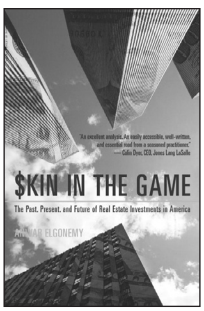
**RECOMMENDED READING**

# Skin in the Game: The Past, Present and Future of Real Estate Investments in America

*by Anwar Elgonemy, CRE (©2012, CreateSpace, 495 pages)*

**REVIEWED BY DANIEL L. SWANGO, PH.D., CRE, MAI, FRICS**



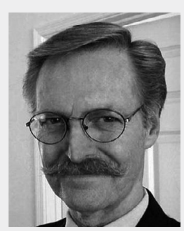

THE TITLE of the book *Skin in the Game: The Past, Present and Future of Real Estate Investments in America* calls attention to a major problem in the economy and in the real estate segment particularly—that many of the investors, loan originators, secondary market entities, investment vehicle creators and others have little or no skin in the game, i.e., their own money and assets at significant risk. This volume is a look at the Great Recession, indirect and direct causes, what has been done and is being done about it, and the outlook for the economy, particularly the real estate sector. There are many lessons for us to learn! But, collectively and individually, will we?

Chapter 1 presents Elgonemy's perceptions of some of the characteristics of the American economy, particularly the real estate component in asset and capital/financial markets. He shares his thoughts about direct and indirect causes of the 2000–2005 "reality of the realty bubble" and ensuing Great Recession. Frugality is not one of our virtues; in this chapter he warns against greed and debt, individually and as a people/country/culture.

In the second chapter he dives into some of the "mumbo-jumbo" that has come about in the last few decades in the real estate capital and financial markets; a host of acronyms and terms including: ABSs, REMICs, pass-through securities, derivatives, multi-layered derivatives, mortgage bonds, CMO classes, tranches, tranche structuring, CDOs and other imaginative and complex inventions. You may think you have an understanding of most of these, perhaps, but here they are clearly and concisely explained—some with visual aids.

It's intriguing how a basic concept, i.e., loaning money with real estate as the security—the basic mortgage—became so incredibly complex in response to the desire for liquidity, risk sharing, and satisfying insatiable simple greed. From the mortgage to secondary markets to securitization to a tangled morass of new investment inventions, mechanisms and instruments, the developments and progressions are explained. And all this was happening at a time of residential real estate price increases exceeding inflation far beyond the historic

## About the Reviewer



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typical one percent or so, and consumerism driving up all types of consumer and corporate debt to Himalayan levels. Enter some black swans, and you have the perfect storm—what has come to be known as the Great Recession.

In the third chapter the reader sees "it wasn't just a bubble; it was a froth of countless tiny bubbles," as Alan Greenspan put it in *The Age of Turbulence*.

Elgonemy reveals the faulty assumptions and how the market drank "the Purple Kool-Aid." It appears that none of the sophisticates understood the new derivatives—sliced and diced investment instruments—and/or didn't want to admit what they didn't know, or find out. Why endanger the golden goose?

> *The American consumer's desire to spend and live well beyond his or her means circuitously contributed to the crisis.* But … *the 'spend-it-before-we-earn-it' consumerism habits were in place long before the housing boom.*
>
> And in real estate: *Tempting, low-rate loans, often with artificial payments, were pushed by greedy, unscrupulous loan officers. They found easy marks in gullible buyers. … It can be assumed that these families seldom had access to an honest real estate agent, loan officer or attorney to guide them through the stressful home buying process—they were often dealing with the low-end of the real estate profession…*

The author correctly points out: "When investment markets digest expectations only, it is a bubble in the making. Investors and bankers can easily get caught up in a feedback loop that reinforces a sense of tunnel vision or expectations group-think." It became standard, normal and accepted. So with all on the same Kool-Aid, the mistakes repeat again and again; the outcome is inevitable.

