In Focus

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ECONOMICS

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The GTA Housing Market: Is There Logic Behind the Madness?

by Benjamin Tal with Katherine Judge

Executive Summary

The future trajectory of housing in the GTA is not written in stone. Low interest rates have created the potential for house price inflation. Policy-driven land shortages released that potential, resulting in today's housing affordability crisis. The GTA is in a twilight zone of home prices characterized by a homeownership mentality that is slow to change to the required higher propensity to rent. With interest rates unlikely to rise any time soon, the future of housing in the GTA will be shaped by the ability of these factors to adjust.

Provincial Policies Limiting Land Supply

- Policies such as the "Places to Grow Act" have limited the availability of serviced land for ground-oriented houses through setting aggressive intensification and density targets
- Poor measurement of existing intensification and density rates can potentially result in even less elastic land supply given current proposals to raise those targets
- Time-consuming approval processes combined with developers holding on to land as it appreciates have increased the amount of time it takes for land to be brought to the market
- A surge in government-related development costs has compounded the affordability issue

Directions for Land Assessment Policy Changes

- The province should reassess the proposal to raise current intensification and density targets
- Future intensification and density targets must be tailored to reflect accurate starting points and account for development in inbuilt areas that cannot be replicated
- Consistent protocols for municipalities to assess and report short-term land supply must be implemented in addition to fast-tracking land development approval processes

Home Buyer Mentalities are a Barrier to Change

- Reduced borrowing costs have partially prevented behavioural adjustments which would favour renting
- Rising amortization periods and increased borrowing to finance down payments are supporting the home owning trend
- Subprime lending is on the rise while the interest rate sensitivity of prime borrowers is elevated
- Recent developments in the rental market such as more expensive rentals and reduced turnover rate suggest that the stigma associated with renting is starting to fade
- Purpose-built rental activity is rising and is expected to account for close to 20% of new supply in 2016; this segment of the market will play an increasingly important role in advancing the adjustment process

Policy Options to Reduce Credit Risk at the Margin

- Using demand tools to deal with supply-driven problems is suboptimal but there is still some low-hanging policy fruit left
- Raise the minimum down payment on homes valued between $500k and $1 million to more than 10%
- The qualification rate on the five-year fixed rate loan which accounts for over 30% of originations should be raised
- The subprime and alternative lending space must be monitored more closely

Incentivizing Purpose-Built Renting

- Tax incentives for the development of large rental units that will accommodate the rising share of seniors as well as young families who can no longer afford the traditional single-family house
- Augment rent control regulations to allow flexibility in the supply of rental units
- Reduce development charges related to the rising purpose-built rental market to help boost the supply of purpose-built rental units

On the Anticipated Rise in Foreign Investment in GTA Housing

- A flipping tax, an empty unit tax, an increased land transfer tax on property beyond a value threshold or limiting foreign buying to new developments are policy options

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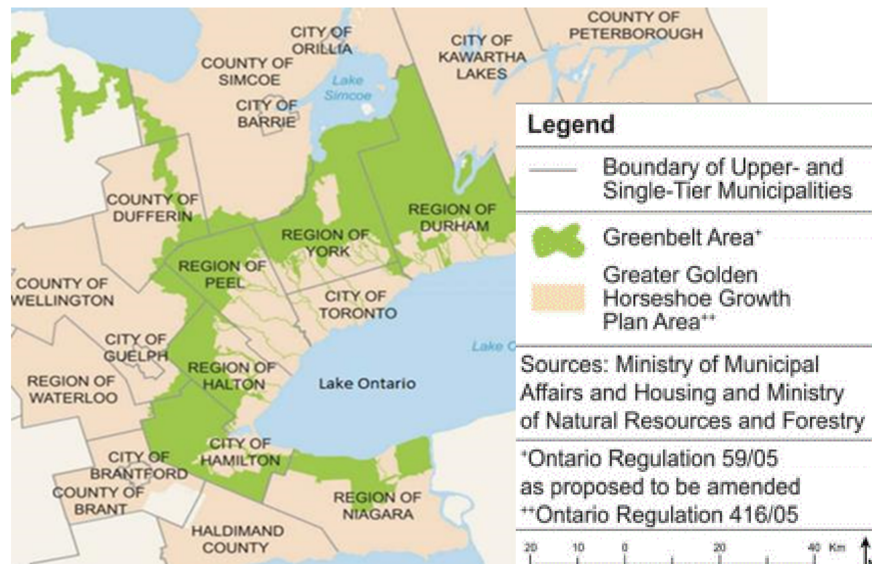
A significant driver of house price inflation in the Greater Toronto Area (GTA) is the lack of serviced land supply for ground-oriented houses. Record-low interest rates are working to elevate demand along the inelastic land supply curve, resulting in ever-rising house prices. Low rates have created an affordability mirage that so far has worked to delay necessary market adjustments including an increased propensity to rent, that could work to ease the pressure. Given current provincial policies aimed at increased intensification of housing activity within urban boundaries, we expect land supply to be even less elastic in the coming years. We also do not see a notable adjustment to interest rates in the near future. So the only thing standing in the way of a full-scale affordability crisis and the potential for a significant price adjustment, is the ability of the market to change. Is it starting to change? Let's take a closer look.

The Supply Factor

Even to the casual observer, it is clear that making a blanket statement regarding Canadian real estate is meaningless. Most of the action, and the attention of policy makers, is on the red-hot markets of Toronto and Vancouver. But even here we have to avoid broad statements due to significant differences in the role played by foreign investment and more so, the impact of government policies on market conditions in these cities.

