

PRINCIPAL REASONS FOR DEFAULT AND IMPACT OF FINANCIAL
STRUCTURE OF DISTRESSED REAL ESTATE.

by

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Submitted to the Center for Real Estate Development
on September 1, 1990 in partial fulfillment of the
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in
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ABSTRACT

This thesis analyzes the factors affecting distressed property and identifies the principal reasons for default.

The thesis further analyzes the impact of financial structure, principal factors of default, and the probability of an individual property successfully emerging from foreclosure.

The central question being explored is: From the vast pool of distressed properties, can opportunities for long term appreciation be identified by analyzing the primary reasons for default and the associated financial structure? The real estate market is currently absorbing the large inventory of product built throughout the 1980's. Distressed property will be the focal point of the real estate industry throughout the 1990's. To a large extent, the business of real estate development will be real estate redevelopment. Understanding the variables that drove the national and regional economies, the local real estate market and the causes of default will allow investors and financial institutions alike to identify the properties with the greatest potential for appreciation.

Thesis Supervisor: Marc Louargand
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DEDICATION

I would like to dedicate this thesis to my beautiful wife Doreen, to whom I was married October 21, 1989 one month after entering MIT's Center for Real Estate Development. I appreciate all of your encouragement, understanding, and patience throughout the year. Thank you for believing in me.

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TABLE OF CONTENTS

1. ABSTRACT.....	p. 2
2. CHAPTER ONE, FOUNDATIONS OF REAL ESTATE DISTRESS...	p. 6
3. CHAPTER TWO, THE WORKOUT PROCESS.....	p. 46
4. CHAPTER THREE, THE ACADEMIC VIEW.....	p. 59
5. CHAPTER FOUR, THE INDUSTRY VIEW.....	p. 66
6. CHAPTER FIVE, SUMMARY & CONCLUSIONS.....	p. 86
7. BIBLIOGRAPHY.....	p. 89
8. INTERVIEWS.....	p. 91

CHAPTER ONE

THE FOUNDATIONS OF REAL ESTATE DISTRESS

This thesis examines the nature of distressed real estate assets. The analysis begins with an overview of the macroeconomic forces which led to the current situation of oversupply of new commercial and residential space in the United States and in New England. This condotion of excess supply is giving rise to large scale foreclosures and is threatening the very integrity of the banking system in the New England region and elsewhere.

Chapter two contains an overview of the workout process; the players and relationships which come together to resolve a troubled or defaulted real estate loan, much of the material in chapter two is based on interviews with industry professionals who are engaged in the work-out process.

Chapter three presents the academic view of the causes of real estate loan failure, based primarily on a 1985 survey conducted by James Boykin[2] . Boykin's results were used as a template for a series of interviews with work-out specialists. The results of

these interviews are resented in chapter four, The industry view. Finally, chapter five contains a summary and conclusions of the research.

In order to understand the current state of the real estate industry it is important to be able to place todays market into some sort of historical perspective. That view may give us insight into the variables that surfaced and converged at the beginning of the last decade to set the stage for a depressed real estate market in 1990's. Eight variables have been identified which stimulated the great building boom and bust of the 1980's. These variables are discussed chronologically and include: Inflation, Disintermediation, Monetary Controls, Deregulation, The Economic Recovery Act of 1981, Shifts in Employment Growth, Loss of Bank Examiners, and the Tax Reform Act of 1986.

(1) INFLATION.

Historically, periods of high inflation have occurred immediately after wars. Post war economies revved up with the increased demand and purchases for all types of consumer and durable goods, thus, causing prices to rise in response to this demand.

Prices started to increase during the Vietnam War in 1966, but, unlike other inflationary surges, they failed to stabilize after a few years. The inflationary surge continued upward for more than a decade. During the Vietnam War, the United States concurrently maintained high defense expenditures and pursued expensive social programs at home. This "Guns and Butter" approach during the Vietnam years set the stage for historically high rates of additional inflation.

The inflationary effect was also due to the inflation related to the cold war with the Soviet Union. After WWII, the economy never returned to a peace time condition of lower military expenditures. For the next 30 years the U.S. maintained a military that was constantly ready for a full scale war. This continued emphasis on military spending resulted in constant inflationary pressure.

Inflation was then raised to greater heights by the twin oil shocks of the 1970's. The first embargo of 1973-74 more than quadrupled the price of oil. The second embargo of 1978-79 had the further effect of more than doubling the price of oil again.

Inflation had become a part of everyday life and everyone learned how to deal with it. In response to this inflation, Americans began to change their buying habits as William Greider describes in Secrets of the Temple:

"By the late 1970's, most citizens had drawn their own practical lessons from the experience. It not only made sense to buy now rather than later; it also made sense to borrow money in order to buy things now. Even with higher interest rates, a loan made today to purchase an automobile or a television set or a house would be paid back tomorrow in inflated dollars that were worth less. So long as wages continued to spiral upward in tandem with prices, one stayed ahead by borrowing. If inflation persisted, as everyone had assumed, debtors would be rewarded and savers would be penalized. (Greider at p. 17)

The changing consumer attitudes also began to surface in surveys. Americans were less willing to avoid debt and thus stop spending as Greider continues:

Jay Schmiedeskamp, research director of the Gallup Economic Service, saw the new behavior reflected in surveys of consumer attitudes. "The brake is off," he said "inflation doesn't slow people down the way it always has. That's a rather historic change. There used to be a brake - inflation came along and people stopped buying. That isn't happening now."

The prudential wisdom inherited from the past, a Grandfather's old-fashioned warning to save for the future and avoid debt, was turned upside down. Smart young consumers now did the opposite. The overall effect was neither irrational nor antisocial. What Grandfather did not understand was that borrowing and buying drove the American economy. (Greider at p. 17)

For years the Federal Reserve Board (FRB) had tried to control inflation, with little success. By the late 1970's things had gotten so out of hand and the FRB felt that something drastic had to be done to moderate the economy:

"After years of inflation" Paul Volker told an audience in the Autumn of 1979, "The long run has caught up with us." The message was clear to every member of the Federal Reserve Board, even to those three reluctant governors who had recently voted against even a modest increase in the discount rate. In the last half of September, their worries about imminent recession were contradicted by the new data on economic output coming in from the commerce department. Despite all the forecasts, the economy wasn't tipping into a contraction; it was accelerating again. (Greider at p. 104)

In spite of the efforts to lower inflation by the FRB, accelerated lending on the part of the banking system circumvented the positive efforts. Lenders continued to finance investment for price-driven opportunities, thus, augmenting an inflationary spiral:

And, despite the Fed's gradual efforts to slow things down with measured increases in interest rates, the banking system was actually accelerating it's lending. Bank credit was expanding at an annual rate of more than 20 percent, and, as the Fed officials heard from worried bankers, a lot of new credit was going into speculative ventures - businesses and individuals borrowing in order to buy things on the rising prices, speculative investments from gold and silver to real estate. They were betting that inflation would drive prices much

higher. The smart speculator would then sell the commodities or other tangibles, repay the loans and reap a smart quick profit. (Greider at p. 104)

Despite the concerns that lending institutions had over where the money they were lending was going, customers had to be kept happy. As tales of customers making profits on their real estate came in, money for new projects continued to go out. A cycle of constant increases in prices due to the demand for real estate as a inflation hedging investment vehicle resulted. While bankers have always said they were in the business of lending money, it never really occurred to them that they may be feeding the population's desire to speculate:

Speculation did not look like a risky bet: the overall inflation rate was near 13 percent and the price of oil was increasing at an alarming rate of more than 6 percent a month- an annual inflation rate of nearly 80 percent. Gold had jumped 28 percent in value in a single month, reaching a new record of \$411 an ounce. The price of silver, in the same period, had increased by a staggering 53 percent, up to \$16.89 an ounce. (Greider at p. 104)

The constant atmosphere of inflation created fear on the part of regulators that a collapse was imminent:

"The specter of 1929 was raised by me and others," Governor Coldwell said. "Look, we're

on the verge of going into hyperinflation in the United States." While that sounded much too apocalyptic, the frenzy of borrowing and buying did resemble the potential for a classic speculative bubble, one of those fevers that had occurred periodically in economic history. The marketplace loses touch with real value and plunges forward in an orgy of acquisition. Whether it is stocks or bonds, corner lots in big cities or undeveloped swampland in Florida, speculative bubbles all derive from one conviction: the buyers are convinced that in a few days or weeks or months they will become sellers and unload their purchase at a profit. Bubbles always collapsed eventually; the fever broke and prices fell drastically. Then speculators were forced to sell at a loss. They failed and so would banks that lent them money to take their gambles. That is approximately what happened to wall street in 1929, when the bubble of financial speculation burst and the stock market collapsed. (Greider at p. 105)

Guarantees on all deposits by the Federal Government meant that government agencies, not the investors, bore most of the risk. In the course of their lending, banks would promote the virtues of a 20% equity, fully collateralized loan. Yet, the banks themselves would only have 3% of their assets set aside in reserves to act as a safety valve. Even if they had ten times that amount in reserves, they would not be able to survive a large, sudden drop in the value of their assets.

The combined result of many variables was a period of inflation unprecedented in the history of the United States. From 1967 to 1979, prices increased by over 100 percent:

Inflation in the late 70's caused prices to rise the fastest they had in 20 years, inflation in 1979 averaged more than 13%. The inflationary surge was reflected in the consumer price index which was calculated as 100 with 1967 prices. By 1970 it was 116. By 1975 it was 161. Four years later in 1979 it was 217. (Greider at p. 101)

Thus, a decade of real estate investment was driven by highly leveraged deals which required price inflation in order to make them successful.

(2) DISINTERMEDIATION.

Disintermediation is a flow of funds out of the banking or financial intermediary system. Financial Intermediation is the flow of funds into the system. Banks act as the conduit between savers and the borrowers. Disintermediation occurs when the money flows away from these intermediaries to alternate investments.

