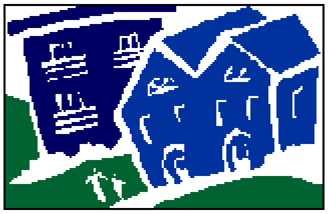
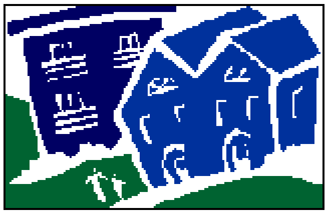


Rental Housing Trends in British Columbia

Rental Housing Trends in British Columbia
The supply of rental housing is a major issue in British Columbia as many parts of the province continue to have some of the lowest vacancy rates and least affordable rental housing in the country. The experience of renters in the province is affected by the ability of the rental market to respond to continued demand. Because new conventional rental supply has been largely unprofitable for developers and unaffordable to renters in recent years, many of the rental units that have been added to the stock have been secondary suites or investor-owned condominiums. The purpose of this paper is to examine rental housing supply, household demand trends, and rental housing financing, and to explore the relationship between these factors in British Columbia.

Conclusion
High land and development costs and the higher returns available from condominium construction will continue to be the major factors discouraging investment in new formal rental supply, especially in the growing population centres of the Lower Mainland, the Fraser Valley, the Okanagan, and southern Vancouver Island. Despite strong growth in the number of households, market rent levels and especially renter incomes are not high enough to support costly new construction in the formal rental sector.

Much of the demand, instead, is being met by the addition of non-conventional rental units. This trend is giving new housing options to many renters, creating a burgeoning class of small landlords, and pushing the bounds of conventional policies affecting rental housing. These market shifts confront all levels of government with challenges in the areas of building codes, zoning bylaws, enforcement strategies, housing program design, research and data collection needs, the regulation of rental market practices, and the demand for and financing of municipal services



Rental Housing Trends in British Columbia

Part 1: Rental Housing Supply and Demand Trends

Data for all provinces show that British Columbia is home to the lowest vacancy rates and some of the highest rents in Canada. CMHC figures for April 1995 show urban British Columbia with a vacancy rate of 2.3 per cent. The national average is 4.2 per cent. The province's largest city, Vancouver, has a vacancy rate of just 1.3 per cent. Other municipalities with vacancy rates consistently at or below the provincial average include Port Alberni, Salmon Arm, Squamish, and Terrace. Average rent data by city indicate that, for each size of apartment, Vancouver and Victoria are two of the four most expensive Canadian cities in which to rent. After Vancouver and Victoria, even the growing cities of Kelowna and Abbotsford have higher rents than any metropolitan area outside of southern Ontario.[1]

Tight Rental Market
High rents might not be a problem if the incomes of renter households were correspondingly high. High incomes offset high rents in Toronto and Ottawa-Hull, so that these two cities have a relatively low proportion of renters with affordability problems (defined as paying more than 30 per cent of income for rent). This is not the case in Vancouver and Victoria, which lead the country in the percentage of renters with affordability problems (41 and 44 per cent respectively).[2]

The tight housing market is due in large part to British Columbia's strong economy. Economic opportunities spur strong in-migration from other provinces and other countries, but natural increase among the current population is also an important component of the province' s population growth. British Columbia has gained more than one million people since 1980.

The key measure of housing demand is not strictly population, but households; on top of the sheer growth in the numbers of British Columbians is a trend toward smaller households. The average number of people living in each household dropped from 3.4 in 1961 to just 2.6 in 1991. Put differently, even if British Columbia' s population had not changed at all in that period, demand for housing would have grown by about one-third just because of declining household size.

Supply Response
Nonetheless, attributing low vacancy rates and high rents to strong demand begs the question of why there has not been a larger supply response. Why haven't more rental units been built to meet the demand? Low vacancy rates and high rents are supposed to be the signals to trigger a market response to increase supply. New supply should gear up to satisfy the demand until vacancy rates and rents return to normal levels.

Yet in the last 15 years, conventional rental housing construction[3] by the private sector has declined in British Columbia. Since 1988, conventional rental housing construction has been relatively stable at approximately 2,000 units per year.[4] At the same time, British Columbia has added an average of 10,000 new renter households each year in the first half of the l990s. This gap in supply has been filled largely by the growth in non-conventional units, mainly secondary suites and investor-owned condominiums.

The decline in conventional rental housing production in the 1980s might be explained in part by the severe recession early in the decade and relatively high interest rates. But in the l990s, while construction of housing for owner-occupants is booming again, rental construction has remained low despite strong migration to the province, low vacancy rates, low interest rates, and an absence of any regulation on rents (see Graph 1). All of these conditions, theoretically, should have stimulated investment in new rental supply.

