

CUER Discussion Paper

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Institutional Features of Canadian Real Estate

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INTRODUCTION

Despite Canada's small number of urban centers, trying to generalize to a "Canadian" real estate market is challenging. The country's political and economic institutions accentuate clear regional differences. Relative to other countries with federal systems, Canadian provinces are especially powerful. The economies of British Columbia (Vancouver), Alberta (Calgary and Edmonton), Ontario (Ottawa and Toronto), and Quebec (Montreal) are driven by very different factors. For British Columbia, these are forestry and resource extraction, tourism, and trade with Asia. For Alberta, it is oil and gas drilling and exploration. Key sectors in Ontario are auto and auto parts manufacturing, high tech and finance. And in Quebec it is diversified manufacturing and forestry. High tech is also a presence in Vancouver and Calgary but in different areas. This chapter focuses on the institutional framework in the four principal Canadian real estate markets, Calgary, Montreal, Toronto, and Vancouver.

Canada is a nation of immigrants and continues to have one of the highest levels of per-capita immigration in the world.¹ This has resulted in a tremendous ethnic diversity and has helped to encourage considerable foreign ownership of real estate and development activity. Foreign ownership of larger Class A downtown properties ranges from a high of nearly 17 percent of all square footage in Vancouver, to 12 percent in Calgary, almost 6 percent in Toronto, and over 7 percent in Montreal. The development of the former Expo lands on the south side of Vancouver's downtown peninsula was initiated by investors from Hong Kong led by Li Kai-Sheng. Compared to other G7 nations the Canadian market is small, but it does have advantages in openness, transparency, and stable legal and political environment.

Though regional issues are extremely important in Canada, there are important national similarities. A simplistic but accurate characterization of English Canada, that is Canada excluding Quebec, is an overlay of American individualism on an English legal and social tradition. Canadians have a more communitarian approach to social issues and greater suspicion of wealth than one would find in the United States. Cultural themes, urbanization, degree of government presence in the economy do vary, but these are dominated by shared values, especially across the major business centers.

The important exception is Quebec, whose social, legal, and cultural traditions are markedly different from those in the rest of Canada. French speakers in Canada are overwhelmingly in Quebec. Over 90 percent of Canadians who speak French in the home live in Quebec and represent 82.8 percent of Quebec residents. This can be compared to 2.9 percent in Ontario. Quebec has a strong, though mostly non-violent, separatist movement. The root of this movement is the "quiet Revolution" of the 1960s that recast French-Canadian nationalism as Québécois nationalism. This movement reached its zenith in 1995, when a referendum endorsing separation came within one percentage point of passing. The effect of the separatist movement has been to strengthen French language and cultural institutions in Quebec. The election of the Parti

¹ During 2001-02, over 255,000 individuals immigrated to Canada, representing 0.81% of Canada's July 2002 estimated population of 31,413,990. In comparison, the US accepted 849,807 immigrants, approximately 0.3% of the population.

Québécois in 1976 on a platform of sovereignty for Quebec and with an aggressive program to preserve French by downgrading English has resulted in Toronto replacing Montreal as Canada's primary business and financial centre.

This chapter presents a number of the central issues that affect real estate investment and development in Canada. The first section provides an overview of Canadian real estate markets. It includes a brief description of the historical performance of residential and non-residential real estate in the four principal metropolitan area real estate markets in Canada, Calgary, Montreal, Toronto, and Vancouver. It also discusses the changes in the patterns of ownership, between REITs and public corporations, and the growing share of real estate held by pension funds. The second section examines property rights in Canada, with a major emphasis on issues connected to aboriginal land claims. The third section describes the allocation of powers over real estate between the federal, provincial, and local governments. The fourth section looks at land use and development regulation. The fifth section addresses real estate financing and marketing.

CANADIAN REAL ESTATE MARKETS

This section provides an overview of conditions and issues in Canadian real estate markets, with a focus on the four main metropolitan real estate markets in Canada, Calgary, Montreal, Toronto, and Vancouver. While Canada is a physically large country, the population is not only highly urbanized, but concentrated in a small number of cities. Collectively in 2001 these four cities had approximately 35 percent of Canada's population of 31 million.² Nearly 80 percent of the office space in the nine investment real estate markets in Canada in 2001 is found in these four cities, and of this, half (40 percent of the total) is in Toronto. These four cities also dominate the market for industrial properties: they have an 87 percent share of industrial space, with Toronto accounting for over half of this with 47 percent share of the total amount of space.

Market Description and Performance

Table 1 summarizes mid-2001 conditions in Canadian class A office markets. In both Ottawa and Vancouver, growth in demand has been much stronger outside the downtown core. This reflects the importance of the high-tech sector in these markets.³ The downtown cores are relatively more important in Calgary, Edmonton, and Montreal. As in other cities in North America, suburban vacancy rates tend to be higher. Data for industrial space in 2001 are shown in Table 2. Industrial activity has been strong across the country, except in Ottawa, where the tech sector has tended to use office space. However, the strength of the oil economy in Alberta shows up in the notably higher absorption rates in Calgary and Edmonton.

² The metropolitan areas had 2001 populations as follows: Toronto 4,682,897, Montreal 3,426,350, Vancouver 1,986,965, and Calgary 951,395.

³ With the collapse of the tech bubble, vacancy rates increased dramatically in these suburban markets in the period following the date of the table.

The cities differ dramatically in their employment growth, with growth highest in the west. Between 1987 and 2001 total employment in Calgary and Vancouver grew nearly 55 and 46 percent respectively.⁴ This is significantly higher than the growth rates of 14 and 26 percent achieved in Montreal and Toronto. Table 3 breaks down the composition of employment by class. Several things are most notable. First, the importance of the oil industry means that the employment share of primary industries in Calgary is nearly seven times greater than in the other cities. The two larger, older cities in central Canada have twice the employment share in manufacturing than do the two faster growing western cities. Vancouver has a relatively larger share of employment in commercial and non-commercial services.

Table 1 - Canadian Office Markets 2001

City	CBD/Downtown - Class A			Suburban/Non-CBD - Class A		
	Inventory	5 yr Avg Absorption	Vacancy Rate	Inventory	5 yr Avg Absorption	Vacancy Rate
Calgary	20,614,000	486,000	5.5	3,676,000	341,000	9.2
Edmonton	8,345,000	85,000	14.0	2,629,000	142,000	7.3
Montreal	19,535,000	523,000	2.5	6,961,000	434,000	8.3
Ottawa	7,730,000	140,000	2.2	10,898,000	556,000	6.4
Toronto	34,520,000	1,294,000	4.2	37,348,000	1,436,000	10.0
Vancouver	14,462,000	110,000	5.4	6,278,000	723,000	8.0

Source: Penreal Capital

Notes: Vacancy rate is as of June 2001

⁴ Employment data is from The Conference Board of Canada. The raw data comes from Statistics Canada reports.

Table 2 - Canadian Industrial Markets 2001

City	Inventory	5 yr Average Absorption	Absorption as Percent of Stock	Vacancy
Calgary	75,968,000	2,286,000	3.0	3.2
Edmonton	67,750,000	1,804,000	2.7	4.1
Montreal	262,600,000	4,267,000	1.6	4.0
Ottawa	23,379,000	360,000	1.5	2.6
Toronto	656,971,000	9,997,000	1.5	4.4
Vancouver	151,450,000	3,061,000	2.0	3.0

Source: Penreal Capital

Notes: Vacancy rate is as of June 2001

Table 3 - Employment by Sector 2001Q4

Sector	Calgary	Montreal	Toronto	Vancouver
<i>Goods Producing Industries</i>	24.8%	23.7%	24.3%	15.3%
Primary and Utilities Industries	7.5%	0.5%	0.6%	1.1%
Manufacturing	8.8%	18.7%	17.3%	8.8%
Construction	7.5%	3.6%	5.7%	4.8%
Utilities	1.1%	1.0%	0.7%	0.5%
<i>Services</i>	75.2%	76.3%	75.7%	84.7%
Transportation, Storage and Communication	6.6%	5.0%	5.0%	6.0%
Wholesale and Retail Trade	15.7%	16.2%	16.3%	17.0%
Finance, Insurance and Real Estate	5.8%	6.5%	8.9%	6.7%
Commercial Services	30.9%	26.9%	29.7%	34.1%
Non-Commercial Services	13.1%	16.9%	12.6%	17.1%
Public Administration and Defense	3.1%	4.7%	3.3%	4.0%

Source: Conference Board of Canada

Both the residential and non-residential real estate markets in Calgary show the effects of the city's dependence on the oil industry.⁵ As Figure 1 shows, real housing prices and

⁵ Housing start numbers are those published by CMHC (Canadian Mortgage and Housing Corporation). Real house prices are calculations based on the results of the Royal LePage Survey of Canadian House Prices <http://www.royallepage.ca/calculators/nptc/index.asp>.

housing starts fell dramatically (35 and 80 percent respectively) following the collapse of oil prices in the early 1980's. Housing starts accelerated in the mid-1990's and the market has remained Canada's fastest growing through 2001. Since 1996 real house prices are up over 20 percent, with starts nearly doubling since 1995. Still, neither real prices nor starts have approached their 1981 peak.

Conditions in the Calgary office market are shown in Figure 2. The market was weak through the late 1980's and early 1990's with high vacancy and relatively little absorption. Growth in absorption in the mid 1990's with the recovery of the oil market and the emergence of Calgary as a home for corporate headquarters such as Canadian Pacific, which moved from Montreal to Calgary instead of Toronto, led to dramatic declines in vacancy and substantive new construction in 2000 and 2001. With a smaller technology sector and one geared to oil exploration, Calgary has survived the tech meltdown better than Ottawa and Vancouver.

