

# Point of View

## The Serpent in the Garden

---

by Marc Louargand, Ph.D., CRE, FRICS\*

Someone once observed that every decade the real estate industry invents a new vehicle for wealth transfer between the inventors and their investors. During my career we have seen this drama play out many times. New wrinkles in capital markets often lead to disheveled portfolios. In the mid 1970s, major banks seized on the mortgage real estate investment trust (REIT) as a vehicle to make loans that were not presentable on their own books. What began as high leverage loans ultimately became construction financing, swing loans, bridge loans, and gap loans, all semantic clothing for what were poorly underwritten risks. The ultimate denouement always comes, and in that era it came in the form of rapidly rising short interest rates (does that ring a bell?). The bank-sponsored mortgage REITs of the day had borrowed short to lend long. Bankers who forget the first principle—keep a balanced book—nearly always have a bad experience.

What causes smart and savvy players in our capital markets to make these kinds of errors? Is it the introduction of moral hazard via the presence of government intervention and backstopping? Is it *hubris* as suggested in the 1980s by Tom Wolfe's characterization of Wall Street's "Masters of the Universe," which has an analog in today's concept of "the smartest guy in the room"? Or is it plain old Gordon Gekko greed? One comforting thought is that real estate is not the only arena where this kind of behavior rears its head, even though it seems to happen in our backyard with some frequency.

---

\*Saltash Partners LLC, West Hartford, CT 06105 or doc@vtonly.com.

In the early 1980s, we had the beginnings of the Savings and Loan (S&L) debacle, which arose in the southwest United States and ultimately swept the country. Deregulation of banking and the thrift industry allowed S&Ls to enter the commercial lending market with a minimal level of oversight. The ultimate resolution of that experiment was the Resolution Trust Corporation, which bailed out a \$30 billion lesson in the workings of moral hazard. With deposits guaranteed by the FSLIC (no longer with us), S&L lenders had few constraints on their portfolio lending activities since the government would make them whole in the worst case. When introducing moral hazard, one should expect the worst case scenario to occur, since it usually shows up after a while. As a Federal Reserve white paper put it in retrospect in 1992, "As the recent record of deposit insurance at banks and S&Ls illustrates, stronger guarantees can easily lead to excessive risk taking."<sup>1</sup>

In the latter part of the 1980s, life insurance companies stepped in to fill the void left by failed S&Ls and chastised banks. Life insurance companies paired their commercial mortgage origination business with single premium deferred annuities (SPDAs) and guaranteed investment contracts (GICs) and became lenders of choice for developers. One of the new wrinkles that emerged at this time was the merging of the traditional roles of banks and insurance companies. Banks had heretofore been construction lenders, taking on the risk of the business of building, while insurers had issued permanent financing when projects were completed, thus taking on the real estate risk but not construction risk. The emergence of the GIC business and parallel changes in banking gave rise to the "mini-perm," a combination construction and permanent loan with a shorter term, anywhere from three to ten years. Over time, these also came to be called "bullet loans," perhaps because of their effect on the developer when they came due in a weak market. Individual investors' SPDAs and pension investors' GICs were a major funding source for developers at a time when abrupt fiscal policy changes wreaked havoc on real estate markets. The Economic Recovery and Tax Act (ERTA) of 1981 bestowed bountiful changes in depreciation and amortization rules on the real estate industry,

kicking off a spate of development activity that corresponded with an economic expansion. But the real estate deals were increasingly tax-driven rather than economics-driven. In 1986, the Tax Reform Act (TRA) took it all away and made real estate investment much less attractive from a tax standpoint. With a massive oversupply in the pipeline, developers continued to deliver new buildings at a time when the economy entered a slowdown and a recession. Defaulted mortgages, workouts, and bank and insurance company downgrades and failures followed. Another vehicle had worked its magic on the capital markets. In 1991 alone, Executive Life, First Capital Life, Fidelity Bankers Life, and Mutual Benefit Life failed. Their portfolios were heavily biased toward mortgages and junk bonds, the other "innovation" of the 1980s capital markets.

