SUPERVISION AND REGULATION RISK MANAGEMENT CONFERENCE
FEDERAL RESERVE BANK OF CHICAGO

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Financing REITs: Is it the 1980s All Over Again?

A. Welcome to our emerging issues conference, "Financing REITs: Is it the 1980s all over again?"

- We are pleased to sponsor this in conjunction with the Federal Reserve System's Banking Supervision and Regulation Strategic Plan Steering Committee on Emerging Issues and System Preparedness.

B. The purpose of this seminar is to provide banking supervisors with a greater understanding of REITs.

1. Recently the Federal Reserve System in response to ongoing concerns within the industry and the supervisory community, undertook an intensive study of lending terms and standards.

2. Several of the institutions reviewed as part of this project had experienced rapid growth in exposure to real estate investment trusts over the past year, with the growth in each case amounting to hundreds of millions of dollars.

3. While there are no substantial safety and soundness issues generally regarding REIT industry lending, it has become an important concentration of credit risk at some banks.

4. The profile of a real estate investment trust of today is significantly different from that of the investment trust of the 70s and 80s.

5. For this reason we have assembled panels comprised of prominent leaders from the REIT industry, rating agencies, banking industry and bank supervision to explore this issue.

C. We have a full day's activities planned, which will provide several different perspectives on the industry.

   1. This morning we will lead off with the industry perspective.

   2. Representatives from the National Association of Real Estate Investment Trusts will provide an overview of the industry and a panel of REIT industry leaders will give us their perspectives on the future challenges facing different kinds of REITs.

   3. The keynote speaker at lunch will share the rating agency's perspective.

   4. This afternoon's panel, composed of lenders and an investment advisor, will present their perspective on REIT funding and credit market issues.

D. Developments in the overall economy have a significant impact on the real estate industry.

   1. The onset of economic problems in Asia in mid-1997, the emerging financial problems in Russia in August, and concerns that difficulties would spread to Brazil and other Latin American countries has served to make our economic outlook more uncertain.

   2. The full extent of the after-shocks to the U.S. economy was and unfortunately, continues to be hard to gauge.

   3. The market developments in September and October quickly turned investors away from additional risk-taking investments.

   4. Investor's appetite for risk clearly declined.

   5. Market volatility increased as managers of financial funds re-weighted their portfolios towards less risky assets.

   6. A worldwide financial flight to quality increased spreads between private debt markets relative to U.S. Treasury securities, which are considered a safe haven.

E. Just as the market has reexamined its risk appetite, so too have bankers.

   1. Federal Reserve surveys and other sources indicated that some banks have tightened their lending standards.

   2. The most recent survey of senior bank loan officers indicated that one-third of domestic banks tightened their standards on commercial and industrial loans to large and middle-market business during the past three months.

   3. REITs must distribute 95% of all earnings therefore they cannot use internally generated funds for expansion.

   4. They must rely on debt or equity markets.

5. The confluence of the double whammy of a jittery stock market and tightening lending standards has made it more difficult for REITs to raise funds.

F. However, we have seen some signs of this risk aversion reversing in the past month.

1. The financial markets have become more settled, with credit risk spreads narrowing since their peak in mid-October, although these spreads still remain at relatively high levels.

G. What has this reaction in the markets meant for REITs?

1. Does it represent effective market discipline or an over-reaction?

2. I'm sure our panel participants will give us their perspectives.

3. Reports from the commercial real estate industry are cautiously optimistic.

4. The third quarter survey of vacancy rates published for the U.S. is approximately 9%, the lowest rate since the 1980s.

5. While the industrial vacancy rate increased slightly, two-thirds of all metropolitan areas are still reporting a decrease in availability of industrial space.

H. These statistics do not point to weakness in real estate markets.

1. But, — and with economists there is always a but—

2. The uncertainty in today's markets does cause regulators to worry—

3. Worry about increasing leverage, about overbuilding and about underwriting standards.

4. Many in this audience have seen what can happen to property values when demand dries up.

I. The FDIC recently published a study titled the, "FDIC's History of the Eighties," where they found that banks that failed during that period had a higher concentration in commercial real estate loan exposures than banks that survived.

1. We will hear about the similarities and differences between today's REITs and those of the 1980s.

2. In particular, how the current structure of today's real estate investment trust may provide some safeguards to limit the risk of overbuilding and a subsequent decline in property values.

3. However, we must always bear in mind what was pointed out in the Federal Reserve's recent supervisory letter— loans to REITs are fundamentally commercial real estate loans.

4. Ultimately the strength of demand for commercial real estate will depend on the continued strength of the U.S. economy.

J. And now I would like to begin the conference by introducing our first speaker, Samuel Zell, who will give us an overview of the industry.

1. Sam is a native Chicagoan who graduated from the University of Michigan and the University of Michigan Law School.

2. He began his real estate career as an undergraduate managing apartment buildings and pursued his interest in real estate following graduation by starting Equity Group Investments, Inc. which he has built into a widely diversified company with interests in both real estate and corporations.

3. Mr. Zell is also chairman of four publicly traded real estate companies: Equity Office Properties Trust, Equity Residential Properties Trust, Manufactured Home Communities, Inc, and Capital Trust.

4. In addition to his real estate activities, Sam is also the chairman of Anixter International, American Classic Voyages, Chart House Enterprises, Inc. and Jacor Communications, Inc.

5. In addition to his other activities, Sam is also the 1999 Chairman of the National Association of Real Estate Investment Trusts.

6. When not attending to his business interests, Sam can be found skiing, playing racquetball, or heading down the highway on his motorcycle.