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RESEARCH PAPER

The Commercial Real Estate Crisis of the 1980s and 1990s

Canadian Business History
Professor Joe Martin

This research paper was prepared by Darren Karn under the direction of Professor Joe Martin as the basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation.

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The Commercial Real Estate Crisis of the 1980s and 1990s

Introduction

The 1980s and early 1990s were tumultuous for the banking industry in both Canada and the United States. While the banks weathered the rash of sovereign debt defaults in the early 1980s, they would experience only a few short years before the next debt crisis — this time precipitated by loose lending practices on domestic commercial real estate, rather than sovereign and business loans in Latin America.

The Commercial Real Estate crisis of the early 1990s proved costly for the financial and real estate development communities in North America. While several banks failed in the United States, the larger, diversified banks of Canada did not fail, but suffered through drastic reductions in credit and significant losses in loan portfolios. Meanwhile, the failure of global developer Olympia and York, the largest bankruptcy in Canadian business history — and fourth largest bankruptcy in the United States — proved to be the case study for the riskiness of the industry and the degree to which the financial community once again failed to maintain sound underwriting.

This paper outlines the nature of the commercial real estate industry and how the inherent risks, coupled with aggressive lending practices, led to a swift crash at the end of the 1980s and early 1990s. The story of Olympia and York illustrates many of these concepts, while data from the northeastern United States and Toronto shows how the business and banking communities were affected by the crash. The experience of one small commercial lender is also covered, demonstrating the difficulty banks have in dealing with crisis, and the lingering effects they bring. Finally, a crash in commercial real estate lending cannot occur without the contagion spreading into the residential real estate market. The outcomes for homeowners in Toronto and New York are also briefly explored.

Note: All figures in Canadian dollars unless otherwise specified.

Commercial Real Estate

Broadly, commercial real estate refers to office, retail and industrial properties. Developing, financing and operating commercial real estate projects is a fundamentally risky endeavour due to several factors, principal among them the long time frame from project conception to completion. This time frame provides for the likely chance that the underlying economic conditions that justified the project early on will change, with potentially disastrous consequences for the developer and underwriters.

Demand for commercial real estate is susceptible to risk from two fronts — both from local and regional economic factors, and national economic trends. Firms interested in renting commercial space at scale are generally quite large and mobile, and thus have options about where to lease. Developers in one part of the country have to be concerned about broader trends in retailing, for instance, should they wish to attract and retain tenants who might consider alternate locales.

Furthermore, commercial real estate projects often have long time frames between project conception, development and occupancy, and consequently are subject to changes in financial and economic trends. In periods of depressed demand, rents — the proxy for the value of commercial buildings — also fall (often quite low) in an effort to attract tenants. The reduced cash flow can mean that the developer is unable to meet its debt obligations, which can be significant as almost all commercial real estate development is funded by loans on the underlying property, or other assets in the developer's portfolio. Due to the highly-leveraged nature of real estate development, depressed rents during market downturns can often leave the creditor with properties worth far less than the underlying mortgage. Real estate development projects are often undertaken by limited partnerships with few other assets — thus the lender has no recourse other than to try and sell the distressed property and absorb a material loss, or hold onto the distressed property, manage it, and hope that prices rebound in the future. In either case, the lender is almost always worse off.

These risks to commercial real estate projects were all on display in the late 1980s. As late as 1987, industry insiders remained confident that the boom in commercial real estate construction would continue, and that demand for all the new construction would remain firm for the foreseeable future. The reverse proved true, of course. In the United States, a downturn in the computer industry[1] and Black Tuesday in October, 1987 softened the market for commercial real estate in Boston and New York, respectively. The events took place after the United States repealed advantageous accounting treatments for owners of commercial real estate in 1986 — an unfortunate coincidence.[2] Toronto, as Canada's financial capital, had a similar experience as the boom of the 1980s came to an end and growing vacancies took hold.

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1 While the overall New England economy continued to grow in the late 1980s, the growth was almost entirely attributable to the booming construction and finance sectors. From 1984 to 1988, New England lost approximately 130,000 jobs from the region's base industries – the highest value of these being the computer and electronics manufacturing hub (Moscovitch, p. 64).

2 Changes to the US tax code in 1981 made investing and developing commercial real estate substantially more attractive — Ronald Reagan wanted to simplify depreciation accounting procedures and boost the economy by raising after-tax business profits. The biggest change was to the allowance for depreciation of commercial real estate assets — which previously had been a straight-line depreciation over 40 years. This changed to an accelerated cost recovery system, which permitted a 175% declining-balance method over 15 years. The benefit was repealed in 1986 due to concerns about tax sheltering activities and abuses of the benefit. (Brazell, et al., p. 22).

The United States

The story of the boom and bust of commercial real estate in the United States can be explained by the convergence of several factors. Favourable changes to tax treatment for investment and development of commercial properties helped to fuel the spectacular growth of commercial construction. There also existed a glut of capital searching for higher rates of return — particularly from smaller savings and loans firms. While the savings and loan crisis in the United States was a much larger event, only a small element will be covered here, as it relates to the contribution to the growth of commercial construction, particularly in the northeastern United States.

Traditionally, S&L firms were mutualized, and could only invest in a certain number and category of loans. These firms typically took the form of community-oriented banks that took deposits from residents and made fixed-rate, medium-to-long term mortgages on residential properties. This business model was quite successful — but changes to the larger economic environment in the United States brought it under stress.

The Chairman of the Federal Reserve, Paul Volcker, made the decision in the late 1970s to fight growing inflation in the US economy by aggressively raising interest rates. This decision forced the small banks into a difficult position whereby they increasingly had to pay depositors higher interest rates, while at the same time earning much lower returns on their existing extended fixed-rate mortgages to clients at lower rates. Meanwhile, many savings and loans demutualized at this time, to become stockholder-held companies. This change in ownership structure placed a greater emphasis on short-term returns and profits than had previously been the case, as shareholders clamoured for greater returns.[3]

Faced with a high-interest environment and ownership pressure for higher returns, these firms began looking for investment opportunities with higher yields; necessarily, these investments were riskier. Dollars flowed to commercial development projects for which savings and loans underwriters had little experience and even less expertise. Any developer with a half-decent sales pitch could find financing in the United States for just about any commercial real estate project.

While real estate developers will typically leverage their projects to the limit, they would still have to raise some capital. Fortunately for the developers, the attractiveness of these risky investments was increased by the changes to the tax code in 1981. These changes allowed owners to depreciate the value of commercial buildings at an advantageous rate, enhancing returns for investors in ways not previously available and ensuring a steady flow of private capital to finance projects.

These factors contributed to a glut of commercial construction in the United States — particularly in larger urban centres. As shown in Figure 1 on the following page, there was tremendous growth in new commercial space — with annual averages of new completions exceeding absorptions by approximately 30 million square feet throughout the 1980s. The market for commercial real estate could last only for so long, with 30% of new construction failing to find paying tenants.

[3] Lamm and O'Keefe, p. 348.

Figure 1:

Commercial Real Estate Construction and Absorption, 31 Largest US Markets[4]

(in millions of square feet)

Period	New Completions Annual average during the period	Absorptions Net change in occupied space
1975–1979	33.6	44.3
1980–1984	97.8	64.2
1985–1989	100.7	73.6
1990–1994	28.1	33.3

When the market fully turned in the late 1980s and early 1990s, many financial institutions in the northeastern United States were left holding mortgages and construction loans on abandoned or half-finished properties, or occupied properties leased to tenants at substantially-discounted rates. In many cases, the developers lost control of the deals as they were unable to meet their debt obligations.