Graph 1:(6.5K) Housing Completions, Province of B.C., 1980-1994

Instead, rental markets have remained tight in many areas of the province throughout the early '9Os, with the Lower Mainland in particular seeing gradually declining vacancy rates. The vacancy rate (shown in Graph 2) for all urban areas in the province stands at 2.3 per cent in April, 1995.

Graph 2:(8K) Rental Vacancy Rates vs. Average 2BR Rents, Urban B.C., 1984-1985

Factors Constraining Supply

There are several reasons for this apparent lack of a supply response. The main problem in recent years has been the lack of profit in building new rental housing. The costs of development are high, because of:

- high land costs, especially in the Lower Mainland and southern Vancouver Island. After falling in the early 1980s, land costs rose 70 per cent in the Vancouver Census Metropolitan Area (CMA) and 125 per cent in the Victoria CMA between 1984 and 1994 (see Graph 3).
- a lack of suitable land for building, which places further upward pressure on land prices and pushes up development costs. The supply of land for development is limited by municipal zoning and other regulations, geographical barriers such as mountains and water close to key urban areas, and protection of land for parks, forest and agricultural reserves.
- rises in interest rates, which increase costs to developers and owners.

Graph 3:(5K) Land Component of the New House Price Index, Vancouver & Victoria, 1984-1994

Still, high costs have not restricted single family, townhouse, and condominium construction in the same way. Housing demand is a function not just of how many households there are but what they are able and willing to pay. While rents have been free to rise, they cannot rise out of proportion to the incomes of households. In fact, census data show that between 1980 and 1990 the average gross rent in the province rose by 78 per cent while the average income of renters rose 79 per cent. It is important to note, however, that in 1981 Vancouver and Victoria were already among the four CMAs with the highest ratios of gross rent to average renter income. This continues to be true for 1991.

Income Distribution Constrains Demand

Average incomes can also mask different trends at opposite ends of the income spectrum. National data show that, while average incomes for the highest income quintile (one-fifth of the population) rose by $6,447 in constant dollars between 1978 and 1986, they fell for the three lowest quintiles. And although the overall rate of home ownership has remained remarkably steady, renters are increasingly concentrated in this lower end of the income spectrum. In 1967, 38 per cent of households in the lowest income quintile were renters; by 1986 this had risen to 66 per cent. This trend has led to the characterization of the private market as a "residual sector," home mainly to those Canadians who have no choice because they cannot afford to own their own home.

Not surprisingly, the ability of renters to afford housing in British Columbia has slipped relative to owners. The ratio of the average income of renters to that of owners fell from 60.3 per cent in 1981 to 58.9 per cent in 1991. Over the same period, the percentage of owners with affordability problems fell from 17.8 to 14.4 per cent, while the percentage of renters with affordability problems rose from 36.4 to 39.7 per cent.5 The relatively low incomes and greater affordability problems in the rental sector are linked to the growing number of single-person households. Single-person households have fewer earners (and hence lower incomes) than other households, tend not to be in their peak earning years, and are roughly twice as likely as other households to be renters.

Profitability of Development

In short, these demand considerations have meant that, in most urban locations in the province, the monthly mortgage and operating costs (the "economic rent") of providing a new rental unit are greater than renters can afford or are willing to pay. The rent that the market will support in a new project is limited not only by the incomes of renters, but also by competition from existing rental buildings and the attractive alternative of buying a home. It has proven much more profitable for developers to build and sell condominium units than to stay in for the much longer term it generally takes to make money on a rental property. Condominium construction has effectively crowded out rental construction in many areas by taking up much of the land zoned for multiple unit development.

In constant dollars, rents have generally remained stable since 1984, and annual rent increases have been very low recently. With these stable rents and high development costs, investing in new, purpose-built rental housing provides insufficient profit for most developers. CMHC estimates that, at the rents it would be able to charge, a new apartment building in Victoria could generate a positive cash flow of only 0.7 per cent per year.6 This rate of return is much too low to attract developers and investors who also have other investment opportunities. The continuation of a viable private rental market as a source of new rental units is in doubt due to the upward cost pressures on supplying a rental unit and the downward trend in the income profile of renters.

Graph 4:(5K) Renter and Owner Incomes in B.C., 1980-1994

Non-Conventional Supply

Fortunately, the market has found other ways to respond. Tight rental market conditions have given rise to an important and growing supply of non-conventional rental housing units, including secondary suites and rented condominiums. The number of secondary suites in the province is estimated to be as high as 100,000, with another five to 10 per cent in rented condominiums. Such units do not show up in official rental housing completion statistics, but are becoming critical in relieving some of the demand pressure and helping the existing housing stock adapt to the decline in household size.

