# REAL ESTATE AND MORAL HAZARD

*A look at real estate today and the truth about financial markets.*

by Bowen H. "Buzz" McCoy, CRE

There is plenty of credit available and at attractive rates. It is just not available to real estate. This is true for several reasons, primarily because of the one to twelve year oversupply of commercial real estate, depending on product-type and location. The over-borrowing binge of the 1980s has created a hugh backup of short-term financed real estate assets held primarily by commercial banks and insurance companies. This classic mismatch of long-term assets financed on a five year, non-amortizing basis was created in the expectation that supply and demand of product would remain in balance and that credit would be available to refinance the debt as it came due. Neither assumption was accurate. As a result, loans are being called, and the value of much commercial property, because of wholesale liquidation, has plummeted to as low as $.40 on the dollar.

Despite the agony of the past three years, there remains close to $400 billion of short-funded real estate assets in the commercial banking and insurance systems. Much of this debt will come due in the next three years. Thus, it becomes simple to predict a credit crunch in commercial property lasting well beyond the midpoint of this decade.

Repercussions of poor lending practices have struck at the core of these financial institutions. Rating agencies such as Moody's and Standard and Poors have lowered the credit ratings of financial institutions having "excessive" real estate assets in their portfolios, creating serious funding problems for certain entities. Likewise, financial institutions wishing to issue equity securities to bolster their capital ratios have run afoul of security analysts who also take a dim view of "excessive" real estate holdings.

At a time of relatively low, short-term borrowing rates and relatively high, long-term Treasury rates, banks are enjoying historically wide earning margins by short funding and investing in "riskless" government securities. At the same time banks are avoiding the high costs of originating, underwriting, monitoring and defending to regulators and others any new real estate loans. The impact of this real estate credit allocation will resonate well beyond the current decade, much as debt aversion extended well beyond the 1929-1933 Depression.

On the margin, one may expect to obtain real estate finance from REITs and other public vehicles, securitization, wealthy individuals, foreign investors and certain pension funds. Nevertheless, without significant participation from commercial banks and insurance companies, real estate finance will remain severely constrained.

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## Risk-Based Capital Rules

The late John M. Keynes coined the phrase "moral hazard" to describe unintended bad consequences of an otherwise positive act. One may trace the current over-borrowing and over-building of commercial real estate to the moral hazard from the misuse of funds raised by government insured deposits. Relatively inexpensive "riskless" capital was utilized to fund increasingly risky investments. The fact that the federal government guaranteed the deposits changed the demeanor of certain bankers from that of stewardship to that of imprudence. Compounding this was the federal government's lack of zealous regulation, the politicization of the regulatory process by certain members of Congress, and overall government policies which resulted in interest rates rising precipitously in the early 1980s, causing thrifts to choose increasingly risky projects.

The cure for the misuse of government insured deposits has been the implementation of risk-based capital rules for both banks and insurance companies. Putting it simply, banks are not required to have equity capital to invest in U.S. government securities and must hold about 8% as a capital reserve against commercial, industrial and real estate loans. These rules, whether applied by regulators or by the private sector arbitrators of capital access (rating agencies, security analysts, accountants, etc.) compound the trend of highly liquid banks loading up on government securities and going out of the commercial loan business. The moral hazard to risk-based capital rules is that, once again banks are short funding long-term assets. Just a whiff of inflation from the new Democratic government could flatten out the yield curve and create a banking crisis on a scale seldom before imagined.

Risk-based capital rules will stifle the current economic recovery, hinder the growth of small business and change the traditional temporal intermediation function of banks to being risk averse investment companies with deteriorating talent to underwrite loans and evaluate risk.

## Mark-to Market Accounting

The accounting profession, the Securities and Exchange Commission, bank regulators, pension fund administrators and the credit rating agencies are united in proposing that financial institutions mark their assets (loans and investments) to market. At present, investment banks mark-to-market, while commercial banks and insurance companies do so only for publicly traded securities. Pension funds in particular are anxious to develop a basis for periodic market valuations of real estate assets in order to incorporate real estate into the capital asset pricing model and make real estate truly fungible with other financial assets. As laudable as the notion may be, it ignores the specificity and idiosyncratic nature of individual large commercial real estate projects. Moreover, any attempt to write all real estate assets to current liquidation value in a market severely lacking in both willing purchasers and willing sellers would threaten the stability of our financial system.

Public policy efforts should be focused on continuing to allow banks to hold real estate assets for future recovery while keeping short interest rates low, thus allowing the banks wider than customary margins to build reserves for future real estate write-offs. A multi-year solution to the real estate problem while prolonging the agony, will preserve the stability of our banking system.

It is ironic that, under the prevailing low, short-term interest rate structure, banks are now realizing larger profits on restructured, classified real estate loans than they did before when the loans were paying their contracted rate of interest.