Left with few options and a depressed market unwilling to purchase these distressed assets, many financial institutions collapsed in the United States. (See Figure 2, below.) To give perspective on the regional nature of the problem, the combined assets of the banks that failed in New England represented 90% of those that failed across the entire country. The volatility of the commercial real estate market proved swift and decisive.

Figure 2:

Bank Failures in the United States[5]

Year	Northeastern Banks	All Banks
1980	1	11
1981	3	10
1982	6	42
1983	3	48
1984	1	80
1985	3	120
1986	0	145
1987	4	203
1988	1	279
1989	5	207
1990	16	169
1991	52	127
1992	43	122
1993	3	41
1994	4	13

4 All data in chart from Freund, et al., p. 145.

5 Lamm and O'Keefe, p. 369.

In light of the financial position that many of these savings and loans found themselves in, regulators realized that they had to require bolstered capital requirements to protect depositors and the liquidity of the institutions. But because these banks held so many non-performing loans, and because they struggled to meet interest payments on their deposits — they had no choice but to try to sell their damaged loan portfolios. With a vanished market, bankruptcy was often the only answer. The FDIC largely covered depositors, but the disruption to the industry was substantial.

Olympia and York[6]

The number of commercial real estate firms that failed during the crisis far outnumbered the banks that became insolvent. One such firm, however, stood out among all others. Based in Toronto, Olympia and York Development Ltd. (O&Y) became the world's largest private real estate developer during this time period. On May 14, 1992, it filed for bankruptcy protection, struggling under the weight of $18.55 billion of debt — the largest restructuring ever for a privately-held company. Up to that point, the bankruptcy was the 4th largest in the United States and the largest in Canada. The opaque manner in which O&Y operated largely contributed to its demise — in addition to the hubris of its management.

O&Y was founded in the 1950s in Toronto as a building supply business. Always a closely-held family business, the Reichmann brothers controlled nearly all aspects of the enterprise — especially as it grew from supplying quality tiles to a commercial development juggernaut. The turning point in the growth trajectory of the Reichmann empire came when one of the brothers, Paul, was in charge of building a new warehouse for the expanding building supply business. Their architect told him that a new warehouse would cost $100,000, and the lowest tender he received was $125,000. Paul built it for $70,000 in less time than it would have taken any of his bidders — and suddenly realized that there was much more money to be made in development than in selling building materials.

Paul Reichmann soon began building, selling or leasing new warehouses in Toronto's growing light industrial parks. When his father, Samuel, and brother, Albert, arrived in Toronto in 1959, they brought with them access to capital from the family's businesses in Tangier as well as a growing network of willing financiers. While the development business grew steadily, the next big break for O&Y came in 1965, when the company had the opportunity to purchase 600 acres in Toronto — the Flemingdon Park lands. The lands were about to be bisected by the expanding Don Valley Parkway — a major north-south highway in Toronto, connecting the downtown core to the major east-west thoroughfare (Provincial Highway 401) that ran across the northern edge of the city. Recognizing the value of the expected boom in traffic, O&Y bought at a time when other developers failed to see the opportunity. It was on this project that O&Y built its first multi-storey commercial buildings and earned substantial returns to fund subsequent growth.

The 1970s saw O&Y enter onto the stage of world-class developers and billionaire business owners. In 1974, O&Y built First Canadian Place, still Canada's tallest office building, at the most important intersection of Canada's financial centre on the corner of King and Bay Streets with the Bank of Montreal as the key tenant. Pioneering new construction and design techniques, the Reichmanns were able to succeed on a business model that saw uncompromising quality[7] and functionality earn

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6 Except where noted, this section draws heavily from Peter Foster's *Towers of Debt: The Rise and Fall of the Reichmanns*.

7 For some months the steel-clad skeleton stood without marble as the Reichmanns sent a boatload of marble back because it didn't meet their demanding standards.

the highest rents and returns. O&Y projects were completed on the shortest construction schedules, using quality materials, and designed in such a way as to maximize leasable floor space.

1977 cemented the reputation of the Reichmanns and O&Y as global commercial real estate leaders. The company purchased what was known as the Uris package in Manhattan, which consisted of 8 high-rise office buildings, for $320 million, using only $50 million in equity. The deal surprised many Wall Street experts — New York City was on the verge of bankruptcy in 1975 and the economic conditions at the time were not favourable for owning commercial real estate in Manhattan. Confident that New York would make a comeback, the Reichmanns decided there was not much risk to the project, and invested at a time when there were no other interested parties.

What would soon be referred to as the "deal of the century" among real estate and business professionals, the value of the group of buildings quickly appreciated to approximately $2 billion by the early 1980s. Riding a wave of commercial real estate investment and construction, O&Y had a global reputation as the best and shrewdest development company. With this substantial new wealth, however, O&Y began to look outside the real estate development world for investment opportunities.

In the mid-1980s, O&Y assumed large positions in forestry and pulp and paper, transportation and energy.[8] The company also extended a $225 million loan to Robert Campeau's Campeau Corporation, secured by ScotiaPlaza in Toronto. Campeau, famous for his extravagance and vanity, became bored with the development business — only to become enamoured with the craze of leveraged buyouts. After purchasing two large retailers[9] in the Unites States, his company folded under the weight of his unserviceable debt (as a result of substantially over-paying for the companies) as the US retail sector slowed in 1989 and cratered in 1990. By that point, O&Y had both invested and lent Campeau $600 million, most of which was never recovered. Such non-core investments[10] would prove to be quite costly to the Reichmanns, as O&Y struggled to meet its own debt obligations amid falling rents and rising vacancies.

While the company diversified its holdings, it also undertook its largest project to date — the redevelopment of Canary Wharf.[11] Canary Wharf was one area designated for redevelopment in London. In 1981, the Thatcher Government created the London Docklands Development Corporation to oversee the development of a stretch of derelict land along the Thames, east of the traditional central business district.

The internationalization of financial services in the 1980s led some tenants to envision a new financial centre with modern buildings and infrastructure — something downtown London would have difficulty providing, given strict building bylaws. Excited by the prospect of creating a brand-new, first-class financial hub, O&Y signed onto the project in 1987.

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8 They acquired San Francisco-based Chevron Corp's 60% interest in Gulf Oil, in what was to that time the second-largest takeover in Canadian history. At the same time, Gulf acquired a majority interest in Abitibi-Price Inc. Then Gulf acquired Hiram Walker Resources Inc.

9 Allied Stores and Federated Department Stores.

10 In a 1993 *Fortune* interview, Paul Reichmann commented that a large part of the undoing of O&Y was the loss from these types of investments: "The mistakes were not in real estate but in our financing of other things, like Abitibi-Price and Gulf Canada Resources, that we did during an inflationary period." While perhaps discounting the degree of risk he took in his real estate projects, particularly Canary Wharf, it does speak to the impact of these non-core investments on the company's overall financial health. (Hylton and Welsh). The same behaviour also affected another (in)famous real estate developer — Donald Trump purchased the northeastern shuttle service of Eastern Airlines in 1989 for $365 million. Industry consensus was that he overpaid, and he lost control of the airline in 1991 after being unable to service the debt he assumed to acquire the company.

11 The Canary Wharf project began after O&Y had already begun developing the iconic World Financial Center site in Battery Park, Manhattan.

The first office building, One Canada Square, was completed in 1991. By that time, however, the project was mired in difficulties. First among the many issues facing the successful development of the project were the lack of transit access to the area and the fact that the City of London took exception to the potential loss of financial tenants by modifying planning bylaws and creating a surplus of commercial office space. With few tenants and depressed rents in London, a collapsing market for commercial real estate in North America decimating cash flows, and mounting development costs at Canary Wharf, the luck had finally run out for O&Y.