Figure 1

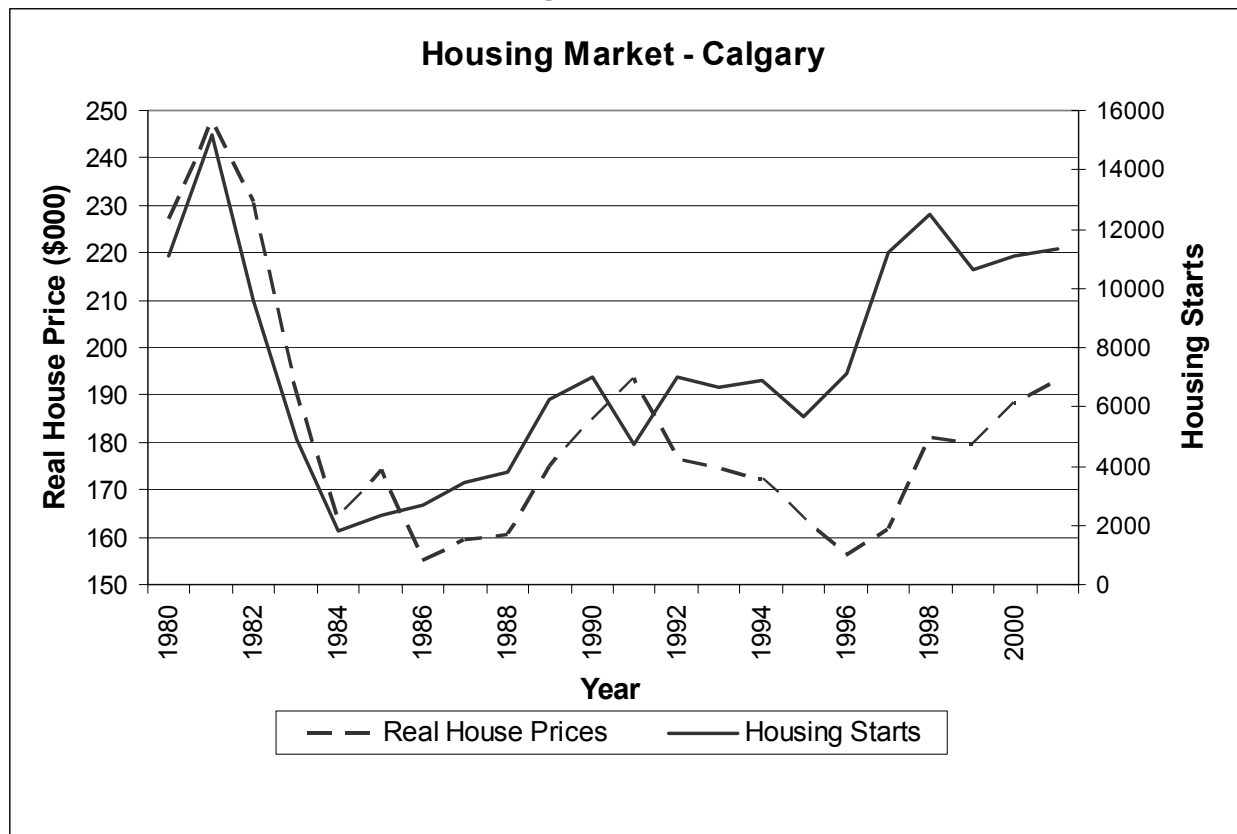
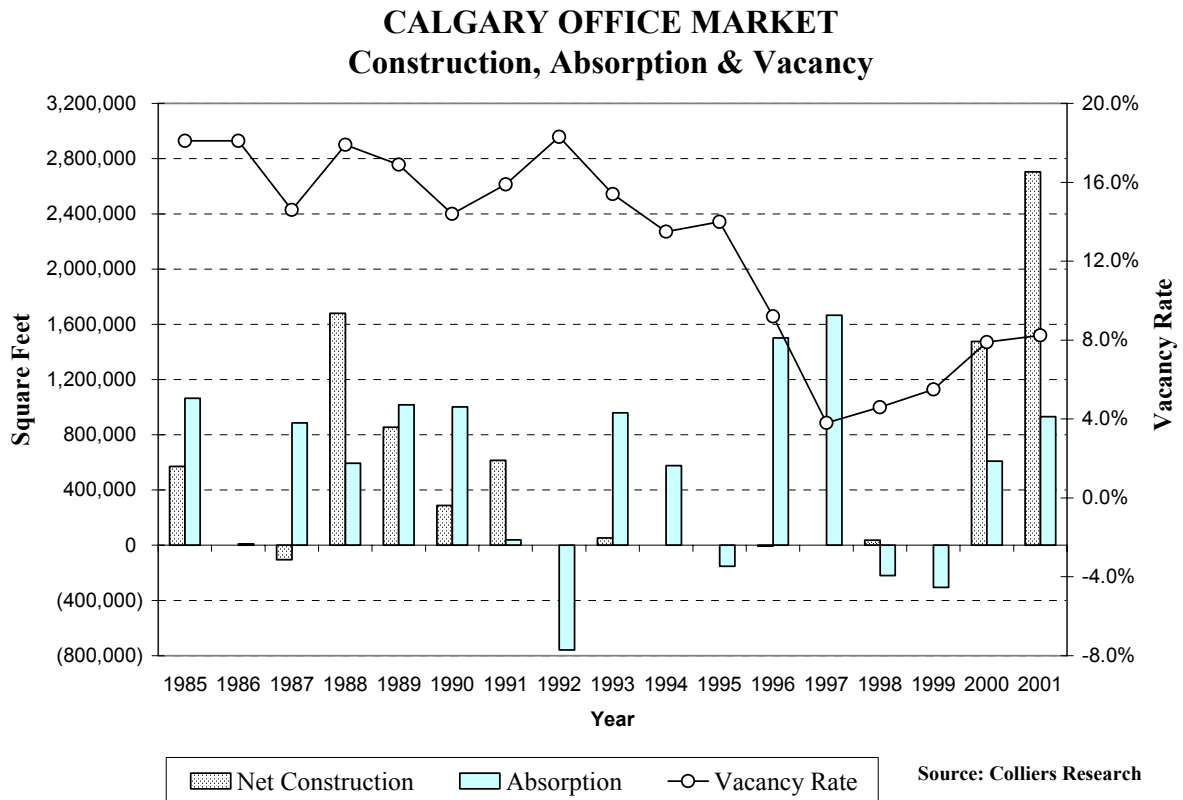


Figure 2



Real estate markets in Montreal declined for 10 years from the mid-1980's through the mid 1990's. Housing starts and real house prices shown in Figure 3 indicate that conditions only began to improve in 1995, but this improvement has been modest at best. Current housing starts in Montreal are similar to those in Calgary, a city one quarter the size. Conditions in Montreal's commercial real estate market (Figure 4) were so bad as to have three consecutive years of negative absorption. While absorption has picked up, private construction remains quite low. Part of this is because two government mega-projects, E-Commerce Place and Multimedia City, have both taken growth and cannibalized existing buildings.

Like Montreal, Toronto suffered a sharp downturn in the real estate market in the early 1990's. As Figure 5 shows, housing starts plunged over 50 percent while real house prices fell 35 percent. However, the strong North American auto market in the late 1980's revitalized Ontario's economy and brought a 147 percent increase in starts, though even after a climb of 15 percent, real house prices remain close to 25 percent below their 1990 peak. The consequences of the late 1980's orgy of overbuilding in Toronto are shown in Figure 6, where the office vacancy rate topped 20 percent in 1994. The legacy of this crash was so great, that there was no new construction in Toronto's downtown until the past year. Real estate markets have basically recovered. However, except for the tech peak in 2000, absorption from 1990-2001 was below the levels of the late 1980's.

