Anatomy of a Crisis

Reflections on the current economic crisis as a basic principal/agency problem.

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SINCE THE LAST financial crisis in the early 1990s, the Urban Land Institute has held an annual real estate finance symposium during which some of the best minds in the commercial real estate industry attempt to discover the truth about what is occurring in the capital markets. Three years ago, at the December 2005 symposium, the following comments were made: "There is untested risk in the system caused by the twin deficits of government spending and trade, as well as speculation in various forms of real estate, hedge funds, credit derivatives, and the like." "Housing is likely to become a drag on the economy. It is estimated that 15 percent of single-

family home sales are to speculators, up from a customary 3 percent. Some of these individual speculators own as many as five to seven homes on which they have over-borrowed at historically low rates, counting on a quick 'flip' of the property to bail them out. Another risk in single-family homes is the increasing detection of fraud in the home mortgage business." "There could be a complete pullback of debt markets, resulting in foreclosures and defaults [that] have not been seen previously." "Underwriting standards have deteriorated and spreads have narrowed. Structured debt has moved loan to value percentages up into the 90s. In many cases, there are no covenants, no lead investors, no controls, and no delineated way to deal with past-due loans and workouts. Commercial bank lending standards have deteriorated as well." "It would be ironic if the financial instruments that alleviated the credit crisis of the early 1990s became contributors to a credit squeeze in real estate in the next few years." "CMBS (commercial mortgage-backed securities) and structured real estate debt remove the property too far from the hands of accomplished real estate operators. A credit crisis in this area will be worse than usual because of the lack of covenants, controls, and the ability to make quick operating decisions."

All the economic incentives were lined up to keep the game going. Annual bonuses, performance appraisals, quarterly earnings reports, and other measures of success were based on continually originating subprime mortgages, structured investment vehicles, collateralized debt obligations, CMBS, and the like. If you did not play the game, you would lose all your productive staff, your revenue generators.

The financial crisis was a systemic breakdown, caused by fraudulent mortgage brokers, fraudulent borrowers, uninformed homebuyers, speculative buyers who owned as many as a dozen homes with no equity and who counted on continually rising prices, overly aggressive Wall Street firms, undisciplined conduits, politically motivated legislators and regulators, politically induced relaxation of mortgage lending standards, overwhelmed and often conflicted rating agencies, and buyers of securitized mortgage debt who did not perform adequate due diligence. Cynicism appears to have run rampant. Speculators in single-family residences never anticipated repaying their mortgages if things went wrong. Due diligence was forgotten in the rush to keep the markets boiling. Far too much emphasis was placed on Aaa ratings of paper as a substitute for doing one's homework. The river of capital and the momentum of money and liquidity became forces of their own, carrying everyone along with them.

Over time, sloppy behavior without limits or leadership led to bad practices,

which in turn led to violations of civil law and regulations and in some cases even to criminal behavior. The financial industry lacked a moral compass. We needed just a handful of leaders to stand up and say, "Hey—this is crazy! This is wrong!" Where were they? Where was their voice? The few who spoke out were ignored.

Risk was not priced into the system. Financial models are based on the standard bell-shaped curve and ignore the instances of extraordinary "fat-tailed" events such as Long Term Credit, the Russian debt crisis, 9/11, and more. We seek out examples that confirm rather than contradict our beliefs. We ignore what we cannot see. We oversimplify. We prefer simple theory to complex (and messy) reality. We see a factoid printed on a page or on a computer screen or in a PowerPoint presentation and the projection takes on a life of its own, losing its vagueness and abstraction. The irony is that if we fully priced random "fat tailed" risk into our financial models, we would price ourselves out of the market. So the game goes on.

WHAT WENT WRONG

In previous years, we took comfort from the fact that real estate fundamentals were strong. Rents were rising and overbuilding was low. The credit-crisis–induced recession has eliminated even that positive underpinning of the market. Although no significant new construction is occurring, the recession is causing occupancies to decline and rents to diminish. The amount of distressed potentially commercial property is estimated at $500 billion. We can expect declining net operating income from commercial real estate for the next two years.

Debt markets are dried up, with only seller financing and limited bank financing available. Debt cannot be refinanced even at a loan-to-value ratio as low as 30 percent. Insurance companies will have little new money for mortgages after refinancing loans that are coming due. The worst thing is to be creditworthy and have to repay maturing debt. Commercial mortgage debt maturities that will come due over the next two to three years will be in trouble.

About $400 billion of commercial real estate debt matures each year. At present, there is about a $350 billion annual shortfall in refunding capacity. CMBS vintages maturing in 2011 and 2012 will present huge problems. On the refinancing, loan-to-value ratios will decline to 50 percent from up to 90 percent, capitalization rates will increase from 5 percent to 8 percent, and rents could be off as much as 30 percent—thus more than wiping out any equity values. These newer classes of distressed debt will hit at a time when, hopefully, many other classes of debt will have

been resolved, extending the crisis even further. The logical solutions would be for banks to extend their loans and for government to guarantee some new securitization structure to roll over individual loans. Resolution is further complicated by the CMBS structure. Additional legislation may be required to sort out the rights of all parties in unraveling CMBS portfolios.