At the end, the company controlled millions of square feet of office space across its empire — impressively owning 75% of Manhattan's office space in May, 1992. Like the hundreds of small savings and loans that were unable to cover interest payments to depositors, O&Y could no longer service the massive debt they used to expand and fund their projects. From 1987 to May 1992, Manhattan vacancy rates reached 20%, with 30% rent reductions — many commercial properties could not service their debt or operating expenses.[12]

Meanwhile, the forest products and newsprint, energy and transportation sectors were suffering from the worst recession they had experienced in decades. The reduction in the value of their holdings, coupled with the poor performance of the real estate, put a severe strain on O&Y cash flows.

O&Y Bankruptcy

Some have argued that the hubris of the Reichmanns was the cause of the company's demise, taking too big a risk and making too many promises on Canary Wharf. Like any real estate developer, however, O&Y never undertook any project without first substantially leveraging their existing assets. The absence of due-diligence performed by the lenders, however, was shocking. In almost all cases, loans to O&Y — despite being backed by Canadian and US real estate — were advanced without review of company financials. Handshake agreements were common, and the financial community thought it impolite to ask tough questions of the Reichmanns, so great was the brothers' aura of financial invincibility.[13]

As a Toronto-based company, O&Y's strongest borrowing relationships were with the Canadian banks — primarily CIBC. But as the company grew, their borrowing needs outstripped the capacity of Canadian lenders[14]; as a globally-recognized leader in real estate development, O&Y had no trouble raising funds internationally. Loans obtained at the peak of the commercial development frenzy in 1989 are illustrative.

In January of 1989, HSBC headlined a $2.5 billion "Jumbo Loan" to the Reichmanns, advancing $750 million of its own money. This loan was a global effort, with German, French, Swiss, Japanese, Finnish and Italian banks lending the balance. The sole Canadian participant was The Royal Bank of Canada, contributing $220 million. Despite the significant size of the loan, the conditions were rather lenient — only once a year did O&Y have to furnish financial statements, and even then,

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12 Ghosh et al., p. 13.

13 Towers, 245. The aura largely revolved around the sterling reputation the Reichmanns had earned, such that they would often deny their bankers the right to examine O&Y's financials. During the boom times, with so many bankers wanting to do business with the Reichmanns, it was easy for them to adopt such a "take it or leave it" attitude.

14 Towers, p. 247.

they were not required to be audited. Interestingly, this loan was backed principally by O&Y's holdings in two public companies (Gulf Oil and Abitibi Paper) — which, at the time, barely covered the value of the loan.[15]

By the fall of 1990, O&Y was the largest private borrower in the world, with estimated debts totalling $17 billion. An announcement in September 1990 ominously foretold the end — O&Y was putting 20% of their US portfolio on the market. Despite vehement denials that the company needed cash to cover its sizable debt obligations, the investment community slowly grew suspicious. In 1991, Citibank, O&Y's largest American lender, decided that the handshake agreements they had with the company were no longer sufficient, and performed their own internal analysis on O&Y's creditworthiness. In the first quarter of 1991, Citibank's own analysts concluded that there existed a 20% chance the company would fold by Q1 1992, growing to 80% by the end of 1992. Any hope the company had lay in whether Paul Reichmann could raise more capital.[16]

Hope evaporated on March 4, 1992. O&Y had quietly negotiated a $240 million loan from four Canadian banks to help the firm meet obligations on its commercial paper. The loan, however, was improperly recorded prior to the actual closing of the deal. The early recording of the loan provided a signal to the financial community that O&Y was about to receive funds to alleviate its difficulties with meeting these obligations, effectively evaporating any confidence in the health of the firm. The loan was subsequently withdrawn and it became public knowledge that a significant loan to O&Y was cancelled. Overnight, the financial community surmised that O&Y was preparing to file for bankruptcy, eliminating any chance O&Y had to raise capital. On March 22, O&Y acknowledged that it would have to restructure about $15 billion in debt from 91 lenders. The formal bankruptcy filing came on May 14, 1992.[17]

The Canadian Experience

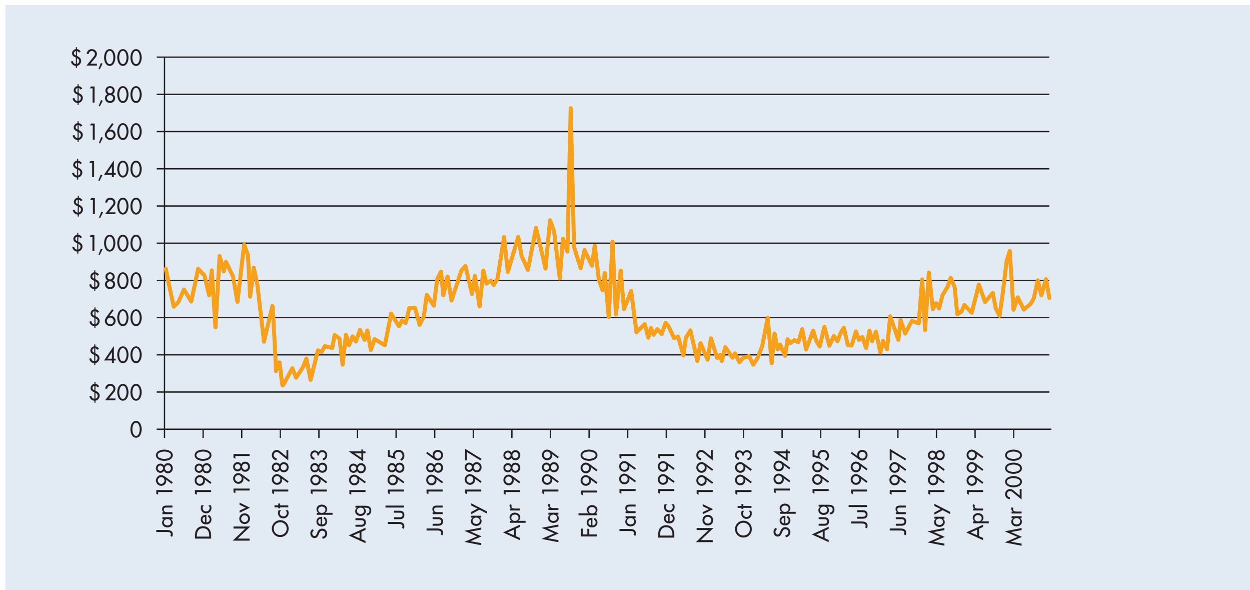
After the economic downturn in 1982, the commercial real estate development sector enjoyed a similar boom cycle to that of the northeastern United States. The value of new commercial building permits in Canada grew more than eightfold from 1982 to 1989, from $200 million to over $1.7 billion. (See Figure 3 on page 10.) The same data for new office space built versus office space absorptions for the northeast US does not exist for Canada, but one can imagine that the trend was similar. This explosion of growth in new construction outpaced the growth rate of the overall Canadian economy, which grew about 25% over the same period.