Figure 3

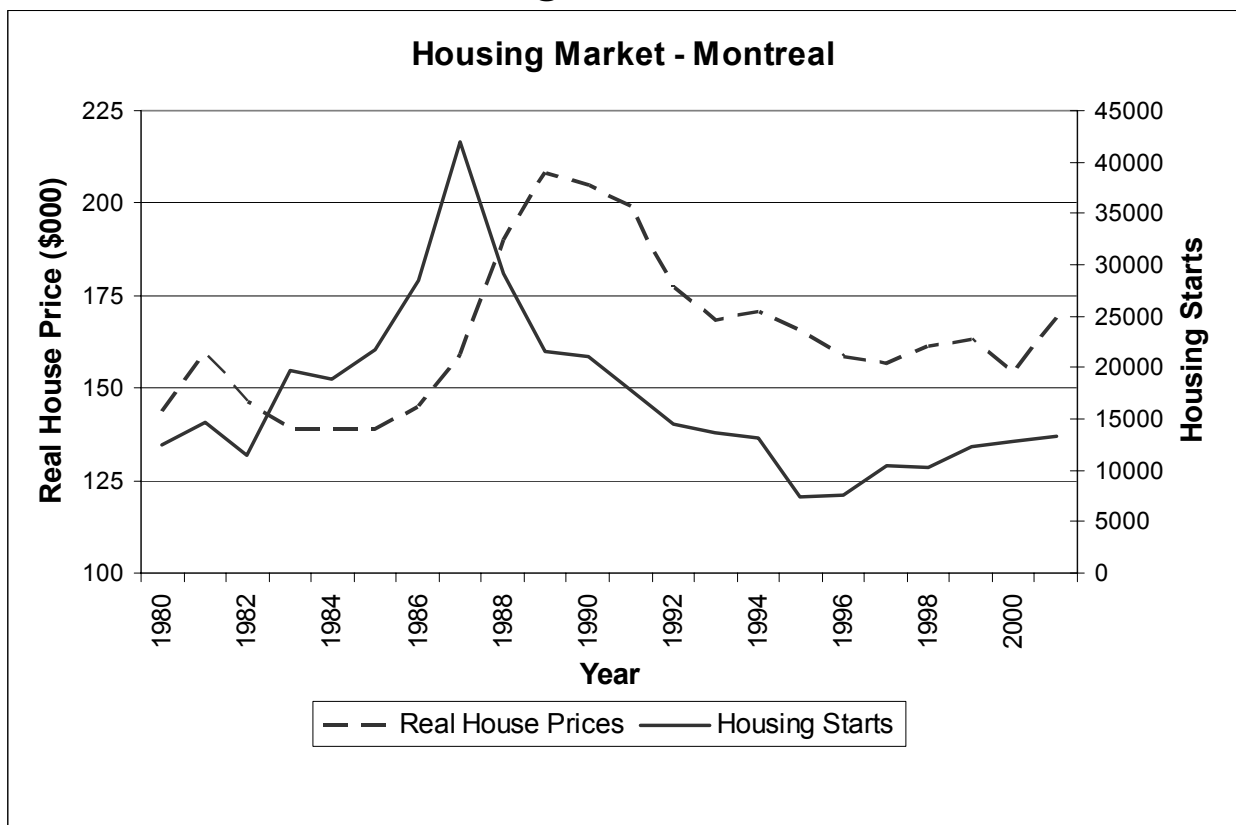


Figure 4

MONTREAL OFFICE MARKET Construction, Absorption & Vacancy

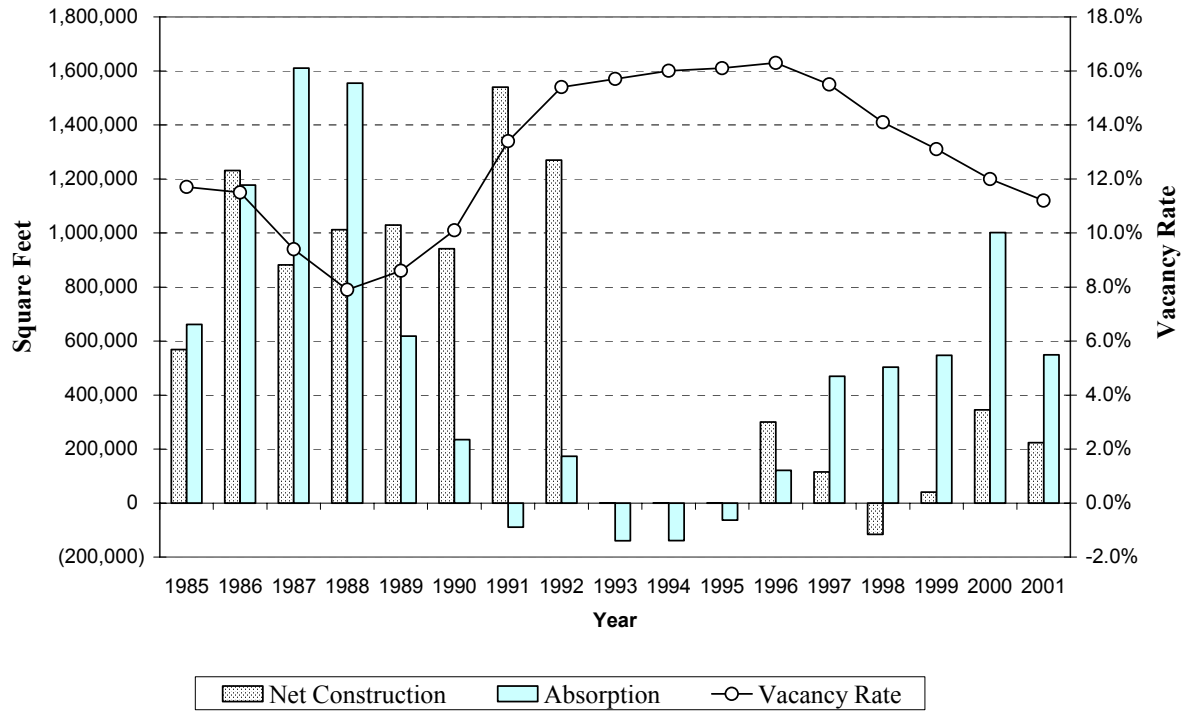


Figure 5

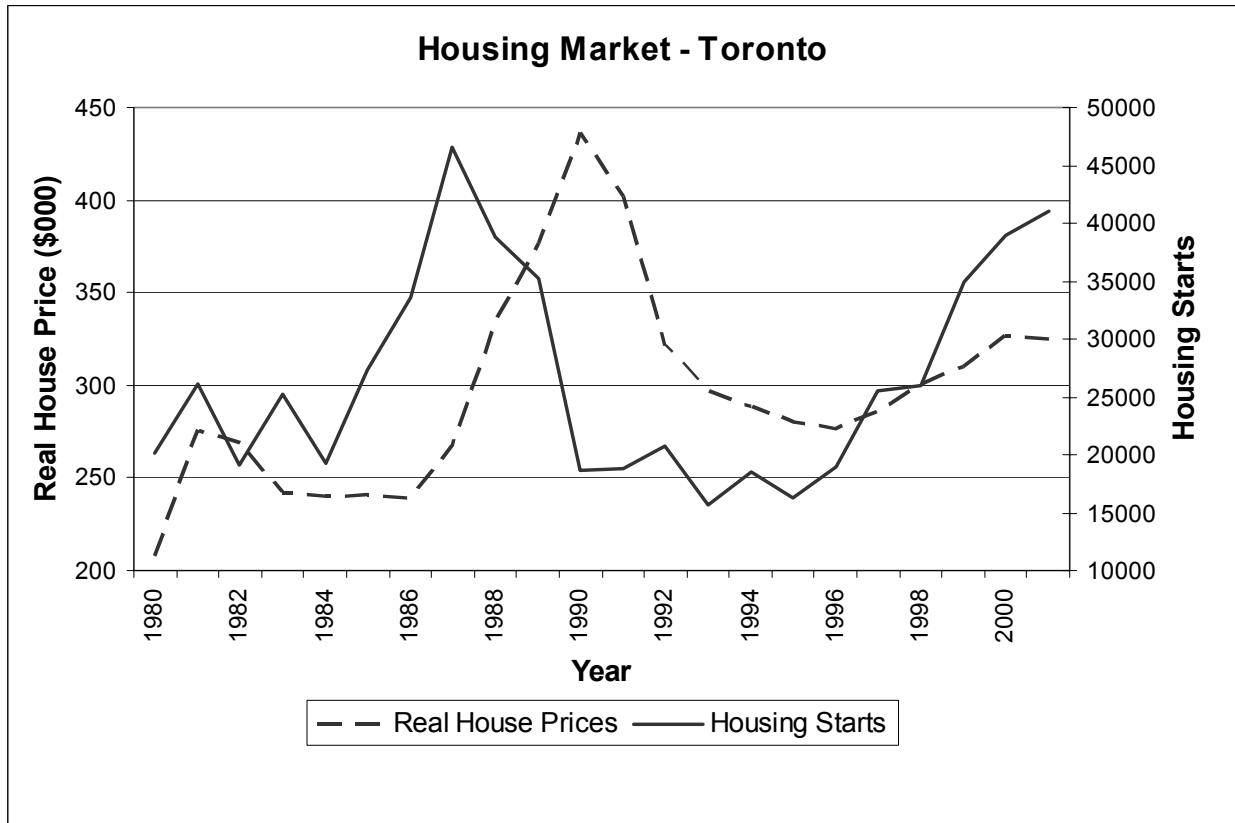
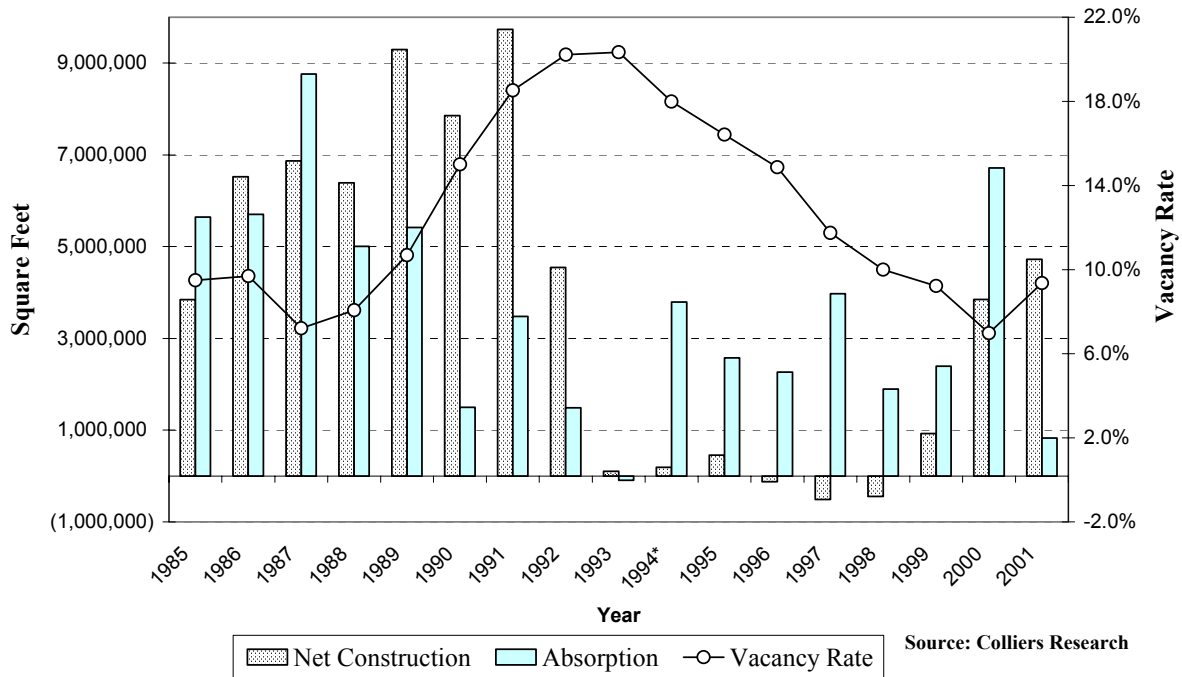


Figure 6

GREATER TORONTO OFFICE MARKET Construction, Absorption & Vacancy



Vancouver's real estate market has been atypical for Canada. First, driven by internal migration and international immigration, the residential market reached its peak in the early 1990's, when other markets were suffering (see Figure 7). Residential markets then began a long slide, reaching their nadir in 1999, when growth was strong in both Alberta and Ontario. This slide had two causes: negative real per capita growth of the provincial economy under its left wing government and the "leaky condo" crisis.⁶ Rot problems kept new buyers away from wood-frame condominium structures, which comprise the bulk of multi-family owner-occupied properties in Vancouver, and prevented owners of units in those structures from selling without actualizing losses in equity. Low interest rates and the decline in the stock market have revived in the residential real estate market, but it remains well below historic levels of activity. As Figure 8 shows, Vancouver's office market did not suffer as much as did other Canadian markets in the early 1990's, with vacancy rates peaking at 13 percent. Still it is only in 2002-03 that the first new downtown office buildings in a decade are being completed. During this period there was substantial growth and new construction in the suburbs. However, Vancouver was

⁶ Buildings suffered building envelope failure caused by rot when water penetrated the structures, but was not able to evaporate. The costs of cleaning up the problem range as high as \$1 billion. To date the problem has affected wood-frame multi-family structures, typically 3-4 stories in height. There is a growing concern that high rise concrete structures are also vulnerable, and will be dramatically more expensive to repair. The Barrett Commission reported on this problem [http://www.hpo.bc.ca/Overview/index.htm#The Barrett Commission](http://www.hpo.bc.ca/Overview/index.htm#The%20Barrett%20Commission). This is also an issue in New Zealand, see the Hunn report <http://www.bia.govt.nz/publicat/pdf/bia-report-17-9-02.pdf>.

hit hard by the technology bubble: extremely high rate of absorption in 2000 followed by negative absorption in 2001-02.