The FRB saw the control of credit as the most important function of the Central Bank. Disintermediation, familiarly known as credit crunches, was a result of the FRB attempting to control the expansion of credit. As the FRB tightened the money supply and pushed up interest rates, thousands of people withdrew their funds in favor of new options like the

money market account offered by Wall Street firms, which offered returns superior to bank and thrift deposits.

Disintermediation was prevalent throughout in the 1970's. Unregulated firms on Wall Street were able to offer small investors money market accounts with check writing privileges which paid a higher yield than the banks could offer. These accounts were the first unregulated depository accounts which could pay yields higher than those allowed by Regulation "Q" which limited the amount of interest that could be paid by banks and thrift institutions.

Money rushed out of financial intermediaries such as the savings and loan associations. As a result these thrifts were unable to make new mortgage loans. When mortgage lending stopped, the housing industry was essentially shut down. Even though the home buyers and contractors were willing to pay higher interest rates for the access to the capital. The shut down came from the investors who refused to provide money since returns were artificially depressed resulting from government ceilings on the amount of interest which could be paid. Investors who had held their funds in regulated savings accounts drawing 5 percent interest withdrew their money and placed it in unregulated investments providing much higher returns.

Financial institutions were suffering from both external and internal threats at the same time. Externally, Wall Street firms had found an ingenious way around Regulation "Q" with their money market funds, these new accounts enticed away the money that S&L's had considered sources of long-term stable funds. Thrifts immediately found themselves unable to depend upon their liability base. In search of new funds to lend, the thrifts were forced to pay a higher price for new money which came from borrowing, not from traditional deposits. The resulting condition thrifts found themselves in was known as "negative yield". This occurred whenever the current cost of funds rose above the mortgage portfolio yield. The Boston Globe describes the situation of the banks in a July 30, 1990 article:

By the late 1970's, virtually all of the money the thrifts made came from long-term, fixed-rate mortgage loans that earned about 6 percent interest. Virtually all the money they lent came from deposits on which they paid about 5 percent interest. As long as there was a spread between the two rates, they were assured of profits. The moment there was not, they were in (negative yield) trouble. The trouble started in the early 1980's when overall interest rates rocketed. The spread on which the institutions depended disappeared, and the industry effectively went broke. (Boston Globe at p. 16)

Each time a credit crunch developed, the FRB was denounced by home builders, the S&L's, and other effected parties. The actions by the FRB choked off the access to credit. The result of these tight money episodes was creation of a pent-up demand for housing. This demand was heightened by the maturation of the baby boom generation into the housing market.

So much money left the banking industry that both bank's and thrift's survival was threatened. Starting in 1978, with an attempt to save the banking industry from the competition of Wall Street firms, Congress started formulating ways to allow banks to compete. The result was the Monetary Act of 1980, a law which deregulated the banking industry. The major part of the deregulation influenced the thrift industry.

Thus, the real estate lending industry changed overnight. Thrifts were given the additional power to go after high yield (and high risk) commercial real estate loans, land and construction loans. In addition, they had new powers to operate real estate development subsidiaries. Banks had new competition for the real estate borrowers at the high risk end of the spectrum. [16]

(3) MONETARY CONTROLS.

The FRB had also failed to achieve a desired rate of economic growth which they had previously done by controlling interest rates.

The Federal Reserve System operated like the modern equivalent of the king's keep - a separate storehouse alongside the private economy and independent of its forces. But the Fed could influence the financial flows inside the plumbing through two tiny valves - mere pinpricks in size compared to all the wealth in circulation. One valve was the discount window at each of the twelve Federal Reserve Banks, where commercial banks routinely borrowed hundreds of millions, even billions, every day to make up for temporary shortages in their required reserves. The other, more important valve was the Open Market Desk at the New York Federal Reserve Bank in the middle of Wall Street, where the Fed bought and sold government securities in the open market, in daily transactions usually running from \$500 million up to several billion. In both cases the Fed created money with a keystroke of the computer terminal (computer accounting having replaced "the stroke of a pen"). (Greider at P. 32)

In times of crisis, the Federal Reserve used the Discount window as a means to inject liquidity into the system. A change in operating method was installed and a monetarist approach was adopted. This change was in response to those people who were feeding the "inflationary psychology". The borrow and buy behavior seemed to permeate everything. The Board's answer was to tighten the money supply.

Historically, the FRB had controlled the economy and access to credit by manipulating interest rates. In 1979, the general feeling was that inflation was out of control. Paul Volker, the Chairman of the FRB at the time departed from traditional wisdom and adopted the monetarist method of controlling the money supply. This approach controlled the total amount of money in the economy at any one time. The result would be controlling spending by not making money available, thus, the interest rate would be allowed to fluctuate according to market.

This change in operating method was put into effect Saturday, October 6, 1979. By making this historic change in the availability of money the FRB was attempting to shock the economy, Wall Street, and the World into the notion that they were serious about controlling inflation. The monetary supply changes made would come to be known as the "Saturday Night Special". (Greider at p. 140)

When money became scarce, resourceful bankers had ways to obtain more of it, despite the rising price, and to amply finance their new loans. Typically, they would sell off government securities to raise funds for lending and raise the market rate offered on their own certificates of deposit- in effect, luring away the deposit money that was fleeing from credit unions and S&L's.

The bankers also borrowed more from the Federal Reserve itself, simply by phoning the discount window officer at one of the twelve

Federal Reserve Banks. Discount borrowing soared shortly after the October 6 announcement to more than \$3 billion a day, subsided for several months and then reached another peak later of \$3.5 billion a day. The Fed's decision to raise the discount rate to 12 percent hardly discouraged bankers from "going to the window," as they called it. When the alternative was borrowing in the money market where short term rates were bouncing as high as 18 percent, The Fed's discount rate was still a bargain.

In theory and myth, The Federal Reserve's Discount lending was the power of life or death over private banks. If a bank relied too much on the Discount privilege, the Fed could simply refuse its request for a loan - threatening the bank with crisis and possibly insolvency. In practice, the central bank rarely, if ever, said no at the discount window. A bank might be scolded, perhaps subjected to a rigorous examination or told to "stay away from the window" until its affairs were in order. But the Federal Reserve would not refuse to make a discount loan unless it had concluded that the bank was already doomed. The Fed's original purpose was to prevent bank failures, not cause them, a reality that aggressive bankers regularly exploited. (Greider at p. 141, 142)

During the late 1970's banks were under siege. The banks were reeling from competition from Wall Street and the negative yields which were being experienced. Banks then started looking for a safe haven where they could stabilize their balance sheets. But, with the change made by the FRB in their method of controlling the economy, the bank's customers were filled with uncertainty regarding their ability to meet their capital requirements. The customers demanded future access to capital and the banks responded with credit lines.

Unfortunately, while the FRB was attempting to tighten the money supply through monetary policy an explosion in the availability of credit took place. Individual bankers made credit lines available to borrowers who felt threatened by a credit cut-off due to the new monetary controls. These credit lines could always be financed through the FRB's Discount Credit Window. The final result was a level of credit available which was actually higher than existed prior to the imposition of monetary controls.

In the months following October 6, while attempting to fine tune the new operating method and tighten the money supply, the FRB inadvertently flooded the financial markets with available cash. The result was the opposite of what the FRB had intended. The banks had the makings of a potential crisis; they had committed to reserving capital for their customers with credit lines and simultaneously placed the FRB's "mistaken cash" into the hands of their credit hungry customers.

(4) DEREGULATION.

Deregulation was a direct response to disintermediation. It was generally felt that without

some adjustment, banks would be hard pressed to survive in a competitive interest rate environment. Deregulation was an attempt to allow banks and thrifts to compete on an equal footing with Wall Street firms for the savings of American families. Although deregulation started with good intentions, the end result forced the S&L's to compete in an arena they were not prepared or qualified to work within. An understanding of the effect of deregulation requires a look at banking before and after Regulation "Q".

Regulation "Q" initially established the rules and regulations governing the thrifts. Under Regulation "Q", banks and thrifts had different purposes in the banking industry: Thrifts were given an interest rate advantage over banks (they were allowed to pay a higher interest rate on pass book savings accounts in order to attract capital) to encourage mortgage lending and broader home ownership. Thrift services included home mortgages, personal loans, and savings accounts with regulated interest rates. The intent and the purpose of thrifts was to be long term lenders.

Regulation "Q" was also a way of settling potential conflicts between banks and thrifts regarding the services each was to provide. It also compensated banks for the interest rate advantage the thrifts were enjoying. Under regulation "Q" thrifts would not be

allowed to use their interest rate advantage by operating in the banks core businesses, such as commercial and construction lending.

Regulation "Q" advanced the idea of matching the term structure of assets and liabilities which was referred to as "balancing the books" by bankers. The thrifts attracted stable, long term savings with their higher interest rate, from which they could lend long term home mortgages. Long term loans, from long term deposits. The bank's asset base was unpredictable and would flee to higher interest opportunities, as a result they offered short term loans. Short term loans, from short term deposits.

Banks offered the same services as thrifts, plus they also offered: commercial lending, brokered certificates of deposit (CD's), acquisition, development, and construction loans (AD+C), and were allowed to operate service organizations or 151 B corporations which is a real estate development subsidiary of the bank . Banks provided these additional services due to the belief by regulators that banks had the expertise to control the additional risk associated with the broader services.

Under the Monetary Act of 1980, Regulation "Q" was discontinued which resulted in the thrifts being

stripped of their interest rate advantage over commercial banks. In addition, thrifts now had to keep a percentage of their assets on reserve with the FRB. The imposition of universal reserve requirements put all banks and thrifts in the same position regarding reserves. Under Regulation "Q" thrifts were limited in offering savings accounts, personal loans, and mortgages. With deregulation thrifts were able to offer all their traditional services of a full service bank, and now were able to offer all forms of commercial lending, brokered CD's and AD+C loans.

Under deregulation the role of the neighborhood S&L went from making personal loans to sophisticated lending such as factoring receivables for large corporations as part of their credit lines and lending on risky commercial real estate projects. Thrifts were also allowed to offer checking accounts or NOW (negotiated order of withdrawal) accounts, which had the benefit of earning interest on their balances, a feature not offered by commercial banks.

