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What means are available to slow the housing market in some parts of Canada?

Solutions exist elsewhere in the world

Several measures have been put forward in recent years to put the brakes on Canada's housing market. Yet major regional disparities persist, with the Vancouver and Toronto markets still skyrocketing. Under these conditions, numerous stakeholders are calling for more focused measures, in particular to control the influx of foreign investors in Canada's large cities. Elsewhere in the world, in the last few years, several regions have decided to manage and rein in the presence of foreign investors in their real estate markets. Before coming up with a solution for Canada, however, it is essential to have a good grasp of all the factors affecting housing demand here, including the contribution from foreign investors.

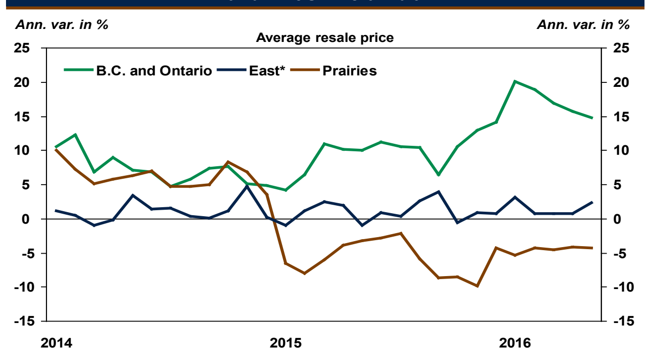
For several years now, Canada's lively housing market and its impact on high household debt loads have been raising some concerns for the Bank of Canada (BoC), the federal government, and most analysts. Yet steps have been taken in the last few years to tighten up the conditions for mortgage credit for loans covered by loan insurance. As early as 2009, Finance Canada announced a reduction to the maximum amortization period (from 40 to 35 years), an increase in the minimum down payment (0% to 5%), and a uniform requirement for the minimum credit rating. Several other sets of measures were subsequently implemented to further tighten credit terms.[1] Among other things, the cap on refinancing was initially lowered from 95% to 90% of the home's value, then from 90% to 85% and, in the end, dropped to 80%. The maximum amortization period shrank again, going from 35 to 30 years, and then, in a later announcement, from 30 to 25 years. A minimum down payment of 20% was introduced if the owner does not occupy the property. The government guarantee no longer applies to properties priced at more than $1M. More recently, the minimum down payment for new insured mortgage loans went from 5% to 10% for the portion of the home's price above $500,000 (table 1 on page 2).

Did these measures work? That is a tough question to answer, as we do not know how the housing market would have behaved if the restrictions had not been introduced. Still, we have to conclude that Canada's housing market remains astonishingly lively, and that household debt continues to rise. In this context, we may well wonder whether other measures are needed and, in particular, what type of action would be most appropriate for slowing the housing market's advance.

REGIONAL DISPARITIES COMPLICATE THE MATTER

The main difficulty in introducing new measures lies in the major regional disparities currently observed, with the housing market operating at three different speeds. Although the Canadian data continues to point to a sustained rise in home prices and sales, this is primarily due to the vitality of the Vancouver and Toronto markets. Other parts of the country are not seeing nearly this kind of euphoria in their housing markets. On the Prairies, the ongoing recession in Alberta and Saskatchewan has come with a substantial slowdown in the housing market. Quebec and the Atlantic provinces are, for their part, seeing moderate growth (graph 1).

Graph 1 Prices are still rising much faster in Ontario and British Columbia



* Atlantic provinces and Quebec.
Sources: Canadian Real Estate Association et Desjardins, Études économiques

[1] This list of measures is a summary; it is not a complete overview of all the measures introduced in recent years to limit mortgage credit.

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Table 1
Summary of federal mortgage credit measures (insured loans)

July 9, 2008 announcement
effective October 15, 2008

⇒ Maximum amortization period goes from 40 to 35 years.
⇒ Minimum down payment goes from 0% to 5%.
⇒ Establish a uniform requirement for the minimum credit rating.
⇒ New loan documentation standards.

February 16, 2010 announcement
effective April 19, 2010

⇒ Must comply with the solvency criteria for a closed 5-year mortgage.
⇒ Maximum refinancing drops from 95% to 90% of the home's value.
⇒ Minimum down payment of 20% if the owner does not live in the property.

January 17, 2011 announcement
went into effect between March 18 and April 2011

⇒ Maximum amortization period goes from 35 to 30 years.
⇒ Maximum refinancing drops from 90% to 85% of the home's value.
⇒ No more government guarantees on lines of credit secured by the home.