Hence, our focus is on the GTA market (Map 1) where, over the past five years, the average house price has risen by a cumulative 44%.

Map 1
Greater Golden Horseshoe Area



Source: Government of Ontario

It's hardly a secret that an important factor behind this acceleration is a severe lack of supply of serviced land for ground-oriented houses, which has resulted in the city facing nothing short of an affordability crisis. This lack of supply is in part a direct result of government policies aimed at intensification, and a very slow process of behavioral adjustment by home buyers.

Over the past decade, the province of Ontario has taken significant proactive steps to manage urban sprawl by modifying and introducing policies aimed at encouraging more sustainable forms of development. Specifically, the government introduced the Greenbelt Plan in 2005, the Places to Grow Act in 2006 and updated the Ontario Planning Act (2004).

The "Greenbelt Plan" governs the type of development that can take place in the Greenbelt area, while "Places To Grow" establishes guiding principles that affect how land is developed, how resources are managed, and how public dollars are invested. The latter plan is, by far, the most important policy action impacting housing conditions in the GTA. Among its many policies, two measurable targets are most relevant to the trajectory of house prices in the region:

Intensification—The required rezoning along transit corridors to provide adequate density to support transit. The Plan mandated that by 2015, and each year thereafter, municipalities must ensure that at least 40% of new developments occur within existing urban boundaries. At any point in time, that intensity level can be achieved through the redevelopment of vacant or brownfield land or the infilling of space between existing buildings. However, it is mainly driven by the development of townhouses and more dense forms of housing (stacked and back-to-back townhouses and apartments). Earlier this year, the province proposed to raise the intensification target to 60%.

Density—New development on previously underdeveloped land (greenfield) will be planned to accommodate no fewer than 50 residents and jobs combined per hectare. In its recent policy proposal, the province is calling to raise that target to 80 residents and jobs combined per hectare.

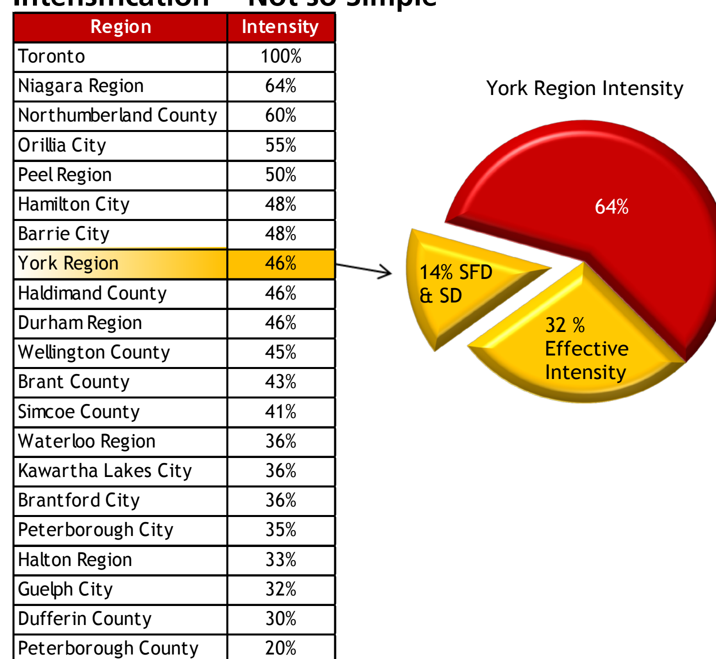
So how are we doing so far? While the process sounds simple, it is highly complicated to carry out. At the time that the targets were initially set, most Ontario municipalities had not previously tracked their intensification rate, and if they had, they did not use comparable methods. The province did not set up a consistent process for monitoring the implementation of these policies. For example, different assumptions regarding "takeouts"— the amount of land that contains environmentally sensitive areas such as wetlands and woodlands or hydro corridors, roads, golf courses and cemeteries— that should not be part of the density calculations, can lead to incomparable metrics across municipalities.

So while the target was clear, the starting point was much less clear. Since then, the Ontario government published a status report which provided the average annual residential intensification rates achieved between 2007 and 2010 (Chart 1).

Now remember, the new proposed target is 60%, and the higher the rate is, the less land is released in the outskirts—adding to the lack of land supply. In fact, there is good reason to believe that even those figures overstate the real intensification rates achieved. Take the region of York, for example. From our discussions with developers and based on data we obtained from Malone Given Parsons Ltd., a significant portion of the region's 46% intensification rate was due to the fact that by the time the region's built (intensification) boundary was assigned, it already included under-construction or about to be built subdivisions of single and semi-detached units. This cannot be replicated in the future as most of the new intensification will be achieved by the development of townhouses and apartment buildings.

Chart 1

Intensification— Not so Simple



Region	Intensity
Toronto	100%
Niagara Region	64%
Northumberland County	60%
Orillia City	55%
Peel Region	50%
Hamilton City	48%
Barrie City	48%
York Region	46%
Haldimand County	46%
Durham Region	46%
Wellington County	45%
Brant County	43%
Simcoe County	41%
Waterloo Region	36%
Kawartha Lakes City	36%
Brantford City	36%
Peterborough City	35%
Halton Region	33%
Guelph City	32%
Dufferin County	30%
Peterborough County	20%

Source: Gov. of ON, Malone Given Parsons Ltd., CIBC

Removing this factor from the equation suggests that the effective intensification rate of York for those three years was actually 32%, not 46%—requiring even more restrictive land supply to achieve the new proposed elevated target. The consensus in the industry is that other regions face similar situations.