Approaching the early 1980's, troubled thrifts were finding it nearly impossible to make enough money to cover the negative yield spread on their large mortgage portfolios. Despite recent congressional focus on savings and loan fraud, recent evidence supports that negative yield, incompetence and inexperience with the

new business lines were the primary causes of the S&L debacle. The July 30, 1990 Boston Globe article dealing with the congressional attempts to prosecute the "S&L's Kingpins", restates what most industry observers now agree:

Virtually the entire industry was bankrupt by the early 1980's, long before most of those now accused of wrong doing had even entered the business. The reason was not crime, but spiralling interest rates that drove up institutions borrowing costs and drove down the value of their principal assets: long-term, low interest mortgages. (Boston Globe at p. 16)

The deregulation of financial institutions led to S&L's competing with commercial banks and Wall Street firms. The search for higher yields resulted in the funding of projects involving higher risk and more speculation. This situation was further compounded by the conversion of mutual thrifts to stock thrifts whose shareholders demanded better performance.

Mutual thrifts are thrifts that are owned by the depositors. Depositors could not take the benefit of ownership in the form of higher interest rates on their savings, because Regulation "Q" limited the amount of interest a thrift could pay to its depositors. This resulted in the thrifts having excess capital on hand, with no means of passing it on to the owners. The Boston Globe describes the results:

"...this led to public anger, over huge salaries, exorbitant perks and cozy deals at individual thrifts" (Boston Globe at p. 16)

Stock thrifts on the other hand are similar to the structure of many companies listed on the New York Stock Exchange. Stock thrifts are owned by share holders with concern focused on the price of the stock, earnings, and quarterly results. The management of these stock thrifts generally operated within a lean environment. Given the approach of stock thrifts of being hard nosed and disciplined with respect to their earnings, the mutual thrifts preferred to remain under their present structure.

The management of the S&L's was simply not qualified to offer the additional services they were now allowed to. After regulation "Q" the S&L's were also not qualified to manage the riskier projects they were becoming involved in. The opinion at the time in Congress was that the S&L's were failing due to disintermediation. Under deregulation competition now took place on an equal footing, Congress had adopted the approach of survival of the fittest.

Vincent F. Martin Jr. CEO of TCW Realty Advisors, a Los Angeles based real estate investment firm feels deregulation of the banking industry had a significant impact on the real estate market. Mr. Martin described

the scenario developers faced in obtaining financing for their projects: previously, the developer had to obtain permanent financing, in order to secure the construction financing to start the project. This situation assured the construction lender (the short term lender), that financing would exist for them to be "taken out" when the developer fulfilled the contractual responsibilities of the construction. [11]

Prior to 1980, fifteen major insurance companies provided permanent or "take-out" financing. These fifteen companies acted as a control to the real estate market not only by controlling the supply of money for projects, but, by also employing seasoned real estate professionals who would filter out projects that were not economically sound. Through 1979, these real estate professionals operated as a check on the unbridled enthusiasm and optimism of developers. These underwriters provided a very important restraint on the market by regulating the supply of money, in turn limiting the amount of finished product which would eventually enter the market.

Mr. Martin contends that the impact of deregulation removed the controls these real estate professionals had on the real estate market. Before deregulation, there were 15 accepted sources of permanent financing, now there were thousands. Deregulation resulted in banks

and thrifts starting to provide "mini-perms" which had a 6 year term and would act as both the construction and the permanent financing for a project.

(5) THE ECONOMIC RECOVERY TAX ACT OF 1981, (ERTA).

The changes made in the Federal Tax Code from the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Reform Act of 1986 (TRA) both encouraged and hindered investment in real estate. These Acts mirrored the boom and bust of the 1980's. Prior to ERTA, the marginal tax rate was 70% and real estate received a 50% capital gains exclusion. These rates resulted in a effective maximum capital gains tax on real estate of 35%. The passage of ERTA in 1981 included tremendous incentives to invest in real estate. Under ERTA, the marginal federal tax rate was lowered to 50% and the capital gains exclusion was raised to 60%. When combined, these rates lowered the effective maximum capital gains tax rate to 20%.

Expansion of the investment tax credits was another feature of ERTA. They offered incentives for specific types of real estate. Credits were given for historic rehabilitation and subsidized housing. Vaguely written Treasury Regulations allowed tax credits to be issued for a wider range of real estate projects than

originally intended. The effect was the creation of a real estate market to take advantage of the tax saving components of real estate. In addition, ERTA introduced very rapid depreciation rules. Which increased the accounting loss in tax-sheltered deals. Passive partners who could write off losses from those real estate shelters against ordinary income with few limits. ERTA changed the depreciation period from the expected useful life of the property to an arbitrarily determined period of 15 years. The accelerated cost recovery system's (ACRS) method of depreciation used the rapid 175% declining balance method. This resulted in ACRS producing an astounding first year deduction of 12% of depreciable cost.

(6) SHIFTS IN EMPLOYMENT GROWTH.

Changes in employment growth came from three different but related sources. First, the maturation of the baby boom generation led to swelling of the job market to accept the largest addition to the work force in the history of the United States. As jobs were created, the corresponding demand for housing challenged the building industry to keep up.

In New England, we also saw the growth of the high-tech and financial services industry and the

evolution of the working population from a traditionally blue collar population into white collar professionals and technical workers.

This change was common in the northeast as shifts in employment growth took place. White collar professionals were typically made up of the technical and administrative population. The new white collar professionals did not absorb the existing housing stock, instead choosing to purchase new and upscale housing. The Northeast region in general and Massachusetts in particular has been losing population and it's manufacturing base for a number of years. Manufacturing has moved mostly to southern states due to the warmer climate, lower wages, and a lower cost of living.

During the years that Massachusetts was experiencing a boom in construction from 1980-1989, the state also experienced a slow growth in population which was offset by out-migration. The overall result was more people moved out of the state than moved into the state. Despite these shifts, many people wishing to enter the state were unable to find housing comparable to what they were accustomed to.

This churning of the population in Massachusetts was driven by the growth of industries loacted on the urban fringe, the semi-circle defined by routes 128 and 495

in the Boston area. The new arrivals sought suburban housing in this corridor, so they were not particularly attracted to the older blue collar inner suburbs lying between Boston and route 128. As a result, a minor change in total population led to a major boom in housing in the outer suburbs of metropolitan Boston.

Between 1984 and 1986, the median price for an existing home went from \$82,600 to \$177,000. The end result was, a single family home in Boston was priced nearly twice the national median.

(7) LOSS OF BANK EXAMINERS IN MID 1980's.

Many examiners left government service with the lure of private sector salaries. The loss of bank examiners during the 1980's had a dramatic impact upon the ability of the banking system to enforce the governing rules and regulations. The exodus was so large that it took the government agency over a decade to replenish the staffs. Dennis Aronowitz, a professor of banking law at Boston University describes the situation faced by bank regulators:

Bank examiners are a cadre of professional employees, whose training is extensive and costly to the agencies. In recent years, many examiners have left government for higher salaries within the banking industry. In fact

during the mid 1980's the Comptroller and the FDIC suffered reductions of as much as one third of their examination forces and only recently rebuilt to the staff levels of ten years ago. (Arnowitz at p. 6)

The loss of bank examiners could not have happened a worse time. The early 1980's represented a time when banking had lost equilibrium and seemed out of control. There was a likelihood that the banks would utilize their safety net of federal deposit insurance, and there was a shortage of examiners to alert regulators to potential problems. According to data supplied by the agencies, the total number of bank examiners currently employed by the three banking regulators is between 5543 and 5788. The breakdown is: 2600 at the OCC; between 1983 and 2229 at the FDIC; and 960 in the federal reserve system.

(8) TAX REFORM ACT OF 1986.

The intent of the Tax Reform Act of 1986 (TRA) was to close loopholes which created tax shelters. TRA classified real estate into two different categories: residential and nonresidential. The two new categories were given new cost recovery periods with 27.5 years for residential and 31.5 years for nonresidential. The depreciation method for both classes became the straight line method. The effect was to take almost all of the

tax sheltered benefits away from real estate.

A contrast of the changes related to tax benefits associated with cost recovery periods from ERTA to TRA is illustrated by the fact that under ERTA's accelerated cost recovery system 100% of the investors money was returned after 15 years. Under TRA, after 15 years less than half of the depreciable cost would be returned with the balance being recaptured over the remaining 16.5 years.

TRA also eliminated all capital gains exclusions, and a single tax rate of 28% was created for all income over \$15,000. As in the past, capital gains losses were allowed to be written off against capital gains. However, if the losses exceeded gains, the amount deductible against personal income was limited to \$3,000. The resulting effect was that these changes significantly reduced the appeal of real estate to the average investor.

Another aspect of TRA was passive loss limitations. The intention of TRA was to allow passive losses to offset passive gains. In certain cases, passive losses can be used to offset other income, if the material and active participation criteria is met. Taxpayers with adjusted gross incomes (AGI) of less than \$100,000 can deduct \$25,000 in passive losses against

non-passive income. If AGI is more than \$100,000, fifty cents on the dollar in passive loss benefits is lost for every dollar which income exceeds \$100,000. Thus if AGI is \$150,000 all passive loss benefits are lost.

THE EFFECT OF THE EIGHT VARIABLES ON THE DEVELOPMENT OF THE NATIONAL OFFICE MARKET.

In order to understand the implications from the eight variables just described, it is useful to examine the growth of national office market through the 1980's. An economic study by Professor William Wheaton of the Massachusetts Institute of Technology and Professor Raymond Torto of the University of Massachusetts documents this tremendous growth.

The impact of the variables as they surfaced and converged during the 1980's was significant. As a means of illustration, a review of the growth of the national office market from World War II proves useful. Wheaton and Torto explain the basic changes taking place in the character of the national office market:

During the post World War II period, the American office market has exhibited two distinct trends: long run growth and a shorter, 8-10 year cycle. The long run growth of the market has come largely in response to the sustained growth of those types of employment that require office space. In general, there

have been two sources of such employment growth.

