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CMHC
Canada Mortgage
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SCHL
Société canadienne
d'hypothèques et de logement

AN ANALYSIS OF THE MARKET
FACTORS BEHIND THE HIGH
ARP DEFAULT EXPERIENCE

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Canada

Market Forecasts and
Analysis Division

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1. INTRODUCTION

The focus of this paper is the extent to which market factors contributed to the high rate of ARP defaults over the last few years, with particular reference to Quebec. To place the Quebec situation in context, the paper also examines the experience of other areas.

2. THE PRESENT SITUATION

The default experience under ARP has been similar to that of AHOP, both in the relatively high rate of claims and in the geographical concentration of these claims. While over 50 per cent of all AHOP claims occurred in Ontario, ARP claims occurred primarily in Quebec. As of March 31, 1980, 78.3 per cent of the 6,741 ARP units acquired by the Mortgage Insurance Fund were in Quebec (see Appendix A).

While in absolute terms, the bulk of ARP defaults was in Quebec, the highest default rate occurred in Saint John, N.B. where they represented 28.9 per cent of all ARP loans. However, as Table 1 illustrates, the default rate in other parts of New Brunswick was nil.

One may be tempted at this point to abstract from the experience in the Province of Quebec and in Saint John, N.B., re-calculate the default rate in the other regions of Canada and argue that the high incidence

TABLE 1.

THE ASSISTED RENTAL PROGRAM

Projects (loans) Acquired by the Mortgage Insurance Fund
to 31 March 1980

Province	ARP Loans Approved	MIF Acquisitions	
		Number of Loans	Percent of Approvals
Quebec	914	70	7.7
Montreal	497	47	9.5
Rest of Province	417	23	5.5
New Brunswick	77	13	16.9
St. John	45	13	28.9
Rest of Province	19	-	-
Sub Total	991	83	8.4
Ontario	406	7	1.7
B.C.	329	5	1.5
Sub Total	735	12	1.6
Newfoundland	30	-	-
P.E.I.	20	-	-
Nova Scotia	71	-	-
Manitoba	84	1	1.2
Saskatchewan	134	-	-
Alberta	126	-	-
Yukon and N.W.T.	6	-	-
Sub Total	471	1	0.02
CANADA	2,197	96	4.4

of ARP defaults in Quebec and Saint John was solely due to particular local market conditions. However, as Table 1 reveals, default rates in Ontario and B.C. also warrant close scrutiny. While default rates in Ontario and B.C. appear low in relation to those in Quebec and New Brunswick, one should not overlook the fact that default rates of 1.5 and 1.7 per cent are high in historical terms. In addition, unlike New Brunswick, where defaults are concentrated in one city, Ontario and B.C. experienced claims from diverse geographical locations, indicating that factors other than local market conditions, and perhaps factors common to the two provinces were contributing to these defaults.

3. DEMAND AND SUPPLY IMBALANCES

This section focuses on the geographical areas where ARP defaults were highest. As Table 1 showed, these areas were Montreal as well as the Province of Quebec in general, and Saint John, New Brunswick. The objective of this section is to identify the factors which operated at the local market level and contributed to ARP defaults in those areas.

3.1 THE RENTAL HOUSING MARKET IN MONTREAL

In the first half of the 1970's, the demand for new rental housing averaged 18,700 units per year while only 14,000 units were being supplied per year. As a result the Montreal rental market experienced increasing tightness. This demand for new rental housing resulted in part from the large expansion of employment in the province, reaching as high as 125,000 net new jobs created in 1973. The average annual growth in employment opportunities between 1970 and 1976 was 55,000 jobs. These favourable economic circumstances were associated with a dramatic turnaround in migration patterns. Rather than

experiencing a net outward movement of population in the order of 41,000 per year the situation was one in which there was an actual net population gain of 4,000 between June 1974 and May 1975.

With Montreal accounting for nearly 50 per cent of the province's population and labour force, the tremendous demand pressure pushed rental vacancy rates down from 8.2 per cent in 1970 to only 0.6 per cent in April 1976. The reinstatement of the special Capital Cost Allowance provisions in late 1974 helped to increase apartment starts in 1975 by about 10 per cent over the very depressed 1974 level. The 1974 level of apartment starts was 40 per cent lower than 1973 starts. Even the 1975 level of production was insufficient to accommodate unsatisfied and new demand.