Equity markets are also stagnant. Valuations are almost impossible because of the few number of trades due to lack of debt financing. Mark-to-market accounting produces disparate and arbitrary valuations. Accounting will become even more confusing with the effective adoption of international accounting standards by 2011 (see "International Financial Reporting Standards in Real Estate," *WRER* Spring 2009). Returns are declining with the lack of debt. Exit capitalization rates are now 8 percent to 9 percent. Institutions are ignoring subscription agreements in limited partnerships, avoiding making capital calls they had committed to. The declining stock market has raised real estate to higher-than-desired levels of asset allocation. There is pressure for liquidity. Foreign investment, including sovereign wealth funds, has been further restricted by adverse tax policies. Some question whether real estate can still be considered a separate asset class.

Government nationalization of the banking system has created huge distortions. The government itself is taking the shape of a giant "zombie" savings and loan, holding long-term assets of indeterminate value and funding them with cheap overnight money. Assets that disappear into the TARP (troubled assets relief program) appear to lose all transparency. Some believe the government should extract more stringent limitations on dividends and board seats in exchange for capital support.

SOLUTIONS

It is important to fix housing. A cascade of debt classes will require resolution. Commercial real estate debt will come later in the cycle. Debt markets will reopen eventually, offering five-year terms, full recourse, a strong corporate borrower, 50 percent loan-to-value ratios, and strong real estate fundamentals. Such financing would be priced at 400 percent to 500 percent over LIBOR (London Interbank Offered Rate) and in amounts of a few hundred million dollars. Simple pass-through CMBS will return, with far less complicated structures and with lenders retaining a risk position in the transaction. It is believed that the United Kingdom already is experiencing lower valuations due to pressure to redeem funds. Germany

is basically shut down, while funds deal with excessive redemptions. The Japanese market is re-pricing, with capitalization rates rising.

This crisis will take at least another couple of years to be resolved, as the contagion moves through successive waves of distressed paper ranging from subprime residential mortgages to Alt A, to home equity loans, to auction priced preferred, to credit derivatives, to overleveraged corporate takeover debt, to consumer credit, to corporate credit, to commercial-mortgage–backed securities, and on and on.

The U.S. government cannot absorb all the losses. It has already committed the equivalent of 50 percent of annual gross national product to the problem. Home foreclosure filings will total three million in 2008 and again in 2009. Banks must continue to raise new equity, diluting shareholders' equity while reducing leverage by at least one third, further decreasing lending capacity and return on equity. The U.S. economy has already lost $3 trillion of its lending capacity. Some participants at the Urban Land Institute annual finance symposium believed the distress could last another three years and that the ramifications will be felt for a decade or longer, in, for example, a declining standard of living. Others believed the recovery will come sooner than expected.

The financial sector will be a shrinking percentage of economic activity. There will be less lending capacity. New business models must evolve, including lower returns on capital, lower compensation, more government regulation, and a return to non-capital-intensive stable businesses such as wealth management. Financial institutions must become less linked to one another by the compounding risks of derivative instruments. They must also regain their role as principals, taking responsibility for the loans they originate, working them out when problems arise, and leaving some skin in the game.

As we recover, aversion will develop to the size and power of the remaining key financial institutions.

The United States appears to be at an inflection point in its economic history. Social historians have written of long wave cycles of liberalism and conservatism. The growth of big business, the trusts, Wall Street, and urbanization made the decade of the 1890s fundamentally different from the previous period when society was agrarian and imbued with the values of America's founders. Likewise, the generations of the 1930s and 1940s, who created private partnerships such as Goldman Sachs and Morgan Stanley, viewed the world differently from those of more recent vintage. Trust was paramount. The client's interests always came before the interests of the firm. It was inconceivable that the firm would trade against the economic interests of the client. The current

crisis will likely become a searing experience that will resonate in the national consciousness for years to come.

We have moved too quickly from an almost hysterical exhilaration into despondency and inertia. It is too easy to lose conviction in the value of what we do. A libertarian adventure, with few rules, has been turned into an antiquated economic system. Some will take comfort from the increased regulatory climate. Yet, rules in themselves do not create the trust that is required for the financial system to work smoothly. Large numbers of rules do not create a better environment, as illustrated by the Sarbanes-Oxley legislation.

The key to a smoothly operating global financial market is trust in the system. When trust evaporates overnight, significant if not major financial firms find it impossible to fund their operations and are exposed to insolvency. Our current crisis is a basic principal/agency problem. As participants in the financial markets system, do we view the stakeholders to whom we are responsible as ourselves, our bonus, our advancement, our power within the firm, or do we consider a broader group of stakeholders to include the owners of our firms and, most important, the aura of trust required to make the financial system run smoothly?

What we have seen in the past and in the recent crisis is an extraordinarily large number of free-riders who take no ultimate responsibility for their actions beyond their paycheck, and a dearth of true leadership willing to take responsible action to maintain trust in the system. It is a classic tradeoff involving short-term personal gains versus long-term societal gains.

If you have not managed your debt structures prudently over the past three years, it is too late. Downsize even more than you think you might have to. Try to do it just once. Make whatever concessions are necessary to hang on to good tenants. Maintain your relations with key financial institutions, even if they are not lending to you at the moment. Find some individuals who are worse off than you are, and help them. Find a way not to be preoccupied with your own situation. If you are young, this is the ideal time to go get an MBA. Applications to business schools (and seminaries) will expand.

We will recover; we have the deepest and most resilient economy in the world. It will just take longer than any of us has ever seen before. In the meantime, “Don’t fight the tape!” Read a good book.