REAL ESTATE LOANS IN A RISING MARKET

Summary of Remarks

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A rise in the general level of prices does not affect all types of real estate uniformly. The value of urban real estate is influenced by the economic background of the city or region in which the property is located, as well as by national forces. The income and the net return of each type of urban real estate also varies in accordance with its location within the specific urban region and the degree of government control exercised over it. Hence, broad generalizations covering all types of real estate in all parts of the country are extremely dangerous. Nevertheless, there are certain national forces which have affected the values and the mortgage loans of practically all the millions of parcels of real estate in the United States.

The trend of national income, wages and prices. As a result of the expenditure of nearly $300 billion for war, the national income was raised from $70 billion in 1939 to $160 billion in 1944, which was almost double the previous record-breaking high of $83 billion in 1929. It is the most significant fact, moreover, that this national income which was expected to decline in 1945 as a result of the unemployment attending reconversion did not drop at all but remained at this peak level of $160 billion. The amount paid for wages, likewise, which has usually been about 70% of the national income, increased from $48 billion in 1939 to $116 billion in 1944 and has been maintained at that level in

1945. If full employment and existing wage levels are maintained, the national income likewise will be sustained at the current high level. In fact, as a result of possible further wage and price increases, it may rise even higher during the next four or five years.

There exists in the hands of individuals in the United States a huge fund of savings amounting to $157 billion, which is nearly four times the entire national income of 1932. Retail sales have risen to the record-breaking level of $89 billion a year. The availability of this great pool of savings, the current high level of wages, and the great backlog of demand for millions of automobiles, radios, refrigerators, and other goods, will probably sustain a record volume of production until 1950 or 1951.

Real estate mortgage loans, however, are loans that are frequently made for periods of from 10 to 35 years. It is necessary to consider not merely the bright outlook for the next four or five years, but also the long term prospects. It must be realized that the production boom in the next few years is being sustained not only by the great deferred demand for goods of which production was stopped during the war, but also by the fact that we have reached a peak in the number of young persons reaching military or marriageable age. We are receiving the impact of demand for new households that resulted from the high birth rate prior to 1929. Beginning in 1950 or 1951, however, not only may the deferred demand for goods be largely satisfied, but there will be a sharp falling off in the age group from 18 to 24 as a result of the low birth rate of the 1930's. At that time it is possible if not probable that we will have some recession in the general level of business activity which will have an adverse effect on real estate values. It is inconceivable, however, that the national income will ever again drop to the $40 billion level of 1932. The necessity of meeting interest charges on the government debt and of maintaining expanded governmental services requiring Federal expenditures of approximately $25 billion will necessitate a national income of at least $100 billion at the bottom of the next depression. In my opinion we have experienced a permanent decline in the value of our money. After expanding our debt of liquid assets to the extent we have, we can never get back to prewar levels of prices. Therefore at least part of the present rise in real estate values will be permanently retained.

<u>Rising prices of farm real estate.</u> It is indeed extremely difficult to make a general statement regarding the prices of farm land which vary from $2 an acre for semi-arid grazing land to $5,000 an acre for orange groves in California. The extent of the rise in farm prices which is justified depends of course upon the kind of crop, the variability of the climate and the fertility of the soil in the particular locality. Some general overall statements, however, can be made which indicate that rises in the prices of farm lands are not as far out of line with reality as they were in 1919. Since 1932 the gross farm income

in the United States increased from slightly less than $5 billion to over $21 billion in 1945. While gross income thus rose slightly over four times, the net income of farmers increased ten times, or from $1,200 million in 1932 to $12 billion in 1945. In this same period the average selling prices of farm lands only doubled. Meanwhile, farmers have reduced their indebtedness from over $14 billion in 1924 to about $8 billion. The total value of farm property increased from $36 billion in 1933 to approximately $70 billion in 1945, and the farmer's equity has increased from $27 billion at the low ebb of values to $62 billion today. The present $70 billion value of all farm real estate is still below the $80 billion figure of 1920, but the net income of the farmers last year was approximately $12 billion compared with less than $7 billion in 1919. This shows that the present high selling prices of farms have not reflected in full the present unusually high net farm income, and that a substantial decline in present farm prices and incomes could occur and still the present sales values of farms would yield a fair return on the investment. This does not mean that there is not a danger of speculation in farm property but so far the rise in farm prices has been tempered by the memories of the decline in farm land values following 1920 and the farmers are in a strong cash position.