15 Towers, p. 248.
16 Towers, p. 266.
17 Ghosh et al., p. 41.

Figure 3:

Value of Commercial Building Permits, Canada, Seasonally Adjusted, 1980–2000

(in millions of 2000 dollars)

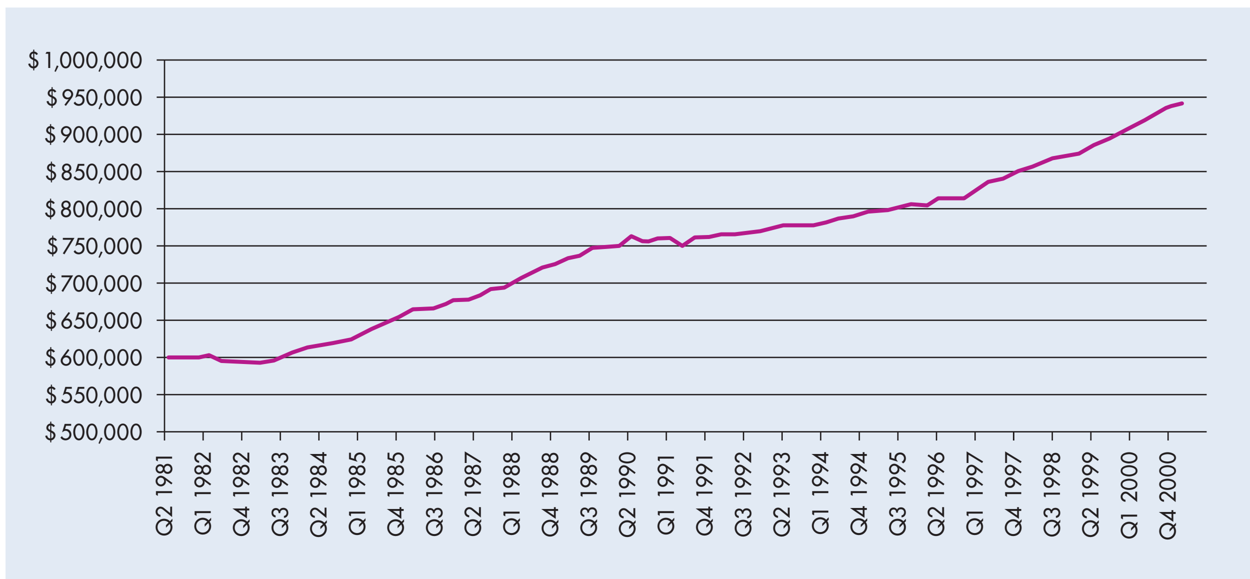


Source: Statistics Canada

Figure 4:

Quarterly GDP, Canada, 1981–2000

(in millions of 2007 chained dollars[18])



Source: Statistics Canada

18 "chained dollars" refers to the method used by Statistics Canada to deflate GDP dollars. It was introduced by the US Department of Commerce in 1996 to provide a more accurate reflection of market conditions, as it uses the average weights of goods and services in successive (rather than singular) years.

For the financial district in Toronto, the growth of office space grew consistently in the years leading up to the crash. Toronto added about 9,000,000 sq. ft. across 20 buildings between 1971 and 1981, and another 10,000,000 sq. ft. across another 26 buildings by 1992. Indicative of the depth of the crash in the market for commercial real estate — and the glut of new space that had been built for a growing economy that never materialized — only 700,000 sq. ft. of space (one building) was completed between 1993 and 1999 in Toronto's financial district as commercial office job growth slowed, and the excess capacity was absorbed.[19]

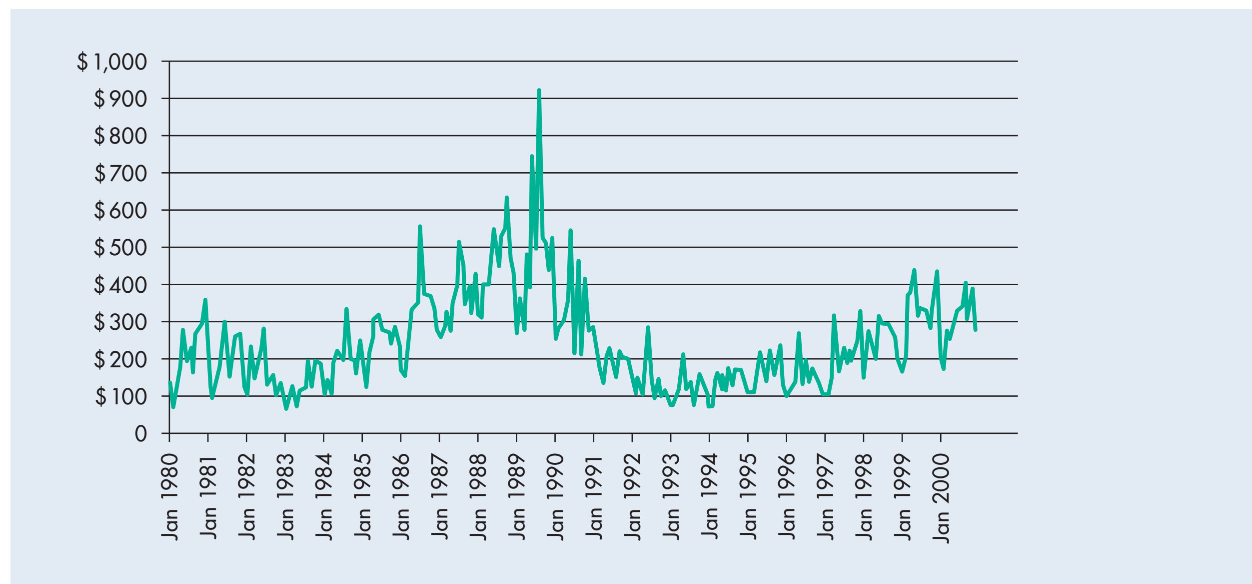
This trend was reflective of the city as a whole. While the net additions of new office space citywide approximately doubled from 35 million sq. ft. in 1971 to 73 million sq. ft. in 1981, the next decade saw growth double again. Through 1991, Toronto added another 68.5 million sq. ft. of commercial space. Illustrating again just how frothy commercial development was during the 1980s, only 6.7 million sq. ft. of new space was built between 1991 and 1999.[20]

The trend is also reflected province-wide, as shown in Figure 5, below. While Toronto is the largest market for commercial real estate in Ontario, there was no soft landing for the industry elsewhere. From a peak of over $900 million in new value permitted in 1989 to a valley of less than $100 million by the end of 1991, the precipitous drop in new activity was devastating for the industry.

Figure 5:

Value of Commercial Building Permits, Ontario (Municipalities over 10,000), 1980–2000

(in millions of 2000 dollars)