First, even though manufacturing employment has continued to decline as a share of the total economy, the proportion of the manufacturing work force classified as "white collar" has risen from 20% at the end of the war to close to 40% today. During this same period, the percentage of manufacturing employees involved in "central administrative functions" has also more than doubled. Thus, even if manufacturing is declining, changes in product, planning, and technique have generated a growing demand for offices.

The second, and much more important, source of office demand has been the enormous growth in non-manufacturing employment -- particularly finance, insurance, business and professional services. Employment in these sectors occupies office space almost by definition, and since the mid 1950's it has grown from 3 to almost 12 million workers. (Wheaton and Torto at p. 3)

Historically, dramatic fluctuations in the growth rates of the national office market supply have taken place. Even during periods of time where economic growth was constant, different rates of long-term employment growth were experienced. In addition, the net absorption rate of the office space fluctuated due to changes in employment patterns. Torto and Wheaton continue:

While these long run changes from an industrial to a service economy, and from "blue-collar" to "white-collar" employment are not likely to abate, the pace of growth has fluctuated considerably. During recessions, such as those of 1960, 1971, 1975, as well as 1982, the growth in office employment slackens to the point of little or no increase. Equally important, during the periods between recessions, there were also significant differences in the rates of longer-run growth. Office employment grew most rapidly during the

last half of the 1960's and 70's, and more slowly during the early 60's and early 70's. Growth during the recent recovery has matched and in some cases exceeded that of the late 1970's.

In response to this pattern of employment growth the net absorption of office space also fluctuated. Net absorption rose gradually throughout the 1960's from annual levels of fifty million square feet in the first half of the decade to 100 million square feet in 1969. Absorption fell sharply in 1970-71, rebounded a little in 1973-74 and fell again in 1975-76. From there it rose again sharply, at several points reaching 140 million per year during the late 1970's, and in 1981. Once again, a recession sent it plunging in 1982-83, from which it has rebounded in 1984-85. (Wheaton and Torto at p. 4)

In spite of these fluctuations, the perception of an increased demand for office space existed. Nevertheless, the result of these dramatic fluctuations was that the demand for office market space became very difficult to predict. Thus, a possibility existed that developers would overbuild due to what they perceive to be greater demand. Wheaton and Torto describe the various periods of growth which have taken place:

On the supply side, the stock of office space has grown from roughly 1 billion square feet in 1955 to 3.8 billion square feet today. The pace of new office construction has fluctuated greatly, however, and since the mid-50's there has been three distinct building booms. The first was during the late 1950's, lasting roughly three years and producing a total of 228 million square feet over that period. From there, construction slowed during the 1960's, grew at a stable rate during the mid 60's and then entered the second boom period, 1968-74. This second boom was more pronounced, and lasted almost seven years, producing a

record 810 million square feet of new space. It ended with a recession, and record 15% vacancy rates.

For two years after the second boom, the market was quite depressed, with building activities at levels typical of the 1950's. This slackening set the stage for the third and current boom, which so far has also lasted seven years, and produced 1300 million square feet of new space -- almost as much as was produced in the entire preceding 20 years. (Wheaton and Torto at p. 5)

The following chart documents the cycles of growth the national office market has experienced:

Office Construction Cycles

Period	Phase	Ann.Const.	Tot.Const.
1957-59	Boom	76.0	228.0
1960-65	Trough	59.0	179.0
1965-70	Stable	74.0	369.0
1970-75	Boom	108.0	810.0
1975-80	Trough	69.0	144.0
1980-84	Boom	172.0	1293.0

(Wheaton and Torto at p. 5)

In explaining the cycles of growth, Wheaton and Torto conclude that the office market reacts to and is driven by the changes in employment population. The results assure that an eight to ten year spread exists between vacancy peaks as the study continues:

The three peaks in office construction have been matched by three peaks in the national rate of office vacancy. From a low of below 5% in the 1950's, the national vacancy rate rose to a peak in the mid-1960's of 8.5%, fell to 4% in the late 60's, rose to 14% in the mid-70's, fell to 5% by 1979 and is currently up to an all-time

high of 16%. Again, 8-10 years seem to characterize the spread between these vacancy peaks - which tend to follow the peaks in construction by several years. (Wheaton and Torto at p. 5)

The complicated nature of the national office market makes it impossible to assume that all growth is related to the supply side of the equation. Surges in demand have also had a dramatic impact upon the growth in the supply of office space. Much of demand is related to time lags from the preliminary phases of the project to the actual completion as Wheaton and Torto explain:

It would be tempting to conclude from this brief historical analysis that the office market has an inherent and predictable cycle of 8-10 years duration, upon which the industry could rely for it's plans. Unfortunately, the market is more complicated than this, because there are alternatives explanations for the cycle, each with a different implication for the future.

The first explanation, which might be called a "supply-side" theory, argues that the industry itself creates the cycle, largely through it's inability to forecast correctly. Without reliable forecasts, developers start new projects only when current market conditions are favorable. Extrapolating these favorable conditions into the future, the industry as a whole continues building. When the space actually becomes available several years down the road, the market naturally softens as the supply is slowly absorbed. The downturn causes the industry to postpone construction plans for a while, which only creates a tight market, and starts the whole cycle over again. According to this "supply-side" theory, then, the cycle is caused by the use of current market conditions as a barometer for the future, rather than by an accurate forecast of demand that also anticipates the likely construction response of the whole industry.

While the supply-induced theory has some supporters, and also some undoubted truth, it ignores the unanticipated variations in demand that have occurred over the last few decades. Consider, for instance, the fact that the sudden surge in office demand during 1966-1970 was totally unanticipated, and found little supply to match it. Even though construction soon raced to keep up with demand, the enormous supply of space authorized during the 1969-73 period did not become available until 1972-76, a period when demand was slowing, ending a recession. In each of these cases, even the best planning by developers would likely have been spoiled by the macro-movements of the national economy. Perhaps more interesting is the prospect that the building activity of the last 18 months will be coming on line in 1986-87, as the economy slows. Thus variations in demand, or long-run office employment growth, and a series of unanticipated recessions, have also clearly been important in explaining the past cycles of the office market. (Wheaton and Torto at p. 5,6,7)

In addition to the surges in the general demand for national office space, there is further growth associated to demand related to specific types of space. Nevertheless, there are dominant factors which dictate the demand for national office space, as Wheaton and Torto describe:

Beyond these major market phenomena, it is also true that there have been changes in the preference for particular kinds of space. Shifts in the demand towards non-contiguous space or "back offices", and a desire for historic structures or high-rise views are examples of trends that have helped to shape the market in any particular period. The fact remains, however, that the state of the economy, the growth of office employment, the price of space, and its availability remain the overwhelmingly dominant factors that explain the past movements in absorption, and should

continue to do so in the future. (Wheaton and Torto at p. 12)

Wheaton and Torto's study of the national office construction cycles of the previous thirty years was used to illustrate that the last ten years were unique. Over the last ten years, the amount which was built in four years would have required twenty years in the past.

Wheaton and Torto provided a look at the national real estate market. The next step is to observe real estate market behavior from a local perspective. An examination of both types of markets should provide an understanding of how the eight variables have affected real estate.

THE EFFECT OF THE EIGHT VARIABLES ON THE DEVELOPMENT OF THE MASSACHUSETTS RESIDENTIAL MARKET.

A review of the growth in the Massachusetts residential market also illustrates the impact of the eight variables. In a study conducted by Karl Case, professor of economics at Wellesley College, it was found that the growth rates in the residential market in Massachusetts over the later part of the 1980's were significant. The following table documents the tremendous rate of growth:

**Total Existing Home Sales in Massachusetts:
1983-89
(Single-Family Homes, Condos and Co-ops)**

Year	# of Units
1983	65,000
1984	66,500
1985	80,500
1986	84,600
1987	100,500
1988	93,300
1989	86,500

(Case at p. 20)

In Massachusetts, economic growth cannot be confused with the general growth in the population and the high number of sales of residential dwellings can not be regarded as sales to new individuals to the area. In the 1980's what took place was a "churning of the market," which is internally driven market activity of homes being sold and resold. "Churning" accurately describes what occurred in the Massachusetts residential market. [16]

As the unemployment rate dropped and the labor market tightened, many of the leading industries of Massachusetts started to transfer employees into the area to support the growth that they were experiencing. The growth of the high tech, financial services, and administrative support industries required many mid to high level executives to transfer into the area. The newly imported managers did not occupy the existing

"blue collar" residential inventory; instead, they located in new and upscale suburban homes.

Later when the "demand generators" cooled for these leading industries, their first reaction was to stop transferring people into this area. The result was demand for new homes quickly curtailed. The prior planning for the construction of these new homes and the investment in time and money into the approvals process encouraged the builders to continue the building process until it was complete.

The dramatic rate of economic growth in the Massachusetts economy has resulted in a large inventory of residential stock being built. Thus, it is necessary that a period of time pass before economic forces regain equilibrium in order for the stock to be absorbed as Richard Pollard, Chairman of the Massachusetts Bankers Association explains:

"The New England economy in general, and the Massachusetts economy in particular, enjoyed an unprecedented boom during the mid-1980's. The boom has come to an end as certain advantages dating from the 1970's and before, such as lower-than-average home prices and an ample availability of labor, have turned into disadvantageously high housing costs and short labor supply.

A rebalancing of macroeconomic forces must work itself out; there is no way simply to will continued hypergrowth when a regional economy has moved out of balance with competing regional economies when the national economy itself must

deal with a huge national deficit and trade imbalance. (Pollard at p. 1)

Despite the current slowdown in the general economy, there are many reasons why Massachusetts should consider itself fortunate for the past 15 years of prosperity. Professor Case describes the history of the current cycle of economic growth recently experienced by Massachusetts:

Massachusetts is fortunate to have a well capitalized banking network traditionally known for prudence and integrity. At the same time, it must be said, and will be widely acknowledged within the industry, that the years of the "Massachusetts Miracle" led to excesses. Like many builders and buyers, bankers were not immune to the illusion that real estate values would soar unremittingly. Banks have failed and more will fail because enthusiasm in some cases resulted in reach exceeding grasp.