<u>The rise in the price of real estate as affected by city and neighborhood factors.</u> In this period of great shortage of homes in practically all parts of the country it might appear that large building

operations could be conducted everywhere profitably. In those urban regions, however, where the prospects indicate either future stationary or declining employment, the housing shortage will be more quickly met and there will be greater risk in carrying on an extensive construction program than in those cities or regions where the prospects are bright for an expansion in the number of jobs.

Even in the same urban region there are prospects that there will be a continuation of the prewar suburban trend with a decline in the population of central areas and the development of many new single family home areas on the periphery. Hence a greater rise in prices and values of real estate may be expected in the suburban areas than in the slums.

Prospects for Increases in Prices and Values of Different Types of Real Estate

Single family dwellings. Everyone is familiar with the fact that the prices of single family homes have increased at least 100% in most cities since 1940. In Los Angeles houses that sold for $4,000 in 1940 have recently sold for more than $10,000, and the same story can be repeated in hundreds of communities--in New York City and Washington, D. C., in Miami, Florida, in Seattle and in thousands of other communities. This rapid rise in the price of homes is due to the fact that the owner who sells his house can deliver possession and thereby escape the effects of rent control. The supply of houses available for sale is shrinking with the result that a high premium is paid for the relatively few houses for which possession can be obtained. Part of this premium is justified by an increase of some 40% to 80% in reproduction costs and by the higher family incomes which enable people to pay more for homes now than before the war. The risk involved in making loans on homes at present price levels can be measured by the extent to which these present prices will exceed reproduction costs in 1947 and 1948 when the supply of building materials becomes abundant. The present day construction costs are inflated by black market prices for scarce materials, by inefficient organization of labor on small jobs, and by extra allowances made by contractors for contingencies due to inability to secure materials. It is possible that prefabricated houses and more efficient organization of the building industry will subsequently lower home building costs. If costs are thus reduced, the prices of existing houses that are above these reproduction costs will fall in the next few years. Certainly the prices of homes can not be permanently maintained at a level much more than two and a half times the annual income of the families living in those homes. In a survey which I have just made for the Joint Legislative Commission on Housing in the State of New York, I found that not more than one employed veteran out of twenty-five can afford to buy a minimum new home at present costs or to live in a new apartment. The $4,000 credit extended by the G. I. Bill of Rights, the lowering of the down payment on homes, the lengthening of the amortization period may well cause thousands of veterans to buy homes at higher prices than they can afford, with the result that there will either later be wholesale defaults or a demand for a moratorium on veterans' obligations. Hence, there is a considerable element of risk in loans on single family homes made at current prices, especially where the houses are selling for more than reproduction costs.

It is unrealistic to assume, however, that prices of homes except in slum areas will ever drop back to prewar levels. I just examined some loans made on single family brick homes built in 1927 in a fairly stable neighborhood in Brooklyn. Two or three years ago these twelve room houses were selling for $7,500 and a loan of $7,500 on these houses was properly classified with $7,000 in Group 2 and $500 in Group 4. Recently I asked a real estate dealer what this house would sell for today. With a sales contract for $13,500 on his desk for a poorer and older house across the street, he said that this particular house would sell readily for $14,500 and a new loan for $8,500 on it could be obtained. Evidently the effect of the rise in the prices of these houses has been to lift the $7,500 existing loan into the Group 1 category. The price of $14,500 for this house may not hold but it will probably not decline in the near future below $10,000. In the meantime if an amortization is maintained, the principal of the existing loan will be reduced to the point where it is a permanently sound obligation. Thus in all parts of the country attempts should be made to ascertain what part of the rise in the prices of homes is justified by higher costs and by the decline in the purchasing power of the dollar and what part must be written off as a premium paid for possession during the time of an extreme housing shortage.

