WHATEVER HAPPENED TO RENT?

The excess supply and decline in value of real estate are directly related to the decline in importance of rental income.

by Richard T. Garrigan, CRE

The decline in real estate values and corresponding losses at savings and loan institutions in the Southwest region of the United States have been the focus of much recent attention. The Southwestern real estate market is in much greater disarray than other regional markets because of the crash in oil prices, which substantially worsened matters in the oil patch. While more severe in the Southwest than in other regions, the problems of excessive capital investment in real estate and resultant losses in value nonetheless exist nationwide. This article provides an overview of several major interrelationships which collectively led to the current excess supply of real estate. Its focus, however, is on the main cause of that excess supply: the fact that both the real estate and lending industries deemphasized rent in their evaluations of properties that were developed in the 1980s.

Real Estate's Four Financial Returns

In exploring how far the real estate and lending industries moved away from an adequate consideration of rental productivity, it is useful to review certain aspects of the four basic types of financial returns that may be obtained through a real estate investment: pre-tax cash flow, income tax savings derived from a tax shelter, equity build-up from amortization of mortgage debt, and capital appreciation. While the first two types of returns generally are received during the operational phase of a property's ownership, the latter two are most often realized upon sale of the property.

In the early 1980s, many investors were placing greater emphasis on tax savings and capital appreciation than on either pre-tax cash flow or equity build-up, returns that had been more important 10 to 15 years earlier. This shift occurred for many reasons. The higher rates of inflation following the escalation of the Vietnam War in the mid-to-late 1960s and the oil shocks in the early 1970s were accompanied by significant increases in operating expenses as well as in the costs of acquiring and developing land. Often, initial rents and related early years' pre-tax cash flows did not keep up.

The adequacy or inadequacy of rentals was related to the kind of property that was developed and its quality. For example, during the 1970s, multifamily residential properties did not typically produce rental increases that were equivalent to the level of increases in the consumer price index. On the other hand, because of a heightened demand for

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office space and a demand/supply equilibrium, well-located central area office buildings with short-term leases often produced significantly higher rents following lease expiration and releasing. Similarly, the growing sales volumes of tenants located in regional mall, retail-type properties resulted in higher percentage rents and then in stepped-up basic rents upon the expiration and renegotiation of the leases.

The idea was an elementary one: even if initial rents were inadequate, it was better in an inflationary environment to develop now and freeze the costs for land and improvements. Until the end of the 1970s, this attitude was strongly reinforced by the availability of long-term, single-digit, fixed-rate mortgage financing. While waiting for anticipated increases in rents and associated appreciation, investors, especially those whose income was in the higher tax brackets, could count on tax savings in lieu of rent during the early years of a property's ownership.

ERTA And The Role Of Real Estate Syndications

Thus, as the decade of the 1980s unfolded, there was strong motivation to invest in real estate because of two principal factors. First was the psychology of inflation; many investors believed that the high rates of inflation of the late 1970s and early 1980s would continue. Second, and extraordinarily important as a motivator, were the greatly increased potential tax savings brought about by the Economic Recovery Tax Act of 1981 (ERTA), through which the depreciable lives of both residential and non-residential real property were reduced to 15 years and deferred income was taxed at the favorable 20 percent capital gains tax rate.

ERTA's Impact—An Overview

The tax shelter made available through ERTA led to an unprecedented demand for real estate investment by individual investors and, correspondingly, for income property mortgage loans. The basic idea—you don't have to make money from operating a property in order to make money in real estate—was to prove especially troublesome when the Tax Reform Act of 1986 substantially eliminated tax shelter benefits. At the time, however, the post-ERTA emphasis on tax shelters and capital appreciation influenced the prices that were paid for real property. As a result, mortgage loans that could not be justified by current rent levels were based on the values that were observable in the marketplace. Ultimately, far too many properties failed to generate sufficient rent to permit the mortgage debt to be serviced, let alone to provide any pre-tax cash flows to equity investors. The result was not capital appreciation but substantial loss in value.

Real Estate Syndications

The demand for tax shelter investments and related mortgage financing probably would have been far less were it not for the efficiency with which investment securities firms gathered equity funds through tax shelter-oriented syndications. Investors whose income was taxed at the marginal rate of 50% were strongly motivated to avoid paying high income taxes, and Wall Street had the syndication products that would result in massive levels of investment in real properties. Often, the unrealistic assumption was made that rents would escalate at rates of 8% for the five years following property acquisition. Meanwhile, the high interest rates on mortgage loans that incorporated pay/accrue provisions (which provided that some portion of the mortgage loan's interest could accrue) resulted in higher losses under the tax accounting provisions applicable to limited partnerships. Eventually, inflation was supposed to bail out everyone—syndicator, investor, lender—and inflation was assured because, at that time, it was inconceivable that the Federal Reserve Board would successfully control inflation.

