and will negatively impact our real estate market. This review focuses on the nature of the new measures and their potential effect on the Québec real estate market.

The federal government took the entire real estate community by surprise on October 3 by announcing a series of new measures affecting both the housing and mortgage markets. This tightening is designed to be preventative and aims to protect the financial security of Canadians, support the long-term stability of the housing market and improve the integrity and fairness of the tax system. Although we will primarily discuss the measures announced on October 3, it should be pointed out that, a few days earlier, the Office of the Superintendent of Financial Institutions (OSFI) announced other measures regarding financial institutions and mortgage insurers. Box 1 explains the nature of these new rules. It must also be remembered that the tightening that has just come into force is the sixth in nine years. Box 2 presents the chronology of the main measures implemented since 2008. Moreover, other measures will be added soon when the federal government has completed consultations on risk sharing between lenders and mortgage insurers (see Subsection d).

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Toronto and Vancouver: The Exception Rather Than the Rule

By definition, there is nothing more local than real estate. In this sense, a Canadian housing market does not really exist. What does exist is a multitude of local markets that, even if they operate in the same regulatory environment, are subject to sometimes very different dynamics.

Box 1 - What are the new measures?

1. On September 9, 2016, the Office of the Superintendent of Financial Institutions (OSFI) amended certain standards for **federal financial institutions** so that they retain a **greater proportion of capital** for insured mortgages.
   a. Goal: Make federal financial institutions more prudent when issuing insured mortgages.
   b. Impact: Could reduce money available for mortgage financing, which could consequently slightly increase mortgage interest rates.
   c. Implementation: November 1, 2016.

2. On September 23, 2016, the OSFI issued a draft advisory setting new standards to determine the minimum level of capital that mortgage insurers must maintain, requiring them to hold additional capital, particularly for loans in higher-risk markets (high property prices relative to household income).
   a. Goal: Strengthen the capacity of mortgage insurers to adequately respond to a crisis in the real estate market.
   b. Impact: Could increase mortgage insurance premiums.
   c. Implementation: January 1, 2017

3. On October 3, 2016, the Department of Finance announced three more measures. The first measure imposes a mortgage rate stress test on all insured **mortgages with a down payment less than 20 per cent** (high loan-to-value ratio). Instead of qualifying for a loan at the interest rate negotiated with their lender, the borrower must qualify for a loan at the benchmark rate published by the Bank of Canada, which is usually higher.
   a. Goal: Limit excessive household debt and reduce the risk of default.
   b. Impact: Harder for first-time buyers to qualify, lower loan amounts.
   c. Implementation: October 17, 2016

   The second measure amends a **tax rule** that allowed foreign investors a **capital gains tax exemption** on the sale of a principal residence. This tax benefit will now apply only to **Canadian residents**.
   a. Goal: Reduce speculation by foreign investors and curb soaring prices in the Vancouver and Toronto markets.
   b. Impact: Reduce overall foreign investment in Canadian real estate and slow price growth in the Vancouver and Toronto markets.
   c. Implementation: When the notice of motion has been debated in the House of Commons, since it is necessary to change the Income Tax Act.

   The third measure consists of **consultations** on how to better protect taxpayers through a more balanced distribution of risk in the housing finance system.

4. On October 14, 2016, the Department of Finance amended the application of a rule announced on October 3 regarding **low-ratio insured mortgages** (down payment of 20 per cent or more). These loans are not required to be insured, but are left to the discretion of the lender. This insurance often takes the form of portfolio insurance which pools mortgages into blocks, thus creating a financial asset that can be sold to investors (securitization). Low-ratio mortgages will now also be subject to mortgage rate stress testing. In addition, several other types of loans will no longer be eligible for portfolio insurance: amortization periods greater than 25 years, rental properties, a credit score less than 600, properties with a purchase price exceeding $1 million, and refinancing loans.
   a. Goal: Limit household debt, reduce the risk of default and reduce the exposure of taxpayers who indirectly support mortgage financing through government-backed guarantees.
   b. Impact: Lower loan amounts available for mortgages and portfolio insurance limited to the safest mortgages.
   c. Implementation: November 30, 2016

Box 2 - Chronology of the Tightening of Rules Regarding Government-Backed Mortgage Insurance

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 is raised from 0 to 5 per cent.

