Will Second-Mortgage Financing be the REITs of Today?

In 1969, the emerging Real Estate Investment Trust (REIT) industry had only a few bank sponsored tax-free trusts and about $1 billion in total assets. By 1974, five years later, the industry had grown to 208 trusts with total assets over $21 billion.[1] The process of growth was simple: offer individual investors high rates of return on construction loans to builders and developers for apartments, motels, condominiums, shopping centers, and commercial rental property. The property managers found aggressive ways to lend funds since their salaries were based on the number of transactions they closed, rather than the creditworthiness of the project. They were not required to judge whether the project could financially survive in a difficult economic environment. Only two years later, in 1976, foreclosed property represented a third of invested assets, dividends were less than one-fifth of what they had been in 1973, and many REITs failed to pay dividends for a 48-month period. The industry was crumbling. But many of the REITs' key characteristics survived in another mode of financing.

Today, the phenomenon of creative financing, where sellers and buyers meet, encouraged by the real estate agent, has three principal points in common with the REITs of yesterday:

1. Both the REITs of a half decade ago and today's creative second mortgage financing involve an individual whose salary is derived from consummating a transaction rather than from examining the creditworthiness of the borrower and his ability to pay the obligation from his current income.
2. Both are predicated on the notion that the asset's underlying value is likely to continue to rise and that appreciation is critical to fulfilling the financial commitment.

History of REITs

The Real Estate Investment Trust was a financial intermediary created by 1960 tax legislation. The trusts were exempt from federal corporate income tax provided they met certain requirements concerning ownership and income distribution to shareholders. The government's purpose in establishing the trusts was to allow individuals to invest in real estate in the same way they buy stocks through mutual funds. The REIT was managed by an adviser who belonged to a completely distinct entity from the trust. However, the adviser could own up to 35% of the REIT stock. The adviser was generally a commercial bank, mortgage banker, financial conglomerate or life insurance company, whose function was to decide upon the types of investments to be made and arrange the financing between the REIT and the borrower. For this service the adviser received a fee based on the loan amount. Typical investments were construction loans for single-family homes, apartments, condominiums, or commercial structures; development loans for site improvement and road construction; and long-term mortgage loans.

The REITs did not become important financial intermediaries in the real estate market until interest rates surged in 1969 and funds for construction and mortgage loans became scarce. As market rates climbed above the legally allowed rates paid by savings and loans,

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The boom in creative financing is helping the real estate industry cope with high interest rates. But similarities between creative financing techniques and the ill-fated Real Estate Investment Trust (REIT) industry raise questions about what will happen in three to five years when balloon payments are due.

3. Both sacrifice scrutiny and critical credit analysis by the institution most fit and qualified to examine the risk of the underlying asset, and both assume that conventional measures of real estate financing are too archaic and conservative for today's market conditions.

Today's Real Estate Market

The current real estate market offers many similarities to the environment which prompted the proliferation of REITs in the early 1970s. Today, savings and loan associations are not constrained by interest rate ceilings. Mortgage funds are available for those who can afford them. However, with mortgage rates ranging from 16% to 18%, few families can afford to purchase a home. Various forms of floating rate mortgages are being offered at savings and loans, but buyers are less willing to take the risk of increasing loan payments. The National Association of Home Builders estimates that only 7% of the families in the United States can qualify for a 15%, 30-year conventional mortgage on $60,000, compared to 18% who can afford the same mortage at a 10% rate.[2] The squeeze in the current market is taking place through the price mechanism; in the REIT market, funds were squeezed by the artificial constraints of government regulations.

In an effort to cope with the current mortgage market, another form of financial intermediation has grown popular — creative financing. The National Association of Realtors estimates that over 50% of existing home sales currently employ some means of seller financing.[3] The reasons for the trend are clear. Sharp inflation in housing prices has left many homeowners with substantial equity in their

deposits flowed out of these institutions. Builders and developers were forced to look elsewhere for funds. Real Estate Investment Trusts were the link between borrowers who were willing to pay a high rate of interest and lenders who were looking for high rates of return. Where government regulations restricted the natural flow of money, REITs helped to fill the gap.