Apartment buildings. Loans on apartment buildings are the chief concern of bank examiners in cities like New York and Chicago where the apartment building is the predominant form of dwelling unit. Apartment buildings differ radically from single family homes because their rents are frozen at prewar levels by the OPA. The prices of apartment buildings have been rising notwithstanding rent control, as the result of 100% occupancy, lower capitalization rates and speculation based on inflation and hopes for the modification or removal of rent control. It is known that new apartments can not be built except at costs at least 40% higher than in 1940 and hence that rents on new apartments must be substantially higher than on existing buildings. All except the oldest and poorest apartment buildings have had 100% occupancy for some time and no further gain can be realized in the total gross income. Meanwhile operating expenses are creeping up as the price of fuel, labor, and other costs mount. The net income of landlords is being squeezed between the fixed rent ceiling and rising operating costs. Meanwhile, deferred maintenance is piling up with many much-needed repairs being neglected. Rent control will probably be the last control abandoned by the OPA and there is strong popular pressure for its continuance. The reason is clear. In New York City the tenants outnumber the landlords six to one, and in Chicago four to one. Landlords of rental property, particularly those owning the larger buildings, are relatively few in number and cast a few votes compared with the tenants. Hence rent control may be maintained for a long time by either Federal or State laws. If in the meantime operating costs continue to rise as is possible, the net income on apartments might dwindle to the vanishing point. The result will be disastrous on new construction of rental properties because in the past a great bulk of the demand for apartment units has come from families moving out of old quarters into new dwelling units which were offered at the same or slightly higher rentals. While thousands of families now doubled up or unable to find quarters of any kind will pay $100 a month for new apartments where $60 is being collected for approximately the same type of apartment in an older building, and while many other families whose incomes have risen will pay more for newer quarters, the great mass of tenants will probably stay put in their old units where they are getting subsidies at the expense of the landlord. The result may well be that after a short-lived boom in the building of rental properties, the construction of these buildings by private enterprise will fall off because of the lack of demand. This may stimulate an expanded subsidized housing program in which either by taxes or further increase of the public debt quarters will be provided for families at rents far below those which can be constructed for private enterprise. Both the direct and indirect effects of rent control would thus tend to lower the value of apartment buildings.

While the margin of protection on apartment building loans is thus narrowed by rent control, there are some favorable aspects of the situation. One of the greatest bugaboos to the lending institution in apartment construction has been the overbuilding of apartments with the result that rentals declined drastically. This takes place when new apartment buildings at costs low enough to permit them to rent for the same as existing apartments. This can not now take place since the cost of new buildings are much higher than the costs at which existing ones were constructed. Therefore the supply of apartment buildings can be increased only at higher rent levels and consequently if rent ceilings are maintained, owners can count on virtually 100% occupancy of the existing buildings because they are offered at artifically low prices. If rent ceilings are removed so that rents on existing buildings rise to the point where there is a proper differential between the rents of old and new buildings, then the vacancies in the older buildings will increase as new apartment buildings are erected. When vacancies in the older buildings increase, a lower economic or social group may move into these apartments with the result that there is a drop in the desirability and rental value of those apartments. If a method is found to reduce the costs of new homes or apartments, it will greatly accelerate the filtering up process which means that the higher income groups will move into new buildings and the lower income groups will move up into the apartments they have vacated. This will greatly increase the risk of loans in older central areas.

Another factor which may tend to lower the value of middle rent apartment buildings in large cities is the construction of large apartment projects by financial institutions which can build at lower costs and can consequently afford to rent apartments at a lower level than those erected by small builders.

If new construction in the United States is to prosper, the same proportion of the national income must be allowed to flow into building activities now as before the war. In 1940, 15% of the national income went to shelter rent. In 1944 as a result of rent control, only 8% of the national income was paying for residential rent. It is paradoxical that we should think that we can maintain rent control which lowers the returns on real estate investments and at the same time expect a great expansion of residential building by private enterprise.

In reviewing the prospects for apartment loans, however, it must be considered possible that the owners will be allowed some increase in rents to cover deferred maintenance or to enable them to maintain the same return on their equity as they received in 1939. If this is done, loans on apartment buildings will receive a safe margin of protection, but otherwise if rent ceilings are maintained in an inflexible manner, the net incomes of the owner and the margin of protection for mortgages on apartment properties will decline as a result not only of large operating costs but an increase in real estate taxes in our large cities.