In fact, effective intensification rates in the region might be even lower. Fundamental to the growth plan and its intensification and density targets are the assumptions and forecasts regarding population growth and housing starts by region. But as we all know, forecasts and reality do not always align. As illustrated in Chart 2, the growth plan understated population growth in the city of Toronto and overstated growth in the 905 regions. The plan also understated the actual growth in housing starts in the GTA by a cumulative 10,000 units since 2011. This means that simply counting new units in the built area as a share of total number of starts that is below plan, would overstate the reported density rate.

The takeaway here is that effective intensity rates may be lower than reported, and raising those targets might lead to even more restrictive land supply as municipalities struggle to achieve a newly elevated target from a lower than perceived starting point. In fact, while it took much longer than expected, many municipalities are in a relatively advanced stage of adjusting to the current intensification and density requirements, with a release of a notable amount of land expected in the coming three to four years. However, to the extent that targets will be modified, that land release might be postponed as municipalities readjust to the new requirements.

Sitting on Land

Now, if you are an owner of potential development land and you are well aware that Places to Grow will result in a shortage of land by even more than currently anticipated, you probably will not be eager to sell. Clearly, time is money for land owners. Holding on to land is already a significant force restricting supply in the GTA.

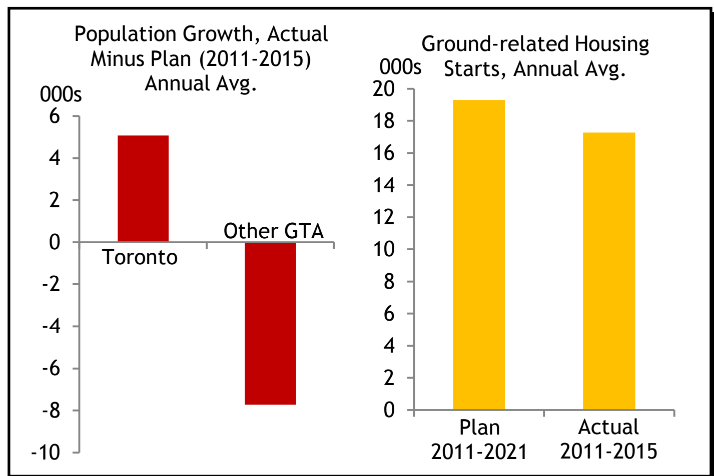
Another factor restricting supply is, simply put, bureaucracy. Whether by design or due to the increased complexity of the situation as described earlier, it now takes much longer to bring land to the market. At any point in time, municipalities are required to maintain a minimum three-year supply of serviced and readily serviceable land. The reality is that most GTA municipalities are not monitoring the adequacy of their short-term supply. It is reasonable to assume that most fall short of this requirement. Currently, it is estimated that for ground-oriented projects it takes more than five years to complete the land acquisition and development process and in many cases even longer.

No Surprise—Land Prices are Rising Fast

It is no surprise, then, that land prices have risen notably in the past decade (Chart 3), accounting for a growing share of the price of a house. The land value of low-density units has doubled over the past decade while the land price of medium-density lots (the prime target for intensification) has risen by close to 150%. In cities such as Markham, Newmarket, Richmond Hill, Vaughan and Brampton, land now accounts for over one half of total house price.

Chart 2

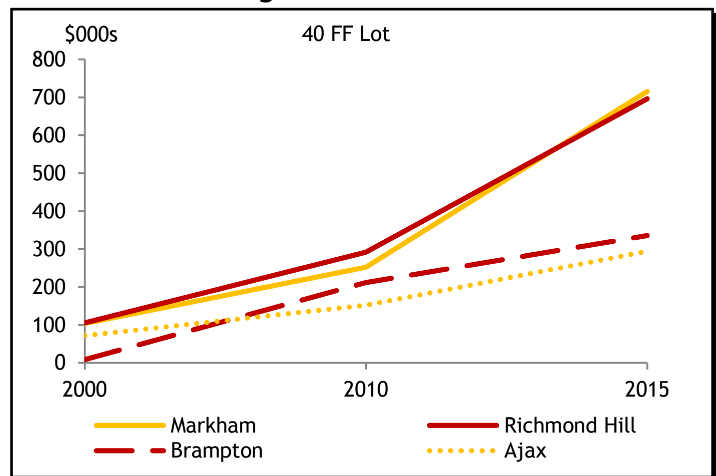
Population Growth and Housing Starts Deviated from Plan



Source: CMHC, Hemson 2013, CIBC

Chart 3

Cost of Land Rising Fast

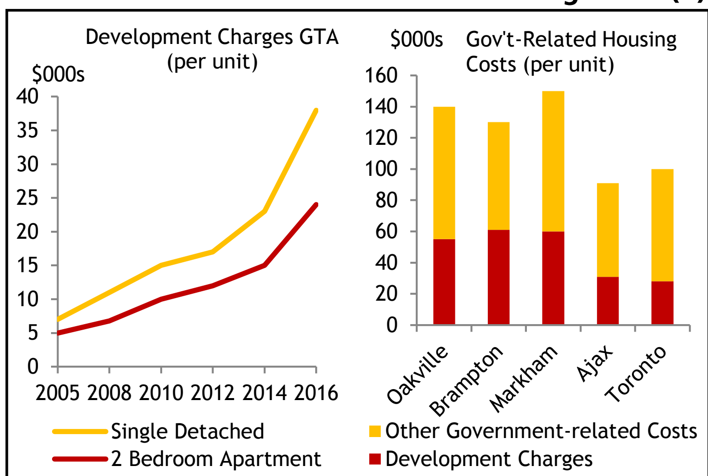


Source: MCAP, CIBC

Adding to land inflation are government-related costs. Chief among them is the meteoric rise in development charges that municipalities levy on developers for land development and redevelopment projects to help pay for the increased capital cost required to service growth. Development charges skyrocketed over the past decade, rising, for a single detached lot, by more than 400% (Chart 4).

