

Global real estate and the credit crunch

Lessons we should have learned long ago

The recent fallout from the credit crunch – including the soaring rise of residential mortgage defaults, plummeting housing values, lack of liquidity for commercial real estate investment, a spate of Federal Reserve interest rate cuts, the International Monetary Fund’s estimate that there would be more than \$1 trillion in losses tied to the collapse of mortgage-backed securities, the sudden submersion of Bear Stearns and the subsequent ascension of the Fed to its new role as apparent go-to guarantor of private investment banks – has spurred a wave of intense debate about the root causes of the ongoing crisis, as well as who is most to blame for not seeing the problems approaching.

In the US, this kind of commentary is often referred to as ‘Monday morning quarterbacking’ or having ‘20/20 hindsight.’ While there no doubt is some advantage to be gained in analysing how we came to where we are, there is no guarantee that such lessons will protect us from having to face a similar sort of reckoning 5, 10 or 15 years in the future. After all, for those who remember the Savings & Loan Crisis of the late 1980s – it’s not like we haven’t been here before.

As a practical matter, maybe all we need to do is relearn some of the simple, common sense lessons that our parents long ago taught us (or should have).

Save for a rainy day.

In the aftermath of 9/11, American consumers were advised by their political leaders that the best thing they could do to reinvigorate the nation’s sagging economy would be to go shopping. And that is just what they did. In the months that followed, consumers racked up ever higher levels of debt on their credit cards and by taking out second and third mortgages – taking advantage of low interest rates and using the constantly increasing market values of their homes as a private bank account to maintain the good life.

According to *The New York Times*, domestic financial debt grew from \$8.5 trillion to \$14.5 trillion between 2001 and 2007, with home mortgages’ share rising from \$4.9 trillion to almost \$10 trillion during that time. By 2007, total indebtedness was three times the size of the gross domestic product, a level not seen since the Great Depression.¹

If something sounds too good to be true, it probably is.

Indeed, over the past five years or so, the US housing markets and commercial property markets enjoyed an unprecedented period of appreciation in values – fueled in part by a steady, strong economy and a federal monetary policy that kept interest rates low (perhaps, in hindsight, artificially so).

Across the country, residential mortgage lenders competed fiercely with one another to provide homeowners and would-be homeowners with more and more piles of money for the purchase of new housing, vacation homes, cars and whatever else suited the borrowers’ fancies. Incidences of so-called ‘no money down’ loans began to multiply while lenders began to pay less and less scrutiny into borrowers’ income verification. Growing numbers of borrowers took advantage of this new-found ‘easy money’

¹ ‘What Ails the American Economy? Everything, and There’s Worse to Come,’ Barry Gewen, *The New York Times*, 21 April 2008, p. E7.

and saddled themselves with increasing levels of debt that it would be difficult to repay. The era of the 'subprime' mortgage had arrived in full force.

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Eventually, increasing numbers of homeowners who found themselves overleveraged and unable to keep up with upwardly readjusted mortgage payments began to slip into default – all this as they watched the market value of their expensive homes steadily decline. In the meantime, thousands of these higher-risk mortgages began to be bundled together and re-sold into the securitisation marketplace and sold to willing buyers both in the US and overseas.

There is safety in numbers.

Basically, securitisation is the transformation of illiquid financial assets, such as individual mortgage loans, into readily-marketable securities. In the US, the lion's share of residential mortgage securitisation is done through the

Federal Home Loan Mortgage Corp. (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Freddie Mac and Fannie Mae accomplish this process by bundling together mortgages and then selling claims on those pools, while also providing a guarantee against default on the resulting mortgage-backed securities. On the commercial side, Wall Street firms like Goldman Sachs and Lehman Brothers, and the securities arms of major banks like Citigroup, J.P. Morgan and Wachovia, sell securities backed by similar asset pools in the form of rated bonds.

In short, assets are gathered, packaged, carved up into different categories that reflect the risk appetite of various types of investors – including insurance companies, pension funds and private equity funds – and resold. These investors decide upon the type or level of investment they are willing to make depending on sophisticated risk/reward models that take into account a range of factors, such as valuation, profitability, quality, momentum, volatility, historical performance, etc.

The advantages of securitisation have, in a relatively short period of time, proven to be multi-fold – giving investors access to broader, more efficient, more stable sources of capital. In theory, securitisation is an efficient process that rests on an assurance of systemic transparency, wherein information is constantly verified, updated and disseminated to all interested parties – resulting in more reliable valuations, better internal management controls and a fairly liquid secondary marketplace.

You can have too much of a good thing.

Unfortunately, the process does not always run as modeled. Increasingly lax scrutiny, together with overly aggressive underwriting on the part of mortgage lenders led to higher and higher levels of inherent risk in their respective mortgage portfolios. This inherent risk subsequently filtered through into

the residential and commercial mortgage securitisations that were created from these loans as they were bundled together and underwritten with the flawed assumption that real estate values would continue to rise. At the same time, the expansion of mortgage credit, combined with the creation of a myriad of new, complex financial instruments such as collateralised debt obligations (CDOs) helped fuel even higher levels of leveraging and speculation, while at the same time obscuring what exactly was being contained in these exciting, innovative instruments – and the level of risk that they carried.

