

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

- I. Other Presentations In Which Either The Date And /
Or Sponsoring Organization Is Missing
 - 6. Real Estate Finance/Mortgage Banking/Mortgage
Guaranty Insurance
 - b. "The Evolution and Place of Real Estate
Finance Among Institutional Investors",
no date.

THE EVOLUTION AND PLACE OF REAL ESTATE FINANCE AMONG INSTITUTIONAL INVESTORS

I. A Brief History of Real Estate Finance in the U.S.

- A. In tracing the complications of the evolution of mortgage lending institutions, it is useful to treat and compare any one institution in terms of five sub-systems characteristics:
 1. Savings attraction system
 2. Loan preference transactions system
 3. Liquidity system
 4. Safety system
 5. Public policy implementation system
- B. A pioneer settlement must initially import financial capital or create its own with innovative technology leading to a producer surplus.
- C. The savings attraction system for the initial capital of early settlements was provided by trading companies, which were essentially equity syndications for real estate development which hoped to leverage bonus land grants by the kings for the benefit of a rich minority.
 1. From one viewpoint real estate finance hasn't changed much; it still promises a share of a new world for stay-at-home investors while exploiting government subsidies to make business for the shipping company and other businesses of the promoters.
 2. Real estate development is a captive customer for services and the object has always been to finance the need for services with somebody else's capital.
- D. Capital for the new world was generated in a number of ways:
 1. Public improvements were made by the settlers who were required to provide labor or cash to build roads, meeting houses, bridges and docks and these services became institutionalized as a real estate tax. When the tax is spent on capital improvements, it is a forced savings system.
 2. The settlers were expected to ship timber, fish and similar things back to the trading company as socage under their tenure agreements, and these profits to the trading company generated additional investment capital.
 3. Cash capital was generated eventually from land speculation as large tracts acquired at nominal cost were then retailed in small pieces to new settlers bringing cash from the old country.
 4. Many colonies tried to create special land banks which sold bonds for limited hoards of cash and then made mortgages on homesteads and urban shops since that was the income property and therefore loan preference of the time. The cycles of agriculture and shop keeping caused them to fail frequently, and failure to provide for liquidity was blamed on appraisers, a banking tradition which survives today.
- E. In the formative years of the U.S. government, there were fears that the king of England and the Tories with their links to English wealth would monopolize the best real estate with cash while the natives could only bargain with character and promises.

1. The state constitutions of all but two of the original thirteen states forbid ownership of real estate by a foreign sovereign government, a little known fact which recently blew up a closing on an Atlanta office building being purchased by Kuwait.
 2. Alexander Hamilton felt that real estate loans were incompatible with commercial banking. When Andrew Jackson tried to force the Bank of United States to accept real estate as collateral for development loans on the frontier, Nicholas Biddle refused, and as a result the charter was not renewed and the nation was not to have a real national commercial banking system for almost 100 years.
 3. For residential and agricultural development the national policy was to divide virtually free land but never provide cash capital, expecting the pioneer to produce buildings and fields with his axe, a strong back, and cooperative work with his neighbors. Cooperation eventually lead to our thirist institutions which we'll discuss in a moment.
 4. For industrial development, Americans advance the art of the English stock company underwriting to a high level of sophistication for speculation and a savings attraction system. 20% of the traders fleeced 80% of the sheep in order to finance great concepts like canal systems, railroads, mass production, etc.
 5. The rascals who understood leverage, the value of a good monopoly for producing surplus, and leverage created a capital base from labor exploitation, rapid technology innovation and a combination of government subsidies of land, inflation, and unregulated banking. (See Lords of the Land or the new book The Builders)
 6. A useful security for financing income property was the French plan of selling a mortgage bond for 60% of value, preferred stock for 20% and common stock for 20% so that investors could participate in a variety of large scale projects. Income real estate seems to be returning to the investment banker for help in tapping the psychic money of the stock market as a way of attracting and pooling savings.
- F. All individually wealth persons and institutions finance department construction, residential finance was shunned by national markets and became very localized in cooperative thrift organizations, state banks, and small insurance companies.