Chart 4

Development Charges Rising (L) and They are only a Portion of Government-related Housing Costs (R)



Source: CMHC, Altus Group, CIBC

The discussion so far suggests that supply issues are important determinants of house price inflation in the GTA. The obvious solution is to release more land and extend the build boundary. But that is unlikely to happen. Places to Grow is all about sustainability, and intensification is an important part of that, given transportation and other infrastructure limitations. While we do not expect significant action here, the province should reassess the proposal to raise current intensification and density targets. Additionally, the province should develop a consistent way to accurately measure current intensification activity by accounting for development in the inbuilt area that cannot be replicated and by adjusting its figures to reflect deviations from the original plan. Furthermore, municipalities should take action to assess and report their short-term land supply on a consistent basis. Additional pressure can be eased by instructing municipalities to fast-track the approval process.

Affordability Illusion Prevents Adjustment

While some things can be done on the supply front, we are doubtful that conditions will change in a meaningful way. At least in the short term, Places to Grow cannot be consistent with lower land prices.

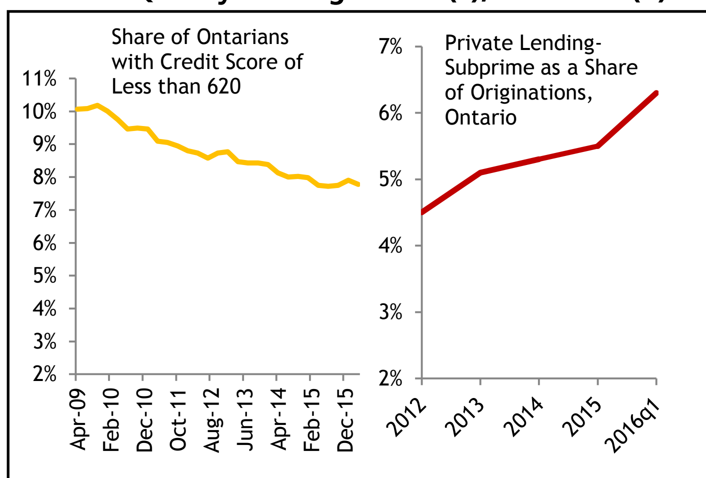
Now, low interest rates are not the reason for higher prices. They create the potential for prices to rise, and market conditions—led by supply factors—release that potential. The main impact of record-low rates is in preventing the normal process of behavioral adjustment associated with higher prices—the main factor behind the increased financial fragility of home buyers.

To the naked eye, things are still okay. Debt-service ratios are not climbing, mortgage delinquency rates are near record low and older Torontonians, in fact, have accelerated their debt payments. But behind the scenes, we are starting to see some cracks. For new mortgages, amortization periods are starting to rise, mortgage qualification criteria are becoming a bit more flexible, and there is some evidence of increased borrowing to finance down payments. A lot of this activity is happening in a less or non-regulated space. This has resulted in a transfer of risk from the regulated segment of the market to the unregulated segment—not exactly a zero sum game.

But none of this is very visible. Many observers point to the still healthy distribution of credit scores and the declining share of high-risk borrowers in Ontario and the GTA (Chart 5, left) as a sign that all is okay. While that is clearly good news, it does not cover what's happening at the margins. The credit bureau data does not cover private lending in the mortgage space. However, from

Chart 5

Is Credit Quality Getting Better (L), or Worse (R)?



Source: Teranet Inc., Equifax, CIBC

information obtained from the mortgage registry for the province of Ontario, it seems that the invisible portion of private subprime lending is continuing to rise—standing at north of 6% of the number of originations (Chart 5, right). Currently, the Alt-A/subprime share of more-established alternative lenders is at 4% and there is a rising share of non-conforming loans held by banks (due to changes in classification as instructed by the regulators). This indicates that alternative/non-conforming mortgage lending in Canada, while not even close to what can be seen in the US in the post-crisis era, is hardly trivial.

While those marginal borrowers will be the first casualties of higher interest rates, the main impact will be on today's prime borrowers. Given stretched qualification criteria, any increased allocation of income to mortgage payments could have a significant impact on overall consumer spending and economic growth. The longer this cycle continues, the more damaging higher rates will be.

So far, the government's main policy to curtail demand in the country as a whole has been via modifications to the insured segment of the market. The latest policy which increased down payments as a function of property prices was clearly aimed at tackling price inflation in the GTA and Vancouver. While using only demand tools to deal with a problem that is largely driven by supply is suboptimal, we believe that there is still some low-hanging fruit left. For the country as a whole, minimum down payments should rise to more than 10% for properties valued between $500k and $1 million. The qualification rate on the five-year fixed rate loan (accounting for more than 30% of originations) should be raised to be closer to the qualification rates of mortgages with shorter terms. Debt-service qualification ratios should be more enforceable and regulators should monitor developments in the subprime and alternative lending space more closely.

None of the above measures will be a game changer for the GTA. They will help at the margin. For a real and lasting change, the market must adjust to reflect today's elevated valuations more appropriately.