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What resulted has been described by at least one analyst as a slow-moving train wreck. In a sense, the market had become something of a self-perpetuating machine. Wall Street firms would provide warehouse financing to accumulators of mortgage loans. These accumulators in turn, would securitise them and then sell to the marketplace. The marketplace, in turn, would buy those securities and then repackage them into CDOs. This process churned round and round in an increasingly frothy stream with the system generating renewed liquidity for itself each time.

All that glitters isn't gold.

About a year ago, as the first headlines began to appear indicating that there were problems in the subprime area, the chief financial officers and chief investment officers of institutions holding these securities began to reexamine their underwriting standards as well as the nature of the assets in their portfolios. Then, in the second quarter of 2007, alarms from the rating agencies began to sound concerning evidence of lax underwriting standards on commercial loans. By the third quarter of 2007, investors began to worry about the commercial real estate sector as similarities to the problems that led to the decline of the subprime residential market began to appear.

Recognising that the process was spinning out of control, investors began to pull back, concerned that many CDO and CMBS transactions had become too risky. Many investors left the market entirely or demanded sharply higher yields. The devaluation of these assets led many lenders to stop lending, as well as to begin hoarding cash out of concern about the possibility of rising defaults.

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The result was a sudden tightening of the spigot for new capital – along with an ongoing series of stark re-evaluations and write-downs on the value of portfolios held by many banks and other institutions, as well as the amount of leverage that was actually held on their balance sheets. Indeed, at least a few of the highest profile players in that game – witness Bear Stearns – have wound up paying what might be termed the ultimate price for their miscalculations.

At the same time, the private equity and hedge funds that do have available capital have been waiting to see if the market has further to fall before they commit new funding. As a result, the lack of willing new capital continues to overshadow the current economic environment. As more and more mortgage loans come to maturity, money for refinancing is increasingly tight and a growing number of extensions are being granted either formally or informally. Delinquencies are edging up and financing for new transactions is subsequently harder to come by as well.

Don't believe everything you read.

If lack of confidence is at the heart of the paralysis in the current marketplace, certainly the rating agencies have played a contributing role. For many years, government regulators and investors' shareholders have relied on the credit rating agencies to be the so-called 'watchdogs' of the securitisation process.

In hindsight, however, that reliance may have been short-sighted. Recent front-page news stories have focused on the level of relationships that link credit agencies with the Wall Street firms that hire them to rate their securitisation packages. The implications are troubling. After all, agencies can only issue ratings if the firm that puts together the security hires them to do so.

Caveat Emptor – Buyer Beware.

Ultimately the rating agencies may have provided higher quality ratings than the underlying assets warranted. Some suggest that any overt culpability is less to blame than the fact that the agencies' underlying models were fundamentally flawed or failed to recognise the increasingly aggressive underwriting that was being done by the originators. The fact remains that the system failed, as too many securities were offered out at AAA ratings that – again, in hindsight – may have had no business having such a rarefied stature.

Even so, it needs to be emphasised that – thus far, at least – that little, if any, AAA paper has suffered cash losses, and, indeed, there have been very few defaults in the commercial real estate sector.

Don't be greedy.

In 1987, Hollywood released the movie 'Wall Street,' Oliver Stone's rumination on the excesses of corporate raiders in the mid-1980s. The memorable mantra of the lead protagonist, uber-raider Gordon Gekko (played by Michael Douglas) was 'Greed is good.'

The fact is, while the ratings agencies certainly helped facilitate what went on, at the end of the day, they are neither the issuers nor the buyers of the securities. Realistically, the investor community needs to recognise its share of the blame.

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The velocity and froth that accompanied the rush to ‘do deals’ created a highly competitive environment that led both issuers and investors to act in favour of the greater greed rather than the greater good. Deal backers continually pushed the envelope to squeeze out the extra nickel, while lenders were encouraged to continually cut a better deal to attract willing borrowers, driven by a huge influx of new investors into the marketplace who relied on others rather than demonstrating an adequate level of responsibility, prudence and thoughtfulness in their own investment due diligence.

Every cloud has a silver lining.

It is often said that the first step towards a cure is the recognition that there is a problem. More and more, what we are hearing in the financial markets is increased recognition that the loose credit that existed was unhealthy. The real estate markets simply could not sustain the price compression and the continual build-up of real estate values while at the same time making debt available at higher and higher loan-to-value ratios, tighter and tighter cash flow ratios, and so forth. It was a crisis waiting to happen. And in the long-run, it should lead to a return to more stable, rational business cycle. Sometimes a healthy dose of fear may be necessary.

