Examining the financialization of rental housing

A Brief submitted to Review Panel on the Financialization of Purpose-Built Rental Housing *

By Steve Pomeroy, Industry Professor and Executive Advisor at the Canadian Housing Evidence Collaborative (CHEC), McMaster University

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**This replicates the brief submitted to the House of Commons HUMA Committee in May 2023*

Introduction

The House of Commons Standing Committee on Human Resources, Skills and Social Development and the Status of Persons with Disabilities (HUMA) is undertaking a study regarding the financialization of housing. This study will examine the issue of financialization in the housing market, including corporate ownership of single-family homes, rent gouging and renovictions. It will also consider the impact of 'real estate investment trusts' on the rental housing market, including increased rental rates and the loss of affordable housing units, as well as the tax treatment of real estate investment trusts. [HUMA May 8, 2023]

This brief first reviews the concept of financialization, and how this is infiltrating into Canada's housing market. It then adds context on trends in rental housing to assess the critical influences creating a rental affordability crisis, which extend beyond financialization. And concludes with a summary of insights and recommendations to address the declining affordability in the rental market.

The impetus for this study appears to be concern about the dramatic decline in affordability of rental housing , influenced by insufficient stock of lower rent properties to meet the needs of lower income renters. While not all renters are lower income, most low-income households are renters. This is reflected in much lower median income of renters (nationally in 2021 $54,800 for renters vs. $102,000 for owners). Census data confirm that there is a substantial shortfall in the number of lower rent units (below $750) affordable to low-income households (incomes under $30,000) compared to the number of low-income households. In 2016 this shortfall was over 370,000 homes). So low-income households are forced to live in higher rent units and pay well over the 30% affordable benchmark for their rent.

With the adoption of the National Housing Strategy Act 2019 there is a new focus on how Canada's housing market and in particular the rental sector aligns with the concept of the right to housing and the commitments created in that legislation for the progressive realization of the right the adequate housing. Other submissions to the committee will address the issue of the right to housing and the degree to which certain policies and regulations enable behaviors that are inconsistent with this statutory right.

The purpose of this brief is to frame the discussion and broaden consideration of the factors (beyond financialization) that are contributing to this rental affordability crisis, as well as policy options to create a healthier more inclusive rental sector.

Understanding financialization of housing

The term financialization has only recently entered the popular policy discourse in Canada and is frequently associated with the expanded role and impact of large capital funds, notably Real Estate Investment Trusts (REITs). The term originates and applies much more broadly across the economy, although it is generally accepted that housing systems are a central aspect of

financialization.[1] And there are many facets of housing financialization, going well beyond the characterization of financialized landlords (and more particularly Real Estate Investment Trusts, REITs).

By its nature housing is extensively integrated into the finance system, with most home buyers (and all investors) relying on mortgage financing to purchase a home. Levered purchasing is a central feature of both housing consumption and investment. The federal government through its housing agency, CMHC, is directly implicated as an agent of financialization through the creation of Canada Mortgage Bonds. As is CMHC's development of mortgage-backed securities (MBS) in the late 1980's – financial mechanisms that converted home loans into investable and tradeable financial instruments to increase liquidity and expand the supply of home finance which supports an expanding housing market. Pension funds have long been active as investors in rental assets to store capital and to generate cash flow to service pension obligations and as such represent another long-standing form of financialization.

Palley (2007) articulates that "financialization is a process whereby financial markets, financial institutions, and financial elites gain greater influence over economic policy and economic outcomes". He further notes that financialization operates through three different conduits: changes in the structure and operation of financial markets, changes in the behavior of nonfinancial corporations, and changes in economic policy. This sets a context that is far wider than just the participation of financialized firms in the rental market, which is the scope established for this study. As is discussed later there is a significant impact from the expansion of small-scale investors in housing, which is having a larger impact than financialized firms and financial elites.

In the context of the current study the phenomenon of financialization is more narrowly framed by the nature and source of financing, where pools of capital are assembled from a range of investors (including individuals and institutional) and deployed to purchase housing assets with a singular goal of generating a competitive yield for anonymous investors. This differs from traditional actors that built and operated rental properties as principle business corporations or as small individual and family holdings – investors that were visible and often known to the properties tenants and consequently seen as more benign landlords.