In the fourth chapter we read how the machine was greased, how loans were pushed, and lower and lower credit acceptable, thanks to greed and incentives to those with little or no skin in the game. The well lubricated machine involved predatory loans with relatively high interest and fees, abusive terms and conditions trapping borrowers, dismissing borrowers' ability to pay, and such.

All this took place in a stew of fraud and law-skirting in property sales, marketing of investment paper, and the loans themselves. This includes aggressive solicitations, kickbacks to mortgage brokers (yield-spread premiums), multi-level sales schemes, purposely making unaffordable loans, falsifying loan applications (particularly concerning income), and even forging signatures and making loans of more than 100 percent loan-to-value. Frauds also included high points and/or padded closing costs and fees, unexpected balloon payments, inflated appraisal costs, bogus broker fees, duplicate services, daily interest for late payments, and forced services and insurance. Discussions about rampant white collar crime and fraud are included in this chapter.

The "Wicked Incentives" are highlighted in the fifth chapter—incentives that encouraged bad lending, then created and pushed bad investments. There was not only large scale *fraud* in the real estate markets and real estate financing and investing instruments, but correspondingly, money *incentives* for individuals and companies to push on and on, exacerbating the problems. In the mix also: very poor risk management and rating, including deliberately hidden data and performance metrics, along with a short-term focus by managers and stockholders.

Then there is, and was, Wall Street's style of evaluation of investments and companies—all based on short-term performance and perceptions of "the come." Maximizing compensation and pumping stock value at all costs—a runaway problem examined and hashed out by the author. Unsustainable prices and stratospheric price-earnings ratios were reached; pricing was more and more "based on the come"—not good. Alan Greenspan's comment about *irrational exuberance* is quite descriptive.

Chapter 6 is appropriately titled "Cheese, Sleaze, and Filling in the Boxes." Real estate had and has a mystique, magnitude and risk arising from lengthy and involved transactions, many different players involved in the industry, and sizeable individual transaction amounts; so the real estate industry was and is bound to attract some shady, greedy, unscrupulous players.

Real estate is risky for several additional reasons, among them the lack of transparency, proprietary secrecy, and lenders lending money they don't own or control over the life of the loan. *They don't live with their loans.* The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is also discussed; it remains far-reaching, with some of its controversial provisions questioned. With the "I-want-it-now" consumer, the ill-informed "get-me-all-I-can-get" borrower, the incentivized marketing and lending brokers and agents on commissions, the appraisers seeking happy clients for future assignments, the predatory loans, the minimal qualification loan requirements, and the lack of responsible work by the credit rating agencies and regulators, there came a tremendous real estate and financial meltdown. We saw " … the biggest missed assessment of real estate debt risk in our lifetime."

Most of this chapter gets it, spot-on. But there will likely be disagreement with some of the statements about Dodd-Frank.

Then Chapter 7, "Mixed Signals," addresses *commercial* real estate, with its own set of problems and challenges, and its guilt by association with the residential sector. There has been an "overload of contradictory economic data" and resulting decision-making difficulty in the commercial scene; this is still unfolding, with a huge amount of CRE debt maturities coming due in 2012 through 2015. (Stay tuned; the fat lady hasn't sung yet.)

Vacancy rates have improved, but lending requirements have significantly tightened, with " … average LTV on senior debt close to 65 percent … with more in the way of recourse." Commercial properties have suffered also because of the general economic downturn resulting in sagging vacancy, rental rates, net incomes, cash flows, and "erratic property values." The author describes a CRE market in flux and turmoil and uncertainty, with mixed signals about the future.

Restructuring of finance packages has been more prevalent in commercial real estate than in residential real estate, with less impact from foreclosures; some refer to "extend and pretend." Delinquency rates are still high in a struggling recovery, massive commercial real estate debt is coming due by 2015, refinancing options are still quite limited, and new banking regulations make for continued difficulties in the commercial real estate world. The author discusses the glass half empty versus the glass half full views. As you soak up this chapter, look at the glass and the water; the status is up to you and your evaluation of the scene(s).