The fact that the growth in renter households far exceeds the number of new purpose-built rental completions is clear evidence that the majority of new rental units are being supplied by non-conventional sources. One detailed study of rental housing in Vancouver7 found that, of approximately 38,700 rental units added between 1985 and 1989:

- 3,100 were considered private conventional supply;
- 7,100 were government funded;
- 10,000 were secondary suites; and
- 18,500 were rented houses or condominiums owned by individual investors.

Another study suggested that the number of secondary suites in Vancouver had grown from 6,000 in 1976 to 26,000 in 1986.8 While data are scarce, this shift in the rental market to a predominantly non-conventional supply is likely to be accompanied by a trend away from professional landlords owning and managing large numbers of units. A survey of suppliers of non-conventional rental units in Vancouver found that 75 per cent owned only one rental unit, and 90 per cent owned four or fewer. Not surprisingly, almost 90 per cent had full-time employment in some other occupation. Individuals comprised 45 per cent of the investors, and those investing jointly with relatives accounted for another 46 per cent.

Consequences of Market Changes
This shift in the rental market has significant implications for individuals and government. On the positive side, rented houses and secondary suites may give renters more choice in the type of available accommodation. For families in particular, such ground-oriented housing may be more appealing than apartment living. Rents are likely to be lower than for newly-built units, since individuals with existing mortgages and some equity are unlikely to demand the same returns as would professional investors using new debt financing.9 Secondary suites benefit individual homeowners by helping with mortgage costs.

Adding secondary suites may also ensure the existing housing stock and infrastructure continues to be utilized at close to full capacity. With declining household sizes, houses with secondary suites may be serving the same number of occupants for which they were originally designed. Better use of existing resources is particularly important when developers and municipalities alike are having trouble keeping pace with the province's population growth and pressures for urban sprawl.

The rise in the number of condominiums available for rent helps to increase housing diversity, and provides opportunities for renters in buildings that are primarily owner-occupied. It also means that newer units are being added to the rental stock, which otherwise tends to be 15 years old or more. The possibility of purchasing a condominium to rent out brings small investors into the market, creating another source of housing capital.

There are also several challenges presented by these changes in the rental market:

- recognizing secondary suites as a critical component of the existing supply of rental housing;
- ensuring that existing secondary suites meet adequate health and safety standards;
- adapting regulations, such as building codes, developed for multi-family apartment buildings to apply to non-conventional rental units;
- revamping data sources to better reflect the current housing market;
- supporting the growing number of non-professional landlords with small holdings;
- facilitating effective communication and business practices in rental transactions so that both renters and landlords are treated equitably;
- recognizing that investor-owned condominiums are vulnerable to being sold into the home ownership market at any time; and
- countering NIMBY (not in my backyard) reactions in some condominium buildings, which limit the number of units that can be rented, and frequently restrict occupancy to adults only.

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1 Data from *Housing Information Monthly*, November 1994, and *Rental Market Report: British Columbia*, November 1994. CMHC and various CMHC press releases in May 1995. Return

2 "Housing Affordability Problems Among Renters", *Canadian Social Trends*, Spring 1995. Return

3 Refers to purpose-built, private market rental completions. Non-market rental completions, such as non-profit or co-operative housing, are not included. Non-conventional units, such as condominiums and secondary suites, are also excluded. Return

4 This development activity in the early 1980s was stimulated in part by several rental supply programs that promoted private rental construction. In 1989 the province introduced the BC Rental Supply Program, which provided interest rate reductions to encourage private rental construction. From its inception through mid-1992, the program subsidized the construction of over 4,100 units. This represents a sizable share of total rental completions this period. Return

5 "Focus on BC: Housing Affordability", BC Stats, May 1994. Return

6 Victoria Rental Market Report, CMHC, October 1994, p.4. The estimated return on equity is based on 75 per cent financing at a rate of 9.875 per cent, and land and building costs as of October 1994. It assumes the developer has secured a suitable zoned site. Return

7 *Rental Housing: A Study of Selected Local Markets*, CMHC and BCHMC, 1991. Return

8 "The Housing Crisis: The Effects of Local Government Regulation", W.T. Stanbury and John D. Todd. 1990. Cited in the CMHC/BCHMC study mentioned in note 7. Return

9 Half of owner-occupied dwelling in British Columbia have no mortgage. CMHC Core Housing Need Data Base. 1991. Return

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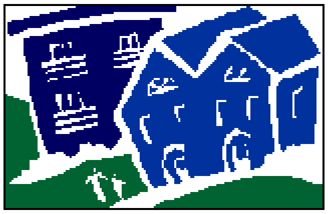

Rental Housing Trends in British Columbia

Part 2: Rental Housing Finance

The large capital investment involved in housing means that interest rates and the cost of borrowing can play a pivotal role in supply decisions. Especially in the early years, the owner' s mortgage payment is often the largest single expense in operating a rental property.