What seems to be lost in the current gloom is where the region and the Commonwealth have been over the last decade and a half. In 1975 the Massachusetts economy hit rock bottom. The unemployment rate went over 12% that year, second highest in the nation behind Michigan. Massachusetts faced a bigger budget crisis that year than it does today. But 1975 was followed by 15 years of sustained economic growth, with a pause for the recession of 1981-82. Since 1980, personal income had risen at a rate of nearly 50% above the national average. Since 1975 nearly 840,000 jobs have been created in Massachusetts, an increase of 37%. The housing market boomed from 1983 to 1987, increasing the value of the existing stock by over a hundred billion dollars in the Boston metropolitan area alone. By mid 1987, the unemployment rate stood at 2.5%. The lowest among the 50 states. It has been a very prosperous decade and a half". (Case at p. 14)

The fifteen year period of prosperity experienced by Massachusetts had a significant effect on the real estate market. Professor Case points out the escalation in prices of housing due to pent-up demand:

The current real estate cycle began back in 1983. In that year the median price of an existing single family home in Boston was \$82,600, 17% above the national average of \$70,300. Pent-up demand coming out of the 1982-82 recession (during which the prime rate went over 21%), combined with rapid income growth, led to a surge of housing demand beginning in 1983. Existing home sales in Massachusetts jumped from an annual rate of 34,500 in mid 1982 to 73,900 in early 1983. Supply in the form of new construction did not respond at first because zoning regulations and permitting were controlled by 351 very independent cities and towns.

The increased demand coupled with a slow supply response pushed prices sharply higher in 1984. At that point an inflationary psychology took over and prices boomed from 1984 through 1986. During those years prices were rising at a rate as high as 3% per month (40% per year), pushing the median price of an existing home from \$83,600 to \$177,000 nearly twice the national median. (Case at p. 14)

The demand for housing was created more as a result of the changing makeup of the population rather than from actual growth. In addition, changes in the Internal Revenue Code encouraged additional purchases in the residential market. The result was an overbuilding of the residential market as Case illustrates:

But there was an important missing ingredient: population growth was extremely slow. Prices were not rising because more people wanted to live here but, because those of us who did live here wanted bigger and better houses. That missing element meant that when the building boom finally caught up with the price boom, the region overbuilt and overbuilt quickly. Between 1985 and 1988, construction employment jumped from 100,000 to 147,000. Housing starts in the five eastern counties of the state rose from a rate under 10,000 per year during the early part of the decade, to just under 15,000 in early 1985 to a peak of over 22,000 in 1986 and 1987.

Another factor that contributed to the overbuilding was the internal revenue code. Much of the building that actually took place in 1986 and 1987 was planned between 1984 and 1986. During those years, the tax laws were very favorable to real estate investment. The Economic Recovery Act of 1981 introduced very rapid depreciation rules, and passive partners could write off losses from real estate shelters with virtually no limit. Condominium investors enjoyed tax sheltered income and expected to enjoy sustained appreciation. (Case at p. 15)

By the time that the builders realized that they had misread demand, a tremendous overstock in the residential inventory had been created. The passage of the Tax Reform Act of 1986 further discouraged the absorption of the existing stock. The consequences from the lower demand for residential housing have been devastating as Case explains:

The overbuilding on the supply side of the market ran headlong into a slowing economy on the demand side and a new tax law. The result was a large inventory of unsold homes and a larger inventory of unsold condominiums, As a result, very few new units are now being built.

The construction sector has lost 31,000 jobs, developers and builders are filling the bankruptcy courts, banks have found themselves with large portfolios of foreclosed property, and the housing starts are back down to under 7,000 per year, a drop of over 70%. (Case at p. 16)

Although overbuilding and the misreading of demand may represent general causes of why projects have failed, no two properties are alike. While generalities offer some insight and partially explain why a specific properties fail, they don't offer complete answers.

CHAPTER TWO- THE WORKOUT PROCESS

Before looking at the reasons why specific properties fail, we will look at the workout process. The bulk of this chapter is based on a series of interviews with workout specialists in the Northeast. As we start the 1990's, we are experiencing a depressed real estate market and a severe credit crunch. The main focus of all parties involved in a workout situation is: survival first, a mutually acceptable agreement second.

Understanding the workout process begins by looking at how the bank views their portfolio of other real estate owned (OREO). When a solution for nonpayment can not be "worked out", the bank forecloses and unless the property can be sold at auction, the property becomes an asset of the bank, thus, becoming part of the bank's OREO portfolio:

Other real estate owned is frequently an unsound bank asset, even when carried at or below the appraised value. The bank's purchase of property through foreclosure usually indicates lack of demand. As time lapses, the lack of demand becomes more firm and the soundness of real estate for which there is no demand becomes more questionable. Banks usually lose money in liquidating other real estate owned despite the apparent adequacy of appraised value. (Comptroller's Handbook, p. 3)

In recent years financial institutions have been faced with a rising number of non-performing real estate loans. In increasing numbers borrowers are approaching their lenders to seek some sort of relief hoping to reach some form of compromise on debt service obligations. Out of necessity, lenders are forced to work with their borrowers by assisting them through these difficult times.

The "workout concession" most commonly granted to the borrower is debt restructuring. This may be in the form of reduced interest rates, extension of the loan amortization period, accrual of interest, forgiveness principal and interest, deed in lieu of foreclosure and many other variations. Regardless of the concession, the lenders aim is always the same, to improve it's position in a difficult lending situation. The borrower tries to obtain these concessions and come to an agreement with his lending officer, a person with whom he usually has a business and personal relationship with.

Reduced interest rates, simply means to lower the contract rate of interest. For example, lowering the interest rate from 16% to 10 1/4% lowers the monthly costs of debt service and attempts to increase the

probability of the bank being repaid.

Extension of the loan amortization period is where the term to maturity may be anywhere from 7 to 15 years, which is normally the case on a commercial building. By extending the amortization period or the term to maturity to 30 or 40 years, it will lower the monthly payment by spreading the repayment of the loan over a longer period of time.

Accrual of interest is when there are two rates of interest. A "pay rate" and an "accrual rate". The idea is that the property can not afford to pay the agreed upon interest rate, hopefully for a determinable amount of time, as in the case where the project requires a longer period of time to reach stabilization/lease up than anticipated. In this case the bank will allow the owner to pay a lower rate of interest for a period of time and will pay the difference at a later date. For example the contract rate of interest will be 16%, but, for a period of time the owner of the property will pay 10 1/4%. The difference of 5 3/4% will be deferred, and usually added on to the total amount owed or it can be paid in a lump sum payment.

Forgiveness of principal and interest is a case where the bank does not require the owner of the property to pay back a certain amount of money, the

amount would be forgiven. This is very rarely done and requires exceptional circumstances for the bank to consider this as an option.

Deed in lieu of foreclosure is when the owner willfully gives the title of the property back to the bank as full consideration of the outstanding mortgage, for which he is liable. Both parties considers it an even swap, property for the debt. The bank would basically turn around and resell the property to recoup the principal.

Being involved with a workout scenario is an emotionally draining experience for all concerned. Many real estate projects are a result of a lifetime of work for the borrower to place him in a position of either building or acquiring a piece of property. The prospect of working so long towards a goal only to see the project on the edge of default is an emotionally stressful situation for any developer.

A workout specialist who has worked with troubled properties in both the northeast and southwest over a seventeen year period explained that the first thing he tries to do is assess whether the problems with the properties are the direct result of the actions by the owner or the result of factors in the market which were completely outside the owners control. Next, the

workout specialist tries to determine if the continued presence of the owner will make a positive contribution to the resolution of the problems or if his presence will hinder the work that needs to be done. If it is decided that the owner will hinder the progress, the owner will be removed from day to day control of the property. The workout specialist feels if it is possible he will keep the owner in place. In his opinion it is always better to work with the property's owners since they have a vested interest in seeing the project become a success. In contrast, a new person entering the project without knowing the details of what has transpired will likely slow the resolution of the problem even further.

The consequences of failing to come to an agreement with your original lending officer to repay the loan often forces the loan to be reclassified as "repayment in question?" Once this occurs the bank will place the loan with the "workout department" where a resolution will most always take place.

The workout department is really the controlled loan department. Individuals who enter the controlled loan department may hope for a "workout", but, in reality will now encounter a bank officer who will probably not be very flexible and who will be determined to obtain specific guarantees so the bank will receive

the money owed to them. The controlled loan department in large commercial banks usually consists of twenty or more bank officers who deal exclusively with people who are not paying their loans and very likely will not be able to pay them.

The workout process begins with the loan leaving the original lending officer and is turned over to controlled loans. Unless a quick resolution can take place, the bank moves quickly to protect its interest, they immediately issue a "demand" for payment and begins the foreclosure procedures against the borrower. The banks plan is to be as efficient as possible in going through the foreclosure process. The next step will be to go to court to get a "judgement" under the Sailors and Soldiers Act of 1941 which should take three to four weeks.

During those three to four weeks the bank will try to negotiate a settlement. The banks are negotiating from a position of strength knowing that a favorable judgement is three to four weeks away. The bank is in the position where they don't have to accept any proposal unless it radically improves its lending position.

A controlled loan specialist at a major New England bank indicates that banks feels if they negotiate first

and then follow with foreclosure proceedings, they face the possibility of losing six months worth of interest and the possibly of having to liquidate the property in a market that could deteriorated further. The bank is concerned about the processing time required to complete a foreclosure if the negotiations fail.

After the judgement is rendered, the court will set a "return date" which will allow the borrower six weeks to come forward with a reason why the loan was not paid or to seek relief under the Sailors and Soldiers Act. Nevertheless, the bank can start to advertise for an auction as soon as the judgement has been given.