II. Thrift Institutions

- A. Savings and loans in Wisconsin reflected the German-Scandanavian origins of early settlers who had experienced cooperative thrift and insurance groups in Europe.
 1. State statutes permitted S & L's by 1850 in Wisconsin and many began as small clubs of neighbors pooling their credit. Platteville Loan and Building Association was first organized in April of 1876 and by 1893 there were 34 groups reporting to the State Banking Department with only one third in Milwaukee.
 2. All began on a terminating plan of subscribing to purchase so many shares on a plan savings program with weekly or monthly collections. Interest on balloon loans plus penalties and premiums were allocated to stock shares and when stock was fully paid it was offset against mortgage debt.
 3. To permit continuity, savers began to be distinct from borrowing members and loans were made to benefit community development, not just member's houses, and now institutions have been developed to permit regional shifts of funds.

4. The Depression revealed many structural flaws so that the simple co-op became a complex network of institutions such as the Home Loan Bank, the FSLDIC, Freddy Mac, and others.
5. Note that government provided the thrifts with an interest advantage for their savings attraction system, a liquidity system in the Home Loan Bank and Freddie Mac, and safety system in the form of FSLDIC. The public policy system has been to restrict the loan preference transaction system of the S & L's to primarily residential with recent modifications to permit things like mobile home parks, land development, and more income property.

- B. The co-op movement has paid a great price for safety, liquidity, etc. Does it represent the best interests of its saving members when it accepts Regulation Q, or its borrowing members when it shapes every deal for the secondary market, or is it regulated for the benefit of community builders and realtors? Over the next decade S & L's will be struggling to define their true nature in the mortgage market.

III. Commercial Banking Institutions

- A. Banks began as savings attraction system but that role has been diminished by their power to create money as a multiple of savings. Today the banks may attract more savings through its trust department, holding company operation, and checking accounts then through traditional savings accounts.
- B. The fundamental investment of a commercial bank is short-term, self-liquidating paper such as an inventory loan, short-term personal notes, and so on. This is reflected in its pension for low ratio loans, without prepayment penalties, on terms to accommodate favored customers of other bank departments, construction loans, etc.
- C. Until 1916, national banks were not allowed to make mortgages. Of course, the bankers tended to create various holding company devices so that legislative prohibitions were very elastic.
- D. With the Federal Reserve Act in 1913, national banks were given explicit permission to make loans on farm property for five years and no more than 50% of appraised value. Loans were not to exceed in the aggregate 25% of the bank's net worth or one-third of its time deposits. In 1916, non-farm loans were authorized but for one year terms and a loan to value ratio of 50%. In 1927, the allowable term for non-farm loans was extended to five years and the aggregate of such loans was permitted to reach 50% of a bank's time deposits. This gave the banks an opportunity to get into mortgage finance with both feet in time for the depression.
- E. In 1935, as part of the effort to increase funds for mortgage lending, national banks were permitted to make ten year loans up to 60% of value provided 40% was amortized during the period. They were also given permission to make any loan insured by FHA.
- F. Since 1960 or earlier banks have been aggressively developing the concept of the one bank holding company, a family of financial organizations which permits them to match different sources of capital to different types of loan opportunities, loan opportunities that may not be compatible with basic banking rules and traditions.
 1. Bank personnel policies often make little distinctions between credit loans and real estate loans so that if the truth were known

inept real estate lending remains the number one problem of the American banking system. Despite a tremendous volume, the largest banks have probably not made any real money if you properly cost management expenses, real losses, and opportunity costs of income not collected.

2. Real estate mortgages retained by the bank will tend to be personal accommodations, construction loans or credit loans which utilize the mortgage as a formality. Real estate investment, however, will be the next big move of bank trust departments as a result of the pressure brought by pension funds and changes in the concepts of the prudent investor.