Figure 7

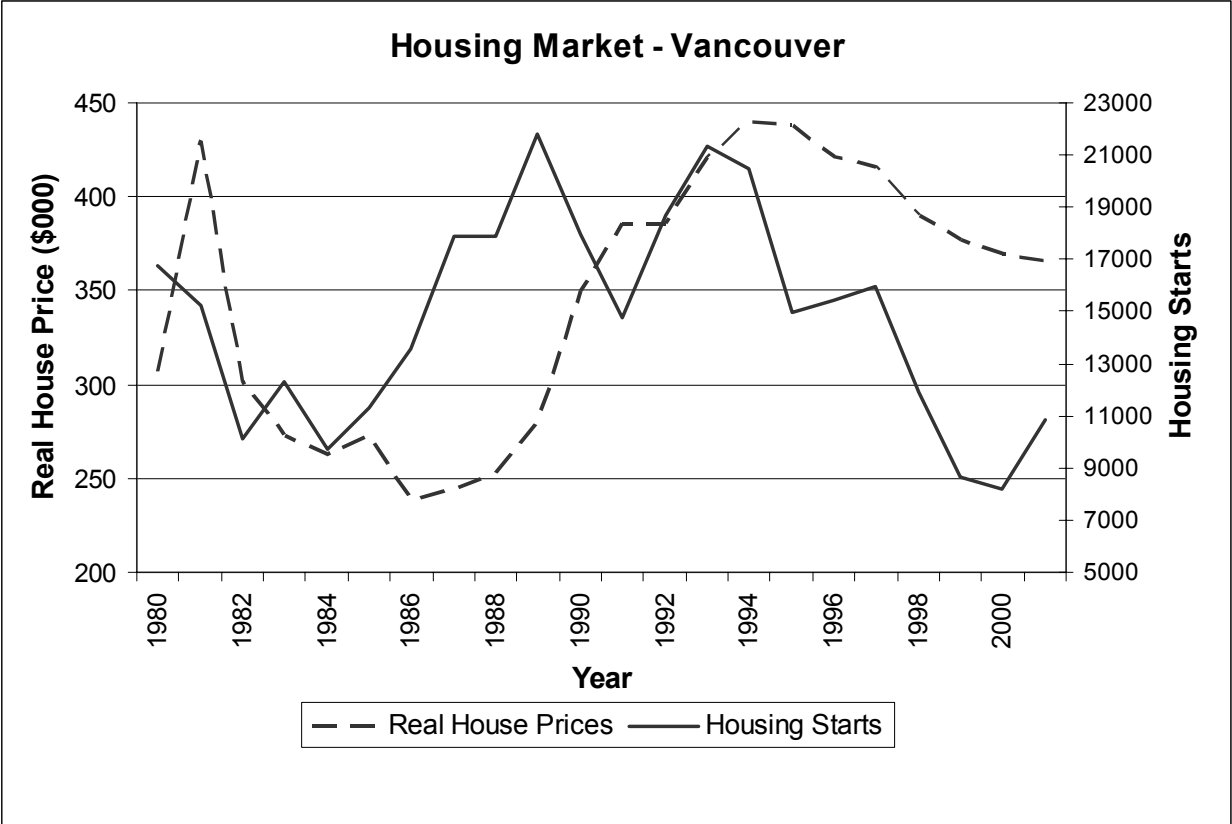
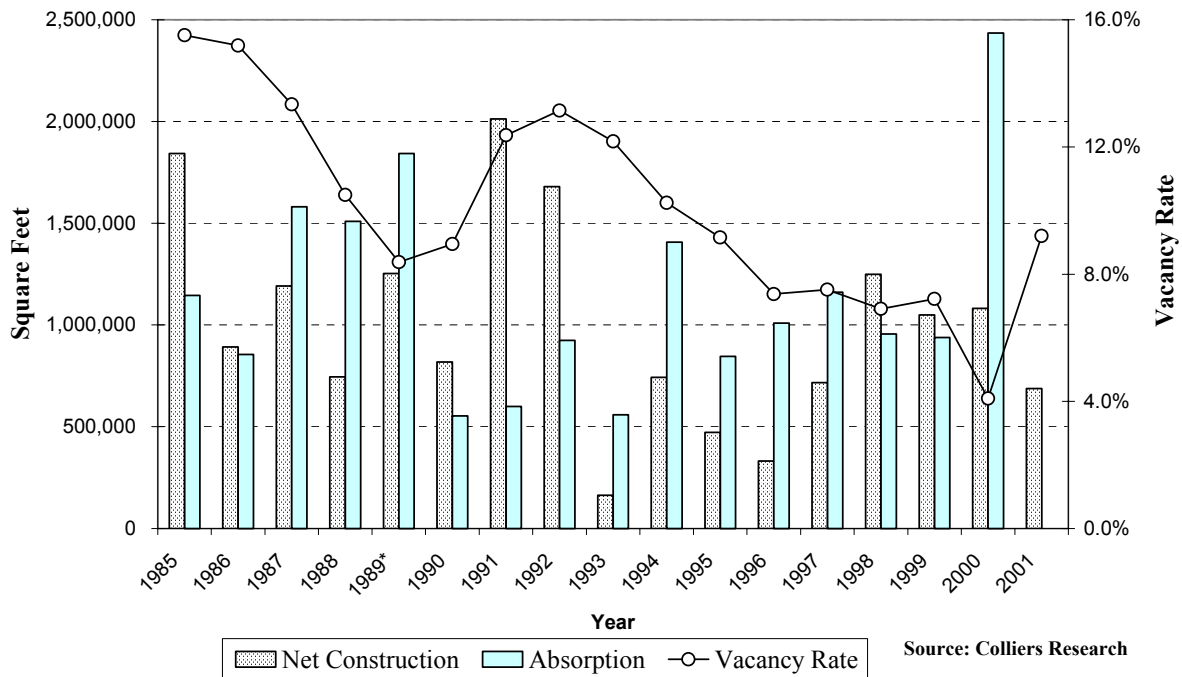


Figure 8

GREATER VANCOUVER OFFICE MARKET Construction, Absorption & Vacancy



Public vs. Private Real Estate in Canada

Compared to the United States, the securitization of real estate equity in Canada has proceeded quite slowly. And in some ways it has moved in the opposite direction. In the last five years, real estate investment trusts (REITs) have grown in number and capitalization, but do not yet approach the market share of REIT's in the U.S. At the same time, the largest Canadian pension funds have taken a dominant role in the holding of class A office and industrial properties. Their acquisitions have actually reduced the size of the public real estate market.

For a variety of reasons REITs as a form of securitized real estate have developed slowly in Canada. The term "REIT" and the institution originated in the U.S. in 1960 with the amendments to the *Internal Revenue Code* that created this vehicle. By the 1980's the number of REITs in the US exceeded 100, and by 1994 there were over 200 REITs. In contrast, the first Canadian REIT was not formed until 1993, and the third REIT was not created until 1996. Canadian REITs emerged out of problems with existing liquid real estate vehicles. Until the early 1990's investors could acquire shares in open-ended real estate funds, so there was not an explicit need for another liquid vehicle for investing in real estate. In the early 1990's the sharp downturn in property markets cause these funds severe financial distress. As returns turned negative investors redeemed their shares. As open-end funds in illiquid assets, redemption prices were based on appraised values,

which lagged behind in the falling market. The funds faced additional problems in meeting these redemptions because of the difficulty in selling real estate assets in a market where liquidity had disappeared. In May 1994, the Department of Finance announced amendments to the *Income Tax Act* that allowed a real estate investment trust to qualify as a closed-end trust and a mutual trust. The first four Canadian REITs, RealFund, Canadian (CREIT), RioCan, and Summit were all former open-ended mutual funds.

Canadian REITs, like U.S. REITs, have substantial tax advantages over public real estate corporations for holding existing properties. Subject to certain restrictions, the income distributed to unitholders is not taxed at the trust level; certain tax shelter features associated with depreciation flow through to the unit holders; and the trust can designate certain portions of income as capital gains, which are currently taxed at 50 percent of earned and interest income. In exchange for these advantages they face many restrictions similar to those faced by REITs in the U.S. A minimum of 80 percent of assets must be in property, cash, bonds, or mortgages situated in Canada. A minimum of 95 percent of the trusts income must derive from these assets. And the trust must make required distributions equal to the maximum of taxable income or 85 percent of pre-depreciation net income. Among the many other restrictions two stand out.⁷ First, the trust has only a very limited ability to engage in real estate development. Second, the REIT will lose many of its tax benefits if at any time 50 percent or more of the units are owned by non-residents. The latter limits their place in the international real estate market.

A number of factors have limited the success of REITs in Canada, particularly among institutional investors. First, because they are organized under the legislation for income trusts, REITs do not have the complete veil of corporate liability. Unit holders can be found to be legally liable for damages resulting from environmental problems. Second, the small size of many REITs makes them illiquid for larger investors, as any sales of shares would depress unit prices. As of October 2002 there were 15 REITs with Canadian properties trading on the Toronto Stock Exchange (TSE) with a market capitalization of \$C 8.7 billion (\$US 5.4 billion). The largest, RioCan REIT has a market capitalization of close to \$C 2 billion, but it is more than twice the size of both the second and third largest REITs. Though the number of Canadian REITs is not dramatically different from the number in America, relative to the size of the economy, Canadian REITs are on average four-tenths the size of US REITs. Particularly striking is how small REITs are compared to public real estate corporations. The three largest of these corporations have a larger combined market capitalization than for all of the REITs combined.⁸ These problems mean that for many institutional investors, REITs can be inferior to direct investments in real estate.

⁷ Other restrictions are: a size test for single investments, limits on their holdings of foreign property, exclusion from most joint venture, and REITs can only invest in mortgages that meet certain criteria (maximum. 75% LTV and minimum 1.2 debt service coverage ratio).

⁸ On 10-21-02, Brookfield Properties, Fairmount Hotels and Resorts, and Four Seasons had a combined market capitalization of \$C 8.9 billion. However, most other public real estate corporations are the size of or smaller than the average REIT. The total for all public real estate corporations was \$C 14.1 billion. This compares with \$C 8.6 billion for REITs.

The effect of a small REIT sector shows up in Table 4, which presents ownership shares in office markets for different classes of investors. What is striking is how large the pension fund share is relative to that of publicly traded real estate. Combining REITs and public corporations, gives shares ranging from 3.1 to 14 percent for all classes and 1.4 to 14.7 percent for class A buildings. In comparison, the market share for pension funds is 2.3 to 8.8 times as high for all classes and 2.7 to 32.5 times as high for class A properties. Pension funds also hold 40 percent of the regional shopping centres across Canada, with a 54 percent share by rentable area. Overall, in 2001 Canadian pension funds held \$C 30.3 billion in real estate assets, over triple the market capitalization of REITs, over double the same measure for all public real estate corporations, and 33 percent higher than the two combined. As well, they accounted for 45 percent of the \$C 6.9 billion invested in Canadian commercial real estate. In comparison, in the United States for all real estate, pension funds had a 21 percent share, as compared to REIT's 18 percent share.