June 21, 2012 announcement
effective July 9, 2012

⇒ Maximum amortization period goes from 30 to 25 years.
⇒ Maximum refinancing drops from 85% to 80% of the home's value.
⇒ The maximum gross mortgage debt service ratio is set at 39% of income, with the total debt service ratio at 44%.
⇒ The government guarantee only applies to properties priced at less than $1M.

February 28, 2014 announcement
effective May 1, 2014

⇒ Increase in mortgage loan insurance premiums for owner-occupied units and rental property with one to four units.

April 25, 2014 announcement
effective May 30, 2014

⇒ Withdrawal of mortgage loan insurance activities for secondary residences and self-employed workers with no third-party revenue confirmation.

April 2, 2015 announcement
effective June 1, 2015

⇒ Increase of about 15% in mortgage insurance premiums for owner-occupied units for buyers with down payments of less than 10%.

December 11, 2015 announcement
effective February 15, 2016

⇒ Minimum down payment for new insured mortgage loans will go from 5% to 10% for the portion of the home's price above $500,000.

Sources: Finance Canada, Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Under these conditions, it is hard to implemente another measure to limit mortgage credit nationwide without hurting the market on the Prairies, in Quebec and in the Atlantic region. Finance Canada could, of course, try to introduce measures by attempting to focus more on the British Columbia and Ontario markets. The recent increase in the minimum down payment for new insured mortgage loans for the portion of a home's price in excess of $500,000 is a good example here, but its impact on the housing market has been marginal to date.

In other words, although not completely out of ammunition, it seems difficult to introduce new changes to mortgage credit conditions that would effectively curb the housing markets in British Columbia and Ontario without hurting the other regions. What can be done under these conditions? Simply wait for the market to adjust naturally? This strategy involves risks: prices are rising very quickly in Vancouver and Toronto, providing more and more fuel to the fears that these markets will eventually correct, with all the harm that could do to the economy and housing markets in other regions. What other means are available to slow the housing market effectively?

AN INTEREST RATE INCREASE MUST BE AVOIDED

Traditionally, the means most often used to curb housing market growth is to increase financing costs by raising interest rates. However, in the current context, this solution has two major disadvantages. For one thing, interest rate changes would apply across the country, making it difficult to target the real estate markets in British Columbia and Ontario. For another, an interest rate change does not only affect the real estate market: it impacts all of the other components of domestic demand as well, including consumer spending and business investment. Given the Canadian economy's ongoing struggles, an interest rate increase must be ruled out for now.

MORE FOCUSED, NON-TRADITIONAL MEASURES SHOULD BE PREFERRED

Given that interest rates cannot be changed immediately and given how difficult it is to implement new, general restrictions on mortgage credit, the use of innovative, more focused measures is increasingly being contemplated. However, this requires government decision makers to have a greater awareness of the issue regionally.

The BoC does seem increasingly concerned about the real estate market's evolution in some regions. On the release of the *Financial System Review*, Governor Stephen Poloz noted that "the pace of house price increases in Toronto, and especially Vancouver, is unlikely to be sustained, given underlying fundamentals. This suggests that prospective homebuyers and their lenders should not extrapolate recent real estate price performance into the future when contemplating a transaction. Indeed, the potential for a downturn in prices in these markets, although difficult to quantify, is growing."

There is, moreover, a growing consensus among private sector analysts on the key role that foreign investors play in the strength of the real estate markets in Vancouver and Toronto. To date, however, the federal and provincial governments, and the Canada Mortgage and Housing Corporation (CMHC) have been fairly evasive about the importance of foreign investors in the housing market. In its last budget, the federal government stated that "it is impossible to have a perfect grasp of the role of foreign homebuyers in the Canadian housing market since there is no comprehensive, reliable data set on the number of homes sold to such buyers." The federal government therefore decided to allocate $500,000 to Statistics Canada in 2016–2017 to gather data on purchases of Canadian homes by foreign buyers. British Columbia's government also intends to ask homebuyers to state whether they are citizens or permanent residents of Canada, or of another country.

Until the results of these investigations come in, evidence on the ground increasingly seems to attest to a fairly large weight of foreign investors in the Vancouver and Toronto housing markets. Among others, many investors from Asia seem to be choosing Vancouver or Toronto. A recently released study by Josh Gordon,[2] of Simon Fraser University in British Columbia, showed that the contribution from foreign investors was the main driver behind the Vancouver real estate market's vitality. Note that, last year, Chinese authorities relaxed their rules on international capital flows. According to the new version of the QDII2 program (Qualified Domestic Individual Investor), Chinese residents of six target cities[3] whose financial assets total at least one million yuan (just under C$200,000) can invest up to half of their net assets abroad in a variety of products, including real estate. Vancouver and Toronto are among the Chinese's six preferred cities for real estate investment.