2 **April 19, 2010** *(measures announced on February 16, 2010)*

- Requirement that borrowers meet the solvency criteria of a five-year fixed-rate mortgage for variable-rate loans or loans with a term less than five years.
- The maximum amount when refinancing a mortgage is reduced from 95 to 90 per cent of the property's value.
- The minimum down payment is raised from 5 to 20 per cent in the case of loans for 1 – 4 unit rental (non-owner-occupied) properties.

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 when refinancing a mortgage is reduced from 90 to 85 per cent of the property's value.

4 **July 9, 2012** *(measures announced on June 21, 2012)*

- The maximum amortization period for new loans is reduced from 30 to 25 years.
- The maximum amount when refinancing a mortgage is reduced from 85 to 80 per cent of the property's value.
- The maximum Gross Debt Service (GDS) is set at 39 per cent of gross income.
- The maximum Total Debt Service (TDS) is set at 44 per cent of gross income.
- The government limits its guarantee of insured mortgages to homes with a purchase price of less than $1 million.

5 **February 15, 2016** *(measure announced on December 11, 2015)*

- The minimum down payment increases from 5 to 10 per cent for properties over $500,000 The minimum down payment remains at 5 per cent for homes under $500,000.

To justify the need for the new measures, the federal government cites its concern about "rapidly rising house prices in some of our biggest cities, particularly in markets like Toronto and Vancouver". Yet, about 75 per cent of the Canadian population lives outside these two metropolitan areas in markets that show no signs of overheating. As shown in Table 1, since the beginning of 2016, prices are in decline in Saskatchewan and the Maritimes, stagnant in Alberta, and growing at less than 3 per cent in Manitoba and Québec.

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Table 1: Average Price of Residential Properties*
January to September 2016

	Price	Variation
Ontario	$529,827	13.9%
British Columbia	$703,986	12.7%
Québec	$281,521	2.7%
Manitoba	$277,722	2.1%
Alberta	$394,730	0.0%
Saskatchewan	$297,157	-0.5%
Maritimes	$206,681	-2.5%

Sources: CREA and QFREB

*All property categories combined.

A Successful Soft Landing for Québec

Since the 2012 tightening of mortgage rules in which the maximum amortization period was reduced from 30 to 25 years for insured loans, the Québec residential real estate market has successfully managed a soft landing. Table 2 shows that sales fell in 2013 and 2014. The markets in most of the province's urban centres rebalanced themselves during this period. Market conditions have even changed to favour buyers in some areas. As a result, the pressure on prices has considerably abated to the point where the median price of a single-family home in Québec rose by only 3 per cent between 2012 and 2015. So far in 2016, after nine months, the increase has been 2 per cent. Overall, market conditions have tightened in most urban centres. However, there remains an excess supply of condominiums in the resale market for all of Québec.

The median price of a single-family home in Québec rose by only 3 per cent between 2012 and 2015.

Table 2: Evolution of the residential real estate market in the province of Québec since 2012

	Sales		Active listings		Median price **	
		Variation		Variation		Variation
2012	77,372	0%	64,693	9%	$224,050	3%
2013	71,194	-8%	70,815	9%	$225,000	0%
2014	70,621	-1%	77,958	10%	$227,000	1%
2015	74,125	5%	81,604	5%	$230,000	1%
2016*	*61,682*	*6%*	*79,509*	*-4%*	*$234,000*	*2%*

*January to September

**Single-family homes

Source: QFREB by the Centris® system

Impact of Each Measure

a) **The new tax rules for foreign buyers will have little impact**

The federal government will eliminate a tax loophole that allowed non-residents a capital gains tax exemption on the sale of a principal residence. One can only applaud this measure since it improves the fairness and integrity of the Canadian tax system.