**Table 4 - Office Market Ownership Shares
(Percentage of Building Square Feet Owned)**

Ownership Class	Vancouver	Calgary	Toronto	Montreal
<u>All Classes</u>				
Pension Fund	34.8%	32.8%	30.8%	27.4%
REIT	1.8%	5.3%	5.0%	2.4%
Public	3.2%	8.7%	5.7%	0.7%
Private	15.0%	18.4%	18.8%	27.1%
Financial Inst.	9.7%	10.8%	8.7%	8.3%
Other Owners	27.0%	19.4%	20.5%	22.4%
Total unaccounted for	8.4%	4.6%	10.5%	11.6%
<u>Class A</u>				
Pension Fund	39.9%	40.2%	44.0%	45.5%
REIT	0.8%	4.7%	5.7%	0.5%
Public	3.9%	10.0%	6.7%	0.9%
Private	11.6%	12.3%	13.6%	15.4%
Financial Inst.	10.9%	11.0%	7.8%	11.6%
Other Owners	25.9%	20.6%	14.4%	13.3%
Total unaccounted for	7.0%	1.1%	7.7%	12.9%

Source: Penreal Capital

The real estate holdings of pension funds have been concentrated in the largest funds. Of the \$30.3 billion, 87 percent is held by the largest funds, even though they hold 52 percent of total pension fund assets. Over the last three years the largest funds have acquired and taken private some of the largest public real estate corporations in Canada: Ontario Teachers', Canada's largest pension fund, took Cadillac Fairview private in 2000; the second largest pension fund, the Caisse de depot et placement du Quebec (the Caisse), purchased and took private Ivanhoe and Cambridge Shopping Centres in 1999; and in 2001, Ontario Municipal Employees Retirement System (OMERS), Canada's third largest pension fund, acquired all of the shares of Oxford Properties and took it private. As a result, the universe of publicly traded real estate has declined while the share held by pension funds, particularly of trophy properties has risen. As major portfolios of real estate assets have come up for sale, it is the pension funds that have acquired the assets.⁹ This concentration has become particularly acute in some markets. As of 2002, four pension funds own 45 percent of the class A office square footage in downtown Vancouver.¹⁰

PROPERTY RIGHTS

Basic Principals

Property rights in most of Canada are derived from English property and common law as part of the English settlement of Canada.¹¹ In Quebec, civil law is based on the French Civil Code that held upon English conquest of French lands in Canada. Canadian landholding rights are in the form of estates held of the Crown with the most common holding being fee-simple estate. Typically urban properties are governed by a provincial charter but some have federal charter. One difference is that with federal charter, a property may be exempt from certain provincial levies and charges.

Property owners in Canada do not have the same protection as do owners in the United States against government actions that reduce or eliminate the economic value of the land. In the United States, the Fifth Amendment to the U.S. Constitution, the "takings clause", states "...nor shall private property be taken for public use, without just compensation." The U.S. courts have ruled this applies to temporary or permanent complete loss of economic value, but not to diminution of value in a legitimate act of state power. In Canada, there is no over-arching constitutional protection to prevent legislatures from passing statutes that reduce or eliminate a landowner's economic value without compensation. There is a tension between the power of the legislature to legislate and the general principal of no unjust expropriation. Recently, the Supreme Court of Canada made clear that expropriation without compensation is possible. The constraint is that the "encroachments on the enjoyment of property should be interpreted rigorously and strictly...that the legislature express himself extremely clearly where there

⁹ Between 1999 and 2001, three of the largest Canadian banks, CIBC, Royal bank, and Toronto-Dominion, sold \$C 2.8 billion of real estate, principally downtown office towers, to major pension funds.

¹⁰ Ontario Teachers' (Cadillac-Fairview), the Caisse (Bentall), OMERS (Oxford), and the British Columbia Super Annuation Fund (source: private Colliers International report).

¹¹ This section draws heavily from (Ziff, 1996)

is any intention to expropriate or confiscate without compensation.”¹² Other cases have made clear that at the same time the courts are to give tremendous leeway to government in making decisions on property rights.¹³ There are legislative controls in place to ensure compensation. For example, in British Columbia the *Local Government Act*, the enabling legislation for municipal governments, requires that local governments, except Vancouver, have funds available in the current budget to compensate landowners at market value if they act to remove all economic value. However, as a statute, this can be overcome by any succeeding statute. In total, property rights are weaker in Canada than they are in the United States.

Aboriginal Land Claims

A large area of uncertainty over title involves ownership and use right claims by Canada’s aboriginal population. From the perspective of Canadian law, settlement by Europeans and the introduction of English and French law did not replace the pre-existing property rights of aboriginal communities. Rather it overlays them. Only a “legitimate act” of power that can act to remove those rights. This was typically done by treaty, where aboriginal title was extinguished in exchange for a set of guarantees, usually for use of natural resources and hunting and fishing grounds. These rights could also be extinguished by a legislative act, in which case the Crown would then act as a trustee for the land.¹⁴ Critically, from a legal perspective aboriginal title does not require an act of government to be recognized, as it already exists. This title, thought, does not typically include the same package of rights found in English property law. As a practical matter, outside of British Columbia and Crown lands, issues of aboriginal title principally bear on aboriginal use rights for forestry and fishing.¹⁵

In British Columbia, title has not been resolved on land held by the Crown because it is the only province where treaties were not signed. In the absence of treaties, aboriginal title remains in force and is protected under Section 35 of the *Constitution Act, 1982*: “Existing aboriginal and treaty rights of the aboriginal peoples of Canada are hereby recognized and affirmed.” The scope of the problem is extremely broad. Overlapping claims by First Nations groups mean that more than 100 percent of British Columbia’s land mass is in dispute. One site held by the federal government in Vancouver is claimed by three different bands. The courts have directed the provincial and federal governments and the first nation groups to negotiate treaties to resolve issues of title.

The British Columbia Treaty Commission (BCTC) was established in 1992 to oversee and shepherd the three party negotiation process.¹⁶ Since then, 53 First Nations

¹² *Pacific National Investments Ltd. v Victoria (City)*, 2000.

¹³ In *Shell Canada Products v. Vancouver (City)*, 1964, the British Columbia Court of Appeal ruled that “the courts, in interpreting the scope of powers of municipal authorities, ought to take a more generous and deferential approach...and should confine themselves to rectifying clear excesses of authority...”

¹⁴ Two recent Supreme Court cases bear on this. First, in *Delgamuukw v. British Columbia*, 1993 the Court ruled that aboriginal land use rights are not eliminated if the primary purpose of a state action is the transfer of land to non-aboriginals. In *R v. Sparrow*, 1990, the Supreme Court of Canada ruled that government must provide a legitimate public policy justification for any reduction of aboriginal rights.

¹⁵ Crown lands constitute most rural non-agricultural land in Canada, especially in the territories.

¹⁶ British Columbia Treaty Commission: <http://www.bctreaty.net/>

representing 122 *Indian Act* bands and approximately two-thirds of the aboriginal people in British Columbia have started the process. However, the process has been slow. Despite ten years and millions of dollars only one First Nation (Sechelt Indian Band) has even progressed to the fifth and last stage. The only treaty signed and put into place by mid-2002 was with Nisga nation, and this was done outside of the formal BCTC process. Even in the absence of signed treaties, the potential for court action by aboriginal groups over land use decisions made on land in dispute will affect provincial government decisions. The current government in British Columbia has developed a new policy that requires government officials to “‘accommodate’ First Nations, through negotiations, side deals, or other forms of agreement” on “all decisions...that are likely to affect aboriginal interests.”¹⁷ The effect of this policy may be to First Nations groups in British Columbia a defacto veto over provincial government land use decisions.

The unresolved treaties and native land claims has the potential to negatively affect investments, especially in rural areas where most land is owned by the crown, and title is unresolved. The uncertainty manifests itself in a number of ways. First, the outcome of the treaty process may render existing leases of crown land, a category that includes many resort developments, void or with reduced rights. Second, even those with clear fee simple title may face problems if their property use depends on access that crosses or their infrastructure is located on land in dispute. For instance, access to the Sun Peaks ski resort outside Penticton in the south-central part of the province has been blockaded by, on several occasions, by members of the Secwepemc (or Shuswap) Nation in a dispute over land transversed by the ski resort’s access road. A third area of concern applies even to land with clear and secure title. The one treaty negotiated and signed to date with the Nisga nation created a new level of government with the power to regulate land use, but one where non-Nisga have strictly reduced political rights.

GOVERNMENT INSTITUTIONS AND REAL ESTATE

Canadian Federalism: Provinces vs. Federal Government

Canada differs from most countries with federal systems as provincial governments are extremely strong. Provinces are autonomous from the federal government in those areas where the Constitution grants them authority. Territories are technically subordinate to the federal government, but have gained province like powers over time. Separation of powers between the two levels of government was drawn up in the Confederation Settlement in 1867 that created Canada as an independent nation.¹⁸ Section 92 lists 16 specific enumerated powers that are given to the provinces, including power over property and civil law. Fights between the provincial and federal government over power, jurisdiction, and revenues have been a constant of the Canadian federal system. While the Confederation Settlement indicates that all powers not granted to the provinces are by default in the sphere of federal jurisdiction, the courts have tended over time to

¹⁷ Palmer, Vaughn. “Natives Get a Veto on Government Decisions,” Vancouver Sun. Nov., 1, 2002 www.vancouversun.com.

¹⁸ The Settlement is also known as the *British North American Act, 1867*.

reduce and restrict non-emergency federal power in these areas of dispute. Thus, for most areas related to real estate development, there is no explicit federal role.

The federal government through the legislative actions of Parliament does retain powers to regulate the use of land pursuant to a limited number of federal purposes. Thus, land adjacent or near airports and harbours is subject to federal action to ensure the proper operation of these facilities. Properties adjacent to Crown lands, property owned by the Federal Government, can also be subject to Federal influence or action.¹⁹

The primary area of dispute between the federal and provincial governments over control with relevance to real estate development is environmental policy. In the absence of explicit references to the environment in the Confederation Settlement, provinces have assumed primary responsibility through their control over natural resources and municipal institutions. At the same time the federal government is also active in environmental policy and regulation. Court rulings in the mid-1980's gave the federal government more legal authority to regulate the environment at the expense of the provinces.²⁰ The primary basis for federal intervention has been its powers and oversight granted for matters concerning seacoasts and fisheries. The *Fisheries Act* gives the federal government clear powers to regulate activities that affect fish habitat in water frequented by fish anywhere in Canada. Any development that will lead to the release or runoff of deleterious substances that can harm fish into waterways is subject to regulation under the *Fisheries Act* by Fisheries and Oceans Canada. For development this is a particularly critical issue in British Columbia, where the federal government has regulated and restricted new development within fixed distances salmon bearing creeks, streams, and rivers, because of the negative effects on salmon habitat.