The supply-demand imbalance however was not peculiar to Montreal as the average vacancy rate across Canada in April 1976 was only 1.1 per cent. In an effort to stimulate the supply of rental housing, the grant-ARP program was introduced in 1975. In 1976 it was replaced by the loan-ARP program. In consideration of the fundamental tightness in the Montreal rental market, ARP assistance further improved the financial viability of rental investments in spite of the rather informal rent controls.

Apartment construction in Montreal responded rapidly. Starts climbed to 22,500 units in 1976, a 74 per cent increase over 1975 starts. This level of starts was considered appropriate in light of the projected 18,000 units of current demand; a 4,000 unit backlog demand; and the restoration of the vacancy rate to a normal level of around 3.5 per cent.

Owing primarily to the end of the construction boom caused by the Olympics, economic conditions worsened in Quebec in 1976. Employment growth stagnated with a net loss of 23,000 jobs in 1977. In addition, after the election of the Parti Québécois in November 1976, net outflows of population from Quebec accelerated from 9,600 between June 1976 and May 1977 to 54,000 between June 1977 and May 1978 before recovering to 40,300 in the following 12-month period. In all likelihood, a large proportion of migrants were from Montreal.

It is estimated that the reduction in job creation coupled with the acceleration of out-migration translated into a drop in rental demand from an average of 18,700 units per year during the first half of the 1970's to 8,800 units in 1976, 4,500 units in 1977 and 5,200 units in 1978.

The upsurge in apartment starts pushed completions up from 12,500 units in 1976 to 18,600 units in 1977 and 16,200 units in 1978. The volume of supply believed appropriate in 1976 suddenly became a surplus. Vacancy rates in Montreal rose rapidly, reaching 5.5 per cent in October 1978. Furthermore, since new units are extremely vulnerable in soft markets because of their high full recovery rent structure, their profitability was reduced markedly. The occupancy rate in new projects was reported to be around 48 per cent and in April 1980, the rate fell as low as 27 per cent.

3.2 ARP DEFAULTS IN THE REST OF QUEBEC

With the exception of the period from June 1974 to May 1975, Quebec has been losing population through migration flows. During the first half of the 1970's the net out-migration declined as economic conditions improved markedly. However, in 1976 net migration began to

increase significantly as economic conditions worsened and because of political developments in the province. Political developments in 1970 and 1976, in part triggered a respective net loss of approximately 41,800 in 1970-71 and 54,100 in 1977-78. As the following table illustrates, net migration has a significant impact on the demand for housing and the vacancy rate.

COMPONENTS OF INTERNATIONAL AND INTERPROVINCIAL MIGRATION, QUEBEC,
1970-71 TO 1978-79 (June to May)

	<u>Net International</u>	<u>Net Interprovincial</u>	<u>Total</u>	<u>Montreal Vacancy Rate</u>
70-71	- 2790	-37995	-40785	8.2
71-72	2714	-20461	-17747	7.2
72-73	4498	-20072	-15574	2.9
73-74	13149	-15136	- 1987	3.8
74-75	13424	- 9299	4125	1.2
75-76	11600	-12642	- 1042	0.7
76-77	13395	-22996	- 9601	1.3
77-78	- 7217	-46905	-54122	3.6
78-79	- 8159	-32110	-40269	5.5

3.3 THE RENTAL HOUSING MARKET IN ST. JOHN, N.B.

Except for the demographic forces which operated in Quebec but were not present in New Brunswick, the high level of ARP defaults in Saint John was created by the same elements which contributed to high defaults in Montreal. Faced with tight rental market conditions

(the vacancy rate in St. John stood at 0.6 per cent in 1975) and attracted by the MURB and ARP benefits, investors in Saint John rushed into rental housing in 1975. The production of apartment housing (starts) which had averaged 444 units between 1970 and 1974, climbed to 1,133 units in 1975. In 1976 another 791 units were started in Saint John. This is illustrated in Table 2. The sharp increase in production had a pronounced effect on vacancy rates which jumped from 0.6 per cent in 1975 to 7.9 per cent in 1976 and 8.3 per cent in 1977. The significant increase in vacancy rates in turn had an adverse impact on the profitability of rental housing, and as in Montreal, the first to be hit in Saint John were ARP units because of their high rent structure.

4. OTHER FACTORS AFFECTING ARP DEFAULTS IN MONTREAL AND SAINT JOHN

Apart from the factors discussed above, several other factors could have contributed to the high ARP default rates in these areas.