Moreover, this measure should only have a marginal impact on real estate activity in Québec since foreign buyers are not very present in our housing market[1].

b) **The mortgage rate stress test for high loan-to-value mortgages will penalize many first-time buyers**

All high loan-to-value ratio mortgages (when the homebuyer makes a down payment of less than 20 per cent of the purchase price) must be insured by the CMHC or a private insurer. Since October 17, 2016, these loans must pass a “mortgage rate stress test”. For borrowers to qualify, this test requires that the gross debt service ratio (GDS) be calculated using the five-year posted rate, and not the contractual mortgage rate. This banchmark rate is set by the Bank of Canada and is based on the five-year fixed rates advertised by the six largest Canadian banks.

Since in Canada, the usual practice of financial institutions is to offer significant rate discounts, the difference between the rate offered and the posted rate can often exceed two percentage points. For example, it is possible to presently obtain a five-year contract rate of about 2.40 per cent, while the Bank of Canada benchmark rate is currently set at 4.64 per cent. This difference can significantly impact the calculation of the maximum borrowing capacity.

[1] For example, according to CMHC estimates, the percentage of condominiums owned by foreign investors is 1.2, 0.6 and 0.3 per cent respectively for the Montréal, Québec City and Gatineau CMAs

Box 3 - The Importance of First-Time Buyers in Québec

First-time buyers are the cornerstone of any real estate market. They are the ones that start the cascade of transactions that subsequently allows the second and third-time move-up buyers to climb the ladder to an upgraded property. This is especially true in Québec. We estimate that over the past five years, the share of first-time buyers in the Québec residential real estate market has reached almost 40 per cent. They are responsible for 30,000 to 33,000 Centris® transactions annually.

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The new measures will especially penalize first-time buyers, and unfortunately, Québec is lagging behind the other provinces in terms of homeownership rates. According to the Statistics Canada census, the 2011 Québec homeownership rate was 61 per cent as compared to 70 per cent or more in all provinces without exception. Nonetheless, Québecers seem to have been catching up in the past few years due to historically low interest rates.

Because owner households create equity that allows them to improve their financial situation over time, the purchase of a property is generally a factor in creating household wealth.

Using the historical evolution of prices, it is easy to demonstrate that buying a property in Québec has almost always been a good mid- to long-term investment. Because homeownership creates equity that allows owners to improve their financial situation over time. The purchase of a property is generally a factor in creating household wealth.

Consequently, this measure strongly penalizes want-to-be homeowners, since in most cases, they do not have the 20 per cent down payment. On one hand, it will significantly reduce the number of households that can qualify for an insured mortgage and, on the other hand, it will considerably reduce the amount that can be borrowed[2].

The net result of mortgage rate stress tests will be to disqualify many potential homebuyers as well as significantly reduce the purchasing power of households since they will not be able to borrow as much as they did before. They will then have to choose between delaying their purchase or buying a home of less value.

Let's look at a simple example (figures are rounded). Prior to October 17, a household that could make monthly payments of $1,600 could qualify for a maximum loan of $360,000 if the five-year rate was 2.40 per cent. Since October 17, the same household must now qualify using the benchmark rate of 4.64 per cent. The maximum amount that it can borrow has been reduced by $75,000 to $285,000. If the household planned on making a $20,000 down payment for a property worth $380,000, it would no longer qualify. It would either have to wait and save up for a much larger down payment, or purchase a property that costs no more than $305,000.

Another way to look at the situation is that before October 17, our example household had to have an income of about $68,000 a year[3] to qualify for a $360,000 mortgage. After October 17, only households earning about $86,000 would qualify. In other words, the income necessary to qualify for a certain mortgage level has significantly increased.

2 Of course, this does not mean that all first-time buyers will be affected, only those who have chosen to buy at their maximum GDS.