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At the same time, the Fed’s sudden move in March to step in and protect Bear Stearns provided a calming psychological salve for many worried investors who fretted that a Bear Stearns bankruptcy would set off a falling stack of dominoes and do irreparable harm to the nation’s faltering economy. The fact that a problem was recognised and some action was taken may have been the start of a rebuilding of consumer confidence. As Federal Reserve Bank of New York President Timothy Geithner told a congressional committee after the bailout: ‘A sudden, disorderly failure of Bear would have brought with it unpredictable but severe consequences for the functioning of the broader financial system and the broader economy.’³

Don’t bite off more than you can chew.

The subsequent calls for a drastic restructuring of the nation’s financial regulatory oversight system likewise show that serious attention is finally being paid to the problems. But how many of the proposed plans will (or should) get implemented is debatable – and in fact is being debated quite actively. Part of the proposed plans would shift key responsibilities for Wall Street oversight from the Securities & Exchange Commission to the Fed, while doing away with another financial oversight body, the Office of Thrift Supervision.

Such a restructuring would be a major undertaking – not something that will happen overnight – and certainly would require the participation and agreement of the US Congress. Needless to say, in a presidential election year, the odds of quick, bipartisan action are long, at best.

Sometimes the cure can be worse than the cold.

But whether or not federal regulators can or should be the ultimate catalyst for change is also a moot point. Even the unprecedented step to bail out Bear Stearns from likely bankruptcy has had its detractors. After all, in a free market,

3 ‘Fed’s Bailout Is Questioned By Ex-Staffer,’ Greg Ip, *The Wall Street Journal*, 29 April 2008, p. C1.

actions have consequences. Those who make misjudgments must be held accountable. By not allowing Bear Stearns to fail, the argument goes, the Fed may be enabling decision-makers at other institutions to take equally imprudent actions with the belief that they, too, will be bailed out with now-available public support.

There is also a somewhat schizophrenic perspective in regard to what federal officials are proposing versus what they are doing. At the same time that they are calling for stricter regulation of mortgage lenders, federal officials have actually been backing off regulations – in one instance allowing Fannie Mae and Freddie Mac to reduce their capital reserve level in order to free more money up for the markets. There are many, however, who view that as an utterly unwise move. In the past, the problem with the banking institutions was that there was not enough capital back-stopping the loan positions, which created risk to the banks. But if the Fannie/Freddie move is any reflection, it would appear that the Fed is encouraging a return to lower reserves in order to put money into an economy that is teetering on the brink of recession.

The federal government's actions thus far (including the quarter-point rate cut made by the Fed on April 30) do not address any of the long-term issues that also impact on the broader economy, such as the continually shrinking dollar and growing inflationary pressures.

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If there is one key issue to address in this far-reaching crisis, it is the problem of loose money and the over-availability of capital in recent years. How that gets regulated with private companies is still unclear, but it is an important question because a lot of that money has been coming from private equity. By freeing up additional capital the Fed would appear to be exacerbating the problem of loose money by not allowing the markets to adjust to an equilibrium that is rational.

It's always darkest before the dawn.

The securitisation market is by no means dead. There are tremendous advantages in it. Remember, it was this instrument that basically got us out of the crunch of the late 1980s and early 1990s. It was the creation of the securitisation model that was used by the RTC to sell loans to interested investors that helped drive that recovery.

Naturally, there will be differences. The more esoteric structures will change. Certainly the CDO market will be reconstituted. Maybe the investments will look a little different, but they will come back. We are seeing some positive signs already. A number of new funds have popped up. Some call themselves distressed

funds or opportunity funds. But the fact is there is plenty of capital supporting them to buy into debt instruments of some sort at the right price.

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The shakeout that we are currently experiencing will, in the long-run, prove to be a healthy correction for what has been a segment of the marketplace known for innovation and creativity. The most experienced players will no doubt learn from their mistakes and undertake proper steps to correct the deficiencies in the process.

The real estate market will come back. On that point there really isn't much conjecture. What is not as clear-cut is exactly when it will come back – will it take 12, 18, 24 or 36 months? In addition, what will it be like when it does come back?

The answer to those questions will (and should) have more to do with Adam Smith's Invisible Hand of the Free Market than any massive regulatory restructuring or, worse yet, government bailout.

One thing that is clear is this simple observation – the more things change, the more they stay the same. We have been through major economic upheavals in the past – the Great Depression of the 1930s, the Oil Crisis and Stagflation of the mid- to late 1970s, the Savings & Loan crisis of the late 1980s and early 1990s. Each time we have emerged largely intact; scarred a bit, perhaps; changed a bit, certainly; but also stronger and wiser for having gone through each crisis.

We have faced crises of confidence in the past and no doubt we will do so again in the future. Once confidence in the real estate markets rebuild, and investors resume their proper places on the playing field, we no doubt will witness the re-emergence and revitalisation of the perception of real estate as a steady, preferred and reliable investment class.