As reported in research by August and Walks (2017), the creation of REITs through tax policy change in the mid 1990's represents a change in the structure of the housing finance system. With their entry, and significant expansion to a point that formal REITs (as distinct from other asset management firms) now own almost 10% of purpose-built rental properties (although less than 5% of all rental housing), they are now deemed to have influence over economic outcomes and affordability in the rental market.

The critical issue before the HUMA study is the degree to which undesirable externalities (loss of existing affordable housing) are **being caused by financialized entities like REITs** vs other

[1] For a more expansive discussion of the nature of financialization of housing see Aalbers, M B. (2017) *The Variegated Financialization of Housing*. Urban Research Publications DOI:10.1111/1468-2427.12522

actors and, would regulatory or tax reform to REITs address these issues? I would argue that the erosion of existing affordable stock is associated with a much broader array of investors, most of whom would not be defined as “financialized landlords”, although many have accumulated investment equity via appreciation of existing assets, and that eliminating REITs alone would not stall or slow the erosion of lower rent properties.

To better understand the factors undermining rental affordability and constraining the realization of the right to adequate housing it is necessary to review the longer-term evolution of Canada’s rental sector and how current market pressures, well beyond the singular impact of financialized landlords are contributing to and creating the affordability crisis. Once correctly diagnosed it is then possible to explore possible policy remedies.

Rental housing as an investment

In a housing system that encompasses a significant private rental sector (34% of households rent, 29% from private sector landlords), investment and investors are a critical necessity. Among OECD countries Canada has one of the largest private rental sectors (and very small social non-market sector).

This was facilitated by several specific policies and incentives to encourage investment in rental housing. In the immediate post-war period, there was a focus on expanding supply to house returning veterans and a surge in new immigrants. The federal government, through CMHC, played a critical role in providing direct mortgage finance – both for ownership and rental.

As the front end of the baby boom matured into adulthood in the early 1960’s this created strong rental demand, so CMHC created a low-rate Limited Dividend finance program to enable construction, abetted by what at the time was very favourable tax treatment of rental investment. These were the peak years of rental development producing over 60,000 units per year (and almost 80,000 per year 1970-74).

Rental construction dropped off dramatically through the later 1970’s as a perfect storm of negative influences conspired against the viability of rental construction. By way of overview these included:

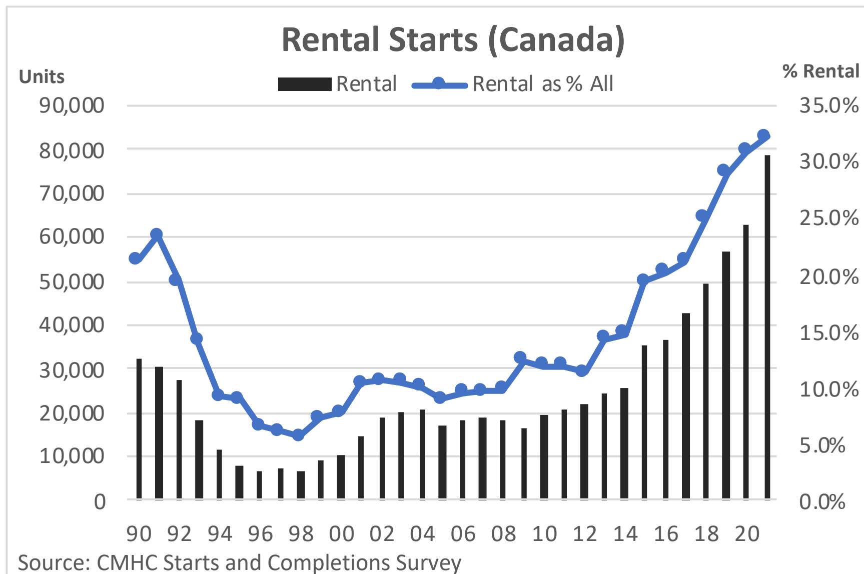
- A program of broad tax reform, which removed the very favorable tax treatment of rental investment income and capital gains (initial reform in 1972; subsequently further revised, with negative impacts in 1986);
- The introduction of strata title legislation in all provinces between 1967-1970, which created a new product competing for multi-residential zoned land (making it more challenging for rental development to secure multi-residential land);
- The introduction anti-inflation legislation in 1975, under which the federal government urged provinces to adopt rent controls to suppress rent inflation (and suppress potential returns on investment);

- In the context of high inflation, all input costs—land, materials, and labour—became increasingly more expensive (while the ability to cover high costs was suppressed by the aforementioned rent controls);
- Demographic shifts: boomers began forming families and sought detached ownership, reducing rental demand and following cohorts were smaller in scale, so didn't replace exiting demand.

