CRE PERSPECTIVE

Tragedy of the Commons: Will it be Different This Time?

by Bowen H. "Buzz" McCoy, CRE

The Tragedy of the Commons

The excesses of the real estate development market of the late 1980s may be compared to the "tragedy of the commons." The tragedy describes the circumstance where a village common is overgrazed to the point where there is no fodder left for the village animals. This occurs because individuals feel an entitlement to their share of the common good and no collective sense of responsibility to conserve or renew the food supply. The result is that no one individual destroys the common, but as a group the village common is devastated and trust in the institution of the village is lost.

In the case of real estate development in the late 1980s, each project was deemed in the eye of its beholder as being very special, having unique appeal, and coming on the market at precisely that window of time when the last full building would be executed and before the devastation of overbuilding. Lost in the analysis was the devastation caused to all buildings in a specific locale by the serious overgrazing which resulted from a number of such seemingly isolated and innocuous decisions.

Real estate development has traditionally been a local business, played chiefly by insiders with information not always readily available to the financial marketplace, where individual entrepreneurs attempt to gain windfalls by getting an edge on the market in general. The lack of broadly accessible, accurate, consistent data on real estate has helped to preserve this insider's game, as it has also contributed to the volatility and amplitude of the real estate cycle. The more transparency, the greater the depth of accurate information available to all players in a market, the less chance there will be for such wide swings in real estate as occurred over the past 10 years.

It is entirely possible that 1998 will be regarded in retrospect as the year of equilibrium; the year when aggregate supply and demand for real estate came into balance; the year in which virtually no new developments caused excessive capacity or declining rents. Along with the achievement of market equilibrium have come the beneficial results of several recent trends—such as securitization, technology, and consolidation. A rising tide lifts all boats, so it is difficult at present to assess whether or not these newer trends in real estate will provide greater stability to the industry. The answer will come only as we swing into yet another real estate recession caused by overbuilding. At the end of a complete economic cycle we will better be able to assess the significance of these new trends. Meanwhile, the issue is: Have these new trends in real estate served to dampen the volatility of the real estate cycle, or is the real estate development game just the same old game being played out in a new wrapper?

The Moral Hazard of Rewards and Punishments

One of the problems with real estate, especially in the late 1980s, is the moral hazard which resulted from a de-linking of rewards and punishments. Those who piled on production in financial institutions, especially savings and loans and commercial banks, were rewarded handsomely for meeting or exceeding targets. Bonuses and longer term incentives were not tied to the outcome of the investment. There was no linking of the rewards for production with the risk involved in the transaction. There was little or no concept of risk- based capital or of risk-adjusted return. This led to loans being made at 100 percent or more of cost to developers with no equity stake or risk in the project, often with all their development fees being paid out on the front end in cash instead of staying at risk in the transaction.

A further moral hazard occurred when entrepreneurs played the RTC game and achieved, in the early years, windfall profits as a result of the Federal government's capital being at risk. The positive side of this event was that we cleaned up the mess in a hurry; a fact that our Japanese friends do not appear to have caught on to. As a result of astute management by Dr. Alan Greenspan, our banking system survived the test quite well. Bank executives were also a beneficiary of this de-linking of rewards and punishments. The Federal Reserve Bank kept rates low, allowing the banks to build up their reserves. Certain bank stock prices initially fell to 20 percent of previous values and then increased eight-fold, giving the bank officers windfall profits on their stock options.

How Can We "Fix" the Real Estate Cycle?

Without the transparency of timely and accurate data on rents, it is unlikely that any system will be developed which will cause punishment to occur prior to overbuilding. The kinds of systems which might produce data in time to prevent overbuilding are probably too draconian to withstand the political and regulatory process. Examples of practices which might prevent overbuilding and truly mitigate the real estate cycle would include the following:

A **national rent index**, with various local components. The Urban Land Institute made some significant progress on this front in the early 1990s, but industry support lagged and then collapsed as the real estate markets improved and it became every institution out for itself once again. Such an index could be derived statistically. It would cost a few million dollars—a cost which could be shared by several of the major financial institutions in the real estate business. The ultimate value could far outweigh the cost. Developers, financial institutions, and tenants could go long or short in various individual geographic markets and product types, smoothing out cycles in local markets.