In Chapter 8, "Violating the Law of the Lever," debt and leverage provide the grist for the mill. In this chapter the author " … emphasizes the dangers of debt, the cocaine of real estate investors." And, "When applied to real estate, the principle of leverage enables investors to purchase properties they would not otherwise be capable of acquiring with all-cash equity."

Elgonemy addresses borrowing, leverage and the advantages and disadvantages of their use in Chapter 8, complete with examples showing both the potential and the destructive power of leverage. He goes on to address "*over-leverage*, the imprudent borrowing of too much money" to minimize equity contribution to maximize ROE. He concludes that, in spite of the Great Recession, we are still in "The Land of the Rising Debt," and calls attention to "The Calamitous Missed Assessment of Real Estate Debt Risk" with "excessive debt growth" in commercial real estate.

What to do? "Fiddling with the System" is the subject matter of Chapter 9. Elgonemy opines that the United States real estate sector has a lack of confidence resulting from confusion arising from the new regulatory expectations, and the questionable ability and effectiveness of the federal government in dealing with the economy. The federal government, he notes, has had a mixed record in these areas, with recurring financial crises anyway. A good graph in this chapter shows the national levels of new home sales from 1963–2010 with notes of major federal government actions, with a suggested cause and effect relationship on new home sales. The author reviews some of what he calls "good fiddling" and "not-so-good-fiddling" by the federal government. There is also some discussion of government distortion, data and risk evaluation problems, and government policies that promote home ownership even for some not in a good position to take on home ownership or debt.

The reader may judge whether he or she agrees with the government's solutions discussed, such as Dodd-Frank, quantitative easing and other measures. Elgonemy notes that " … government intervention isn't a bad thing, but it should not be excessive." "Excessive" is not defined; and he opines boldly:

> *All financial crises are caused by too much leverage.*

Further:

> *…if we look closely at the cunning financial products that were created by some very smart people—CDOs, CDSs, and so on—a defining feature was that they were intended to exploit loopholes in the U.S. legal system. Innovation was therefore about dancing on the edge of laws, regulations, and ratings.*

Risk is the next topic, in Chapter 10, along with the need in the system for participants to have "skin in the game," holding that lending quality is better when lenders "… have a loss risk on the loan products they sell to investors." Likewise for borrowers—there *must* be significant equity capital involved. Mortgage-backed securities loan originators weren't taking any particular risk, but must.

A good discussion of human nature and the nature of business makes up most of the chapter including good information about leveraged buyouts, no-risk securitizations, and challenges in the worlds of FHA, Fannie Mae and Freddie Mac. (Remember the "liar loans" and the no-doc loans?)

The eleventh chapter, "Facing the Music," examines "additional unresolved problems in post-crisis America." Elgonemy says debts in the U.S. are "particularly worrying because they threaten to destroy the financial future of generations of Americans." Consequences of such incredible, inconceivable, astonishing levels of debt as we have and likely will have for some time include:

- more savings going to buying government debt rather than investments in productive factories and capital goods;
- higher tax rates to pay interest on the debt with less left for buying of products and services creating jobs, expansion, growth and innovation;
- reductions in needed government services because of proportion of budget to go to interest; and
- more risk in cases of future financial crises.

He also reviews the impact of debt on growth, individual/household earnings, inflation and society. Relative to these "debt points and concerns," he chews over five key problems:

> *"1. Misconceptions about housing; 2. Negative home equity; 3. Delinquencies, defaults, and foreclosures; 4. Commercial debt maturities; and 5. Private-level mortgage-backed securities."*

Housing, he says in Chapter 11, is not always a good long-term investment because:

- it is an indivisible asset;
- it is not diversified (inflexible);
- buy/sell transaction costs are high;
- it is easy to get money out when prices are rising but not when falling;
- it is highly correlated to the employment market;
- it is not necessarily prudent to buy a house a with low down payment;
- owning a home is not always cheaper than renting; and
- homes don't automatically increase in value.