It was this combination of reinforcing factors, not simply tax policy reform alone that stalled rental production after the mid 1980's, a point that recent and current advocates for tax change (to restore pre 1972 provisions) to fix the lack of rental construction tend to overlook.

The incentive programs – the Assisted Rental Program 1975-78, Canada Rental Supply 1982-85, and a temporary tax measure Multiple Unit Residential Building (MURB) that reinstated some of the more advantageous features of the pre '72 tax regime temporarily propped up the viability of rental investment through the 1970s and early 80's. But these all ended in the mid 1980's and funding of new social housing was also terminated at the end of 1993, further curtailing rental construction.

Thus began a period of minimal rental construction, the consequence of which we are seeing today – a long term chronic undersupply of purpose-built rental housing. While one-third of households are renters new rental construction 1996-2016 averaged below 10% of all new home construction each year.



This lack of supply was, however, offset by easy access to ownership. After wallowing between 62-63% for thirty years (1966-96) the homeownership rate increase from 63% (1996) to 68% in 2006 (and then peaked at 69% in 2011). This dramatic increase was enabled by a strong economy, with increased employment and incomes together with declining mortgage rates that facilitated homebuying. The consequence for the rental sector was that between 1996 to 2006 800,000 renters transitioned to become owners – it had the equivalent effect as building

80,000 new rental units per year. With so many exiting renting this created vacancies and took pressure off the rental sector, concealing and offsetting any effect of low rental construction.

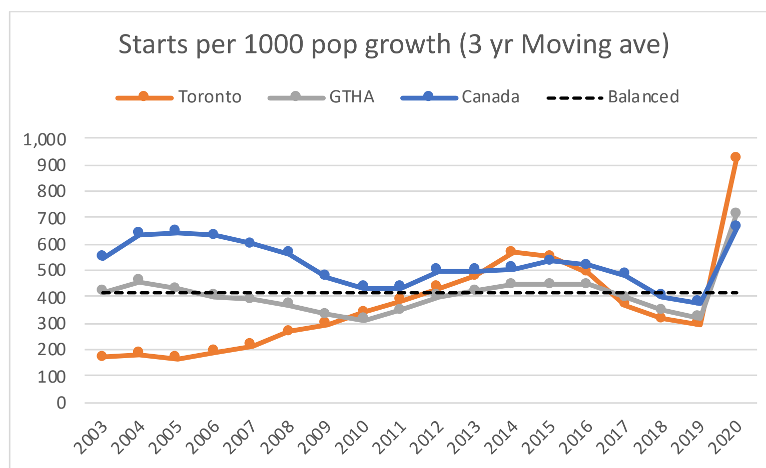
Flash forward to 2016 this "pressure release valve" has been shut down by a combination of excessive home prices and macroprudential policies (e.g., stress tests and more stringent CMHC qualifying criteria) that make it extremely difficult for first time buyers to access ownership. The consequence is they remain renters and do not create the vacancies that tenure transition did in the earlier decade.

Alongside this group of "stalled exits" from pent up buyer demand, additional rental demand is now being created by high immigration levels. While the target for new permanent residents is increasing, the far larger impact of immigration is from temporary foreign workers and international students.

In 2022, the number of non-permanent residents jumped by around 600,000 on a net basis, a record increase. This group includes international students, along with those temporary workers whose permits are issued outside of the TFW program.[2] These new entrants all rent, so the pressure is on the rental market, not so much the ownership and home prices.[3]

Housing is inherently supply inelastic – people can jump on a plane and arrive tomorrow – it takes 3-4 years to build them a house. The imbalance is a more recent phenomenon, as NPR have substantially added to demand (halted temporarily only during covid boarder closure). The new non-permanent residents (NPRs), and residual (blocked buyers) demand is the primary cause of the current supply imbalance, not the asserted chronic shortage of supply.