## Valuation Terminology

Another form of moral hazard in the current environment is the degeneration of appraisal terminology and methodology and of appraisers themselves. A typical scenario has a developer explaining his property to a bank in terms of a ten-year, hold-to-recovery and a *discounted investment value*, while the bank is examining the same property in terms of a three-to-five year-hold and a *current market value* and simultaneously the bank examiner is scrutinizing the same property in terms of immediate disposition and a *liquidation value*. All three parties argue with one another while utilizing terminology which the others do not comprehend. The property may, or may not, have an *intrinsic value*, but whatever that value is, it is impacted by the capital structure and holding power of its current owner.

This current cacophony of terminology is creating increasing dissatisfaction and confusion with the appraisal process. More and more individuals add to the confusion by attempting to clarify the issues. Kenneth Leventhal & Company suggests classifying real estate assets as follows:[1]

1. Quality assets with acceptable cash flows (given the weak economy) and some long-term potential. Such assets could be held or sold.
2. Assets that could be rehabilitated and converted to new uses and then either held or sold.
3. Problem assets that must be restructured, held until the economy and market improves and then sold.
4. "Trapped" assets that cannot be sold because they are in litigation or bankruptcy.

James R. Cooper of Georgia State University suggests these categories:[2]

1. *Investment Value:* An optimistic view of the value of a property if held in a financially stable, long-term portfolio and sold in the future in a stabilized market.
2. *Market Value:* The most probable price for cash that a property will bring if sold in a competitive and open market under all conditions requisite to a fair sale, both buyer and seller acting prudently with available financing and no undue stimulus.
3. *Current Value:* The most probable selling price under whatever conditions exist at the date of appraisal.

4. *Liquidation Value:* The price an owner is compelled to accept when the property sale is mandatory with less than reasonable market exposure; the lowest price that a democratic capitalistic system produces under conditions of market failure; a buyer dominated market.

The degeneration of appraisal terminology has been abetted by under-qualified government regulators requiring documentation which, at times, has been unnecessary and irrelevant. The confusing state of the market has been acknowledged by the Appraisal Institute. In June 1992, its special task force issued a report on value definitions. Yet The Counselors' own CRE and past president, James Gibbons, has stated "We do not need more definitions. We have enough; and they are well understood; the recent difficulties arose from inappropriate data inputs. Our major difficulty seems to be inadequate or faulty communication."[3]

## Valuation Methodology

FIRREA and government regulations have forced wholesale appraisals of real estate loans and investments held by financial institutions. Real estate professionals are complaining more than ever about the inadequacy and irrelevancy of the appraisals they receive. Tens of millions of dollars are being spent on appraisals which have no use in business decisions and are mere window dressing for the files. As appraisals became de-linked from market clearing prices on the way up, they are likewise not reflective of either the market or the intentions of the real estate holder's assets on the way down. As Gibbons stated, there is a vast communication problem among the requirers, holders and makers of appraisals.

In the absence of comparable sales data or even a market for property, it seems an appraisal must more and more focus on the holding power and intentions of the holder of the asset. An appraisal must reflect the most likely pattern of the market recovery over the term of the established holding period. An appraisal also must incorporate a business plan for continuing investment, repositioning and marketing of the asset.

A final economic value may well be the calculated expected value of probable outcomes. Such a detailed economic model of a project would not be warranted for assets with a value of less than, say, $50 million. Such an appraisal would have a major impact on the holder of the asset's business decision.

Such an economic evaluation should provide lucrative employment for fellow CREs. As Counselors, we must be concerned with the devaluation of valuation methodology. Whether or not we also serve as appraisers, Counselors cannot afford to allow major capital pools, such as pension funds, to consider our industry as unprofessional and chaotic.

## Data Collection And The CREs' Role

A major inhibiting feature of real estate as an investment asset category is the deterioration of a reliable database. Pension funds, in particular, will not return to the marketplace until they are convinced that a credible database exists for real estate.

In the current marketplace, there is no coherent basis for determining demand for space or for determining true economic (net effective) rents. Thus, there is no coherent basis for determining value. Contract rents are meaningless in the welter of kickbacks, side payments, free services and the like. Buildings are measured differently in different cities. Seemingly modern structures are technologically outmoded or riddled with asbestos.

A true moral hazard has been created in that many major institutional investors no longer trust real estate data. The current supply-demand situation will resolve itself temporally, as will the burden of past due and delinquent debt. The resonance from the lack of trust in real estate as an asset class will last longer. Here is where CREs can add clarity and professionalism to the process as advisors to financial institutions and by convincing clients that their long-run interests are best served by sharing and opening up their databases, heretofore deemed proprietary.

### NOTES

1. *Real Estate Newsline*, Kenneth Leventhal & Company, October November, 1992, p.3.
2. Cooper, James R. and Brown, Robert K., "Research Monograph Number 104," *Georgia State University,* (1992) pp.59-64.
3. Personal letter to author, October 8, 1992.