Loans on office buildings. The vacancies in office buildings in American cities has declined from an average of 25% in 1932 to less than 2% today, with office space non-existent in modern buildings in the best locations in most cities. As the gross income of offices has increased with rising occupancy, office rents have also risen. It is certain that the rents of office buildings w ill continue to rise unless checked by State or Federal control until they reach a point where the rents are sufficient to yield a return on new buildings. The margin on equity on office building loans is thus increasing, as witnessed by the rapid rise. in real estate bonds, because there is no danger of overbuilding of office buildings until rents on existing buildings rise to the point where they will yield a return on present operating costs and on the reproduction cost of new buildings which are at least 40% higher than in 1940.

Loft buildings. The net income on prices of loft buildings in New York City has increased 50% to 100% in the last two or three years, notwithstanding State rent control. Instead of placing a flat prewar ceiling upon rents as in the case of the Federal residential rent control, the New York State Act allowing a 15% increase in rents over 1943 also allows the owner to earn 6% on the existing value of his property and 2% on amortization. It further allows the landlord and the tenant to agree upon a rent by arbitration. These provisions have given sufficient leeway to allow a very substantial rise in rents and vacant space not subject to control which rented for $1 a square foot in 1940 has brought as much as $5 a square foot. Mortgage loans on loft buildings have thus received an enhanced margin of protection because of the rising income in the past few years and because the existing supply of loft building space can not be increased except at a much higher level of cost.

Since the rents in new loft buildings would have to be at least $3 a square foot to cover operating costs and construction costs on new buildings, the existing buildings will remain fully occupied until average rent rises to about $3 a square foot.

Hotels. The net income of hotels has greatly increased during the war as a result of an increase in occupancy from 65% to 100%. This full occupancy will continue until hotel rates are stabilized at a point sufficiently high to enable the builders of new hotels to earn a return on their investment at costs much greater than those at which the existing hotels were built. Hence, since there is no danger of overbuilding of hotel space except at a higher level of rents, there is an increased margin of protection on hotel loans. However, since the operating costs of hotels will rise as a result of the necessity of providing more services than during the war, the peak wartime rate of earnings of hotels will probably decline.

Commercial properties. Tremendous increase in the volume of retail sales has given the record volume of business to stores and has caused increases in rents in stores not under long term leases or under State rent control. The prospects are very favorable for loans on commercial properties in the best central locations and in the best outlying suburban centers where adequate space for parking automobiles is provided. However, there is danger of making real estate loans on commercial properties in off center or marginal locations which may do a good business during lush times but whose volume of sales will contract sharply when there is a flowing back of consumers to the main channels of distribution.

Conclusion. It is obvious from the different kinds of local forces and controls operating on different types of real estate in all sections of the country that a rising price level will not inflate all types of real estate uniformly. A permanent rise in the value of any type of real estate can come only as a result of the net income in dollars or a lowering of the capitalization rate. It is therefore of the utmost importance to secure records of the long time gross and earnings, operating expenses and net earnings of each type of real estate over an entire real estate cycle or in the period from 1925 to the present time. This will illustrate the principle that on the rise the net income rises much more rapidly than the gross income. The reverse is true on the decline. Since operating costs including real estate taxes, wages, fuel, etc. are fairly rigid and do not decline quickly with the onset of a depression, there is a very rapid shrinkage in net income when both rental rates and occupancy declines. Therefore in calculating future security of loans it is highly important to consider not merely the possible net income during the next four or five years of good times, but also the possible net income that may be expected after 1951. In addition to cyclical factors, there are the long time adverse effects of continuation of residential rent control, rising real estate taxes, the obsolescence of buildings resulting from new types of construction, the decline in the character of neighborhoods and a rise in the general rate of interest, all of which can suddenly impair real estate equities and weaken the margin of protection for mortgage loans.

The following types of properties appear least likely to share in the general inflationary rise in prices.

1. Properties subject to rent control, particularly if rents are frozen at pre-war levels.
2. Buildings particularly single family homes for which a premium has been paid for possession now selling for more than their stabilized reproduction cost in 1947 or 1948.
3. Properties in slum or blighted areas.
4. Residential areas into which lower income groups will filter up during the next decade.

The following types of properties would be in the best position to share in a further rise in general prices.

1. Office buildings, if not subject to rent control.
2. Hotels, if not subject to rent control.
3. Suburban land accessible to mass transportation to central areas or in close proximity to existing built-up areas.
4. Stores and commercial properties in the best existing locations or in new suburban locations with ample parking facilities.
5. Apartment buildings constructed since 1921 in the better locations if rent control is removed or modified.