Allocation of Powers: Provincial vs. Municipal Governments

In contrast to the United States, municipal governments in Canada are quite weak. All municipal and regional government powers are granted by provincial legislation. With a few notable exceptions, provinces have not passed home-rule amendments to give municipal and regional governments independent and equal legal standing as is the case in the United States. Without constitutional protections for their status or explicit charters, the independence and scope of powers available to municipalities and regional governments are both entirely a function of provincial government permission and perhaps more critically subject to change with the political regimes at the provincial level. Below we present conditions and issues in the relationships between provincial and metropolitan governments in Alberta, British Columbia, and Ontario that bear on real estate, and particularly on real estate development.

Alberta has a relative high degree of harmony in the relationship between the provincial and the lower level governments. The reasons stand out. First, all levels of government in the province have been led by right of centre governments for a considerable period of time. Second, the two largest cities, Calgary and Edmonton, include a much higher

¹⁹ Crown lands include all national parks, defense establishments, 99 percent of the land in the Yukon, Northwest Territories, and Nunavut, and many sites in the Ottawa area.

²⁰ *R. v. Crown Zellerbach* (1988) and *Friends of the Oldham River Society v. Canada* (1992)

percentage of their metropolitan area's population than in other Canadian cities.²¹ Consequently, there is both relative philosophical harmony and the political interests of the provincial and principal local governments have been fairly consistent.

Municipal governments in Alberta are extremely weak. Although they have wide ranging powers granted them in the Alberta's *Municipal Government Act*, this same act limits municipal funding to the property tax, which is market value based. In particular, the Act makes it illegal for communities to impose levies on developers. Land use planning powers are delegated to the municipalities, but the province retains the power to overrule municipalities regarding "environmentally sensitive" sites, a power which they have been wielding with greater frequency. The constraints on municipal finance have ensured that province is a major player in the discussion over infrastructure provision.

In contrast to Alberta, Ontario has considerable tensions between the various levels of government. Local governments in Ontario have considerable more independence in levying by-laws and imposing fees on development than do local governments in Alberta. The Ontario Provincial government has tended to take a hands-off approach, except in areas of "provincial interest". However, the provincial-level Ontario Municipal Board (OMB) acts as a constant constraint on municipal independence.²² Members of the OMB are appointed by the provincial government, but the board's operations are independent of cabinet and any provincial ministries. The OMB acts as an appeals court for any individual citizens, public bodies, or corporations who wish to appeal the decision of public authorities such as local or regional councils, land division committees, boards of variance (committees of adjustment), or the provincial Minister of Municipal Affairs and Housing. Among the areas of jurisdiction for the OMB are official plans, zoning by-laws, subdivision plans, variances, and development charges. In hearing appeals, the board acts much like court with testimony under oath and the allowance for council.

The practical effect of the OMB is to constrain the ability of jurisdictions to maliciously block development or extract unreasonable concessions from developers. The OMB tends to be more consistent with general planning principals and less-willing to listen to local citizen groups and the environmental lobby than local politicians have been. It is quite easy for developers to appeal to the OMB. Since the mid-1990's, local government are under an obligation to reach a decision regarding development applications within 90 days. If they do not reach a decision, developers can immediately appeal to the OMB. The practical effect is that in areas where development has tended to encounter stiff resistance from local groups opposed to redevelopment, such as in the City of Toronto, developers will simultaneously submit a redevelopment application to the city and an appeal to the OMB.

The Ontario provincial government has been quite aggressive at forcing amalgamations of municipalities and school districts in the name of achieving scale economies. Between 1996 and 2001 the Ontario government managed to reduce the number of municipalities

²¹ The Cities of Calgary and Edmonton have population shares of the metropolitan areas (CMAs) of 92 and 71 percent respectively. This compares to 53, 30, and 27 percent in Toronto, Montreal, and Vancouver respectively.

²² <http://www.omb.gov.on.ca/>

from 815 to 590. The most dramatic example is the January 1, 1998 amalgamation of Municipal Toronto and five surrounding suburban jurisdictions to form the new City of Toronto. The move was both politically motivated, and an attempt to solve the problem of conflict between a regional body, Metropolitan Toronto, and its constituent jurisdictions.²³ These had grown in intensity following the introduction in 1988 of elections for seats on the Metropolitan Toronto (Metro) council. However, this amalgamation has not solved the most pressing regional issues of infrastructure and congestion as most of the economic growth is occurring in those parts of the Greater Toronto Area (GTA) outside of the new City of Toronto.

The provincial government in Quebec is extremely strong and actively interventionist both in local governance and the economy. This reflects a statist tradition that has long been present in Quebec. It cleaves more to a European model of government intervention than one observes elsewhere in the U.S. and the rest of Canada. For instance, the government has frequently put pressure on the largest provincial public employee pension fund, the Caisse, to use its assets to insure Quebec-based ownership of business institutions in the province. In real estate, public monies are used to fund development. For example, in an effort to turn Montreal into a high tech centre, the province announced the development of the 3.2 million sq. ft. E-Commerce Place. They also offered \$C 1.5 billion (\$US 1.0 billion) in tax credits over ten years to induce firms to move into the development.²⁴ This explicitly crowded out private investment, stopping construction of the first private downtown office tower to be built in ten years. A second provincial project, the 1.5 million square foot Cite du Multimedia (Multimedia City) is the renovation and redevelopment of an old factory and warehouse district. It has been extremely successful and not generated as much criticism from the development community, though it has siphoned away tenants from other locations. Emblematic of the interventionist approach in Quebec, in Toronto and Vancouver this type of development was all done by private developers without the use of public monies. Finally, the provincial government has interfered at the local level. Against much opposition, the Quebec provincial government forced a 2002 merger of the 28 municipalities on the Island of Montreal to form a new larger City of Montreal. A chief objective for the separatist Parti Québécois in power was to reduce the power of smaller communities with English speaking majorities by diluting them in a larger majority French city

As in other Canadian provinces, the government in British Columbia has wide-reaching powers and abilities to dictate to municipal governments. No city has home-rule, though the charter granting municipal powers to Vancouver is broader and farther reaching than the *Municipal Act*, which governs all other jurisdictions in the province. The current Liberal government, which is right-of-centre, has proposed legislation to expand the powers and independence of municipalities in the province. The proposed “Community Charter” would fundamentally alter the allocation of powers and responsibilities between

²³ The five suburban jurisdictions were themselves products of earlier mergers. Other important Canadian amalgamations took place in Ottawa and Halifax.

²⁴ Subsequent to the 2001 tech meltdown and following substantial criticism from the local development community, the project has been cut in half and the E-commerce tax credit extended to the entire downtown area.

province and municipalities.²⁵ Municipalities in British Columbia would come much closer to the U.S. model of local government independence, though there would remain clear spheres of distinct provincial and municipal jurisdiction. While the current Municipal Act limits areas of municipal jurisdiction to areas explicitly set out in the act, a list which includes land use regulation and zoning, the proposed Community Charter would reverse this, granting municipal governments powers in all areas *except* those identified in the charter. Effectively, local governments would gain greater scope for action and raising revenues, without being subject to provincial oversight and review. More critically, the proposed Charter includes an explicit statement that the powers of local government must be interpreted broadly. Currently, all by-laws are subject to provincial veto.

The real estate development community, through its lobbying arm the Urban Development Institute (UDI), has argued that this change will increase the ability of local and neighbourhood groups to thwart measures that are in the best interest of the entire community. UDI's concern is that in the absence of legal provisions for compensation, downloading powers to lower level governments will result in more violations of developer rights. In response, supporters, such as the BRITISH COLUMBIA Association of Municipal Governments, contend that because the bill leaves land use regulatory rights unchanged, the Community Charter should not adversely affect real estate development interests.

LAND USE REGULATION IN CANADA

General Conditions and Processes

The Canadian provinces have different philosophies about land use regulation and restrictions on development. As well, within any province, there can be large differences across jurisdictions, from those that welcome development, to those that make it extremely hard to engage in any significant redevelopment. This section will examine a number of important issues in Alberta, Ontario, and British Columbia that characterize the regulatory environment for real estate development.

Development applications in most cities in Canada follow a similar process and deal with the same types of institutions, constraints and procedures. What vary are the details, flexibility, participants, and the disposition to accepting development. There are two steps, the development approval and the building approval. The first is an application process for the concept, the second for a particular building. Any development is expected to be consistent with the various community and official plans that describe the city's objectives for development and vision of its future. The relationship between the vision outlined in these plans and what development is actually allowed will be specific to every city. Development plans are submitted to a specific department that then guides them through a review process. In Calgary this is the Corporate Planning Applications

²⁵ Detailed information is available from the British Columbia Ministry of Community, Aboriginal, and Women's Services <http://mcaws.gov.bc.ca/charter>.

Group (CPAG).²⁶ Comments are solicited from any city agency or department affected by the plan, and developers are expected to comply with these comments. Typically, a mechanism exists to solicit public input, though the importance of these hearings varies. When a proposed development is inconsistent with existing zoning and the various city plans, the process becomes much more problematic. Prior to the standard development application process, the developer must apply for a rezoning or variance. This involves many of the same stages, but with greater opportunity for public and political input. It is here in particular that “pro” and “anti” development environments are most evident.

One area of variation across Canada is the difference in the explicit monetary cost of the various government fees and charges tied to development. All locations charge fees to defer the costs of processing applications, though the amount varies. For instance, the cost for a major rezoning application in Vancouver is over \$C 700,000.²⁷ Development cost charges, called impact fees in the U.S., are levied to pay for off-site infrastructure and public facilities. While these charges are prohibited in Alberta, they are aggressively used elsewhere. Municipal and regional charges in the Toronto area can easily exceed \$20,000 per single family house and for parkland dedication and school construction in addition to infrastructure. In British Columbia, local governments are also aggressive in their use of development cost charges, though total fees and development cost charges tend to be below \$20,000 per single family unit.

Sustainable Growth

An area of uncertainty for land use regulation is how the issue of sustainable growth will play out. This is a topic that is on the agendas of all of the provinces, though they take different approaches. In Alberta the primary issue of concern is the relationship between growth and infrastructure provision. Calgary’s fast growth, the metropolitan area (CMA) grew 10 percent between 1998 and 2002 compared with 3.7 percent for the other 19 largest CMAs, has made congestion a priority item. Unlike other areas in Canada, the government response has not been to limit growth, confine it to certain areas, or try to enforce higher densities, but to form a joint provincial/municipal task force to figure out mechanisms for financing and providing infrastructure to meet the increase in demand that come with growth.