The Savings And Loans In The 1980-85 Period[1]

When the Paul Volcker-led anti-inflation drive began in earnest in late 1979, the S&Ls were among the early casualties. For more than a decade, the understanding that had existed between the S&Ls and the federal government called for the government to control the cost of short-term funds by placing ceilings on interest rates and for S&Ls to finance mortgage loans with long amortization terms at fixed interest rates. By 1980, it was clear that the government was not able to protect the S&Ls from skyrocketing interest rates; thus, the Depository Institutions Deregulation and Monetary Control Act, passed the same year, provided for phasing out ceilings on interest rates on all deposits offered by S&Ls and other financial institutions. Unfortunately, while Congress removed ceilings on the cost of S&L liabilities, it continued to restrict the financial returns that could be realized on the industry's principal investment—single-family residential mortgage loans.

By the end of 1981, more than half of S&L mortgage loans carried interest rates of 10% or less, while the industry's cost of funds had increased to about 11.6%.[2] The hemorrhaging that took place in 1981 and 1982 resulted in losses totaling $8.8 billion.[3] And while this sum now appears to be small, it was large enough at that time to significantly erode the weak capital base of many S&Ls.

The Garn St. Germain Act—Setting The Stage For Growth

The Garn-St. Germain (GSG) Depository Institutions Act had an enormous and largely negative impact on much of the S&L industry mainly because of two key provisions: (1) 100% loans on income-producing properties were authorized for federally chartered institutions, and the maximum permissible percentage of assets which could be invested in these loans was increased to 40% from a former limit of 20%; (2) the money market deposit account permitting head-to-head competition with money market mutual fund accounts was authorized. This latter authorization was followed by enormous deposit inflows during 1983—a $110 billion total increase ($63 billion in new deposits and $47 billion in interest credited).[4]

The growth in deposits also was due to a huge increase in brokered deposits. By obtaining funds through brokered deposits, numerous institutions were able to fund rapid growth. Much of the growth in brokered deposits occurred as tens of billions of dollars in funds flowed out of money market mutual funds. Securities brokers used brokered deposits as a way of meeting their customers' yield requirements while earning fees by directing funds to S&Ls that were willing to pay high rates—rates that could be justified only through higher yielding but riskier investments.

The Deregulated Savings And Loan Industry
S&Ls responded to the substantial deposit inflows that had occurred during the 1970s by greatly increasing the amount of single-family residential lending for both existing housing and new construction. Immediately following the passage of GSG, however, S&Ls found that such lending was not economically feasible because interest rates were much too high for prospective single-family residential mortgage borrowers. Even single-family adjustable rate mortgages could not prudently be priced low enough to substantially increase the demand for home loans.

As operating losses mounted in 1981 and 1982, equity capital at many S&Ls eroded. Without their being able to deploy huge deposit inflows into single-family residential loans, S&Ls faced the prospect of further erosion. This risk led many S&L executives to sell out their ownership interests. Federal regulators were accommodating; they changed the minimum number of shareholders in an S&L from 400 to 1. Many of the new owners were interested in making acquisition, construction and development mortgage loans in order to garner the large fees and potential profits that such deals offered. These investments were structured as loans, but in reality they were direct investments. These investments also were made through affiliates of S&Ls called service corporations, often with a marked lack of success.

Other S&L executives who either could not dispose of their mutual institutions or did not wish to sell their stock institutions worried about breaching the then 3% minimum net worth requirements and thereby incurring the risk of being merged out of existence. Thus, they were strongly encouraged to try to restore lost net worth. Many of these same individuals seized the opportunity to move into construction lending on both multi-family residential and commercial properties as a means of recouping previous losses. The motivation to depart from traditional lending was strongly influenced by the high fees and high prospective yields from such deals.

Also encouraging such lending was the ability of S&Ls to immediately recognize the large front-end commitment and origination fees typically produced by these loans as well as to accrue the interest income set up through interest reserves. It was possible, therefore, for large amounts of income to be earned and for net worth to be partially restored through the use of bookkeeping entries. For permanent loans, interest in many cases was based on pay/accrue provisions, and the portion of the interest that was not paid in cash increased the outstanding mortgage debt—a process called negative amortization. The properties thus financed were unable to produce net rentals that were high enough to pay the high interest rates prevalent at the time. Given investors' wish to secure tax shelters and realize capital appreciation, rents were of little consideration. This lack of concern for adequate rental income was all the more prevalent because property ownership through syndications typically was financed through non-recourse mortgage loans. Thus, the S&Ls making such loans restricted themselves to the rents and collateral values of the properties should the borrowers default.