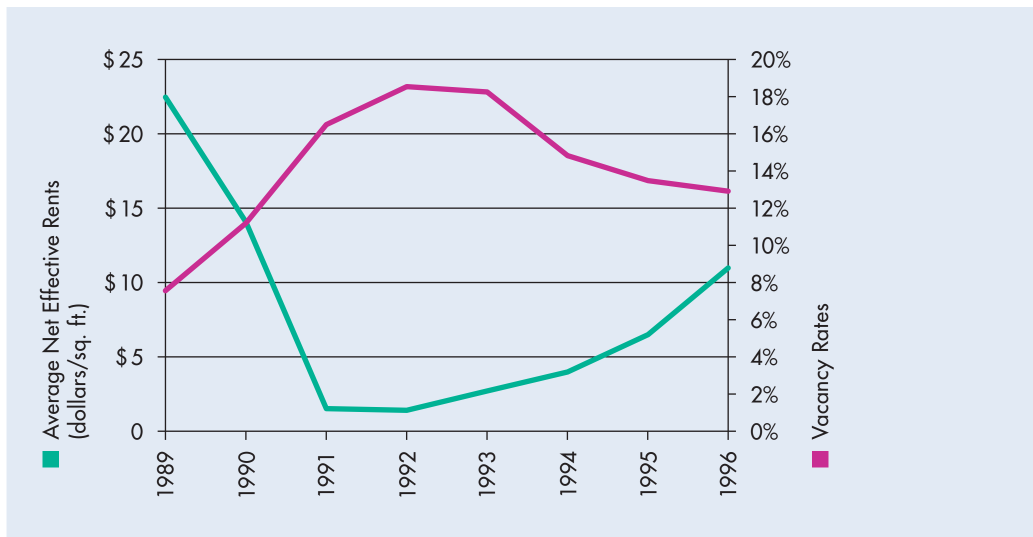
Source: Statistics Canada

19 Chamey, 2000, p. 181.

20 Chamey, 2000, p. 173.

Looking at vacancy rates and net effective rents in Toronto over this time period illustrates the volatility of the sector. While there were signs of economic distress starting in 1987 with the Black Tuesday in October, net effective rents in Toronto maintained a healthy rate above $20/sq. ft., sitting at about $22.50 in 1989. Reflecting the difficulty in attracting and retaining new tenants, by 1991, rents for the same calibre of office space had plummeted to $2/sq. ft. At the same time, vacancy rates continued to grow from less than 8% in 1989 to more than 18% by 1992.

Figure 6:
Downtown Toronto Class AAA Net Effective Rents and Class A Vacancy Rates, 1989–1996



Source: RBC Internal Documents

In light of these numbers, one can imagine the difficulty of maintaining the necessary cash flows to avoid bankruptcy in this climate. Fewer and fewer tenants paying a fraction of the rent from only two years prior represented a deep shock to developers and owners of commercial real estate. For companies like Olympia and York, which relied on their North American holdings to act as security for their loans funding new construction like the Canary Wharf project, bankruptcy protection was the only option. And like the experience of the US banks trying to recover as much of their commercial loans as possible, the Canadian banks that had extended credit to Canadian developers found themselves holding loans that significantly outstripped the value of the underlying properties.

Canadian Banks Weather the Downturn, Northeastern US Banks Suffer

The Canadian banks, by virtue of their size and oligopolistic nature, were able to weather the storm of non-performing loans and loan losses. Being so large and geographically-omnipresent, the banks were also able to offset real estate losses in the urban pockets of major cities with business across the country and other banking units.

While the commercial real estate crisis was costly for Canadian banks, the experience was perhaps indicative of banking attitudes of the time. In the 1970s and early 1980s, Canadian banks became overexposed to foreign sovereign borrowers, lending indiscriminately to many Latin American and other less-developed countries in a search for higher returns. With the default of Mexico and other nations on this debt, the banks found themselves in a difficult position, having demonstrated themselves less-than-adept at managing their own risk profiles.[21]

Partly in response to the foreign debt crisis — and to the situation concerning the wild and largely unregulated behaviour of trust companies at this time — the Office of the Superintendent of Financial Institutions was created in 1987 to rebuild a sense of confidence in Canada's banking system. A first step for the new regulator was to force write-downs and greater loan loss provisions for Canadian banks exposed to bad foreign debt.

Only a few years later, with the collapse of the commercial real estate market and the bankruptcy of O&Y, the Canadian banks again found themselves on the wrong side of their lending practices. With each bank competing with the others for the privilege of lending on commercial projects — particularly those with developers like O&Y — banks chose to overlook key practices of loan underwriting. With most Canadian banks lending hundreds of millions of dollars to O&Y on the basis of handshake agreements and cursory glances at out-of-date and unaudited financial statements, it is unsurprising that the banks made poor decisions. Recently chastened by a more stringent federal regulator, the banks were quick to recognize losses on much of their commercial loan portfolios.

RBC is an instructive example, as it was the largest Canadian financial institution at the time. In response to the growing importance of its commercial real estate portfolio, RBC began separating out this portion of its loan portfolio in 1988 in its annual reports. As seen in Figure 7 on page 14, the portfolio of loans for commercial real estate approximately doubled from 1988 to 1991 — meteoric growth at the height of the construction frenzy.

1992, however, was markedly different. Commercial real estate lending declined by approximately $500 million, as the market evaporated and RBC made the decision to halt all commercial real estate lending in 1991. It was not until 1993 that RBC would again underwrite commercial real estate deals, using more conservative guidelines for lending.[22] In the meantime, RBC worked to wind down most of their real estate lending. It would be a decade until the portfolio would grow again, with a modest $200 million increase on a base of $2.4 billion from 1999 to 2000.[23]

21 See Karn, Kobrack and Martin, work in progress, for a more thorough treatment of the LDC debt crisis.
22 Personal Communication, RBC.
23 RBC Annual Reports.

For RBC, the crisis took hold firmly in 1992. The bank's non-accrual loans (those loans for which interest is more than 90 days in arrears, and the bank has decided that interest and principal is likely to go unrecovered) increased more than threefold to $1.142 billion in 1992, from $360 million in 1991. These poorly-performing loans would peak in 1994 at $1.8 billion as borrowers' resources to meet their obligations dwindled throughout the crisis.

Figure 7:

RBC Commercial Real Estate Loan Portfolio, 1988–2000

(in millions of dollars)

Year	Loans	Non-accrual Loans[24]
1988	3,616	51
1989	5,148	35
1990	6,292	136
1991	7,098	360
1992	6,539	1,142
1993	5,468	1,202
1994	4,534	1,809
1995	4,234	1,126
1996	3,285	599
1997	2,872	348
1998	2,523	182
1999	2,400	186
2000	2,594	90

Source: RBC Annual Reports

Unsurprisingly, the geographic distribution of RBC's commercial real estate lending was concentrated in Toronto. More than half of all outstanding commercial real estate loans for RBC were located in Toronto in the early 1990s. By 1994, the proportion dropped just below 50%, but remained at 44% in 1995.[25]

The remarkable concentration of lending in Toronto for RBC mimics the intense local concentration of commercial lending of the New England-based banks that failed in the wake of the crisis. In 1993, more than 50% of all commercial real estate loans made by RBC in Toronto were in arrears.

24 Non-accrual loans are those where RBC no longer has reasonable assurance of the timely collection of principal and interest, or if a payment is 90 days past due.

25 RBC Annual Reports.

In a June 1992 interview, RBC CEO Allan Taylor spoke to his bank's resiliency in the face of the commercial real estate crisis. Despite having just classified $510 million of RBC's $780 million in loans to O&Y as non-performing, RBC's earnings were only slightly off the prior year's numbers. Critical of the popular media's reporting of his (and all the banks') dealings with O&Y — particularly the lack of due diligence performed by lenders in an effort to win O&Y business — Taylor maintained that the underlying assets RBC had lent against remained of the highest quality. Recognizing a "tremendous meltdown in real estate values," Taylor maintained that "there will continue to be basic long-term value" in the O&Y properties.[26]

Despite the fact that the bank was highly exposed to one metropolitan market where more than 50% of its loans were non-performing, Taylor foresaw continued growth and profitability for the bank in the coming quarters. RBC earnings did rebound throughout the 1990s, but it seems that the only credit that can be given to Canadian banks and RBC in particular is that their size and geographic distribution allow them to survive somewhat reckless lending practices.

Figure 8:

Commercial Real Estate Loans in Metropolitan Toronto and the Rest of Canada, 1992–1995

(in millions of dollars)

	Loans		Non-accrual Loans	
Year[27]	Metro Toronto	Rest of Canada	Metro Toronto	Rest of Canada
1992	3,826	3,664	1,487	136
1993	3,628	3,520	1,924	375
1994	2,798	3,072	1,436	373
1995	2,188	2,742	917	209

Source: RBC Annual Reports

Looking more broadly at the Canadian economy, GDP did fall during the crash. Canada entered into a period of recession in 1990–1991, and languished there longer than the recession of 1981–1982. The broader economy recovered gradually, and continued to grow again by the fourth quarter of 1991.