New Rental Construction
Interest rates help determine the economic rent needed to support new construction. At the same time, high interest rates make home ownership unattainable for many first-time buyers, thus increasing the demand for rental housing. Statistics Canada research has shown that higher interest rates tend to reduce new rental housing construction despite the extra demand from people who, because of the high rates, are prevented from buying.[10]

High interest rates alone may make new construction unprofitable, thereby depressing supply. Even if developers are willing to build, they may not be able to secure the necessary financing because lenders insist on low loan-to-value ratios and adequate debt service coverage. The lender' s underwriting guidelines may require that rents in the first year cover all expenses and debt service with a comfortable margin over. Larger properties may be required to take a minimum mortgage term of five years. Later, lenders always have the option of not renewing a mortgage if they believe the rents will not support the new debt service, although, in practice, this rarely happens.

Existing Rental Property
The impact of interest rates on rents in existing rental properties is much weaker than the effect on new rental construction. Many factors besides current interest rates affect a property' s actual mortgage interest expense. Different rates accompany the different loan terms an owner may choose. Owners can put up their own capital or syndicate a project to other investors to increase the ratio of equity to debt. Owners may later choose to refinance or add a second mortgage in order to take accumulated equity out of a property or to finance other investments.

Interest rates also change over the life of a property, with mortgages being renewed multiple times. The rental market consists of properties financed at various times, for various terms, and thus at a variety of interest rates. Whatever interest rate it encounters, a rental property whose mortgage comes up for renewal must still have rents that are competitive with all other comparable rental properties in the local market. Graph 5 shows that, when the general rate of inflation is factored out, there is no clear relationship between changes in rents and mortgage rates in British Columbia over the past decade.

Graph 5:(9.5K) Change in Real Mortgage Rates vs. Change in Average Rents, Urban B.C., 1985-95

Small investors with holdings of one or two units may be most affected by interest rate fluctuations since the mortgages available to and selected by such owners include many with shorter terms, similar to those for homeowners; and larger owners with several properties are likely to be more diversified, with mortgages of various terms and maturity dates. Current CMHC data for British Columbia show that 78 per cent of rental units covered by mortgages insured under the National Housing Act (NHA) have mortgage terms of five years or more.[11]

This means that, between their infrequent mortgage renewal dates, most owners are unaffected by mortgage interest rate movements. At mortgage renewal, the key comparison is with interest rates at the beginning of the previous mortgage term. As of May 1995, for example, holders of expiring five-year mortgages- and this includes most owners of multi-family rental properties-were able to renew with another five-year mortgage at a lower rate. The rise in interest rates since the spring of 1994 meant, however, that mortgages with terms shorter than three years would have been renewed at somewhat higher rates.

Graph 6:(7.5K) One-and Five-Year Mortgage Interest Rates, 1984-1995

Investment Considerations
Of course, if the market will not support a proportionate rent increase, an owner' s cash flow may suffer from increased mortgage interest expenses. Given the need to compete with other properties-the majority of which do not have mortgages up for renewal-it is unlikely that an owner would be able to pass on much of the increased mortgage interest expense on a particular property to the tenants. But investors in rental property are motivated by more than just positive cash flow. They also invest with the expectation of long-term gains. General partners may also be collecting management fees. Research shows that providers of non-conventional rental housing, in particular, are generally motivated by the expectation that their property will appreciate in value and by the help that rental income gives in meeting their mortgage payments.12 Tenants, particularly in secondary suites, can be seen as helping the owner with the mortgage payment while the owner controls the asset and benefits from any appreciation. The landlord, not the tenant, bears the interest rate risk, just as other property owners do.

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10 "The Market for Rental Housing: Factors Influencing the Supply of Rental Housing", Rene Van Diepen, The Consumer Price Index, Statistics Canada, April 1993. Return

11 Terms of conventional loans on rental properties are likely to resemble those of NHA-insured loans. Note also that unmortgaged rental properties may represent a significant fraction of the market, though likely not as high as among homeowners. The ratio of debt to equity in different types of rental properties is unknown. Return

12 A 1991 survey of investors in non-conventional rental housing in Vancouver found that the majority were motivated primarily by long-term investment goals (40 per cent) and the prospect of help with their mortgage payments (12 per cent), not by short-term, cash flow considerations (only 5 per cent). Rental Housing: *A Study of Selected Local Markets*, CMHC and BCHMC, 1991. Return

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