The Condo Market—A Stabilizing Factor

The reason behind these rising fragilities is that, due to low mortgage rates, the process of adjustment to the worsening affordability issue has been too slow.

By far, the largest and most visible adjustment process to date has been the surge in the supply of condo units in the GTA. The lack of new supply of ground-oriented units is very visible throughout the GTA with its share in housing starts falling from 51% in 2009 to the current 39% (Table 1).

Table 1

Changing Composition of Housing Starts—Not Only in Toronto

Type of Dwelling	Year	Toronto	York	Peel	Halton	Durham	GTA
Single & Semi	2009	8.4%	71.7%	45.8%	66.1%	74.6%	39.9%
	2015	7.2%	36.5%	46.8%	31.7%	55.7%	26.9%
Row	2009	3.6%	14.9%	15.7%	20.8%	18.4%	10.9%
	2015	2.6%	18.1%	19.5%	23.7%	18.3%	12.2%
Apartment & Other	2009	88.0%	13.5%	38.5%	13.2%	7.0%	49.2%
	2015	90.2%	45.5%	33.8%	44.6%	26.0%	60.9%

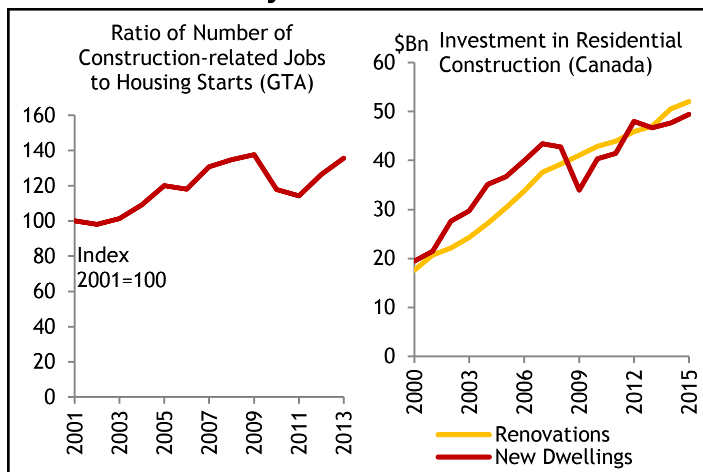
Source: CMHC, CIBC

This dramatic change in composition of housing construction in the region is having a significant impact on the building industry. Most notable is the negative impact of the lack of supply of land on relatively small builders (100-200 units a year). Builders are facing increased difficulties as they do not have new projects, production-scaling capabilities or the know-how to switch to condo developments. As well, the switch from low-rise construction to high-rise construction should lead to reduced demand for labour since condo construction is less labour intensive. But, as illustrated in Chart 6, this has not been the case, with the ratio of construction-related jobs to housing starts in fact rising. This can be explained in part by increased demand for workers in the renovation market where total spending on renovations, in fact, exceeded investment in new dwellings last year—another form of adjustment to rising prices.

There is little doubt that, from an affordability perspective,

Chart 6

More Construction-related Jobs Helped by Escalating Renovation Activity



Source: Statistics Canada, CMHC, CIBC

the surge in the supply of condo units, not only in Toronto where they account for close to 90% of starts, but also in regions such as York and Halton, acted as an important stabilizing force. As illustrated in Chart 7, the price gap between detached houses and condos has reached an all-time high in both the 416 and 905 regions.

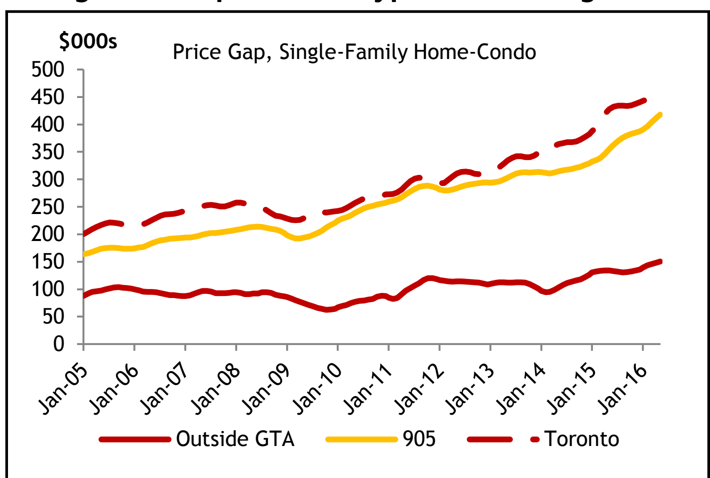
While in absolute terms, the condo scene in the GTA appears to be excessive with no less than 20,000 units scheduled to be completed in the coming year, that figure makes a lot of sense when assessed in the context of the dramatic decline in the supply of ground-oriented units. As illustrated in Chart 8, at this point the condo market appears to be relatively stable with supply and demand conditions supporting annual price inflation of a moderate 4% per square foot. Also note that the average project size is no longer rising with the number of units per condo building stabilizing (Chart 9). Based on what's in the pipeline, we believe that the average project size will, in fact, fall in the coming years.