Conversely, US banks, largely characterized by smaller capitalization and local markets, suffered substantially, particularly in the northeast. As the commercial real estate crash was largely a story of urban markets, the US northeast was particularly susceptible to the volatility of the market. As in the case of the Toronto market, construction of new office space in the US outstripped demand. In all major US markets, new completions exceeded absorptions every year from 1980 to 1992. Meanwhile, US office employment growth fell to -2.7% in 1991.[28] As mentioned above, the market collapsed, leaving lenders in difficult positions.

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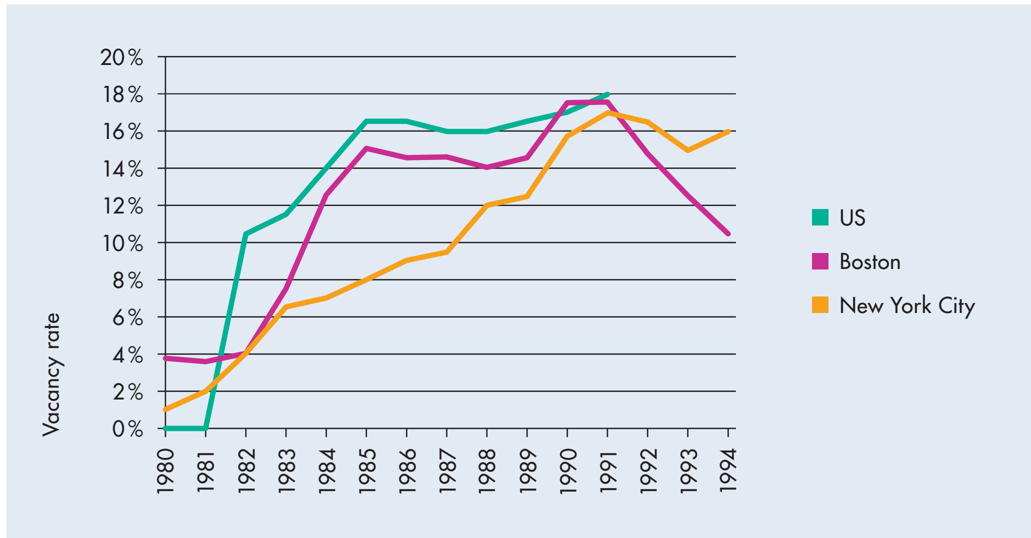
26 Newman, p. 41.

27 The bank only reported the information publicly in this manner from 1992 to 1995. These numbers are presented as of October 31 for the years in question, and as such, differ from the totals presented in the previous chart detailing RBC's commercial lending, which were recorded at year end.

28 Freund et al, p. 146.

Figure 9, below, shows that vacancy rates in Boston and New York City reached 17% at the peak of the crash — rates in downtown Manhattan were worse, exceeding 20% in 1991.[29] The more depressed situation in New York and Boston (when compared to the rest of the country) left the region's smaller financial institutions in a more precarious position. Unsurprisingly, many of these banks failed.

Figure 9:
US, Boston and New York City Office Vacancy Rates, 1980–1994
(as a percent)



Source: Adapted from Lamm and O'Keefe

As noted earlier in Figure 2 on page 5, many banks failed in the United States in the late 1980s as a result of the savings and loan crisis taking hold across the country. When the commercial real estate market crashed at the end of the decade and in the beginning of the 1990s, the collapse of northeastern banks outpaced those across the rest of the US. While the remainder of the country's financial system stabilized in the early part of the 1990s, those banks that had funded the commercial property construction boom in the northeast suffered. In 1990 and 1991, northeastern bank failures represented more than 40% and 35% of nationwide bank failures, respectively. Indicative of the relative size and importance of these failures, FDIC losses as a result of northeastern bank failures comprised 91% and 77% of nationwide losses in those two years.[30] The northeastern banks overextended themselves in their local commercial real estate markets, and paid dearly as a result.

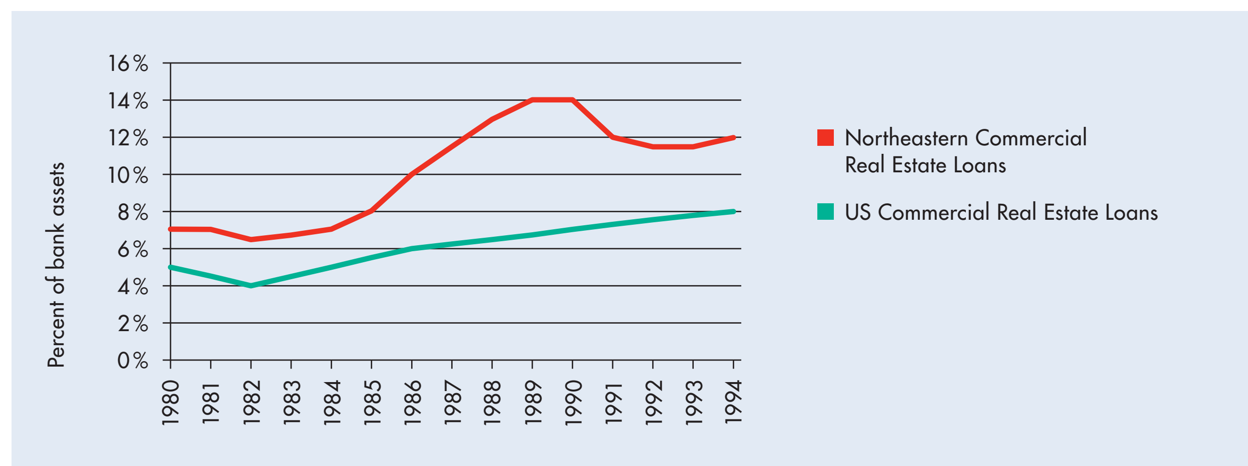
29 Brauer and Flaherty, p. 70.
30 Lamm and O'Keefe, p. 369.

The extent to which northeastern banks were overexposed to commercial real estate is illustrated in Figure 10, below. In comparing the total outstanding commercial real estate loans of northeast banks to the national average of banks across the US, it becomes clear just how invested in the local commercial markets these banks found themselves. Commercial real estate loans as a percent of assets were about double the national average for banks in the northeast, from approximately 1986 through 1990.