Under these conditions, more and more stakeholders propose implementing measures to limit and further manage foreign investment in some Canadian cities. There are a number of legal and fiscal considerations to be weighed, particularly in terms of international agreements. That being said, more and more potential solutions are emerging, and experiments tried in some parts of the world to control the flow of foreign investment into the real estate market can serve as examples.

Taxation that targets foreigners more

One of the means put forward to slow foreign investment is to introduce a graduated tax on property value, to be collected by the province or municipality each year. Foreign real estate purchases are primarily concentrated in high-end properties, so a new tax that would increase with the value of the property could curb demand for luxury properties. A floor could be contemplated, below which the tax would not apply. To avoid penalizing Canadian citizens and foreigners who are active participants in Canada's economy and the labour market, some people suggest offsetting the impact of the new tax with an additional tax credit on earned income for these owners.

Another option would be to tax the capital gains earned by foreigners when they sell their Canadian property, a measure that would curb speculative real estate transactions. This solution was put forward in the **United Kingdom** to cool the euphoria in the London real estate market. Starting April 6, 2015, the United Kingdom has charged a capital gains tax of up to 28% on the sale of foreign-owned property.

Increase purchase costs for foreigners

Other countries have instead chosen to institute measures that increase acquisition costs for foreigners. **Australia**, for example, charges foreigners a fee of AU$5,000 just for the right to submit a purchase offer on property priced at up to AU$1M. The fee can rise to AU$10,000 for properties priced at more than a million dollars. In **Hong Kong**, among other things, non-permanent residents are charged a 15% tax when they buy a property.

[2] Josh C. Gordon, "Vancouver's Housing Affordability Crisis: Causes, Consequences and Solutions," *Centre for Public Policy Research*, Simon Fraser University, May 2, 2016, 59 p., www.sfu.ca/content/dam/sfu/mpp/pdfs/Vancouver%27s%20Housing%20Affordability%20Crisis%20Report%202016%20Final%20Version.pdf.

[3] Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen and Wenzhou.

Tax vacant units

Many buyers purchase property abroad as an investment. This is one way to diversify assets, complementing securities and other investment instruments. It is also an additional way to diversify a portfolio geographically. For such investors, an actual need for housing is a very secondary part of their decision to buy. Many owners spend little, if any, time in their foreign residences during the year. Although some look to renting to fill the units, many properties end up vacant for part of the year. According to fragmentary information, this is the case with many Vancouver condos, for example.

Under these circumstances, many people are proposing a tax on vacant units. The major problem with this measure, however, is identifying vacant units properly, making it hard to implement.

Restricting the inflow of foreign capital

A number of countries have opted for more direct control of real estate purchases by foreigners. In **Australia**, foreigners are usually only authorized to purchase new properties. Moreover, non-residents who purchase a residential lot must put a home on it within two years. In **Switzerland**, the government sets quotas for each region to limit the number of homes that can be purchased by foreigners. **Mexico**, grappling among other things with a wave of purchases from the United States, only authorizes foreigners to buy properties in the interior, and prohibits foreign purchases in the restricted zones, around the capital and less than 50 kilometres from the coasts. **Hong Kong** has established zones in which new units can only be sold to permanent residents.

CAUTION IS IN ORDER IN FINDING A SOLUTION FOR CANADA

Government decision makers have several options for slowing the country's housing market in a targeted way. The challenge lies in finding a Canadian solution to the problem. To achieve this requires a solid understanding of all the factors that affect housing demand, especially in Vancouver and Toronto. Under these conditions, the effort to adequately assess the role foreign investors play in housing market evolution in Canada's large cities must be pursued.

Also, as a country, Canada is highly open to the world, in terms of both trade and the flow of investment. Regardless of what measures may eventually be instituted to curb the foreign contribution to the housing market, Canada's reputation as a country that welcomes foreign investors and immigrants must be protected.

The danger that introducing new restrictive measures could cause the housing market to slow too quickly if such measures are poorly calibrated or have a poor fit cannot be ruled out. More information on the importance of foreign investors is therefore essential. That being said, we are short on time, because, as property prices rise further in Vancouver and Toronto, the risk of imbalance increases, increasing the potential for an eventual correction.

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