The index must be monitored by an independent fiduciary in which there is a high degree of trust. The Urban Land Institute could be such a body, as could any one of the major universities involved in real estate education. Such an index would be organized by geographic sector and by major property type. The moral hazard here is the industry's lack of willingness to make real estate a public utility and share the formerly inside information so broadly. Each player feels advantaged to "get an edge on the market." In so doing, they increase the volatility of the cycle and are thus each a cause of the major windfalls and catastrophic losses which occur in the industry with embarrassing regularity.

The Controller of the Currency could require each major bank to report on a **quarterly basis the details of each real estate financing** in which they have engaged, including accurate data with respect to volume of construction lending, loan to value, true equity, degree of risk taken by the developer, rental concessions, amount of preleasing, and the like. As one who is fundamentally anti-regulation, this draconian tactic has little personal appeal, but it could provide a basis for mitigating the cycle if such data were reported out to the public on a real-time basis, i.e. on the Internet.

The Securities and Exchange Commission could require each publicly traded real estate operating company, real estate investment trust, originator of commercial mortgage backed securities, etc., to **report publicly on a quarterly basis net effective rentals** on all of their properties on a consistent basis. Such data could be fed by the Internet to all interested parties, including a public or quasi public utility which would construct the rental indices referred to above.

What Is Different This Time?

In theory, the securitization of a significant amount of real estate, primarily through real estate investment trusts and commercial mortgage backed securities, provides the marketplace with a much greater pool of data than was the case when such assets were held by private institutions. Punishment seems more directly linked to the negative event. For example, if an REIT persists in over-developing a particular market, the word gets out quickly, and the public and the financial institutions will sell the shares of that particular REIT, increasing its cost of capital and most likely making it a take-over candidate. The public disclosure required of publicly held firms provides for a much more rational market, although the punishment does not occur until after the overbuilding has occurred.

Likewise, one may surmise that properties controlled by opportunity funds are likely to be more closely scrutinized and more aggressively dealt with than those financed by large financial institutions which, at least at the beginning of a cycle, have traditionally stretched out problem loans, quarter by quarter, hoping to avoid a write-off.

In general, the current real estate industry structure has more monitoring devices than before. The imposition of risk-based capital rules have forced commercial banks and insurance companies to become more rigid in their real estate analysis. Wall Street common stock analysts as well as credit analysts are quick to punish a public company for a missed earnings forecast, excessive leverage, non-accretive acquisitions, or overbuilding. These stock and bond analysts ride herd on the publicly held financial institutions as well, such as commercial banks and insurance companies; and they are quick to punish excessive financing to real estate on the part of these firms.

In general, real estate benefits from the consolidations and the larger sized real estate firms, both public and private—(especially if their larger size allows them to make the investment in technology that is required to attain efficiencies in operations). Most larger,

consolidated firms also have a more conservative debt structure than was the case in the 1980s, as they wish to gain the advantage of an investment grade bond rating and lower cost capital. The consolidations will truly benefit real estate if they can bring off the benefits of professional management, discipline, and scale to an industry which has been highly customized and hand crafted for too long.

What Is The Likely Outcome?

It has been said that "disciplined, speculative" development is an oxymoron. This is somewhat surprising, given all the newly developed risk management tools in the financial markets. If this is true, then the only real discipline in the real estate markets is the flow of capital. So long as the financial sources maintain discipline, the real estate cycle will be moderated. In the late 1980s, the financial institutions became part of the problem themselves as they contributed to the overgrazing of the public commons.

The larger real estate firms need to develop discipline. A truly mature industry should not be relying solely on capital sources and regulators to keep it from excessive behavior. It will be difficult for real estate firms to develop such discipline, however, if a significant portion of new development continues to be carried out by local entrepreneurs who have no incentive other than to get and keep an edge on the market. Such behavior, which is always rational in the individual sense, creates an imperfect and distorted market overall. It is impossible to punish such behavior in advance of overbuilding.

Thus, in the absence of some draconian moves to produce transparency of markets and information, it is highly likely that the real estate development market will remain imperfect; i.e. the same old business in a new wrapper. The major difference at present is that the punishment is likely to come faster and be harder. Those who avoid "overgrazing" and keep their powder dry will be there to mop up the pieces at substantial discounts and take ultimate advantage of such imperfect markets. The tragedy of the commons will continue with all the concomitant windfalls and losses. Perhaps that is the ultimate reason why so many of us find real estate such an entertaining and stimulating place to make our living. REI

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