Searching Farther Afield

But evidently, a condo unit is not for everybody. Many priced-out millennials in search of a single-detached house simply take to the highway and start driving away from Toronto, not stopping until they find something that they can afford—in the suburbs and farther afield (Chart 10). While for regions such as York, the Toronto premium is almost nil—as the median price has risen twice as fast as in the city of Toronto over the past year—in other GTA regions, the premium has fallen or stabilized (Chart 11). Beyond the GTA where the premium is significant, there are early signs that price increases are more or less in line

Chart 7

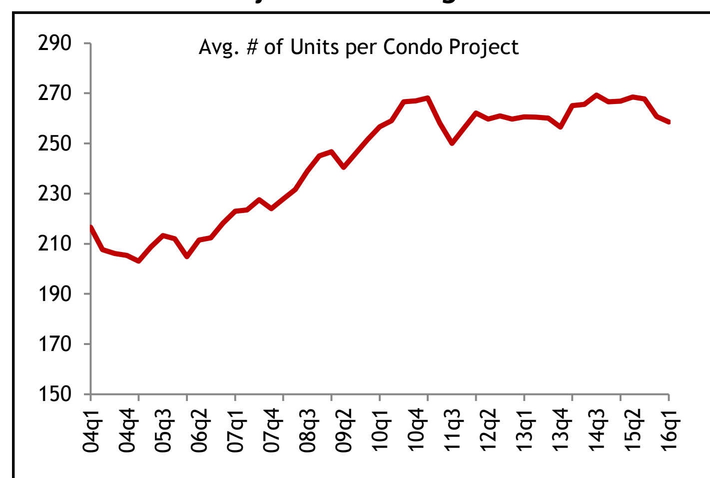
Rising Price Disparities in Types of Housing in GTA



Source: Brookfield, CIBC

Chart 9

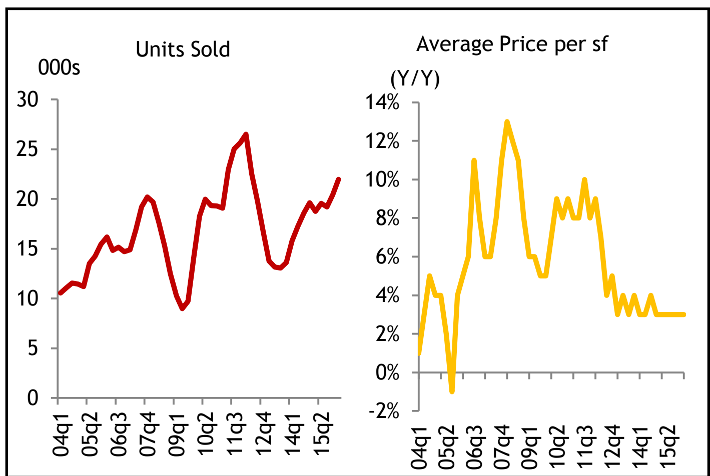
Size of Condo Project Stabilizing



Source: Urbanation, CIBC

Chart 8

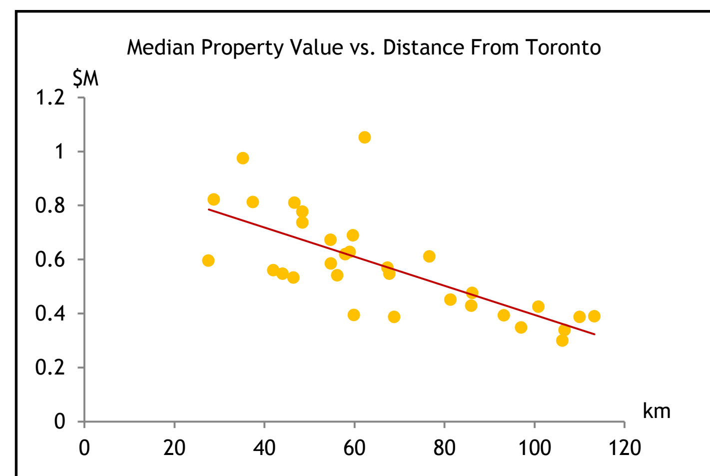
The GTA Condo Market—So Far, So Good



Source: Urbanation, CIBC

Chart 10

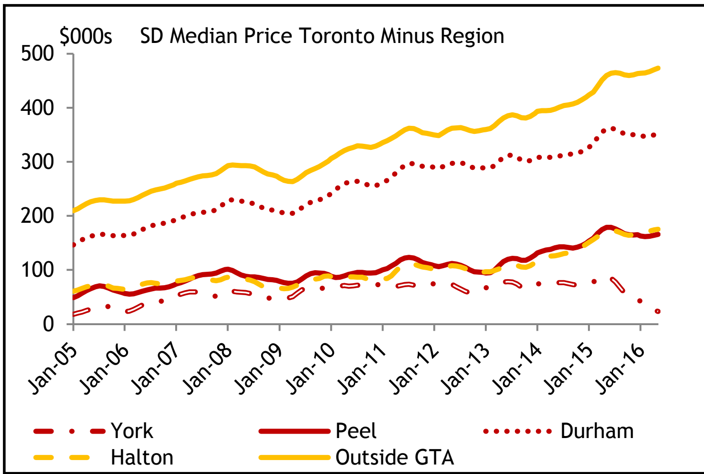
It's Worth the Drive to...