The differential between average market rents and the average rent of new ARP units offered on the market was relatively greater in Montreal and Saint John than in most other cities (Table 3). Because of over-supply, and the rents required on new ARP units, ARP investors in these two cities had to face vacancy rates higher than anticipated.

TABLE 2

LOCAL MARKET INDICATORS

VACANCY RATES (PER CENT)

	ARP Defaults (%)	1975	1976	1977	1978	1979
Montreal	9.5	0.7	1.3	3.6	5.5	4.5
Saint John	28.9	0.6	7.9	8.3	5.4	3.7
Toronto	1.5	1.8	1.2	1.0	0.8	1.2
Vancouver	-	0.1	0.7	1.6	1.4	0.2
All Met. Areas	N.A.	1.2	1.3	2.3	3.2	2.9

HOUSING STARTS (APARTMENT AND OTHER)

	Ave. 1970-74	1975	1976	1977	1978	1979
Montreal	14,790	12,896	22,477	16,355	8,513	6,279
Saint John	444	1,133	791	60	-	-
Toronto	20,640	10,777	9,672	12,279	12,493	6,022
Vancouver	7,422	4,869	6,114	7,082	3,555	3,523
All Met Areas	78,355	50,530	65,556	69,514	56,741	37,238

It does not appear that ARP defaults in Montreal and Saint John were caused by a failure of market rents to rise rapidly enough to cover increasing costs. In fact, during the 1975-1979 period, rent increases in Montreal and Saint John were greater than in a number of other cities where no ARP projects defaulted.

5. ARP DEFAULTS IN ONTARIO AND B.C.

Ontario and B.C. are similar in terms of both ARP and AHOP activity and default rates (ARP defaults: Ontario 1.7%, B.C. 1.5%; AHOP defaults: Ontario 7.9%, B.C. 8.0%) and in terms of provincial government stacking benefits on these programs. To the extent that provincial stacking of benefits permitted marginal ARP investors to supply units which otherwise would not have been viable investments with ARP federal assistance alone, it may have contributed to defaults in Ontario and B.C. In addition ARP defaults are not independent of the production of other types of dwellings offered on the market during the peak years of ARP production. AHOP production to a large degree competed with ARP units. This factor was particularly significant in all three provinces.

TABLE 3

COMPARISON BETWEEN AVERAGE MARKET RENTS AND
AVERAGE RENTS CHARGED PER NEW ARP UNITS

	Average ⁽¹⁾ Market Rents (A)	Average Rents Charged ⁽²⁾ Per New ARP Units (B)	(B)/(A)
Montreal	152	298	1.96
Saint John	141	231	1.64
Toronto	243	320	1.32
Vancouver	233	264	1.13

(1) Statistics Canada, July 1977

(2) CMHC mortgage approval file, as at July 1977.
See "An Evaluation of the Federal Assisted
Rental Program (1976-1977)", Irwin Lithwick,
CMHC, February 1978.

6. FACTORS INFLUENCING FUTURE ARP DEFAULTS

Two major factors will affect ARP default rates in the short and medium term. These factors are:

- (i) problems that ARP investors may face when their mortgage becomes due for renewal; and
- (ii) the problems that ARP investors might face if vacancy rates were to increase again, in the next two years. Should the federal government initiate any major subsidy measure to stimulate the construction of rental housing in the next two years, efforts should be made to introduce only measures which could be appropriately targetted to specific market areas.

APPENDIX A

THE ASSISTED RENTAL PROGRAM

Dwelling Units Acquired by the Mortgage Insurance Fund
to 31 March 1980

Province	ARP Units Approved	MIF Acquisitions		
		Units	Percent of Approvals	% Dist. of Units
Newfoundland	1,502	-	-	-
P.E.I.	240	-	-	-
Nova Scotia	3,485	-	-	-
New Brunswick	1,595	204	12.8	3.0
St. John	634	204	32.2	3.0
Rest of Province	961	-	-	-
Quebec	33,004	5,283	16.0	78.4
Montreal	21,990	4,199	19.1	62.3
Rest of Province	11,014	1,084	9.8	16.1
Ontario	40,222	901	2.2	13.4
Manitoba	7,643	70	0.9	1.0
Saskatchewan	5,989	-	-	-
Alberta	11,447	-	-	-
B.C.	15,901	283	1.8	4.2
Yukon and N.W.T.	276	-	-	-
CANADA	121,304	6,741	5.6	100.0