The tight money period in 1969-70 gave the real estate industry a taste of the profitability of REITs. In the two-year period 1969-70, REIT industry assets increased five-fold from $1 billion to almost $5 billion. At the beginning of 1969, only 8 REITs existed, but by the end of 1970, 53 new trusts had been formed.[10] Interest rates subsided, but real estate values continued to climb. REITs flourished throughout the early seventies, as investments were made based on the expected appreciation of real estate. The advisers earned profits amounting to 60-80% of the fees they collected.[11] These profits, which attracted many firms into the industry, increased competition and tempted advisers to make risky loans. Another cyclical rise in interest rates in 1973 and 1974 drew funds away from the savings and loan associations and into the REITs where yields were higher. Of the 208 trusts at the end of 1974, 39 were advised by commercial banks which held 32% of industry assets.[12] The banks made ideal advisers since they needed a mechanism for real estate lending in place of their own constrained services. The banks could benefit from the new deposits brought in by the REITs, and in return the REITs had easy access to bank credit lines.

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homes. High interest rates and housing prices have raised the monthly payments on mortgages, making qualifying by potential borrowers more difficult. Present levels of interest rates are also well above those of the recent past, giving home buyers incentive to assume existing mortgages when that is possible. In addition, demand for homes is being buoyed by the movement of a large segment of the population into the home-buying age group, the general view that homes are a good hedge against inflation, and the inflation-induced rise in the tax-incentive for home ownership.

These motivating factors call for financing techniques that allow secondary financing, loan assumptions and other methods to ease the purchasing of a home. Such techniques primarily involve several variations on the second mortgage, but they may also involve special terms for first mortgages. The creative techniques are perceived in the marketplace as ways of easing housing transfers for both buyer and seller. Realtors see them as ways of assuring sales in a slow market, and lenders see profit potential in creative financing.

Seller-financing is being encouraged by real estate agents whose traditional role in the marketplace has been to match buyers with sellers. In order to close sales in the current mortgage market, however, realtors are becoming financial innovators as well. They often encourage creative techniques in order to satisfy both the buyer's and the seller's demands — and preserve their commissions in a troubled market as well.

One common technique that realtors are encouraging is the use of second mortgage financing. The seller's loan may be assumable, but the buyer may not have enough cash to fulfill the seller's equity needs. A typical example is a $100,000 home financed with an assumable first mortgage of $50,000, a second mortgage of $40,000, and a down payment of $10,000. Commercial lending institutions, especially mortgage bankers and finance companies, have jumped into the second mortgage market to meet this demand. However, the rates they require (generally 18% or higher) may be just as prohibitive to the buyer as taking a new mortgage. Instead, realtors have encouraged sellers to finance the second mortgage at a below-market rate of interest.

Balloon payments are common in creative financing. Lenders seek to avoid long-term commitments of funds, while borrowers seek to limit monthly payments. The remaining portion of the buyer's second mortgage will be payable to the seller in 3-5 years (whenever the "balloon" is due). Borrowers in such cases will be faced with the need to finance their balloon at some future date. Many borrowers and lenders seem to be depending on continued inflation to raise incomes and home values enough to ease refinancing requirements when the balloon comes due. Balloon repayments are consistent with

Why REITs Failed

REIT loans were decided upon by the adviser who was paid a commission on the dollar amount of investments he made rather than on the long-term profitability of the firm. The profits from these ventures were extremely rewarding, and as long as the market held up, no one objected to the high degree of risk. Many advisers were lending (1) without long-term takeouts (loans broken into increments with conditions for approval), (2) without assessing the supply of and demand for the projects, (3) based on unrealistic appraisals of properties which often caused the loan-to-value ratios to be greater than 100%, and (4) in concentrated markets to one developer, in one type of loan, or to one geographic market. These lending practices put assets on the books which were overvalued or for which only a distress market existed once the economy declined.