Source: Brookfield, CIBC

Chart 11

The Toronto Premium



Source: Brookfield, CIBC

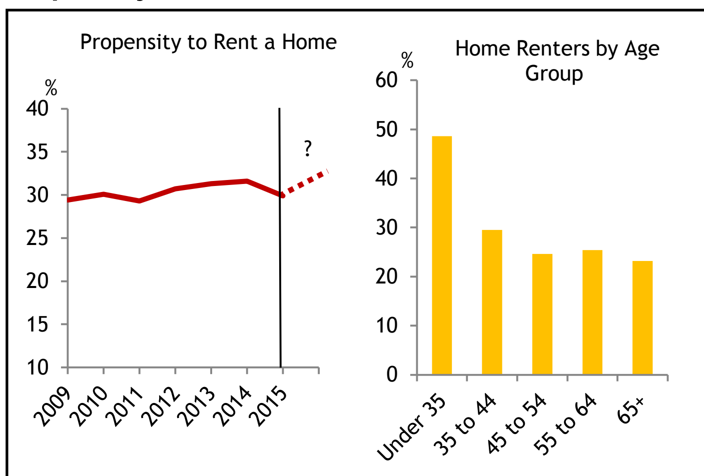
with what we see in Toronto—rising on average by close to 9% over the past year as cities such as Barrie, Innisfil and Bradford West Gwillimbury witnessing double-digit price appreciation. While the need to commute to Toronto is a major obstacle, the rising trend of telecommuting will make this alternative more attractive and doable in the coming years, providing an additional pressure relief valve to the GTA's housing market.

The Rental Market—Early Signs of Adjustment?

The most significant impact of the changing composition of housing supply has been on the rental market. While we all hear about the tight rental market in the GTA, the reality is that the propensity to rent in the GTA did not rise in recent years in a way that is consistent with the rapid pace of house price appreciation (Chart 12) . Again, there is no doubt that low rates turn many potential

Chart 12

Propensity to Rent in the GTA Should Rise Soon



Source: Financial Monitor, CIBC

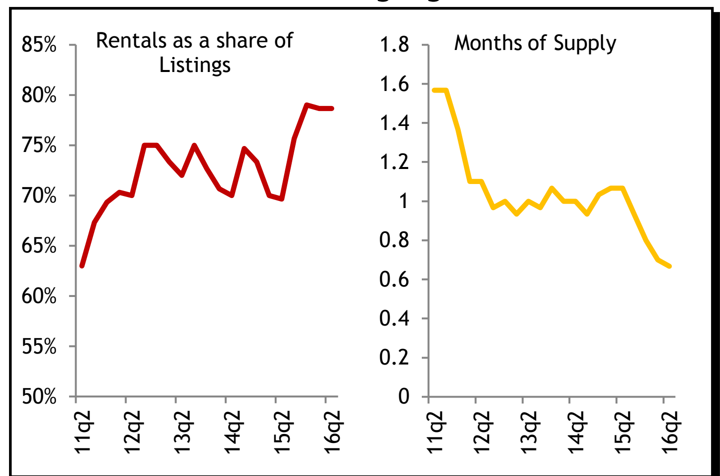
renters into home buyers. And that's where the GTA market has been slow to adjust. In many ways, the GTA's rental market can be characterized as a twilight zone of home prices that require a higher propensity to rent and a homeownership mentality that is slow to change.

But things are starting to change. If the rental market was tight, it is getting even tighter by almost every measure. The number of rental units as a share of listings is now hovering at around 80%—10 full percentage points above the level seen a year ago, with months of supply falling by more than 20% in the past year (Chart 13).

It is no surprise, then, that rent is on the rise with both rent per unit and rent per square foot rising by close to 5% on a year-over-year basis (Chart 14). This convergence of rent measures is significant. Over the past few years, rent

Chart 13

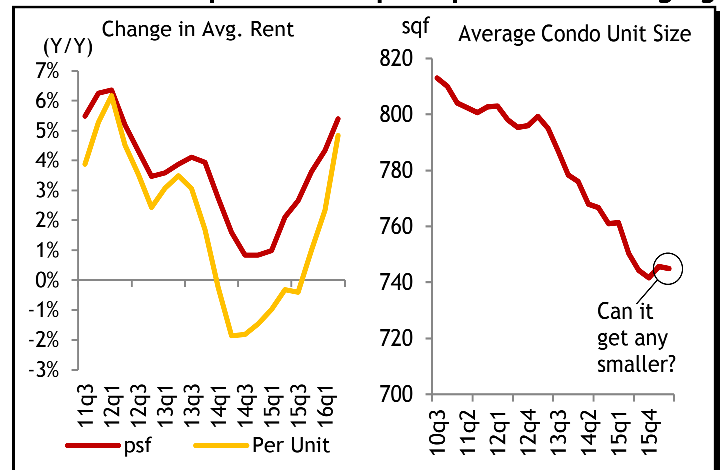
GTA Rental Market: Getting Tighter



Source: Urbanation, CIBC

Chart 14

Rent Increases per Unit and per Square Ft. Converging



Source: Urbanation, CIBC

per square foot rose faster than rent per unit, reflecting the dramatic decline in the average unit size. But there are early signs that the average unit size is stabilizing, in part reflecting an increase in the share of larger and more expensive units starting to rise. Over the past year, the share of units leased for more than $2,000 a month rose from 20% to almost 30% while the share of units leased for $1,600 or less fell from 43% to 31%.