While Massachusetts is the only state in the union that has not repealed the Sailors and Soldiers Act, the Act will only provide limited protection to the thousands of businessmen and women who are unable to pay their debt service. The Act only provides protection to sailors and soldiers who are currently on active duty in a declared war. Nonetheless, the Act does provide some time for the average borrower to find a solution.

The controlled loans department spends most of their time dealing with problem loans. Controlled loan officers feel their job is to attempt to collect on "projects that should never been financed. Money was lent to inexperienced, undercapitalized individuals on

ill conceived projects". Many individuals in these departments feel that "sweetheart deals were rampant" and that people in authority turned their backs on the standard lending criteria which allowed risky loans. With the knowledge that most of these loans were imprudent, ...it was the herd mentality of the worst kind".

Most real estate professional interviewed agreed in retrospect that even if it were possible to maintain discipline within the banking industry from 1982 to 1986, they still would not have cooled the enthusiasm for real estate development. A specialist from a controlled loan department of a major Boston bank echoed these feelings:

...bankers should have never given out 100% financing, and developers should have never taken it, everyone knew it was wrong. They (lending officers) used examples of large profit taking as an excuse to open the flood gates and allowed years of experience to remain silent.

In addition, there are serious questions regarding the mentality of developers during the boom period. A senior workout specialist at a major bank in New England describes the aggressive behavior of developers:

Many developers believe those late night cable programs on real estate development. The ones that say you can buy all that property with no money down, and if anyone says that you can't, then we'll show you away to negotiate around them!. Workout specialists have little patience for the naive, new, arrogant developers.

As a result of this attitude, developers who have been draining the excess cash flow from their projects are balking when the banks require they increase the equity in existing projects.

Times have changed, eighteen to twenty four months ago a successful workout would likely have resulted from the discussions held with a officer in controlled loans. However, with the declining market in real estate, and with many of those agreements coming back to the bank because the borrower cannot pay the negotiated lower debt service. Banks find themselves in a position of having to liquidate the properties in a market that is significantly worse than it was two years ago. Given the failure rate of these renegotiated loans, banks have come to see the "workout situations" as a giant set of mistakes.

Changes which have taken place in the bankruptcy laws greatly assist the banks ability in recovering their assets. In October of 1989, the laws where revised to speed up the process in order to make the borrowers assets more available to lenders trying to seek repayment. Prior to being revised, the entire bankruptcy proceedings would take six to nine months. Currently, the same proceedings will take four to six

months.

The marriage of the real estate and the banking industries during the 1980's, is dissolving in the 1990's. The relationship is hostile. The banking and real estate industries are very different than in recent past. Banking professionals are no longer willing to offer the same solutions that they previously made available. Borrowers perceptions and expectations need to change to deal with the new realities of the current business climate.

While borrowers would benefit greatly from the assistance offered by banks, more often than not borrowers are using threats as an attempt to coax the lenders into offering concessions. Borrowers threaten to go into bankruptcy or to file a lender liability suit as a means to forestall foreclosure. Obviously, these threats contribute greatly to the current hostility between banks and borrowers.

As long as these threats are part of the negotiation process a mutually satisfying agreement is unlikely and the odds of irreparable damage to the relationship between lender and borrower increases.

In the past, bankruptcy was the primary tool used as the lever to force bankers to yield concessions.

This was especially true of the troubles experienced in the Southwest. However, times have changed and lender liability has become the latest weapon borrowers are using to persuade lenders to workout their loans. Many of the officers in the controlled loan departments who were interviewed say that lender liability is an issue that they have to deal with on a daily basis. A Vice President in charge of the controlled loan department of a major Boston bank explains:

"If one of the clients I'm dealing with does not threaten me with lender liability, then the guy next to me will be threatened".

The legal basis for lender liability originates from a court decision which held that: "verbal statements were implied commitments."

The lender liability suit surfaced from conversations which occurred when a borrower was signing a loan approved by the lending officer with whom he had a long term business relationship. The loan was negotiated with a few years to maturity. These loans are referred to as bullet or balloon loans. In this case the borrower had no experience with this type of agreement. During the signing, the borrower asked the lending officer how the balloon payment was going to be made when the note came due in such a short time?. In response, the lending officer assured the borrower not to worry and that the situation will be worked out when

the time comes.

The judge ruled that "verbal statements were implied commitments" and in this case the verbal statement implied a commitment to offer new financing when the note came due.

Regardless of the impact of the lender liability suits, the trend is clear. If you cannot pay your debt to the bank, it will be increasingly difficult for you to maintain control and ownership of your property. Banks are now under enormous pressure to deal with their problems. As a result, the banks are faced with examiners who want them to recognize their assets at their current value, which means tomorrows liquidation price.

The problem of recognizing the current value of troubled property, forces everyone involved to realistically deal with the economic viability of the property. A pension fund advisor discussed the realities of a depressed real estate market:

The property is only worth what the property can produce in income, regardless of how much it cost to build. This is not rocket science, and any property can be sold or fully leased if you lower the price far enough.

The pension fund advisor further felt that workouts are more of a political issue at banks. The

question is when will a Sr. V.P. authorize his people to bite the bullet and lower the price?. The pension fund advisor sympathized with the workout choices the banks have :

How are the decisions at the banks were made? How much is quantitative and how much was emotional?... At some point you have to come to grips with a loss or settle for lower returns.

There will be lasting effects from the failed market of the past. The current workout environment will play a large role in the future of real estate. One predictable result according to a Vice President of a major New England bank is that the heavy losses the banks are experiencing in real estate will prompt banks to reclassify real estate into a much higher risk category. This reclassification will result in the cost of capital for real estate increasing significantly in the future.

The potential action by banks to reclassify real estate projects into a high risk category is consistent with the feeling held by TCW's Vincent Martin, he feels that it is important for that the real estate market develop a control mechanism to restrain the supply side of the equation. An increasing cost of capital resulting from tighter bank controls may be just the control mechanism needed.

CHAPTER THREE - THE ACADEMIC VIEW

Chapter One described the history of some of the factors influencing the real estate market over the last decade. The eight variables included in chapter one were accumulated through interviews and surveys of real estate professionals. To begin the research for this thesis, these professionals were asked what they felt were the primary forces driving the real estate market of the 1980's?.

This chapter focuses on specific properties and projects and discusses the impact of these variables on the micro real estate market. Specifically their impact on distressed real estate is examined at length. A 1985 survey by James Boykin provides an excellent point from which to start questioning these real estate professionals, about the specific causes of project failure.

If more specific reasons for the default of individual properties can be determined and understood, this information will serve as the foundation for sound economic decision-making as the properties re-enter the market. The following chapter continues toward the goal of this thesis to develop a framework for thinking about

workouts in the future.

The article by Boykin entitled "Why Real Estate Projects Fail" provided the results of a 1985 national survey of real estate executives of the primary reasons why real estate projects fail. Boykin identified nine specific reasons why projects fail.

- (1) Inaccurate or overly optimistic market feasibility study.
- (2) Poor planning.
- (3) Financing problems.
- (4) Location problems.
- (5) Improper timing.
- (6) Lack of professional experience.
- (7) Construction problems.
- (8) Weak project management.
- (9) Inadequate cash flow projections.

In order to better understand the nine specific reasons for real estate failures which Boykin includes in his study, an individual discussion of each reason should prove useful.

- (1) Inaccurate or overly optimistic market feasibility study.

The industry surveys proved to Boykin that the age old problem of overestimating market demand for real estate still holds true today. The overestimation was attributed to several factors ranging from poor data bases to improper analysis:

The executives who faulted feasibility studies all implied that the studies erred by forecasting an overly optimistic absorption rate of space or of market acceptance of the space. This failure was sometimes identified as an inaccurate determination of the magnitude of need for the proposed space. Other studies were characterized as containing inadequate analysis of market data or as poorly interpreting the available data such as terrain, markets, and demographics. Some executives suggested that reasonable economic feasibility and marketability reports occasionally were analyzed improperly by the developer. (Boykin at p. 89)

(2) Poor planning.

A number of survey respondents concluded that one of the key ingredients consistently missing was in the preliminary planning of a project. Often, goals were set which could simply not be accomplished:

Inadequacy of planning prior to a project's development or the acquisition of real estate was the second most frequently mentioned cause of failure, but it was a difficult cause to pinpoint. Sometimes it was identified as lack of project preplanning or improper design and conception. It was related to "unrealistic goals" or to uncertainty about the final goal to be achieved. (Boykin at p. 89)

(3) Financing problems.

One of the most critical elements of any successful real estate deal-- proper capitalization -- was also consistently cited as a reason for the failure of many of the 1980's real estate deals. The effects of higher interest rates, undercapitalized projects, and overleveraged financial structuring contributed significantly to the growth of failed real estate:

Respondents specified two types of financing problems that led to project failure: a rise in interest rates after the project was conceived and improper structure of financing. Not surprising, the second problem was always associated with the first. However, even in the absence of interest changes, projects failed because they were undercapitalized or overleveraged structures that resulted in unanticipated financial difficulties when there was an unfavorable change in economic conditions. (Boykin at p. 89)

(4) Location Problems

Inexperience on the part of real estate developers new to the process led to the consistent selection of poor locations. Again, a wide range of problems existed which included poor selection of sites and numerous zoning conflicts.

Location problems included sites that were

simply wrong for the given project, sites that did not coincide with local planning objectives, and sites that clashed with surrounding zoning and building esthetics. The failure to obtain the appropriate zoning was included among location problems. (Boykin at p. 89)

(5) Improper Timing.

The lack of experience was also evident in the area of judging the economic feasibility of real estate projects. Poorly evaluated projects were extra sensitive to the changes in market conditions:

Improper timing as a cause of project failure seems to be almost entirely associated with "inaccurate feasibility study". (Of course, the same is also true, to a lesser degree, of "financing problems" and "location problems".) Projects fail because they encounter unfavorable changes in the local or national economy, because they ignore national or local trends, or because they fail to specific market downturns. (Boykin at p. 89)

(6) Lack of professional experience.