The myth of a chronic undersupply is revealed in the chart below. Based on the average household size (2.45 people per home in 2016) the number of homes required per 1,000 growth in population can be compared to new home construction.



[2] https://www.theglobeandmail.com/business/article-use-of-temporary-foreign-worker-program-soared-in-2022/

[3] It is however acknowledged that some TFW recruited to work in agriculture and resource industries are often housed in bunkhouse type accommodations, so do not impact local rental, markets.

This reveals that, except in the Toronto cma, at a national scale we have not had a chronic undersupply – the number of new homes built exceeded the number required in every year until 2019.

The consequence of these increased demand pressures in the rental market is upward pressure on rents. And this pressure is exacerbated at the lower end of the rental market by both an absolute shortage of low rent homes, worsened by an ongoing process of erosion (described more below) as rents inflate well above affordable levels – a process enabled by provincial rent regulations that allow vacancy decontrol in most jurisdictions existing tenancies are limited to an annual guideline increase; but vacated units can adjust to market**. It is this regulatory mechanism, in combination with strong rental demand, that has created an environment that enables inflationary behaviors and practices.**

For units which have been occupied for many years and thus rent controlled, the rents have fallen well below the potential full market rent. There is a significant benefit to the landlord when tenancies turn over – and almost one in five do turn-over every year. It is this potential rental income uplift that is highlighted in the prospectus of asset management firms and REITs – celebrating the use of turnover to strengthen yields (August and Walks, 2017).[4]

And realtors frequently market rental properties with explicit mention of current "below market rents" and the associated potential to increase rental income – see for example advertisement in the Globe and Mail, May 23rd.

At a more extreme level, this also creates an incentive for asset owners/landlords to try and encourage or force existing tenants to leave – including "reno-victions" and "demo-victions" a practice discussed by August and Walks, (2017), when property owners use the intent to undertake renovations or redevelopment as a basis to evict.

But it is not only financialized landlords that behave this way (and several large asset managers are not structured as REITs) all forms of landlords and especially small single property landlords have been extensively documented in media stories for evicting based on requiring a property for their own or family member use or plans to renovate.

A new expanding small-scale investor

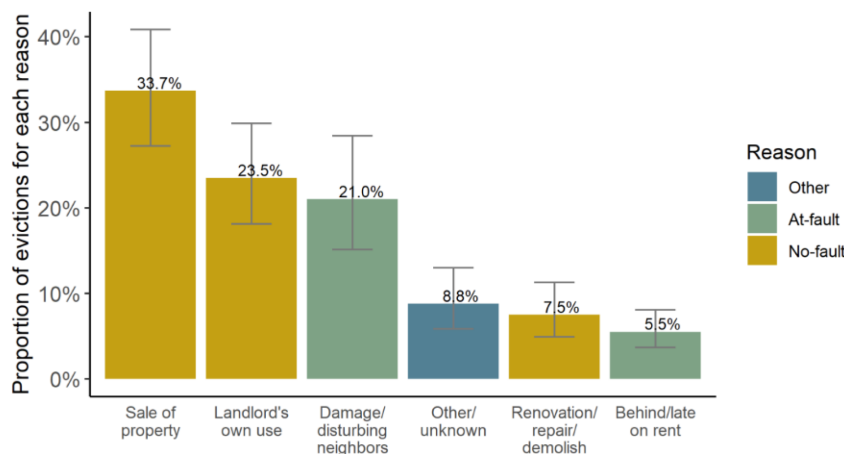
Low purpose-built rental construction from 1996-2016 was also compensated, in part, by the shift to condominium development and the emergence of a new form of small-scale landlord –

[4] August, M., (2017), *Gentrification, suburban decline, and the financialization of multi-family rental housing: The case of Toronto*. Geoforum http://dx.doi.org/10.1016/j.geoforum.2017.04.011

individuals purchasing condominium units as rental investment properties.[5] And this phenomenon expanded dramatically post 2016 fueled by appreciation in home values, which many borrowed against to buy investment properties. These are part of what is labelled as the secondary rental market (distinct from "purpose built rental" buildings) and included rented houses, suites in houses and increasingly rented condominiums.