Unfortunately, many S&Ls were not able to realistically appraise and evaluate the risks of such properties, much less underwrite or administer such loans. Disaster loomed and ultimately, when the loans did not pan out, the cost of these institutions' insolvency increased greatly.

As a result of these many circumstances, huge amounts of mortgage money flowed into multi-family residential and commercial mortgage loans. From the end of 1982 until the end of 1985, multi-family residential mortgage loans at S&Ls grew from $38.9 billion to $66.6 billion, and commercial mortgage investments grew from $51.3 billion to $84.1 billion.[5] All too frequently, other S&Ls that were located far away from the sites of the properties they were financing bought into such deals through mortgage loan participation investments.

The Plight Of The Regulators
When the GSG Act was passed, there was little if any concern that the Federal Savings and Loan Insurance Corporation was intended to insure deposits for a highly regulated, predominantly single-family residential lending industry and that a major conflict existed between deposit insurance and the extensively deregulated S&L business that was brought about by GSG.

Although regulators were overwhelmed by the changes in S&L operations, the federal government was not willing to authorize additional needed staff. It failed to recognize that deregulation required more, not less, examination and supervision, especially given the substantial numbers of newly chartered institutions formed under the liberal statutes of California, Florida and Texas.

1986 Tax Reform Act
Whatever the other effects of the 1986 Tax Reform Act (TRA), the impact upon real estate values was disastrous. Through the earlier ERTA, the government had encouraged non-economic investment in real estate on an unprecedented scale. Then, only five years later, the 1986 TRA increased the length of depreciable lives, imposed at-risk rules upon real estate investments, significantly increased the capital gains tax rate and all but eliminated real estate investments' ability to shelter externally derived income. It would have been reasonable to expect either grandfathering or transitional rules which would

have cushioned the effect of these draconian changes. Without such modifications, however, real estate investors were hit hard in two significant ways. First, they were not able to achieve the tax savings that provided the motivation for much of their investment. Second, the investment value attributable to the potential tax benefits for future buyers was decimated, ruining the potential for value retention, let alone appreciation. The obvious course of action for many of these investors, especially those using non-recourse debt, was to turn over the properties to the lenders.

Thus, the federal government has given, and it has taken away. Unfortunately, the tax revenues that the government may realize by eliminating tax shelter benefits on properties acquired by S&Ls are minor in comparison to the enormous costs of marking down the values of and operating these properties. Had suitable transitional rules been applied to such properties, tax revenues would be fewer, but the overall cost to taxpayers would be far less.

The Evolution In Commercial Bank Mortgage Lending

Recently, much concern has been expressed about the quality of real estate loans financed by commercial banks. Before concluding this article, it is desirable to consider how commercial banking practices pertaining to income property lending have changed over the past decade.

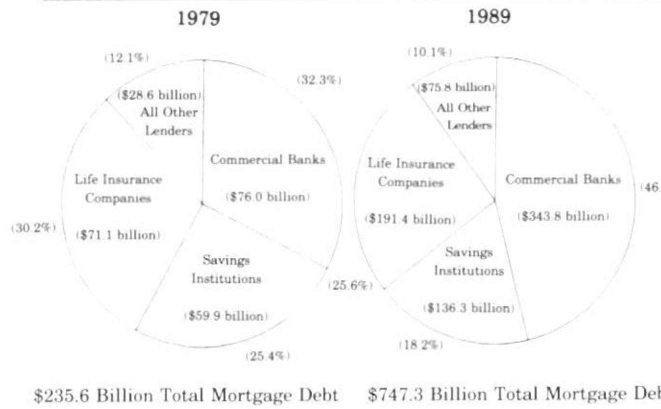
In the development of large shopping centers, office buildings, industrial parks and hotels, the construction mortgage lender often has been a commercial bank. Prior to 1980, permanent loan (or takeout) commitments, generally issued by life insurance companies, were an iron-clad requirement before a commercial bank would issue interim loan commitments. Among the key provisions contained in a permanent loan commitment were those dealing with an agreed-upon construction completion date, procedures for approving changes in plans and specifications and rental achievement requirements. By making permanent loan commitments, life insurance companies have been a major element of loan quality control, especially given their policy that their non-recourse mortgage loans would be subject to the production of adequate rentals at the time the permanent loans were funded.