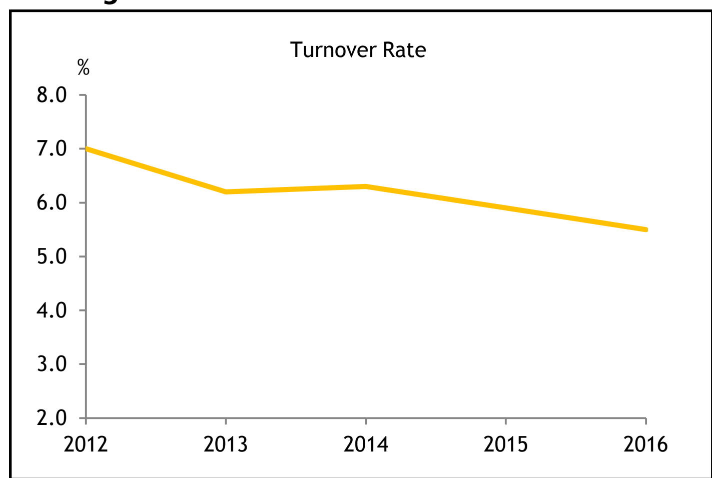
Furthermore, the turnover rate in the market is on a decline (Chart 15), standing today at 5.5%—notably below the 7% seen in 2012. These two important developments (more expensive rentals and reduced turnover rate) might be early signs of a market starting to adjust to the price reality of the GTA, with renters taking a longer-term view not seen before in the region.

These changing dynamics might be the reason behind the recent entry of deep-pocketed investors such as pension funds into the purpose-built space. Until recently, the condo market was, in fact, the rental market. Now, however, the share of purpose-built units is rising. In 2016, purpose-built is projected to amount to north of 2,000 units or 18% of total new supply. That additional supply will help bring the market into a more balanced position (Chart 16). But if we are right and the propensity to rent is about to rise, we will need even more supply to prevent lease prices from rising even further.

We believe that purpose-built should play an increasingly important role in advancing the adjustment process the market desperately needs. Municipal policies should encourage this by providing tax incentives to these developments. Specifically, development charges on purpose-built projects should be lowered. Furthermore, current rent control regulations should be updated and adjusted to increase rental supply flexibility. Municipalities should also incentivize purpose-built projects to allocate a larger share to larger units, to accommodate young families and the growing share of seniors in the rental market.

Chart 15

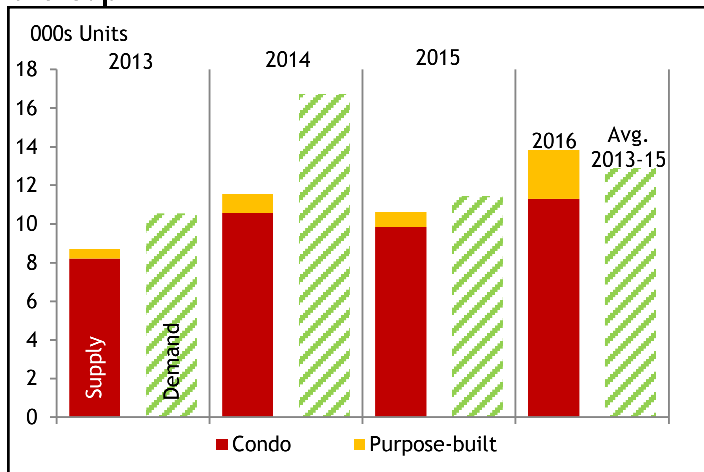
Falling Rental Turnover Rate Suggests Long-term Renting on the Rise



Source: Urbanation, CIBC

Chart 16

GTA Rental Market: Purpose-built Starting to Close the Gap



Source: Urbanation, CMHC, CIBC

How Should Foreign Buyers be Dealt With?

Of course you cannot discuss the condo and the rental markets without saying something about the role of foreign investment. Foreign buyers are not the chief cause of rising house prices in the GTA, but their impact is not trivial. We estimate that foreign buying currently accounts for 5% of transactions in the GTA with an additional 10% of demand coming from a satellite-type situation in which the money comes from abroad but the unit is occupied by a relative (spouse, student, etc.) who resides here. Those estimates are based on conversations with developers and agents, but at the end of the day, they are nothing more than a guess.

But do we really need to know the exact number of foreign buyers before acting? Delaying action will make the situation even worse, as we expect more foreign money to enter the GTA in the coming few years. In an earlier report, we suggested a flipping tax on foreign buyers as a start. We also support an empty unit tax. Increased land transfer tax on property beyond a certain value might also be a step in the right direction. Limiting foreign buying only to new developments should also be considered.

The future trajectory of the GTA's housing market is not written in stone. It is largely a function of the ability and willingness of the market to adjust to high and rising valuations. The most obvious and effective remedy should come from the supply side of the equation as a lack of serviced, ground-oriented land continues to put upward pressure on prices. In reality however, we expect very little change here as current (and potentially future) intensification policies are likely to keep land supply highly inelastic.

So we are in a position in which demand tools are being used to tackle a problem that is driven largely by supply forces. Current low interest rates are not the reason for house price inflation but they release the potential for higher prices caused by inelastic land supply. While higher interest rates are not in the cards anytime soon, there is still some low-hanging policy fruit left. Those include higher down payments, some modifications to qualification criteria as well as a version of taxation on foreign investment . At the same time, policy makers should pay much closer attention to the alternative lending segment of the market that continues to gain market share.

By far, the most effective demand adjustment must come from the rental market. The current propensity to rent in the GTA is still too low given the affordability issue facing the region. Recent figures suggest that we might be in the early stages of change on that front as we expect the propensity to rent to rise in the coming years. That added rental demand should be accommodated increasingly by the purpose-built segment of the market. That adjustment is crucial for the future health of the GTA's housing market. With interest rates unlikely to rise materially anytime soon, there is enough time for that adjustment to unfold. In fact, developments in the rental market in the coming years will determine the nature and severity of the adjustment in the region's housing market when it is eventually tested.

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