

The Effect of the Recent Changes to the Mortgage Qualifications Rules on Condominium Pre-Sales

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Pre-construction sales (“pre-sales”) of condominiums have been a very popular method of buying real estate in British Columbia for over a decade. For many, condominiums are not a home but an investment. This paper will discuss the recent changes to the mortgage qualification rules and their impact on these investors and, in turn, all condominium owners.

Three significant changes to mortgaging in Canada took effect on April 19, 2010:

1. Purchasers must now qualify for a five-year fixed-rate mortgage. Previously purchasers only had to qualify for a three-year fixed-rate mortgage. This may preclude buyers who would have qualified under the old rules but who cannot qualify under the new ones. Many first time home buyers fall into this category.
2. Homeowners may only re-finance up to 90% of their home value rather than the previously permissible 95%. This change is not expected to have a significant effect on pre-sales.
3. A minimum 20% down payment will be required for properties not occupied by their owners. Under the previous rules the down payment required for such properties was 5%. The minimum down payment for owner-occupied homes remains at 5%.

Pre-sales and typical home purchases - what's the difference?

The starting point in this discussion must be the difference between pre-sales and the typical purchase and sale of a home that already exists, whether it be a condominium, detached house or any other type of home.

In a typical sale the vendor and buyer negotiate a purchase price, deposit and closing date. An industry standard four-page agreement is then signed along with an addendum that includes a number of subjects typically for the benefit of the buyer. The vendor and buyer agree to a date on which all of the subjects must be removed. If the subjects are removed, the agreement becomes a binding contract. If the subjects are not removed, the agreement is canceled and the vendor is free to sell the property to another prospective buyer.

The most common subject states that the agreement is subject to the buyer obtaining approval for a new first mortgage on terms set out by the buyer. If the buyer cannot obtain that mortgage approval the subject is not removed and the deal is cancelled.

A pre-sale is very different. The most obvious difference is that the buyer has no opportunity to inspect the property before he or she agrees to buy it. At the time the agreement is entered into the property is often nothing more than a vacant lot on which a proposed condominium development is to be constructed. A demonstration unit may be set up in a sales centre. However it is unlikely to be an exact replica of the intended final product.

A pre-sale contract is much longer than the industry standard contract for an existing home. It can range from 12 pages to more than 30 pages of fine print and is written almost entirely in favour of the

developer. In the heady days of the real estate boom the terms of these contracts - including price - were generally non-negotiable. Even today, price is only occasionally negotiable. A buyer may be able to negotiate a decorating allowance, an additional appliance, fireplace or the like. However, the vast majority of contractual terms remain non-negotiable.

Pre-sale contracts do not contain agreed upon closing dates. They typically contain a target completion date that may be extended many months without penalty to the developer. The buyer may be given as few as 10 days' notice of the eventual closing date. If the buyer does not close on that date, the developer may keep the deposit and sell the property to someone else.

There are no subjects in a pre-sale contract. Notably, the pre-sale contract is not subject to the purchaser obtaining a mortgage. If the buyer cannot obtain a mortgage when it comes time to close, the developer will keep the deposit and sell the property to someone else. This, combined with the changes to the mortgage qualification rules, has posed serious problems for some buyers.

Fortunately, all pre-sales are subject to the *Real Estate Development Marketing Act* (the "Act"), consumer protection legislation that governs the marketing and sale of pre-sales.

The *Act* is a technical statute that imposes various obligations on the developer. The purchaser may be able to cancel the pre-sale and get his or her deposit back if certain obligations are not met (e.g. If the developer fails to notify the purchaser of changes in the condo design).

How do the new mortgage qualification rules affect pre-sales?

A purchaser may have signed a pre-sale contract in 2007 expecting to complete the sale in 2010. The new mortgage rules could throw a significant wrench in those plans.

1. *Tougher mortgage qualification standards*

The requirement to qualify for the conservative five-year fixed-rate mortgage makes it more difficult for many purchasers to complete on their pre-sale contracts. As the pre-sale purchase is not subject to a mortgage pre-approval, purchasers who are unable to obtain financing will either:

- (a) find a way to assign their pre-sale contract to someone else (usually at a fee payable to the developer);
- (b) find a lawful way to cancel or rescind the pre-sale contract (generally pursuant to a right provided by the *Act*) and have the deposit returned; or
- (c) lose the deposit and walk away from the deal.