The adviser could lend REIT funds to his own firm at more favorable terms than could be obtained elsewhere. Shareholders could not easily detect this conflict of interest, since the favorable terms were often in non-price forms such as overstated appraisal values. Advisers also had the incentive to borrow as much as

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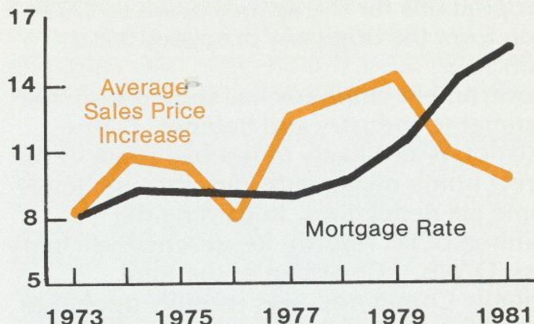
transient markets. Buyers finance a 5-year balloon note expecting to sell their homes before the note is due. The proceeds of such a sale would repay the balloon and leave the borrower with some extra money if inflation of housing prices persists.

Similarities to REITs

These seller-financed second mortgages are based on the belief that inflation will continue *and* the mortgage market will improve. Similarly, the REITs made risky loans with the expectation that demand would continue to be strong and inflation would push up real estate values. Today's sellers are trusting that buyers will be able to make the balloon payment.

Just as with the REITs, assumptions are being made that rule out the possibility of a real estate downturn. However, a new tide has turned in government policy which is likely to trim back the special considerations given to the housing industry in the past. The current deregulation of financial institutions allows the money markets to control the level of interest rates as a balance between demand and supply. In the past, Americans have essentially paid a negative rate of interest to borrow money for home purchases. This funding subsidy increased the incentive to invest in real estate for individual use and for speculation. But with new mortgage rates now tied to the fluctuations of the money markets,

Chart 1. Existing Home Sales



Sources: Federal Home Loan Bank Board and National Association of Realtors

the costs of financing real estate may soon override the benefits of appreciation. For example, from June, 1980, through June, 1981, the average mortgage rate on resale of existing homes was almost 15%. Over the same time span, the average sales price of existing homes rose only 10% (Chart 1).

The current administration's desire to reduce government intervention in the economy has not only been evident in deregulation but also in cutbacks on direct subsidies for housing. The 1982 level of new subsidized housing units has been reduced to 153,000 from the previous administration's proposed 260,000 units. This action decreased the budget authority by nearly $10 billion. Other cuts in the budget of the Department of

possible to increase loanable funds. A highly leveraged position was often not in the best interest of the shareholders, although it increased the income of the adviser.

Advisers were not the only ones at fault in encouraging REITs to take on risky assets. Investment bankers profited from underwriting the REIT shares and encouraged formation of new trusts. Underwriters were approached not only by those knowledgeable in the real estate market, but also by people with no background who wanted to raise millions of dollars to start a trust. As early as 1969, *Barron's* quoted an investment banker who said in regard to the neophyte trustees, "I asked them what they knew about the field. They replied that they didn't need to know anything; they could always hire a mortgage man from a bank."[13]

And the banks lending to the REITs tended to ignore the warning signals of overleveraged trusts. Had they required the REITs to provide documented evidence of market demand for projects, more equity from developers, more realistic cost estimates and budgets, and firmer takeouts from lenders, much of the precarious position of the industry would have been eliminated. Through REITs, bankers indirectly financed projects which would never have withstood a rigorous credit analysis within their own institutions.

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Urban Development brought total appropriations for the agency down to $25.6 billion from the originally proposed $38.2 billion.[4]

Government emphasis has shifted from the consumer to industry and defense. Future legislation is also likely to remove some of the indirect home-owner subsidies through fewer income tax deductions. Regarding the likelihood of tax reform, Representative Henry Reuss (D.Wis.), Chairman of the Joint Economic Committee, was recently quoted as saying, "Second- and third-home deductions will be out."[5]

With investment interest in housing waning, home values may begin to advance more slowly. Owners who hold low-interest fixed-rate mortgages will be less willing to sell, and the turnover of existing homes should gradually slow down.