In 1980, however, following the rise in interest rates, life insurance companies closed their permanent loan commitment windows. The banks were then faced with a dilemma. Continuing their policy of requiring permanent loan commitments would require them to shut down their construction loan operations. Because of the importance of construction loans to the banks' total commercial lending operations, the banks eliminated the requirement that a permanent loan commitment must be obtained before the construction loan would be approved.

Over the last decade, many commercial banks have moved into the void created by the departure of the life insurance companies, aggressively expanding their market share of commercial mortgage loans by making both construction and permanent mortgage loans on such properties. As shown in Figure 1, between the end of 1979 and the end of 1989, bank-financed commercial mortgage loans grew a phenomenal 352%, expanding in dollar value from $76 billion to $343.8 billion; meanwhile, banks increased their market share of such loans from 32.3% to 46.1%. In contrast, life insurance companies' market share declined from 30.2% to 25.6% over this same period. An even larger market share decline was recorded for savings institutions, i.e., S&Ls and mutual savings banks. From the end of 1979 to the end of 1989, the market share of these institutions declined from 25.4% to 18.2%.

FIGURE 1

Commercial Mortgage Debt Outstanding
for the Years Ending 1979 and 1989



In making permanent mortgage loans, the principal loan product used by commercial banks has been the miniperm. Miniperms have terms of five to, say, seven years, following the completion of construction, and they are generally priced on a floating rate basis. Missing from the miniperm loan arrangement, however, is the separate evaluation of the project by the external permanent lender, which formerly occurred when the permanent loan commitment request was being processed. Also disquieting is the absence of suitable loan maturities consistent with full amortization of the mortgage debt.

As noted above, the banks' market share of commercial mortgage loans grew enormously during the 1980s. The jury is still out on how severely the losses from these loans will impact banks' capital structures. But the existing vacancy levels for most categories of commercial properties are an ominous sign.

Conclusions

During the 1980s, far more than a decade's worth of space requirements were built in just ten years. Now the better part of the current decade will be needed to absorb that space. In the capital-driven development environment, real estate for all intents and purposes became paper—paper to produce artificial losses, paper to record non-cash interest, paper to claim "future gains." In the process, rent was forgotten. But real estate as an investment form is like other investments; its value is determined by its income stream, and that income stream is determined by rent.

The emphasis on tax shelter and capital appreciation thus has proved to be a delusion which has its roots in the inflation of the 1970s. Without rent, obviously there cannot be any pre-tax cash flow. Without adequate rent, there cannot be any equity build-up or capital appreciation either. Mortgage debt has long been ballyhooed as an essential ingredient in the creation of real estate wealth. When used in the extreme, however, it is a negative element for borrower and lender alike. Debt must be a function of the quantity and quality of current rent levels.

When the sheltering of taxes is the overriding reason for investing in real estate and space is thrown on a market, even the best feasibility studies can be rendered worthless by the resulting market disequilibrium. As a consequence, market expertise is devalued. When the mere ownership of real estate and not its successful rental operation is the basis for investment, the services of successful property managers also are undervalued. The potential for rental productivity-driven capital appreciation occurs when a demand/supply equilibrium exists. The emphasis on a tax shelter destroyed that equilibrium.

There is reason, nevertheless, for some optimism. The present re-regulation that is occurring in both the S&L and commercial banking industries, while painful, will measurably help the real estate industry in the long run. The lessons of the last decade, so severe in nature, will not be easily forgotten.

In the early 1980s, one did not have to be knowledgeable about real estate to make money; ownership permitting tax write offs was sufficient. In the 1990s, a premium will be paid for knowledge, especially given the impact of demographic and employment changes upon the demand for space. While debt will be harder to obtain and more equity capital may be required, once an equilibrium is restored, equity returns based on properties' productive and creative use will be competitive with returns on other investments. For the present, however, it is back to basics, undoing the damage that has been done.

NOTES

1. For excellent in-depth coverage of the savings and loan industry during this period, see Strunk, Norman and Case, Fred. *Where Deregulation Went Wrong* (Chicago: United States League of Savings Institutions, 1988).
2. Jacobe, Dennis, Smith, Brian P., and Fahey, Noel. "The Thrift Crisis: The Result of High Rates and Bungled Deregulation," *Savings & Loan News* (April, 1982): 46, 48.
3. *Savings Institutions Sourcebook* (Chicago: United States League of Savings Institutions, 1989): 52.
4. *1985 Annual Report* (Washington, D.C.: Federal Home Loan Bank Board, 1986): 8.
5. *Federal Reserve Bulletin* (December, 1985): A39; *Federal Reserve Bulletin* (December, 1986): A39.