In a declining market, the risks to purchasers increase.

Purchasers who fail to complete may face a lawsuit for additional losses. The purchase price is locked in when the pre-sale contract is signed. If the real estate market declines and the purchaser fails to complete when the unit is ready, the developer will sell the unit for less than the price set out in the pre-sale contract. If the developer ultimately sells the unit for an amount that does not equal: a) the re-sale price plus; b) the deposit already paid by the original purchaser, the developer might sue for the difference.

In 2009 some condos were re-sold for 40% less than the agreed upon purchase price. If the original purchaser paid a 15% deposit, the developer still lost 25% of the money it expected to receive. Many

developers have sued the original purchasers for that 25% difference in addition to the deposit already paid. Purchasers who have already lost significant deposits are being asked to pay even more.

2. *Increased down payment for investment properties*

Perhaps the most worrisome rule change for pre-sale purchasers is the quadrupling of the minimum down payment from 5% to 20% for non owner-occupied properties.

Pre-sales have been a popular form of investment since the 1990s. In addition to gains in equity, completed condos can serve as a valuable income-generating asset.

Most investors enter into pre-sale agreements with the belief that their investment will increase in value. They will pay a deposit to the developer (typically about 15% of the purchase price) and, if all goes well, the unit will be worth more at closing. Obtaining a mortgage for the balance of the purchase price (including 12% HST) will be fairly easy.

Of course, things don't always go as planned. Under the old rules many purchasers – both investors and those purchasing a home – have been confronted with a situation in which the value of the unit is now equal to or less than the price they agreed to pay.

If the unit has dropped significantly in value it may be worth less than the purchase price less the deposit. The bank may view the purchaser's 15% deposit as moot. This would have posed a difficult problem for many when the minimum down payment was 5%. At 20% it is impossible for most.

An illustration aptly demonstrates the significant impact of the increased minimum down payment. Assume an investment pre-sale was purchased for \$500,000 with a 15% deposit. The illustration below shows the amount of cash the purchaser will require at closing under the old and new mortgage qualification rules. It is assumed that the market value of the unit is equal to the \$500,000 purchase price.

Old Mortgage Qualification Rules

Pre-sale purchase price	\$500,000
Less 15% deposit	- \$75,000
<u>HST</u>	<u>\$25,000</u>
Amount owing at closing	\$450,000
Amount bank will finance (95% of market value)	<u>\$475,000</u>
Cash needed at closing	\$ 0

New Mortgage Qualification Rules

Pre-sale purchase price	\$500,000
Less 15% deposit	- \$75,000
<u>HST</u>	<u>\$ 25,000</u>
Amount owing	\$450,000
Amount bank will finance (80% of market value)	<u>\$400,000</u>
Cash needed at closing	\$ 50,000

In the above illustration the investment purchaser needs \$50,000 cash in order to even be considered for a mortgage. In a declining market, the situation for a purchaser only gets worse. Using the above example,

a 10% decrease in market value results in the purchaser requiring \$90,000 cash at closing in order to be considered for a mortgage.

Some investment purchasers have foreseen this problem and consulted a lawyer long before the anticipated completion date. However, unless the developer is in breach of the *Act*, a purchaser's only option may be to walk away from his or her deposit and hope the developer does not re-sell at a loss greater than the amount of the deposit.

Will this affect other condominium owners?

The effect of the changes to the mortgage qualification rules on real estate investors as a whole remains to be seen. It is likely that the changes will preclude some who would otherwise buy an investment condominium from doing so. This would, in turn, lead to fewer non-owner occupied condominiums.

Those who live in stratas with a high number of rental units are likely aware of the difficulty in getting owner approval for significant expenses. Investment owners are loathe to spend money on anything that does not yield immediate results. Proposed expenses that do not increase rental or asset value are likely to be opposed by non-occupying owners.

Strata councils in some new buildings may be spared some of the difficulties of managing and operating a building not occupied by many of its owners, but only time will tell if the changes to the mortgage qualification rules will have this consequential effect.

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If you have questions about a strata property or other real estate matter, you are welcome to contact Wesley at any time via phone (604 895 2843) or email: wcmillan@harpergrey.com

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