The interest in sustainable development in Ontario has taken on a different form. In the February 2001 the provincial government established the Smart Growth Secretariat.²⁸ The secretariat is charged with developing recommendations to both promote and manage growth and with incorporating the views of all levels of government and public and private stakeholders. To date the government has divided the province into five zones and charged panels in each zone with developing an agenda with strategies for addressing solid waste, gridlock, and growth management. However, it is not clear

²⁶ Information on the details of the process for the City of Vancouver and the City of Toronto are available from <http://www.city.vancouver.bc.ca/commssvcs/developmentservices> and http://www.city.toronto.on.ca/planning/planning_app.htm respectively.

²⁷ Most of the areas of Vancouver not zoned for single family residential uses are for a comprehensive development district. These are effectively site specific zoning. Use, density, and design are not proscribed in advance, but all applications must go through an arduous review process.

²⁸ <http://www.smartgrowth.gov.on.ca>

whether there will be any binding recommendations. Unlike Alberta, in Ontario there will clearly be provincial and regional level strategies for growth management at some point in the future. The prospect for provincial action is real, as the current right of centre government has shown a willingness to intervene and impose policy on development in areas of provincial interest. The most recent example is its imposition of a development freeze using provincial legislation to override municipal decisions in defining the areas open and closed to development in the Oak Ridges Moraine.²⁹

Sustainable growth in British Columbia has been delegated to the province's regional governments. Like most Canadian provinces, British Columbia has been fairly aggressive in creating regional government bodies. British Columbia first established regional districts in 1965 and there are now 29 regional districts in British Columbia, covering virtually the entire province. In rural areas they do have effective land use powers, but all decisions also require the agreement of the affected provincial ministries, particularly those with responsibility for highways, environment, forestry, and agriculture. In the Vancouver area, the regional government is the Greater Vancouver Regional District (GVRD), a partnership of the 21 municipalities and one electoral area that make up the metropolitan area of Greater Vancouver. In addition to its role as the supplier of services that are regional rather than local in nature, including regional park system, drinking water, and sewage treatment. The oversight for public transportation and major arterials are under the responsibility of a separate regional authority, Translink.

The GVRD adopted the Liveable Region Strategic Plan (LRSP) in 1996. The objective of the LRSP was to encourage higher-density development in a number centers to protect green space and promote transit use. The provincial Growth Strategies Act requires municipalities in the GVRD to submit regional context plans, demonstrating how they will comply with the goals of the LRSP. Any proposed development that is not in compliance with this plan, and thus the city's objectives under the LRSP, must be approved by the GVRD board, which is made up of mayors and city councillors from the member municipalities. In November 2002 for the first time, the GVRD used powers granted to it by this provincial legislation to reject a development proposal already approved by a city on the grounds that it was in conflict with the municipality's regional context plan.³⁰

Specific Provincial Issues

Government regulation of development in Alberta is much weaker and governments are more "pro-development" than elsewhere in Canada. The consensus of developers is that the process is more straightforward and less fraught with uncertainty in Calgary and Alberta than in other provinces. Thus, in the spring of 1999, the Urban Development Institute Alberta (UDI), representing the real estate industry, initiated discussions with

²⁹ The Oak Ridges Moraine is a ridge of sandy hills 160 km in length, of which 65 percent lies within the Greater Toronto Area. Provincial legislation halted all development, planning, and zoning activity in the area while the province developed a plan to identify areas for preservation, conservation, and development. The final plan, limits development in 90 percent of the Moraine and even areas targeted for development puts conservation and protection requirements on development.

³⁰ By a vote of 55-52 the GVRD board rejected a plan to build high density residential buildings in Richmond on land designated for agricultural and industrial uses.

the Alberta Urban Municipalities Association (AUMA), representing local government, to develop a set of guidelines to address regulation and development levies. This resulted in a set of guiding principles for development regulation to be submitted to the Alberta Minister of Municipal Affairs.³¹ The guidelines recognize that “municipalities and developers have a shared responsibility for defining and addressing the existing and future needs of the community.” While municipalities have the right to flexibility to address community objectives, the principles state that “policies should be applied equitably and fairly to all within that community”, that participation in financing infrastructure should be shared on an “equitable basis” by “all beneficiaries of development”, and there be full disclosure of the allocation of costs. It is hard to explicitly identify the direct effect of the agreement. However, it does indicate that in Alberta municipalities and the real estate community have been able to work together to address a set of issues that typically result in contentious by the between developers and local government.

Alberta provincial regulation is relatively structured and organized. Projects move along a process where the individual bureaucrats have a relatively limited scope of power. As in Ontario, developers can appeal and have the case reviewed on its merits. Local and provincial governments have strict timelines for reaching decisions, and failure to reach a decision in the allotted 90 days is grounds for appeal. Alberta land use laws grant developers more certainty, so that there is more communication and consistency across departments and ministries. Once a development permit has been granted, a developer faces little regulatory uncertainty or risk. Contrast this with British Columbia, where departments act independently, there are no limits on how long government officials can take to make a decision, and the opportunities for appeal as circumscribed.

The City of Toronto has undertaken a number of new approaches to encourage the redevelopment of older industrial areas. This has taken the form of replacing old zoning categories with more flexible zoning for non-residential areas ripe for redevelopment. For example, the downtown shoulder areas of King/Parliament and King/Spladina were rezoned to remove restrictions on density and non-nuisance uses. In its place, the city retained controls on design, setbacks, and community integration, where each project was evaluated on these merits on its own. Active redevelopment has followed. The 1998 municipal amalgamation has resulted in the need for a new Official Plan for the newly enlarged city. The objective of the new plan is to continue this approach, designating 25 percent of the city along certain corridors and in redevelopment areas as locations with fewer hurdles and constraints on redevelopment and more flexibility for developers.³² Despite this official openness, community groups in Toronto fight against most development quite aggressively.

Land use is aggressively regulated in British Columbia. Bureaucrats have considerable latitude and flexibility in making decisions on allowable land uses, rezoning, subdivision plans, building and development permits. While land use decisions are the jurisdiction

³¹ AUMA/UDI/AAMD&C Development Levies Task Force. See position and policy papers of the Alberta Urban Municipalities Association (AUMA) <http://munilink.net>.

³² See <http://www.city.toronto.on.ca/torontoplan> for details on the new Official Plan. The areas targeted for less constrained and more flexible redevelopment are mixed use, employment, regeneration (brownfield), and institutional areas.

of municipal governments and the regional districts in areas without municipalities, the province has asserted its interests in a number of ways. Through the Agricultural Land Reserve (ALR) and Forest Land Reserve (FLR) considerable tracts of land have been designated off-limits to all development.³³ Lands in the ALR include most of the farmland in the Vancouver metropolitan area, lands suitable for resorts in the valleys of the province's interior, and farmland surrounding the fast growing cities in the Okanagan region such as Kelowna.³⁴ One single family dwelling per land registry parcel is permitted within the ALR, and land cannot be subdivided. In addition, one secondary suite within a single family dwelling and one manufactured home up to 9 m in width, for use by the owner's immediate family are also permitted, unless otherwise prohibited by a local government bylaw. Additional permanent dwellings may be permitted if they are required for full time, legitimate, bone fide farm operations.

Environmental regulation by the province in British Columbia has been especially strict. This has mainly targeted the preservation of streams and waterways that serve as fish habitat, especially for salmon. In 1997 the province passed the *Fish Protection Act*, which was subsequently strengthened in a January 2001 amendment. These statutes effectively prohibit development up to 50 meters from the top of a bank or ravine bordering a stream. The stream does not even need to have flowing water all of the year. While the election later in May 2001 of a right of centre government is likely to weaken this, British Columbia remains a location with strict environmental regulations on development.

³³ The ALR was established in 1973 through the *Agricultural Land Commission Act* and includes 4.7 million ha, about 5 percent of the province, but about 50 percent of the non-mountainous land. It is administered by the Agricultural Land Commission (<http://www.alc.gov.bc.ca>).

³⁴ Approximately 38 percent of the land in the City of Richmond, due south of the City of Vancouver, is in the ALR. The city of Surrey has a population of nearly 350,000 has been one of the fastest growing cities in Canada, yet approximately half of the city's land mass lies in the ALR. These percentages are higher for undeveloped land.

REAL ESTATE FINANCE

Characteristics of Canada's Financial Industry

The financing of real estate in Canada has changed greatly over the last two decades. The combination of the financial difficulties incurred by financial institutions, such as the trusts and insurance companies in the wake of the real estate meltdown in the mid to late-1980's and changes in Canadian banking law have served to greatly increase the importance of commercial banks in the supply of residential mortgages, term financing of commercial real estate, and the provision of acquisition, development, and construction financing. In comparing Canada with the United States several differences relevant to real estate lending immediately stand-out. First, Canada has always had national branch banking and lending. Second, the historical importance of real estate lending by non-banks. Finally, the comparatively low degree of securitization of real estate debt in Canada. This section presents an overview of the supply of credit to real estate, with a focus on these three aspects.

The primary suppliers of credit in Canada have been the chartered banks, trust and loan companies, the co-operative credit movement (credit unions or caisses populaires), life insurance companies, and securities dealers. The chartered banks differ first in that they are exclusively chartered by the federal government, as opposed to the trusts and life insurance companies, which can have either, and the credit unions which are chartered exclusively by provincial governments.³⁵ Historically, the chartered banks focused on commercial lending, while the trusts were the primary suppliers of residential mortgage credit. Their small national share hides the major role the credit unions play in British Columbia and Saskatchewan and the caisses populaires in Quebec. Mortgage credit has been one of their traditional lines of business.

The role of the commercial banks in mortgage lending has grown dramatically in recent years. Until 1954 the commercial banks were effectively excluded from residential mortgage lending. The amendments to the *Bank Act* in that year allowed them to make mortgage loans insured under the *National Housing Act*, insurance now provided by the crown corporation the Canada Mortgage and Housing Corporation (CMHC). The 1967 amendments permitted banks to make conventional un-insured mortgage loans. From a market share of 10 percent in 1970, banks' share of residential mortgages has grown steadily. As Table 5 shows, by 1984 the banks had become important suppliers of mortgage credit. They are currently the dominant providers, following their acquisition of most of the major trust companies in the early 1990's, many of whom had suffered greatly from the downturn in commercial real estate in the late 1980's and early 1990's.

³⁵ The Credit Union Central of Canada (CUCC), which is a national organization providing administrative, technical, and financial support services to member credit unions is governed by federal legislation.