The negative prospects for the housing market intensify the concern over the increased popularity of seller-financing. As in the REIT experience, financing is being arranged by people who have not developed an expertise in that area. Realtors are being forced to sell financing techniques to their clients in order to sell homes. Their incentive is based on the sales price of the home, not the soundness and profitability of the financing arrangement.

The seller-held second mortgage is a relatively illiquid asset. The mortgage can be sold on the secondary market. However, most seller-financed mortgages are at a lower-than-market rate and can be sold on the secondary market only at a very substantial discount. By lowering the sales price, the seller may be able to avoid holding a second mortgage. The profit could be close to the same as it would be by financing and selling the mortgage. With the proliferation of seller-financing, perhaps sales price reductions have been overlooked.

Survey

Recently we surveyed realtors in the Southeast to determine the extent of creative financing during the first quarter of 1981. We contacted realtors in each of the following cities: Atlanta, Birmingham, Jackson, Jacksonville, Orlando, Nashville, New Orleans, and St. Petersburg. The survey, based on over 200 telephone interviews with realtors during the first two weeks of April, 1981, also provided insight about their attitudes toward creative financing. The purpose of the questions was to determine first, the percentage of total closings that involved seller-financing, and second, the extent and terms of balloon payment financing. The following questions were asked:

1. What was your total number of transactions during the first quarter of 1981?

Why REITs Failed *(continued)*

The REIT industry, with its shaky foundation, began to crumble as the recession hit in 1974 and 1975. While REITs had seemed the answer to the real estate market's prayers, they only exacerbated the normal cyclical downturn. This violation of prudent lending principles may have gone undetected had the real estate market continued to appreciate rapidly and had the U.S. economy marched upward and onward. But risky ventures were not able to withstand the blows of a declining economy that left many REITs unable to collect on their loans.

When the recession hit, unexpectedly high rates of inflation boosted building costs far above the projections made for loan commitments. Rather than foreclose, or leave a structure standing unfinished, REITs lent additional funds. Some developers gambled that interest rates would improve by the time of the project's completion and began construction without firm takeouts. Rather than improving, the interest rate outlook worsened and funds were impossible to obtain. The recession left the nation immobile, and speculative construction found no demand. Even when foreclosures became necessary, the recourse was an effort to minimize loss. The market for foreclosed

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2. How many transactions involved second mortgages held by the seller?
3. What was the average maturity of the second mortgages?
4. How many of the second mortgages were 2-3 years long?
5. How many of the second mortgages could be prepaid without penalty?
6. How many of the second mortgages were financed with balloon notes?

The results indicated that 43% of single-family homes sold in the first quarter of the year involved seller-financing with a second mortgage (Chart 2 next page). (Statistical application of a "t-distribution" indicated that we may be 99% confident that the population mean truly lies somewhere between 31% and 55%.)

Most realtors indicated that sellers are charging below-market rates on their loans. While institutions are charging 18% on second mortgages, sellers are financing them for 10-15%. This low rate encourages the proliferation of seller-held debt. Where loans cannot be obtained through financial institutions, sellers are slashing finance charges to make the purchase affordable. This discounting of market rates is similar to the REIT lending practices where funds were advanced by the trusts for projects which could not have passed the scrutiny of institutional lenders.

Realtors found that creative financing techniques became increasingly popular as mortgage rates climbed above 12% and almost a necessity as rates topped 14% and fixed-rate money dried up. With the prospect of mortgage rates remaining at very high levels, seller-financing will only continue to grow.

Those respondents who were aggressively pursuing creative financing indicated their sellers depend upon the income from the second-mortgage to make the payments on another home. Those realtors with little activity in creative financing said only those sellers who did not need the cash were extending loans.

The survey showed the average length of the second mortgages to be 8.3 years, but that figure is biased upward by several responses of 20-25 years. The frequency distribution indicates that the average length of most second mortgages is five years or less (Chart 3 next page). The balloon payments varied in maturity from 2 to 5 years. This time period is critical. In the next several years, the demand for mortgage financing should leap upward as balloon payments become due, in addition to the normal needs for financing. Depending on the financial environment at that time, defaults may rise and heavy losses could be incurred.