Figure 10:

Size of Commercial Real Estate Loan Portfolios, Northeastern vs US Banks, 1980–1994

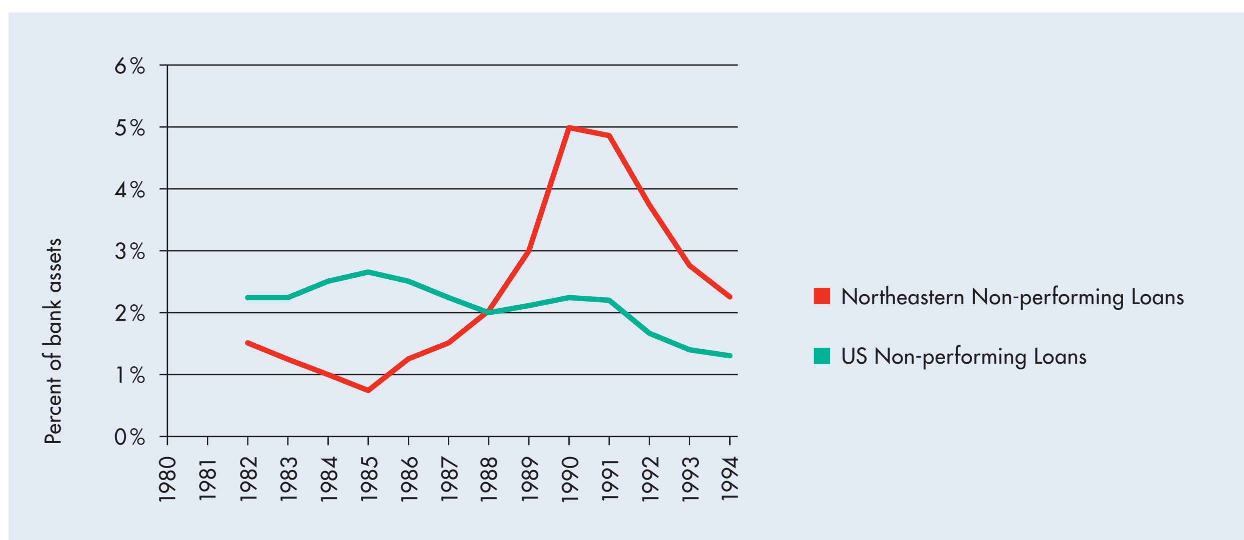
(as a percent of bank assets)



Source: Adapted from Lamm and O'Keefe

This overexposure came back to haunt these banks when their portfolio of non-performing loans is examined. In the early 1980s, northeastern banks actually outperformed the national average of banks by almost a factor of 3, with only 0.75% of bank assets non-performing in 1984. The situation quickly reversed, however. While the US average for non-performing assets generally declined from 1985 onward, northeastern banks saw a dramatic increase in non-performing assets. (See Figure 11 on page 18.) For northeastern banks, non-performing assets surged to approximately 5% by 1991 as their portfolio of commercial real estate loans degraded in quality. Rising vacancies and falling rents in New York and Boston, coupled with negative growth in office employment, proved a catastrophic mix for the region's banks.

Figure 11:
Non-performing Loans, Northeastern vs US Banks, 1982–1994
(as a percent of bank assets)



Source: Adapted from Lamm and O'Keefe

Conclusion

The commercial real estate crisis on the 1980s and 1990s was devastating to many players involved in the market. Most deeply impacted were smaller US banks, and almost all commercial developers — including giants like Olympia and York. While Canadian banks suffered during the downturn — at RBC, for instance, more commercial real estate loans were in arrears than were in good standing during the early 1990s — they largely weathered the storm on account of geographic reach and diversified interests.

Crises often breed new behaviour — in the case of MortgageCo, it eschewed bank financing for private money — a move that provides for greater flexibility in closing development deals. In the low interest rate environment that has existed for the past 20 years, there has been a glut of private investors looking to earn returns beyond what a bank can offer; these investors have enjoyed the returns earned by privately financing deals. In the case of large financial institutions, projects had to meet much stricter standards to win financing. RBC cut all commercial lending, before gradually re-entering the market by tentatively lending to Real Estate Investment Trusts, a new real estate finance vehicle spawned in 1993.

Real estate markets since the early 1990s, however, have remained relatively stable and are now a favoured asset class for institutional investors and homeowners. Though prime markets, like Toronto and Manhattan, weathered the financial crisis of 2008–2009 quite well, it is instructive to note that real estate is inherently risky as an asset class and the impact of crashes can be long lasting. Extending the historical horizon beyond 20 years illustrates that it can take a decade for demand to rebound for office and retail space, while residentially, the Toronto market required 20 years for housing prices to return to pre-crash levels.

Appendix

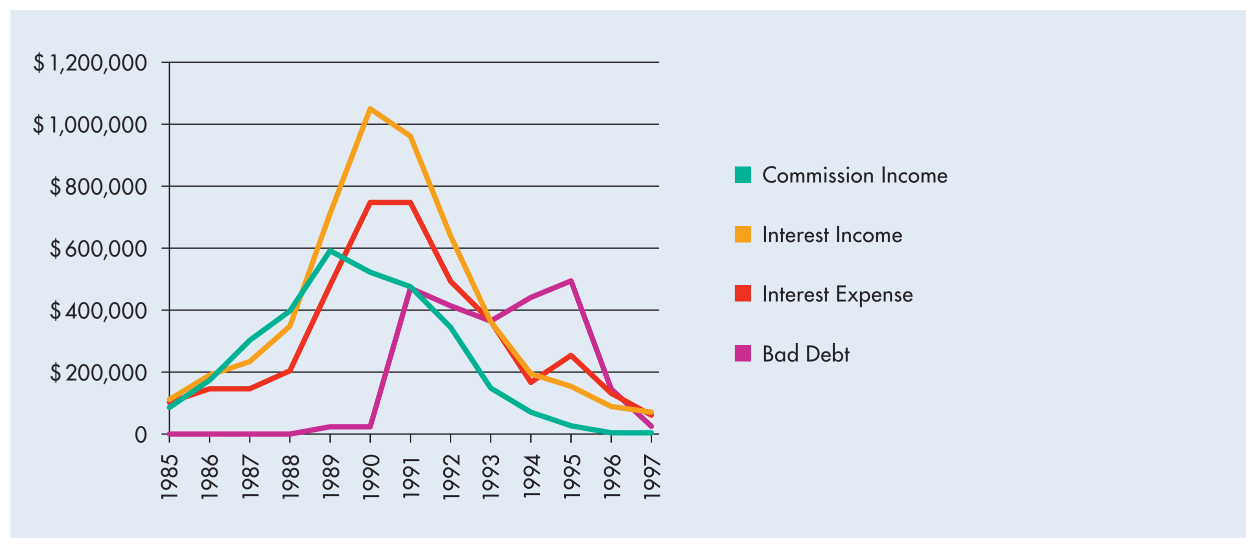
Exhibit 1

The experience of MortgageCo[31] during the Commercial Real Estate crisis

With banks like RBC holding such a substantial proportion of their loan portfolio in arrears, regulators and management alike were concerned. While the majority of these loans involved the bank acting as the broker and lender on the deals, RBC also provided lines of credit to other brokers and real estate firms. The degree to which the bank panicked during the depths of the crisis is evident from the example of MortgageCo — a small, private lender on commercial and residential real estate.

As shown in Figure 12, below, MortgageCo opened for business at just the right time. Following the small recession of the early 1980s, MortgageCo quickly grew in scale. Despite operating as a two-man outfit, the company grossed about $200,000 on commission and interest income, on a loan book of $860,000 (funded largely by a bank loan from RBC of $760,000) in 1985. Business grew sixfold by 1989. Gross revenue grew to approximately $1.2 million on a loan book of more than $6.2 million. The loan portfolio was composed of about 60 residential and 30 commercial mortgage loans, with a similar dollar-value proportion.

Figure 12:
MortgageCo Limited, Selected Revenue and Expenses, 1985–1997



31 MortgageCo is a real mortgage brokerage and administrator, operating in Ontario. All figures are genuine — only the company name has been changed.

Like all lenders during this period, business was profitable. And like all lenders, each loan portfolio gradually slipped into arrears as the crisis began to take hold. In the case of MortgageCo, bad debt spiked in 1991 and remained relatively constant through 1995. Also of note was that while interest income grew quickly, so did interest expense — much of the funding for MortgageCo's loan came in the form of a line of credit. During the boom times, the line of credit was the lifeblood of the company — without the money, there was no way to fund the deals that the formal banking sector either wouldn't fund or couldn't move quickly enough to capitalize on the opportunities. These lines of credit, however, were among the first points of attack for the bank to attempt to remedy its disastrous loan portfolio.