IV. Life Insurance Companies

- A. The tremendous capital pools attracted by life insurance companies shows the results of door to door selling of a savings concept, and the impact on investment preferences of a long term savings account. Liquidity is provided by continuing premium flows and safety is the responsibility of the state insurance commission. The life insurance industry has adroitly avoided federal regulation and therefore enjoys most flexibility in real estate investment.
 1. Until the early 1950's the dominant investments were bonds, private placements and conservative mortgage portfolios. When residential mortgage yields failed to parallel comparable alternative investments, many of the big companies withdrew from single family home loans.
 2. Because of experience with bonuses attached to industrial bonds, life insurance companies began to search for hybrid real estate finance instruments which would permit the position of creditor on the down side and profit participation on the up side. Participation loans lead to:
 - a. Requiring certified statements which revealed profitability of successful shopping centers, office buildings, etc.
 - b. A creditors position has limited ability to provide control
 - c. Marketing and management require sophisticated control which goes with ownership.
- B. Inflation and rising interest rates are causing major insurance companies to reconsider the concept of the long term, constant payment amortized mortgage as well as the investment prudence of being a creditor. As a result the next phase of life insurance real estate investment will be:
 1. Direct ownership, direct development or short term rollover loans with rising interest rates or other participation formulas.
- C. Real estate is becoming recognized as a commodity speculation in space/time use, on the one hand, and money exchange units on the other.
 1. A mortgage on an income property is a classic straddle position, a call on future appreciation and put to the lender, a mortgage is a contract for future delivery of monthly payments where the borrower gains from inflation and loses from deflation.
 2. The cost of the put reflects downpayment, fees, and penalties for default; the money market speculation is a function of interest rates, prepayment penalties, participation, or some other index of adjustment to the terms of the mortgage.

3. Europeans cannot believe the survival of the long term fixed interest mortgage in the U.S. given our inability to deal with inflation, or energy, or labor.

V. Pension Funds

- A. The private and public pension programs is a trend which has recently reached banking institution proportions.
- B. Assets of private non-insured pension funds have soared from 97 billion in 1970 to \$181 billion in 1977 while the assets of all private and public pension funds has gone from \$239 billion to \$501 billion over the same period of time. Interestingly enough social security assets have gone down and total only \$32 billion.
- C. The rate of growth in investable assets is just beginning to escalate because of ERISA, passed in 1974 (Employee Retirement Income Security Act of 1974).
 1. It requires funding of vested benefits as earned
 2. It imposes tight restraints on investment policy to eliminate insider deals at arm's length capital market investment.
 3. The law forces liquidity and provides a guarantee of safety with federal insurance of private benefits, ala FDIC, etc.
 4. Since employer funding is required to make up the difference between future value of assets and present value of claims, fund managers will have a preference for investments which appreciate during inflation.
- D. The literature has already indicated that the prudent fiduciary must protect the purchasing power of the corpus as well as the historical value. Stocks and bonds decline in value during prolonged periods of inflation so that only real estate, particularly equity positions, seem suitable as an inflation hedge along with commodity inventories like coal.
- E. Pension funds will be investing in real estate directly or indirectly by buying shares in comingled funds, insured Fannie Mae and Ginnie Mae collateral trust notes, and REIT's.

VI. Institutional Investment in Real Estate

- A. The real estate mortgage for income property is a miraculous contract which brings together an institution which wants absolute safety, maximum return, liquidity, and freedom from default while the borrower seeks mortgage financing because the investment is too risky for his capital, because he can make more money than the cost of the loan, avoid repayment if he meets minimum monthly requirements, and be comfortable in the knowledge that safety of principal is an accounting concept of the lender that is irrelevant to the speculator in real estate commodities and money markets.
- B. The case against institutional involvement
 1. Decentralized markets
 2. Void of reliable historical data
 3. Entrepreneurial orientation
 4. Tax shelter haven

5. Restrictive liquidity
 6. Valuation concerns
 7. Lack of professional management expertise
- C. The case for institutional involvement
1. The real estate capital markets
 2. Efficient market theory
 3. Historical precedence
 - a. Traditional depositories of retirement funds
 - b. Prudent man rule
 4. Investment characteristics
 5. Competitive rates of return
 6. Fundamental alterations with the real estate markets
 7. The professional real estate investment managers
- D. The major issues
1. Prudence
 2. Competitive characteristics
 3. Total portfolio strategy considerations
 4. Levels of participation
 5. Investment expectations
- E. The concept of risk - the variance between assumptions and realizations, between proforma budgets and historical accounting results.
1. Residential mortgage markets have institutionalized risk as the mortgage has become a fungible commodity.
 2. Income property capital markets allocate risk by contract between lender and borrower and still permit the implicit assumption to be the risk of the party who do not ask the right questions.