Table 5 - Mortgages Outstanding (Million)

Year	Chartered Banks	Credit Unions	Life Insurance Companies	Trusts & Mortgage Loan Companies
RESIDENTIAL				
1984	34,956	16,770	10,159	32,425
1985	40,899	18,381	10,626	35,881
1990	102,660	31,994	16,339	72,084
1995	184,499	47,057	20,742	40,029
2000	269,323	56,619	16,640	4,976
2001	295,341	62,232	16,425	5,401
Share 1984	37.1%	17.8%	10.8%	34.4%
Share 2001	77.8%	16.4%	4.3%	1.4%
NON-RESIDENTIAL				
1984	3,079	3,403	10,255	6,329
1985	3,525	3,388	11,920	7,235
1990	7,505	2,863	29,176	15,610
1995	13,012	7,265	27,476	4,005
2000	15,811	9,170	22,674	529
2001	15,898	10,253	22,516	511
Share 1984	13.3%	14.8%	44.5%	27.4%
Share 2001	32.3%	20.8%	45.8%	1.0%

Source: Bank of Canada

Securitization of Residential and Commercial Mortgage Debt

In comparison to the United States, the securitization of real estate debt has lagged tremendously. Of the \$US 6.194 billion in outstanding residential mortgage debt in the US at the end of 2001, \$US 3,462 billion or almost 56 percent was held and securitized by the government sponsored enterprises (GSEs) Fannie Mae, Freddie Mac, and Ginnie Mae, and private mortgage securitizers (the latter have a 18 percent share). In sharp contrast, in 2001 in Canada only \$C 34.7 billion of the \$C 460 billion in outstanding residential mortgage debt, or 7.5 percent was securitized. One reason is that until parliament allowed CMHC to guarantee timely payment in 1985, there was no possibility of securitization by a government affiliated agency. More critically, compared to the U.S. there has been little demand or supply side pressure for these securities. National banks, trusts, and life insurance companies already have a geographically diversified

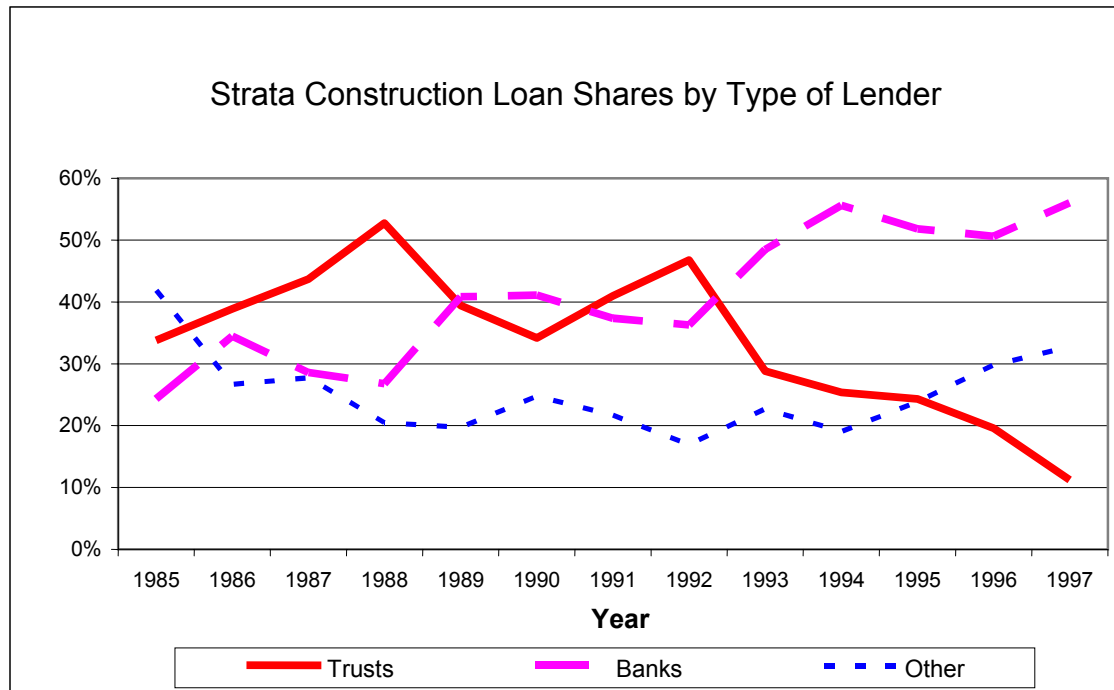
portfolio, so they do not need to sell mortgages to achieve balance. Since the 1960's the deposit taking lenders have done a good job of matching their mortgage and deposit terms, so they have not faced disintermediation risks. Deposit insurance only covers deposit with terms of no more than five years and financial regulations in Canada for conventional mortgages allow the prohibition on pre-payment for the first five years of a mortgage. Thus, most mortgages in Canada have a term of five years or less. Competition for mortgages is quite aggressive and they are perceived as a desirable asset to hold. Consequently, more loans remain in a lender's portfolio. On the demand side, CMHC, the crown corporation that is the securitizing agency can only work with *National Housing Act* insured loans (42 percent of new loans in 1999), which reduces the size of the market.

The Canadian commercial mortgage backed securities (CMBS) market has also lagged behind that in the U.S. In the U.S., CMBS has risen from \$US 5 billion in 1990 to \$US 74 billion in 2001. Since 1996, CMBS in the U.S. has been the largest single source of permanent commercial mortgage financing. In Canada, the first issue was not even brought to market until 1998. Total new issues in Canada in 2001 were \$C 1.6 billion, less than 2 percent of the U.S. total, and well below the 10 percent rule for Canadian markets as a percentage of those in the U.S. The two primary issuers of CMBS in Canada have been Merrill Lynch Canada and CDP Mortgages, an arm of the Caisse de Depot. Since the banks have preferred to keep mortgages in their own portfolios and they own most of the major investment banking firms, there has been less impetus for this market to develop. In 2003, though, the first development loan CMBS issue is likely to come to market using loans generated by MCAP Financial.

Development Financing

The growing importance of banks as a source of financing also holds for development lending. Data on construction financing in the Vancouver area by Somerville (2002) finds that between 1985 and 1997 the banks dramatically increased their share of construction loans from 24 to 56 percent. As with national term financing, this growth came principally at the expense of the trusts, many of which were absorbed by the schedule I banks. Figure 9 shows this change over time. One important difference here is that although most bank loans are by national lenders, a substantial portion of the growth in activity is because of lending by the Hong Kong Shanghai Bank (HSBC) following its purchase of the Bank of British Columbia. The growing role of HSBC, whose Canadian unit's home office is in Vancouver, is most evident in data on market share by lender home office location. Ontario based lenders, which includes nearly all of the national banks, increased their shares through 1992. But with the downturn in their home market, there was a sharp drop in their British Columbia market share in 1992 and 1993. At the same time, British Columbia based lenders, especially HSBC and to a lesser extent the province's largest credit union VanCity, started to increase their loan activity. British Columbia based lender share increased through 1997.

Figure 9



Analysis of lending flows into the Vancouver strata (condominium) market finds that bank capital flows across the country in response to market conditions. As the Vancouver market improved relative to a lender's home market, they increased their lending in Vancouver. The number of senior and junior loans made in the Vancouver metropolitan area falls as market conditions in a lender's home housing market rises relative to the Vancouver market. This pattern holds true for market share as well. This research provides evidence that suggests that Canada's lending market allows capital to flow effectively, but that there is clear segmentation within the market by class of lender into loan size, types, and clientele.

The statistical analysis of mortgage characteristics raises some provocative results that demonstrative quite strongly that there are qualitative differences across lender types. First, irrespective of housing market conditions, national banks are more likely to make senior loans. Schedule I banks charge a premium in the spread over prime for their loans relative to other lenders. Local lenders make smaller loans, and appear to provide capital to smaller, less well capitalized builders.

Since the troubles in the financial industry because of the real estate downturn in the late 1980's and early 1990's, development financing has been harder to obtain. Even as real estate markets recovered in 2000-02, senior term and development financing has rarely exceeded a 75 percent loan to value ratio. For new construction, developers in Canada must pre-sell or pre-lease space, with the minimum amount a function of the developer's track record, to obtain senior financing. In Alberta and Ontario, pre-sales deposits can be used for construction, but in British Columbia they must be held in escrow.

Rules governing the financing and marketing of real estate are a provincial responsibility. Depending on the province, developers can face a very narrow window of opportunity for generating sufficient pre-sales to finance development. This is especially true in British Columbia where to pre-sell residential units, developers must either have an accepted prospectus by or have filed a disclosure statement with the Office of the Superintendent of Real Estate (SRE). The former is a much more strenuous requirement and takes longer to be accepted, such that they effectively preclude pre-sales. Amendments to the *Real Estate Act* in 1985 that allowed a disclosure statement in lieu of a prospectus are what allowed for pre-sales to become possible. However, if the SRE does not like the prospectus or believes the development is “risky” they will require that a prospectus be accepted and place a halt order on all sales activity. Critically for development finance, both the disclosure statement and prospectus require that financing and building permits be in place prior to sales.³⁶

Developers face a challenge in that they need pre-sales to obtain financing, but cannot file a disclosure statement and receive deposits without financing in place. To break this deadlock, developers have several options. First, even without a disclosure statement they can engage in market testing, but they explicitly are not allowed to enter into contracts, receive deposits, list a specific price, or give prospective purchasers “the impression they have the right of first refusal or have actually purchased a lot.” Second, Policy Statement #5 by the SRE allows pre-sales prior to the issuance of a building permit, if it will be issued within six months and a number of other restrictions. Third, the SRE’s Policy Statement #6 creates a six month window where developers can pre-sell and take deposits of up to 10 percent of the price prior to a commitment of financing. However, once the financing commitment is obtained and the final disclosure statement is filed and delivered to purchasers, they have seven days in which they can cancel their contract and receive all monies in return with applicable interest. Effectively, developers have six months after getting through most of the regulatory process to sell enough units to obtain financing.

CONCLUSION

The adage by the late U.S. Speaker of the House Representatives Tip O’Neil that all politics are local applies equally well to real estate. In Canada, it is not just that markets conditions can be highly localized. Rather the intersection of Canada’s high degree of provincial autonomy and local regulation of land use means that while it is one country, local institutional knowledge is critical. Although, the shared legal traditions and the federal framework allow capital, developers, and investors to seamlessly cross provincial boundaries, much must be relearned in each jurisdiction, especially for real estate development. With Quebec even these similarities as the language, cultural, and legal traditions are all different.

³⁶ These must be filed with the Superintendent of Real Estate. A disclosure statement must include descriptive details about the developer, development, legal interests of the developer, list of existing and proposed encumbrances on the property, outstanding litigation against the development or developer, an indication of government development approval, and a filing commitment.

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