Between 2011 and 2021, census data reveals that the number of rental units in condominium properties (so investor owned) almost doubled (from 419,000 to almost 800,000 nationally; and in Toronto alone from 81,000 to 178,000). This is double the growth of the financialized REIT sector. These small-scale landlords more frequently evict on the basis that they require the unit for personal use, or due to a sale to an owner occupant. And such evictions are far more frequent in comparison to evictions due to renovation.

National data from 2012-21 examined reasons for evictions and determined that sale of property (34%) and use by landlord (24%) accounted for most evictions; eviction to facilitate renovations was a much smaller proportion at only 8%. This suggests that focusing only on financialized landlords and renovictions overlooks a much larger issue. It is unknown what proportion of units in which evictions were conducted subsequently re-entered the secondary rental sector, but at the higher decontrolled rent levels.



Source: Xuereb, X. and Jones, C. (2023)

Profile of rental investors

The rental market totals roughly 4.5 million homes and is comprised of three segments: the primary purpose-built sector (46%,), the secondary market (38%) and non-market social housing (14%).

The small-scale condo investors discussed above are found in the secondary market, alongside mainly other small investors that own detached and semi-detached homes, some with multiple

[5] The expansion. Of such small scale investors in documented in a recent study drawing of data from the new Canada Housing Statistics Program: Xuereb, X. and Jones, C. (2023). *Estimating No-Fault Evictions in Canada: Understanding BC's disproportionate eviction rate* in the 2021 Canadian Housing Survey. Balanced Supply of Housing Research Partnership

suites in the structure. Recent media stories have suggested the emergence of corporate investor groups targeting single detached properties to build investment portfolios (more prevalent in the US), but data in this phenomenon remains lacking in Canada.

In a 2017 research report, CMHC examined the characteristics of ownership in the larger purpose-built sector (multiple unit properties of 3+ units) and determined that the largest group of owners are individuals and family holdings at 49% followed by corporations primarily active as real estate owners/managers at 40%. This accounts for 89% of all purpose-built rental units.

REIT ownership accounted for only 8% of all purpose-built rental units. And when combined with the secondary rental market (1.7 million units), the overall share of REITs in the full rental sector falls to less than 4% of all rental housing.

Scoping the study of financialization to focus on REITs and any policy recommendations to lessen the influence and impact of REITs alone will therefore have a minimal impact in addressing the critical issue of renter affordability and rent inflation, issues associated with a broader group of investors.

That said, REITs and other institutional investors historically purchased existing properties because these were significantly lower costs than building but also there was immediate known cash flow and this avoided construction related risk and delays. As rents have risen and driven up asset values, the acquisition cost discount has narrowed. And newly constructed properties generate higher rents as well as operating outside of rent controls in most jurisdictions. So, both the REITs and institutional investors have recently pivoted in favour of new build over acquisitions. This helps to build needed new supply albeit not at affordable rents but does contribute positively to the supply issue. It would be desirable to encourage this pivot.

Ongoing erosion of low rent units

As noted earlier, there are many more low-income households seeking low rent accommodation than there are low rent properties. The opportunity to raise rents on unit turnover contributes to the ongoing erosion of these low rent units.

Many low rent units existed as a result of historically lower rents and stable tenancies, in which long -term tenants were protected by rent control and the unit rents increased only marginally and lagged potential market. But as these tenants leave, either voluntarily or through eviction, the rents jump up to full market.

Another important factor is the process of urban intensification, in part an attempt to grow up vs. out to minimize unsustainable low density urban sprawl. As noted in the historical review of the rental development peak in the 1960’s and 70’s, many mid-rise properties were constructed and most in the then central areas that are now areas targeted for intensification. So small older mid-rise properties, which are often key elements of the lower rent stock, are being demolished to make way for new higher density, and typically much higher priced development.

Erosion of the lower rent stock occurs via two parallel processes – absolute loss due to demolition and redevelopment of the older lower rent properties; and rent creep, where the structure still exists, but due to vacancy decontrol rents are rapidly inflating and moving above the affordable range.