(7) Construction problems.

(8) Weak project management.

If the three reasons for failure, lack of professional experience, construction problems, and weak project management, are considered to be different facets of a major category, "failure of the project developer to control the project," this cause becomes as important as the first cause on the list, poor feasibility studies. Examples of developer failure are as diverse as the number of failures. Among the subcauses that contribute to developer failure are the following:

- * Insufficient experience
- * Lack of "follow through" after the project is completed
- * Inept administration
- * Inexperienced or incompetent project personnel
- * Understaffed project teams
- * Excessive personnel turnover on project teams
- * Inaccurate construction estimates
- * Ill-advised economies on construction materials
- * Excessive or unanticipated cost overruns (for many reasons). (Boykin at p. 89)

Failure to understand the pipeline and the unwillingness to recognize the impact of other properties are recognized as two examples of the lack of professional experience in the field of real estate. During the 1980's with the general availability of capital, many people entered the real estate market who were clearly unqualified to do so. Successful businessmen, accustomed to watching the details and overseeing their own businesses assumed the skills of their business were transferrable to real estate development. They entered the development business often times for a single project which ended with tragic results.

(9) Inadequate cash flow projections.

Inaccurate cash flow projections are a cause of failure that can be subsumed in all of the preceding sections. The problem may be caused by a lack of understanding of the project, unrealistic assumptions, lack of knowledge about the market or the suitability of the project for that market or by underestimated expenses and costs. (Boykin at p. 89)

The lack of specific knowledge regarding the financing of real estate projects also became very apparent with the number of failures due to poor financial analysis. Cash flow projections were simply wrong in a number of cases.

Boykin's survey was conducted during a period when New England real estate was booming and Southwestern real estate was crashing. During the New England boom, local observers were fond of pointing out the differences between New England and Texas. Since Boykin's failure sample represents the Southwestern experience to a great degree, a local New England sample of interviewees was asked to respond to the Boykin factors. Their responses to the list is contained in chapter four, The Industry View.

CHAPTER FOUR - THE INDUSTRY VIEW

This chapter explores variables that impacted specific real estate projects by presenting the results of interviews and comparing them to the framework for questions presented in chapter three. The intent in these interviews was to encourage industry professionals to go beyond the generalities to explain the specific reasons why properties failed. Thirty interviews were conducted, interviewees included: bank presidents and members of a bank board of directors, real estate brokers, workout and controlled loan specialists, real estate lawyers and bankruptcy attorneys, accountants, consultants, professors, developers, and property managers.

REASONS FOR DEFAULT

Boykin presented nine variables that can be used to explain why a particular property would go into default. In general, the interviewees agreed with the variables Boykin presented, although they tended to group the nine variables into three main categories: inaccurate or overly optimistic market feasibility studies, debt

structure and lack of professional experience. The industry professionals, as a group, placed the remaining six variables under the three main categories because they regarded them as inseparable. The interviewees expanded upon the descriptions that Boykin offered and proposed several variables that were not included in the Boykin model.

THE INTERVIEWEES MODEL:

(1) Inaccurate or overly optimistic feasibility study:

- * Poor planning
- * poor market knowledge
- * location problems
- * improper timing
- * overbuilt markets

(2) Debt structure, capitalization: debt/equity

- * related to inexperience

(3) Lack of professional experience:

- * construction problems
- * weak project management

ADDITIONAL VARIABLES ADVANCED BY INTERVIEWEES:

(4) Slow down of regional economy:

- * overestimating demand
- * ignore macroeconomic factors which impact businesses need for real estate

(5) Relaxed lending criteria, Fraud

(6) Obsolescence:

- * functional
- * physical

* economic

INACCURATE OR OVERLY OPTIMISTIC MARKET FEASIBILITY STUDY.

Over half of the interviewees cited overly optimistic market surveys as the main reason that projects fail. Within this category, they included characteristics Boykin described under his category of the same name as well as those he described under poor planning, poor market knowledge, location problems and improper timing and overbuilt markets. To the interviewees, these variables were intricately related to each other and to the downturn in the real estate market.

A bank consultant specializing in dealing with distressed properties said he saw cases where "developers would go through the proper procedures of conducting a survey of the market that they intended to build in... while at the same time... two other developers would use the same market survey to support the feasibility of their project." In these cases he saw all the variables at work.

An example of a specific project which illustrated this was described by a vice president of an eminent development firm which is adjusting to the market by

counterbalancing their excess capacity with workouts for banks. She cited an example where developers did not correctly assess demand and in addition, failed to consider other similar projects planned and under construction in the area.

Three residential condominium projects were built in a small village in Massachusetts. The second and third developers started similar high-end attached housing projects based on the enthusiastic response that the first developer received from the village residents. Developers two and three did not confirm if there was enough of a demand for their projects. As it happened, there was not sufficient demand to sell out all the units in the first development, let alone projects two and three.

The developer responsible for the workout of the first project pointed out that the units were priced too high to attract people from the local area. The original developers remained inflexible when the market started to shift during the construction phase, and later, the banks refused to allow the developer to drop the prices when it became apparent the market had changed. The banks action was described as "holding the developers feet to the fire," all this resulted in the bank foreclosing on the property and resulted in the bank spending hundreds of thousands of dollars to

differentiate the first project from the second and the third. The bank also found it necessary to offer low interest rate financing in the hope of selling the units.

She agreed with other interviewees who stated that most often, "your first loss is your best loss." The reasoning is that a troubled property doesn't improve with age, and it is better to cut your price, sell the units and learn a lesson. In this project specific example, the impact of the variables was characterized by the inability to correctly assess demand, form realistic goals, select a location that would support the product, acknowledge general market trends and understand the impact of competition on the existing demand. All of these variables were critical factors which affected the project.

A university real estate professor and developer offered his insight in regard to "poor planning." He saw people utilizing "short term strategies for long term goals," and explained that many people unrealistically entered the real estate market, which has always been a long term business, with the intentions of selling out within a period of months instead of years.

"Improper timing" described by Boykin attributes the failure of projects to unfavorable changes in the

regional or national economy, specific market downturns or trends. Many interviewees attributed the failure of specific projects to this variable. A banking consultant commented on the slow down of the regional economy when he said, "demand generators," or businesses, are being negatively affected by the regional economic slow down. A fundamental fact is that, since real estate provides facilities for other businesses, a slow down in the regional economy eventually hurts real estate. He went on to describe what occurs when you combine the downturn in the economy with the existing oversupply of real estate.

"The competition for tenants drives down the rental rates and real estate values decline as a result."

He maintained that the large supply of excess inventory has to be considered to be one of the principal reasons of default, although it is more a result of the variables discussed in chapter one.

DEBT STRUCTURE.

Throughout the interviewing process, professionals attributed the failure of many projects to improper debt structures. The phrase "too much debt" was used over and over again. Many times a project was started just

because the financing was available. Lenders regularly accepted the projections developers presented to them. In many cases, bankers based their lending decisions on personal relationships with developers and past successes, rather than on the economics of the specific project. During of 1982 to 1986 many projects were "tax driven deals", the reason many projects were built or acquired was to exploit tax benefits for investors.

A vice president in a major accounting firm said that developers were "great salesman, very aggressive, bullish and very optimistic. The accountant said many times the developers would ask for 100 percent financing, fully expecting the bank to only authorize 80 percent. When they got the full amount of the loan, they would consider it "free money," and in many cases would use the money to initiate the next development project. They place an enormous amount of their efforts just to get financing for their projects. "The developers loan presentation was so polished that when the developers received the full amount they requested, they convinced themselves the project could support the full amount of the loan".

The bank consultant specializing in distressed properties also felt that the "easy money" of the 1980's was primary cause of default. He said that "giving developers 100% financing was unfortunate because they

just did not handle it in a responsible manner".

A real estate professional specializing in property management and who manages troubled assets for banks commented that in many cases there was simply too much debt. He said he could not believe the "amount of money that was lent on these properties, they could only support 25 percent of the debt." He was involved with three apartment buildings suffering from deferred maintenance with a 40 to 60 percent vacancy rate that had been refinanced well above the properties ability to support the new levels of debt.

The president of a bank consulting firm gave the only different opinion regarding debt, by cutting right to the heart of the debt issue. I asked him if he felt the main causes of failure were "overbuilding and too much debt"?, his response was: "If you feel debt was the cause of failure, then you just don't understand!". He pointed out that the overall real estate market and individual properties are affected to the same degree whether they have all debt or all equity. "Is a property which is owned by a large pension fund that has zero debt affected any less than the property owned by a first time developer with 100% debt, when the regional economy slows down and there is an oversupply of real estate?" He continued, "...an oversupply of property creates competition for the same tenants, which drives

down rental rates and as a result the value of the real estate declines." The bank consultant pointed out that debt only magnified the problems of the real estate, causing certain people to be taken out of the market sooner.

Pension funds have the financial strength to weather any downturn in the real estate market, but when real estate produces lower yields, the pension funds will respond by pulling future fund allocations out of real estate and place a higher concentration of their funds in alternative investments.

The consultant had another point about the impact of the changing tax benefits on a project. He said that TRA of 86 took away the tax benefits "that subsidized the value" of real estate; when tax benefits were discontinued, the realization that the projects were not economically viable had to be dealt with.

A former banker and workout specialist who is currently working for a real estate syndicator in Texas, talked about his experiences regarding the properties his new employer acquired. The company he currently works for acquired 351 buildings and created limited partnerships to take advantage of the tax benefits real estate was enjoying from 1981 to 1986. When the tax benefits were substantially discontinued with TRA 86,

not one of the properties could support it's underlying debt.

The syndicator spends his time taking each property through chapter 11 bankruptcy proceedings to restructure the debt.

LACK OF PROFESSIONAL EXPERIENCE

Almost two-thirds of the interviewees cited lack of professional experience as a variable which played a major role in the failure of specific projects. As a group they felt inexperience contributed to many of the problems related to the first category involving inaccurate or overly optimistic feasibility studies, poor planning, poor market knowledge improper timing and location problems. To a lesser degree this variable was also related to problems with the financing structure of projects that failed. There were, however, other problems rooted within inexperience that were separate from those already described in the first two categories, including one that Boykin described as weak project management.