In 1991, as part of the larger bank policy on commercial real estate lending, RBC froze MortgageCo's line of credit and required the company to reduce its exposure as loans were repaid. What was interesting during this time period was the nature of the communication from the bank. From 1991 onward, the bank continually asked that MortgageCo reduce its draw on the line of credit, despite the fact that MortgageCo was successfully managing its bad debts and finding new deals. Nevertheless, the balance on the bank loan declined by about 50% from a high in 1989 to 1994. Throughout this time, RBC continually reaffirmed that the bank valued MortgageCo as a client, and that at the end of the crisis, it wanted to make sure companies like MortgageCo remained as clients.

The tone changed abruptly, however, in 1994. Under the auspices of a regular update meeting, the company was — without warning — told to meet with a manager at the "special loans" desk — which dealt with problem clients. At that meeting, the bank demanded full repayment of the line of credit.

MortgageCo survived the disintegration of its relationship with its banker, largely by negotiating a settlement and resorting to completing new deals under a different legal entity. As noted in Figure 12 on the preceding page, commission income fell to nearly nothing by 1995, as RBC had little appetite for extending credit to those businesses operating in the alternative lending market.

This example of a small, independent business operating in the commercial real estate market during the crisis is instructive of the difficulty banks have in unwinding their portfolios. While the apex of the crisis occurred in 1991 and 1992, RBC was unable to collect on the line of credit it had extended to MortgageCo until 1997, when a final settlement was reached.

The nature of the private mortgage business, however, changed considerably in the aftermath of the crisis. As business picked back up in the 2000s, companies like MortgageCo realized that they could no longer rely on bank financing in times of stress. As a consequence of their treatment during the crisis, the private lending industry turned to alternate sources of funding. Today, MortgageCo operates a similarly-sized portfolio, funded almost entirely by a group of private investors.

Exhibit 2

What happened in the Toronto housing market during this period?

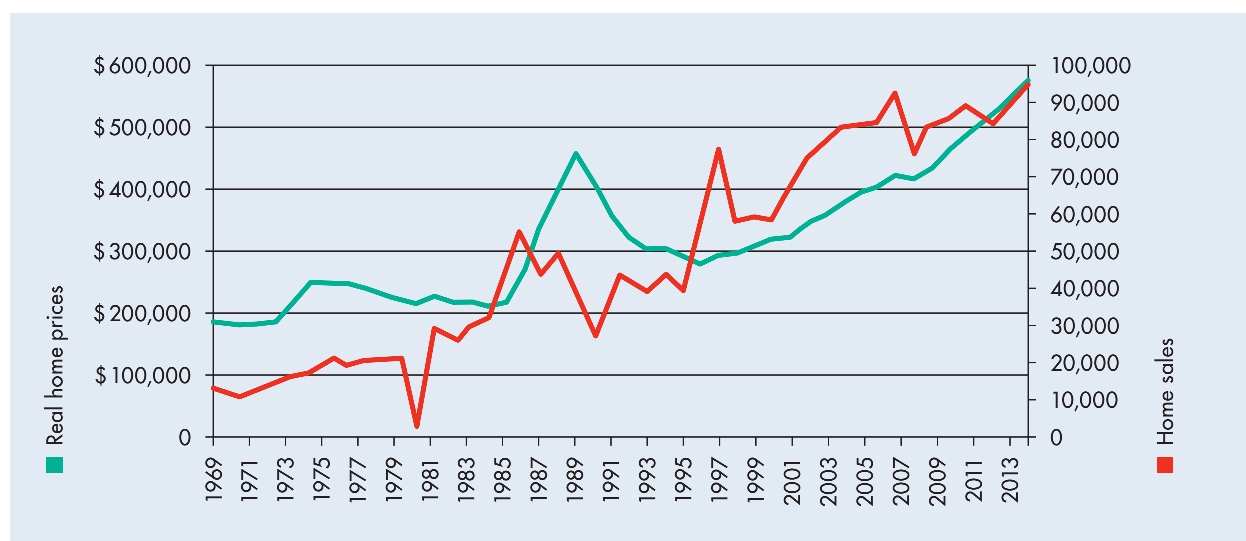
Given the pattern followed by the commercial real estate boom and bust, it bears examining what happened in the residential market at the same time. Focusing on major urban centres, it is clear how the residential market followed suit.

As shown in Figure 13, below, real Toronto housing prices increased by 2.5 times from 1985 to 1989 — clearly Toronto homeowners were caught in the same frenzy as the commercial developers and financiers. For context, the peak prices in 1989 would not be matched again until 2010 — when average real home prices again reached about $460,000. The crash was almost as precipitous, with average prices falling back below $300,000 by 1995.

Figure 13:

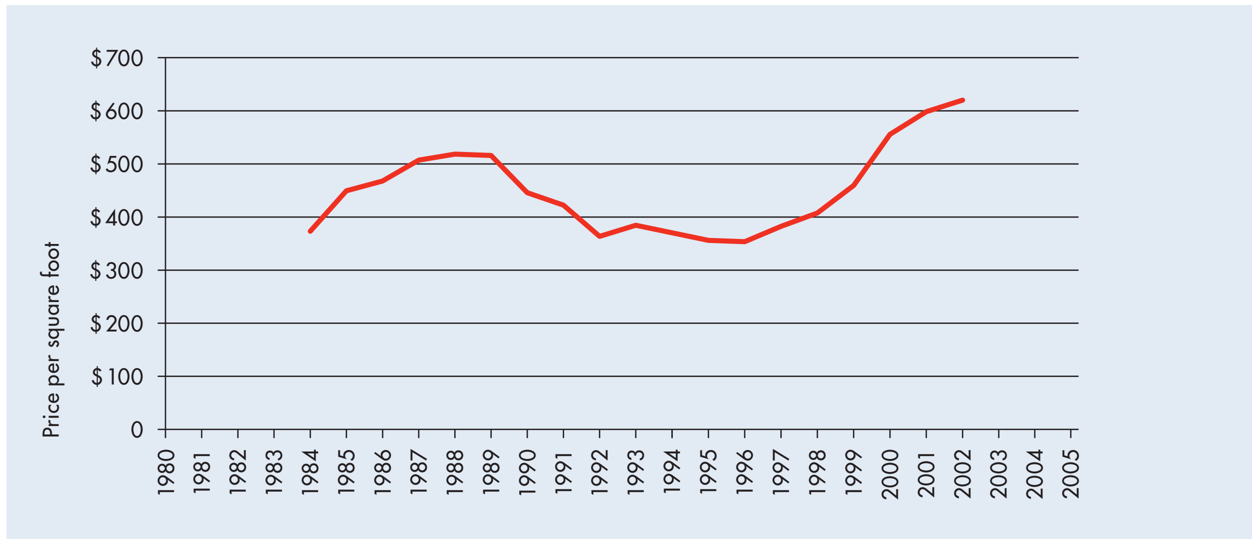
Toronto Home Prices and Sales, 1969–2014

(in 2014 dollars)



Looking at Manhattan condominium prices from 1984 to 2002, prices followed a similar path. (See Figure 14, below.) While prices only appreciated about 40% from 1984 to the peak in 1989, prices dropped below the pre-crisis level throughout the mid-1990s; this outcome was more costly for Manhattan homeowners than those in Toronto, who saw an elevated price plateau following the collapse of the commercial real estate market.[32]

Figure 14:
Mean Manhattan Condo Price Per Square Foot, 1984–2002
(in 2002 dollars)



32 Glaeser, et al., Table 1, p. 44.

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