Using the benchmark of $750 which is affordable at 30% at an income of $30,000, the change in the number of such low rent units has been tracked across the 2011-21 census. It reveals a very large erosion with some 320,000 fewer units in 2016 vs 2011, and a further reduction of at 230,000 between 2016-21. In total over 550,000 units below $750 were lost over that decade. This represents 6% of total unsubsidized rental housing.

And it means that many low-income households are forced to rent above $750 and pay well over 30%. Those that need to move (work, family separation, eviction) are then confronted with much higher rents as other vacancies will have moved to full market – which is often unaffordable. One consequence is encampments and homelessness, or living in a car, as reported for a nurse in Halifax in the Globe and Mail May 23rd. [6]

Increasing attraction of rental properties as an asset class

The phenomenon and erosion of lower rent properties together with the increased level of investment in existing properties is primarily a consequence of rising potential rent levels. Over the 1996-2016 period with high exits into ownership there was weak demand and less upward pressure on rents. This has significantly changed post 2015 as strong demand has emerged, as discussed above.

And it is this strong demand, in combination with a regulatory environment of vacancy decontrol, that has transformed rental housing from an unattractive to an increasingly attractive asset class. And this is attracting a wide range of investors – both small scale individual as well as large financial firms and institutional investors.

And in the face of strong demand and the potential to substantially increase rents on turnover this engenders investor behavior that is inconsistent with the goal of improving affordability and the concept of the right to housing.

It is not simply that the growth of REITs over the last 3 decades has changed the structure of the rental market (although it may contribute in small part), it is because of the transition of rental housing into an attractive asset class. And the inflationary behavior this engenders across all classes of investors.

One way to remedy these negative impacts is to reduce the attractiveness of rental investment, or at least investment in existing assets. This would best be achieved by reforming and removing the regulation of vacancy decontrol. However, this is an area of provincial jurisdiction, so beyond the control of the federal parliament, other than through moral suasion. There is however some precedent for asking the provinces to pursue such regulatory reform. As part of

[6] https://www.theglobeandmail.com/canada/article-halifax-housing-van-life/

the 1975 anti-inflation wage and price controls, provinces were requested to implement rent control, limiting rent increases – all agreed to do so.

Conclusions and recommendations

The foregoing analysis has revealed that the issues contributing to ongoing phenomenon of rent gouging and renoviction and the dramatic ongoing erosion of lower rent options are pervasive and relate to a wide range of investors, of which REITs are a very small fraction. These behaviors have more to do with the transformation of rental housing into an attractive asset class, in large part due to an insufficient supply of rental housing to address pent up residual demand from potential buyers and a large cohort of non-permanent residents, including students. And this is enabled by provincial rent regulation that permits vacancy decontrol. A narrow fixation on reforming tax treatment and regulation of REITs is therefore unlikely to have a significant effect, nor will this alone reverse the trend of excessive rent increases and erosion of the low rent stock.

Recommendation 1: Request the provinces revise current rent regulation to (at least temporarily) remove the vacancy decontrol mechanism to moderate the excessive increases in rents (while new construction catches up to excess rental demand related to immigration)

Recommendation 2: Direct CMHC to establish more stringent conditions to limit rent increases for investors utilizing mortgage insurance to purchase existing low rent properties.

Recommendation. 3: Encourage the ongoing pivot of REITs toward investment in new rental supply, rather than purchase of existing assets.

Recommendation 4: Encourage institutional investors and pension funds to review and update ESG investment guidelines to minimize enabling the practice of renoviction and large rent increases in properties in their portfolios.

Recommendation 5: Request that the government amend the National Housing Strategy to create a funding and financing mechanism, including use of low-rate financing to enable non-profit entities to acquire existing lower rent properties to preserve and protect low rents and isolate these assets from excessive rent inflation.[7] This could take advantage of the disposition of REIT properties that they seek to sell into a nonprofit affordable fund or trust.

Recommendation 6: Encourage Immigration, Refugees and Citizenship Canada (IRCC) to review and recalibrate issuance of international student visas and temporary foreign worker permits to better align with new rental supply; and direct CMHC to provide low-rate financing incentives to facilitate construction of purpose-built studentl housing to better manage rental demand from international students.

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[7] Currently CMHC asserts they lack cabinet authority to use these financing and funding programs to support acquisition of existing rental – they are authorized only to fund new supply and retrofit of existing affordable housing.