3 For this purpose, we have assumed that the monthly mortgage payment corresponds to 28 per cent of gross income. When the borrower has a credit score below 680, the gross debt service ratio (GDS) should not exceed 35 per cent, based on a monthly fee that also includes property and school taxes, electricity and heating costs and condo fees, if applicable.

In sum, the net result of mortgage rate stress tests will be to disqualify many potential homebuyers as well as significantly reduce the purchasing power of households since they will not be able to borrow as much as they did before. They will then have to choose between delaying their purchase or buying a home of less value.

c) The new loan insurance restrictions for low loan-to-value ratio mortgages will reduce mortgage market competitiveness

Low loan-to-value ratio mortgages (when the homebuyer makes a 20 per cent or more down payment of the purchase price) can also be insured at the discretion of the lender. This insurance typically takes the form of portfolio insurance, i.e. mortgages are grouped or pooled together and then securitized[4]. Once sold to investors, the amounts collected can be used for issuing new loans. Securitization is an economic form of funding to the extent that, on one hand, the mortgages are insured and, on the other hand, the timely payment of principal and interest is guaranteed by the Government of Canada if the securities were issued under the NHA MBS program.

Portfolio insurance is a very important source of funding for non-bank lenders. Generally, they have fewer sources of funding available to them than deposit-taking institutions whose funding sources are more diversified (in particular, they can use deposits from individuals to fund mortgage lending).

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In recent years, non-bank lenders have contributed to making the mortgage market more competitive with more choices, more options and, by extension, more competitive mortgage rates for borrowers. However, the new rules will significantly restrict the use of securitization by non-bank lenders, and deprive them of a vital source of funding that enables them to compete with large banks. The changes that will take effect on November 30 will consequently reduce the availability of funding and competitiveness in the mortgage market, and likely result in higher mortgage rates.

d) Risk sharing between lenders and mortgage insurers: toward an increase of mortgage rates

The federal government also launched a consultation process on October 21 regarding risk sharing between lenders and insurers for government-backed insured mortgages. This would require mortgage lenders to bear a portion of the losses on insured mortgages that default. This risk sharing could take several forms. For example, one possible approach is that the lender assumes the first 5 per cent of a loss due to a default and the insurer assumes the remaining 95 per cent. Currently, the risk is fully assumed by the insurers who cover 100 per cent of losses, and indirectly by taxpayers through the guarantee provided by the Government of Canada. The goal is to reduce the exposure of Canadian taxpayers to the inherent risks of the mortgage market.

While we believe that this is an excellent initiative, it must be understood that no matter the form that this risk sharing will take, it will necessarily increase mortgage rates since lenders will have to actively manage the risk of loss. A preliminary analysis conducted by the federal government suggests that the average increase in lender costs could be between 20 and 30 basis points.

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[4] Securitization is the process of transforming blocks of eligible mortgages into mortgage-backed securities.

Overall Impact: Significant Slowdown of the Québec Real Estate Market

In summary, the main projected impacts of this rain of new measures from Ottawa and the OSFI are:

— the disqualification of many potential first-time buyers;
— the reduction in permissible loan amounts;
— the reduction of available funds in the mortgage market;
— an increase in mortgage rates[5].

We believe that many of these measures make good sense. However, the crux of the problem is that they all come into effect at almost the same time and that their effects will be compounded in a context of anemic growth of property prices in Québec and other provinces. The impact of these changes will be major.

For the QFREB, there is no doubt as to the consequences: there will be a guaranteed short- and mid-term slowdown of the real estate market. Accordingly, we will significantly revise downwards our 2017 forecasts. The impact on the number of sales will be, at minimum, as important as the 2012 tightening of mortgage rules which reduced the maximum amortization period from 30 to 25 years. In terms of property values, there is a real risk that prices will decline. Since a home is the main asset for most households, a decline in the sense of prosperity and confidence could, in turn, negatively affect consumer spending.

We will significantly revise downwards our 2017 forecasts.

[5] We are talking about rates offered to borrowers and not posted rates.

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