To the above he adds the problem of negative equity, noting about 23 percent of homes in 2011 had negative leverage, or were underwater, with many more borderline. "The urge to own a home is part of the problem with the U.S. economy today. It's what helped get many Americans into excessive debt."

Beyond houses, he addresses the coming problem of a huge amount of 2012–2015 commercial debt maturities. Making matters even more ominous, according to the MIT Center for Real Estate, commercial real estate values dropped about 44 percent from the peak in 2007–2009 largely because of downward pressure on rent, increasing vacancy and increasing capitalization rates. With lower values and more stringent loan underwriting came the obvious painful problems in commercial real estate. Elgonemy notes: "Research by Moody's and Real Capital Analytics indicates that about half of the commercial real estate acquired or refinanced in the last five years are now upside down on their loans, with asset prices falling below the mortgage amount. … Deutsche Bank and CoreLogic also estimate that 65 percent or more of CMBS loans could fail to qualify for refinancing."

The twelfth chapter presents a discussion of unresolved problems and some outlook. There are many lessons to be learned from the Great Recession, but memories of U.S. real estate cycles tend to be short "and some of the lessons are never taken onboard at all."

Elgonemy has a number of wide-ranging suggestions; for lenders particularly:

- do a better job of understanding risk;
- make loans with realistic probability of repayment;
- demand equity;
- stick to your core competencies;
- don't over-rely on financial models;
- watch incentives; and
- don't get caught up in hysteria.

He seriously questions the home ownership iconic goal/dream in America and the mortgage interest deduction, citing pros and cons of each. He says, "Although it's not 'morning in America' yet, there are hints in 2012 of dawn on the horizon [with the] country in the 'hope' stage." But he continues, "The story so far is that after a desultory three years from the official ending of the Great Recession, the United States might be drifting along in a Japanese-style funk." Further, "American business and political leaders must rebuild growth and employment that's based less on excessive debt, consumption, construction, and imports, and more on manufacturing and export."

In the Epilogue, Elgonemy opines:

> *Therefore, it is hoped that the Great Recession has enabled U.S. real estate investors and consumers to discover four needed changes in their behavior:*
>
> - *Avoiding Complacency* [He mentions 'black swan fatigue,' i.e., tiring of the idea that a low-probability event could happen and cause havoc.];
> - *Caution;*
> - *Doing More with Less;*
> - *Obsessing Less about Money.*

Appendix A provides a simply great 20-page overview of "The Evolution of U.S. Mortgage Finance, Securitization, and Real Estate Derivatives." (It starts in the early 1900s.)

Appendix B is a seven-page "Summary of US Government Intervention During and After the Financial Crisis." An Index (20 pages) makes it easy to reference items of interest—useful because this book is one you will want not only to read, but to have for future reference.

I would have liked to have read more about commercial real estate in addition to the residential real estate matters, more on the credit rating fiasco and inherent problems, and more on the Great Recession's non-real estate changes in consumer spending and retail, employment levels, consumer confidence levels sales (impacting rents, vacancies, industrial, commercial real estate in general), and foreign influences on the Great Recession, especially that of Europe (particularly Greece, Spain, Portugal and the EU problems) and Asia (specifically China).

But then again, even a 490-plus page paperback has room for only so much. Maybe in the sequel. (It will be a long movie, with need for an intermission.)

In spite of these druthers, I wholeheartedly recommend this book. It's a well written, well documented, interesting, clear, significant treatise about real estate in the Great Recession—its background and causes, what has happened in response to it in the public and private sectors, where we are—and where we may be going.

In one role or another, you've been a participant in the Great Recession—so it's enjoyable and enlightening to see and grab that elephant from different angles. This book invites you to read more about the drama that has been testing your knowledge, skills and thespianship.

Why read this book? Why care? Well,

- because *you need to know* as much about your profession as you hope your surgeon knows about his/hers;
- because *you want to learn from experience*;
- because *you care about your career, your profession* and want to improve its *contribution to your descendants, America and society*; and certainly
- because *CREs aspire to be part of the solution, not part of a future problem*. ■