At least real estate has had company along the way. In the mid-1980s, a concept called "portfolio insurance" (the ancestral progenitor of quant trading and the hedge fund sector), attracted substantial interest until it failed to deliver in the market crash of 1987. The early years of hedge fund growth included the spectacular failure of Long Term Capital Management in 1998, whose Nobel-laden management made massive bets on interest rate spreads that went brutally against them. Moral hazard played a perhaps unanticipated role when the Treasury and Federal Reserve intervened to ease the pain. The concept of "too big to fail" was the justification for their actions.

Following a period of expansion in the 1990s, the U.S. economy went into a recession in 2001, followed by a robust expansion that has continued to date. Early in the current cycle, monetary and fiscal policy encouraged investment in housing. Most economists would expect that housing would receive capital flows at the end of a cycle and be the flywheel that would restart the cycle. This has been housing's role for many decades. But this time we had a confluence of events that created a perfect storm. Policies that encouraged housing investment, demographics that swelled the ranks of likely homeowners, and a reluctance to embrace the stock market after the tech crash of 2000 all combined to ignite a housing boom that could only be sustained by the introduction of another new

instrument, the collateralized debt obligation or CDO. The mortgage market has had a rich buffet of securitized instruments for many years. Real estate mortgage investment conduits (REMICs), typically residential, collateralized mortgage obligations (CMOs), typically commercial real estate, as well as derivatives built from these basic forms. One such derivative offered the ability to magically transform what was known as “toxic waste” into highly rated paper, the CDO.

The toxic waste was, of course, the various types of home loans known as “sub-prime.” What made a loan sub-prime? There were some fairly innocent ways to earn the designation. Sub-prime had a near neighbor in the “Alt-A” category. These were loans that appeared to be less risky but still did not fit into traditional models. They were too big (“jumbos”) or lacked a full set of documentation (“no-docs”) or had high loan-to-value ratios. But the elephant in the room is the pool of sub-prime mortgages that were:

- Made to borrowers who would not have qualified for a mortgage a decade ago;
- Made to borrowers who borrowed their downpayment; or
- Made to speculative buyers who had existing residential mortgage debt supportable only by the continuation of a housing boom.

In 2001, according to Fitch Ratings and Derivative Fitch, 41% of the average CDO portfolio consisted of real estate mortgage-backed securities (RMBS) paper. By 2005 that had doubled to 82% of new CDO issues. Thus, the portfolio risk of CDOs was increased substantially by abandoning a prudent diversification strategy to rely on mortgage paper. But the risk was compounded by the growth of sub-prime tranches in RMBS issues until sub-prime RMBS tranches came to dominate the portfolio of CDOs. According to Standard & Poor’s, the 2006 vintage CDOs that it rated *averaged* 70% sub-prime RMBS collateral.<sup>2</sup> If the average was 70%, we can assume that some were even higher.

Rating agencies have been the critical element in the proliferation of derivative securities. If institutional investors can buy a piece (a tranche) of a

derivative instrument that a board member or trustee might not understand but can point to a rating of AAA or anything above BB, then they have apparently met their fiduciary duty. But the content of the instruments changed dramatically over the past decade without any apparent shift in the relative ratings of each tranche or the share of the total offering that was highly rated. It was a classic example of capital market magic, supported by a booming housing market and declining interest rates. Rating agencies apparently used models that estimated default rates under rosy conditions, not those that might be obtained if rates rose while prices flattened or declined. Today, we have a problem of valuation in these instruments. The problem is that no-one who holds them wants them to be valued by reference to market transactions rather than by reference to a pricing model. “Marking to model” may be the most significant weakness of the entire episode. Marking to market will seriously impair their perceived value.

Ratings are about the estimation and underwriting of risk. One Wall Street veteran recently observed, “When I was first on the Street, people talked about risk-adjusted rate of return—now it’s risk-ignored rate of return, and that always has sad ends.”<sup>3</sup> That remark seems prescient when considering the miracle of transformation that turned a pool of junk-rated paper into a tiered pool of investment grade paper with only a minor toxic residual. It brings to mind the medieval alchemists and their search for the “philosopher’s stone.” Who knew it was in lower Manhattan all along, waiting to turn dross into gold?

