A Return to Reason

By Dr. Claude Gruen

For good or bad, a crisis is a turning point. The foreseeable change in the sources of real estate finance will benefit the scaled-down real estate industry, but for us in the industry, the change is traumatic. These fund sources have grown feverish in the heat of melting asset values. An overindulgence in debt accompanied an unusually long, speculative real estate binge and together they brought financial institutions to this dangerously unhealthy condition.

The real estate portion of the debt expansion was particularly unhealthy because so much of it came from commercial banks—probably the least stable source of long-term debt. The following table presents an estimate of mortgage growth in the 22-year period that ended with the third quarter of 1992. Mortgages held by commercial banks grew by 1,121%, more than three times the growth of mortgage debt issued by other financial institutions. In 1970, mortgages owed to commercial banks accounted for 16% of such real estate loans by financial entities. By 1992, bank-held mortgages were 36% of that total.

Now, commercial banks look to quickly unload portions of a debt overload they should never have funded in the first place. This exacerbates the value drop and eviscerates borrowers who relied on these short-term lenders for long-term funds. Even so, the banks' capital withdrawal is not a basic cause of the drop in value. Values started their fall because the availability of mortgage, syndication and other funds made development profitable even as climbing vacancies and dropping rents eroded returns on land uses, including those being developed.

While the banking system is jettisoning large chunks of its real estate debt and both lenders and equity investors are hurting from the write-downs taken and anticipated, the financial system is not going to entirely dry up. To the contrary, as the climbing value and volume of the stock market attests, the pool of dollars that savers and their representatives will lend and invest will fill once more. In fact, the same aging population that is slowing the rate of increase in the demand for space will expand the portions of U.S. income saved.

Furthermore, as real estate values have declined, the rates of return that attract investors are climbing for properties located, built and operated to serve the preferences of today's lifestyles and the needs of competitive firms. Equity funds are already being drawn to those real estate investment trusts that investors feel can judiciously select and operate properties that generate returns competitive with those of non-real estate businesses. If, as expected, the "five-or-fewer" rule that inhibits private and public pension funds from investing in REITs is changed, the current expansion in the role that such entities are playing in real estate will accelerate.

REITs will be a major seller of stocks to channel savings from pension funds, insurance companies and individuals into equity real estate and even mortgages. But these will not be the only securities used to tap the growing pool of savings. As the RTC has shown, mortgages can be packaged and sold by Wall Street. Mutual funds specializing in the assets of real estate companies, including REITs, will become significantly larger than today's pioneering efforts. While one difference in these emerging sources of funds will be that the mix between equity and debt will shift toward equity, a more fundamental difference is that the attraction of real estate for such funds will be based more on the search for earnings and less as shelters against taxation and inflation.

One reason for this is that long-term bond rates have dropped below 7%, which has not only profited holders of bonds but also made mortgages better alternatives. The booming stock market prices have driven down the yields on many industrial and service securities to where real estate cash-on-cash returns are very competitive. The capital that will replace the funds being withdrawn from the real estate market by banks will flow to those perceived as being able to reconfigure, develop and manage real estate profitably. Like any other business, real estate will attract what it can earn. The scale of activities and the size of the workforce in real estate will be determined by what space users are willing and able to pay. Capital sources will serve these markets, but not drive them. ■

MORTGAGES IN BILLIONS OF DOLLARS

	1970 $	1992[1] $	Change %
Non-Bank Financial Institutions	302.2	1,276.5	322
Commercial Banks	73.3	895.0	1,121
Insurance Co.	74.6	266.5	257
Pension Funds	10.1	42.2	318
Total	460.2	2,480.2	339

[1]3rd Quarter
Source: Federal Reserve Bank

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