Interviewees pointed to the personality of the classic real estate developer as a reason causing him to have unrealistic expectations. Another workout

specialist commented that young inexperienced business people "feel immortal" when they receive a large sum of money. They "kid themselves into thinking they have the golden touch and ignore the voice of experience."

Some of the examples of these variables advanced by the interviewees included instances where projections that continued to escalate over the life of the investment. Other common errors were found in many proformas, they included: requiring a 5% increase in net operating income (NOI) per year, no planned vacancy, and no reserves to pay for future tenant turnover expenses.

A workout specialist described inexperienced developers this way: "These new developers just did not know what they were doing..... They got land... got contractor... got financing... got building... and got clobbered!".

A mortgage broker who had similar experiences commented that he saw cases where people inexperienced in development or in operating property obtained financing, got half way through the project and realized they were out of money.

Several senior workout officials at a major accounting firm pointed out that this problem also existed in large development firms. They said managers

in development firms rarely had the in-house controls necessary to properly manage the development phase or the project management of existing properties.

These accountants noted that financial controls were critical to provide managers with feedback on the financial status of the projects and they had seen cases where controls were extremely inadequate and by the time problems were recognized it was too late to make the appropriate adjustments. Lack of sufficient staff as well as overburdened staff also led to crisis situations within real estate companies. Their suggestion for bankers was that "lenders should look to the substance to accomplish the realities." He thought that many companies did not have the staff to supervise a development project. They said Eventually "the realities of the market catch up" and many of the failures he saw were a result of in-house deficiencies instead of real estate specific problems.

RELAXED LENDING CRITERIA AND FRAUD

An interviewee who worked in a controlled loan department brought up this variable which Boykin did not include in his article. The officer who worked in a large bank said that relaxed lending criteria and fraud was the reason many troubled loans were approved. He

had seen cases where there had been "money under the table to the lending officer, misrepresentation to the loan committee and non-presentation to the loan committee." He had also seen loans on troubled properties that were made because a member of the board of directors had an interest in the project.

He cited cases where lenders were given improper incentives to lend. For example, in some instances lending officers' pay was tied to the quantity and not the quality of loan dollars placed. Another example involved bank lending goals which had been set unrealistically high and had forced lending officers to stretch lending guidelines to achieve them.

Although fraud probably played a part in project failures, it is unlikely it was a major cause. None of the other interviewees made any mention of fraud, although they did describe cases of incompetence which bordered on fraudulent behavior by lending officers.

A Boston Globe article on fraud in the Savings and Loan debacle supported the opinion of many of the interviewees by down-playing the role of fraud in the thrifts:

"Despite, or perhaps because of, the regulators efforts, saving and loan loses are now so large that for fraud to account for even one third of them, or \$50 billion, would require a level of criminal wrong doing so substantial

many authorities think it unlikely.

For example, it would mean that fraud in this one industry was more than twice the \$23.5 billion of fraud of all types that the federal government investigated in the 1980's, and 25 times the amount that it prosecuted, according to justice department statistics.

"If there was that much fraud, why are only hearing about it today?" asked James R. Barth, an Auburn University economist formerly with the office of thrift supervision, which regulates savings and loan institutions. "Does anyone really believe that people could loot these institutions of that much and the government not know a thing until it was all over?"

Public anger over the huge salaries, exorbitant perks and cozy deals at individual institutions have been raging for more than a year, but concern that fraud was endemic in the industry, and a principal cause of many of the losses taxpayers must now foot, took off this spring when federal regulators reported that they had discovered evidence of wrong doing at 60 percent of failed institutions....

Of the 21,174 cases of suspected savings and loan crime referred to the department so far, 83 percent involve less than \$25,000, Attorney General Dick Thornburgh told a senate committee last week.

"The mere fact that you can find fraud at these institutions is not surprising; companies in their death throes lose control of their employees," said Edward J. Kane, an Ohio State University economist who has written extensively on the crisis.

Along the way, all agree the policies attracted some crooks.

"What the government did was the equivalent of giving away the keys to the bank," said Litan. So who do you blame when the money's all gone, the people who took it, or the people who gave away the keys?"

The controlled loan officer said he had seen avoidable mistakes made by inexperienced lending

officers. In one example a lending officer had accepted land as collateral based on an appraisal without ever seeing the property, only to find out that the lot was land-locked, unbuildable and the same lot was used as collateral on four other projects. In another situation land was held jointly and could not be sold to satisfy the debt. It is clear that loan documentation has emerged as a main focus for controlled loan officers. Evidence of inexperience on the part of other professionals can be seen in several of the examples given above.

A manager at a large accounting firm commented that it was difficult for professional outside the real estate industry to understand why developers and bankers apparently did not perform adequate risk analysis.

OBSOLESCENCE

Two of the interviewees identified one last variable that contributes to the failure of specific projects. That variable is obsolescence. Obsolescence is broken down into three types: functional, physical and economic. **Functional obsolescence** can be the result of poor design in a project, whether it be residential apartment complex or a commercial distribution facility. If the original use of the project can not be realized

because of poor design, the project would be considered functionally obsolete. **Physical obsolescence** can be the result of age and can affect many types of real estate, including apartments or multi-story wood frame manufacturing facilities. The former banker turned syndicator attributed the failure of many of the apartment complexes with which he was taking through bankruptcy to the combined effect of the changes in the tax code in 1986 and the obsolescence (design and age) of the buildings.

Economic obsolescence is a loss in value due to factors external to the property and considered out of the owners control. Some of the causes of economic obsolescence is: poor location, noxious uses nearby, access problems. The economic obsolescence accrues to the improvements on the property only.

Obsolescence is either curable or incurable, the following three matrixes are used to illustrate the most likely form you will observe under each category.[16]

FUNCTIONAL OBSOLESCENCE

CURABLE INCURABLE

DUE TO:

DESIGN X X

TECHNOLOGICAL X
CHANGE

Many variables that would make new projects functionally obsolete are considered curable, however, most professionals interviewed considered poor design to be incurable. An example of obsolescence as a result of technological change would be the case of inner city multi-storied, wooden, manufacturing facilities that were replaced by large single story plants built out of steel and concrete, which required the space to take advantage of assembly line production.

PHYSICAL DETERIORATION

	CURABLE	INCURABLE
<u>DUE TO:</u>		
DEFERRED MAINTENANCE	X	
AGE		X
DAMAGE	X	

Physical obsolescence occurs in existing buildings and can be the result of one or a combination of deferred maintenance, age or damage to the structure.

ECONOMIC OBSOLESCENCE

	CURABLE	INCURABLE
<u>DUE TO:</u>		
POOR LOCATION		X
OR A CHANGE IN NEARBY USE		X

Ill-conceived projects are considered economically obsolete and are considered by most professionals to be incurable.

Questions exist as to who is to blame for the current oversupply of real estate? Was the overshooting of the supply due to the overly lax credit standards and intensely competitive expansion by the banks during the boom years of real estate? Was the oversupply due to overly optimistic developers? The answer probably lies somewhere in the middle. Karl Case of Wellesley College explains how the inherent competition within the real estate industry promotes overdevelopment:

One the reality is that we do not have central planning in this economy; private risk taking entrepreneurs who build projects in Hull don't coordinate their activities with those who build in Old Orchard Beach or in Revere. From the standpoint of banks, what could be safer in the environment of 1983-87 than an 80%, fully collateralized loan? In fact, it was a natural downturn, and now the results must be dealt with.

CHAPTER 5- SUMMARY AND CONCLUSIONS

Given this unprecedented time in the history of the real estate and banking industries, it is unnecessary to spend the time to assess blame for the currently depressed market. Assessing blame is both counterproductive and likely to offer very little value. While this paper is an initial step in understanding why troubled properties exist and how the workout process affect them, the paper also illustrates that further research is needed in developing a solution to successfully dealing with large portfolios of distressed properties.

These interview results are generally supportive of Boykin's results, but they differ in the way that respondents view the relationship between the factors. In addition, the two new categories of Obsolescence and Fraud were added.

A dominant theme that consistently surfaced throughout the research for this thesis was the obvious lack of an adherence to the fundamentals of market and financial analysis. Developers simply did not conduct even the most basic analysis on many of the properties developed during the 1980's. In response to the

competitive market most banks were facing, many of their financing decisions made during this period of time were based on guidelines generated internally rather than on a complete analysis on a project-by-project basis. Given the long term impact of real estate development decisions, it is imperative that these decisions be economically sound based on a comprehensive evaluation of all market and financial information available. This type of analysis is critical in determining the feasibility of the acquiring and developing new properties.

Four primary conclusions can be drawn from this thesis. First, the importance of sound, consistent and unyielding underwriting criteria for financial institutions. Guidelines must be established that are both practical and realistic. Second, that there is no substitute for sound experience and judgement as the development industry has proven once again. The current rash of failures illustrates that the ability to obtain financing and build a building is a very small part of the complex business of real estate. Third, the importance of fundamental market analysis is absolutely critical. In addition, it must be understood that supply and demand are separate and distinct and very few assumptions can be made without sufficient analysis. This thesis includes several examples of inexperienced developers who mistakenly believed that the constant

supply of new products entering the market reflected additional demand. The current market proves that it does not. The real estate market will simply not absorb every product produced. Finally, investors must recognize that banks are financial institutions which loan money. Banks are not investment advisors. There is an obligation on the part of investors to complete proper analysis and make informed decisions to invest independent of the influence of lending officers. In addition, borrowers must be willing to accept 100% of the risk associated with properly repaying the liability.

If anything, the current real estate market reflects a hard learned lesson on the part of developers that being overly aggressive without doing proper homework is a dangerous combination. It is the responsibility of the developers of the future to avoid the same mistakes which have put the real estate market in the precarious position it is in today. Only then will equilibrium return to the real estate market.

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