Why have investors taken on so much risk? The simple answer is that long-run allocation models are built on the returns of the past twenty, thirty or forty years—a time when annual returns were generally high. But forward-looking estimates are far less generous and the mainstream thinkers tend to see mid-to-high single digit returns in the equity and debt markets for some time to come. As a result, investors have moved heavily into alternative investments including real estate, derivatives, commodities, and private equity of all stripes. According to Lipper, alternative funds (typically defined as real estate, venture capital, buy-out, and hedge funds and commodities) have grown by 600% since 2002.<sup>4</sup>

Long-short funds, known as 120/20 or 130/30 funds, are a popular flavor today. Their concept is simple, invest 120% or 130% of capital in long positions and fund the overinvestment by taking on 20% to 30% in short positions. The only flaw in this model is that the long positions must go up and the short positions must go down or else it does not work.

Hedge funds have grown dramatically in the past decade despite the fallout from Long Term Capital Management in the mid-1990s and Amaranth's recent multi-billion dollar loss. The source of the Amaranth loss was a classic example of someone making a huge bet on the direction of a single commodity price. In this case, it was natural gas, but didn't the Hunt brothers teach us that lesson in the silver markets back in 1980?

The most recent entries into the alternative investment arena are the infrastructure funds that buy or lease public assets and privatize them. One major issuer of such funds has recently acquired a 99-year lease on a major urban highway, the Chicago Skyway. The terms of the deal are such that the heavily levered fund is also borrowing the annual leasehold payments since current earnings do not approach them. How will this play out when the effective payout requirement climbs precipitously in years to come? According to a Morgan Stanley analyst,<sup>5</sup> the Skyway deal calls for initial year interest payments of \$129,000 to allow for needed capital improvements, but the \$961 million debt contract calls for escalating payments, rising to \$480 million in 2018. How will the operator service a rapidly growing debt service burden? The parallels to the current subprime and adjustable rate mortgage issues are striking. Will the infrastructure deals meet the same fate as the leveraged buyout transactions (LBOs) in the recent credit squeeze? Short-term bridge loans by banks

to the LBO funds were to be taken out by refinancings in a low rate easy credit environment. After spreads widened and availability tightened, these bank loans became "hanging bridges" suspended in a tight credit market with no apparent connection to the Promised Land.

So, is it moral hazard, hubris or a reliance on a government willing to step in when it is not obligated to do so? Today in 2007 we are engaged in a public discussion over the legitimacy of intervention to aid individual homeowners who are caught in the credit squeeze. Perhaps we need to broaden that debate to include those who are "too big to fail," as well as the homeowner down the block. Perhaps the discussion should address the introduction of moral hazard at all levels of the capital market. While we're at it, perhaps we should take a long, hard look at the role and behavior of rating agencies as well. It will be enlightening and entertaining to follow the debate. There is one certain outcome that can be predicted today. At some point in the future, in some room, the "smartest" person there will come up with an idea that will start the whole process over again. Count on it.

---

## Endnotes

1. SPDAs and GICs: Like Money in the Bank? Richard M. Todd and Neil Wallace, *Federal Reserve Bank of Minneapolis Quarterly Review*, Summer 1992, volume 16, number 3.
2. Susan E. Barnes, Patrice Jordan, Victoria Wagner, and David Wyss, "Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market," *Standard & Poor's Ratings Direct*, April 5, 2007. Italics added for emphasis in text.
3. Wilbur Ross, legendary buy-out investor and distressed debt buyer quoted in "Wall Street Veteran Keeps Faith in LBOs," *Financial Times*, October 1, 2007.
4. Sam Mamudi, "The Long and Short of Long-Short Funds," *Financial Times*, October 1, 2007.
5. Matthew Davison, "The House that Debt Built," quoted in *Fortune*, "The Real MacQuarie," Bethany MacLean, October 1, 2007.