Not all seller-held second mortgages are being financed with balloon payments. The responses to the question regarding balloon financing fell into three general categories:

property remained stagnant for months and even years in the case of many condominiums. The taxes, interest carrying charges, and maintenance costs on foreclosures eroded any retrievable equity.

As the situation worsened, investment analysts began to shun the trusts. The NAREIT stock price index (1966 = 100) for mortgage trusts fell from over 400 in 1972 to less than 100 in mid-1974.[14] However, there was still confidence in the survival of the industry. Investors were quoted in the spring of 1974 as saying that the industry would survive. The failure of a large bank-managed REIT was deemed impossible since the bank's name was at stake. Investors believed the REITs would have easy access to funds from their sponsoring bank. *Business Week* wrote as late as March, 1975 that, "it is hard to imagine the world's third-largest bank letting an REIT that shares its name go down the drain."[15] But the losses drained so heavily on the banks' earnings that they were finally left with no other choice but to admit their mistakes.

As the industry folded, many REITs were abolished and commercial banks took severe losses to rid their books of the overvalued assets. Dividends distributed by the REIT industry fell from a high of $155 million in the fourth quarter of 1973 to $30 million in the third quarter of 1976.[16] Today, trusts hold assets of only $10.3 billion in current dollars compared to the high of $21 billion in 1974.[17]

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1. ***Aggressive*** — Almost all second-mortgages have been financed with balloon payments. The realtors believe "balloons" are a good tool for closing sales.
2. ***Diversified*** — Some of the second mortgages have been financed with balloon payments. The realtors believe "balloons" are a useful tool, but they are using many and varied financing techniques to aid in closing sales.
3. ***Wary*** — Very few second mortgages have been financed with balloon payments. The realtors perceive the risks and are wary of using this form of creative financing.

The frequency distribution of second mortgages financed with balloon payments showed the responses clustered heavily on either end of the distribution (Chart 4). Over 50% of the respondents replied that either virtually all their second mortgages were financed with balloons or that very few were financed with balloons. The risk is not spread evenly across the real estate industry. The mean of the sample indicates 40% of seller-held second mortgages are financed with balloon notes, and 16% of all transactions involved balloon financing (Chart 5).

When asked if there is any risk to the seller in taking back a second mortgage, realtors emphatically responded, "No." They defended seller-financing for basically three reasons: (1) If sellers demand a sufficient downpayment, generally 50% of the equity, then a default would not cause a serious cash loss. (2) If the buyer defaults, the home value will have appreciated and can be sold for a substantial profit. (3) The seller can only benefit from a default since he has the opportunity to sell the house again for a sizable profit.

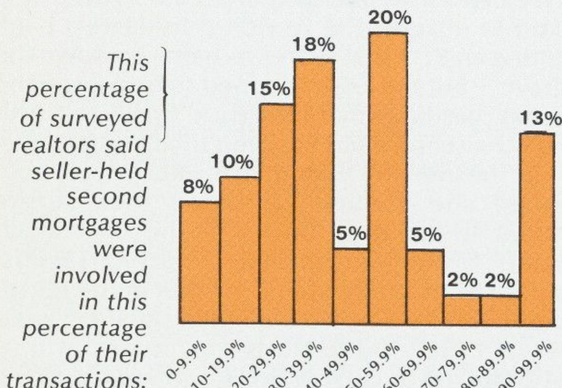
Realtors are educating themselves on ways to implement financing techniques and enlightening their clients to its advantages. Wary sellers must be sold on the idea of taking back a second mortgage. Many realtors said that their sellers had made no attempt to qualify buyers. If a large enough downpayment is made, the seller feels that the buyer is going to protect his equity by making every effort to fulfill the obligation. Yet some are worried. As one realtor put it, "seller financing involves little risk, but if the mortgage markets are as tight as they are now in three years when balloon payments come due, we will all be in hot water."

Enforcement Problems of Balloons

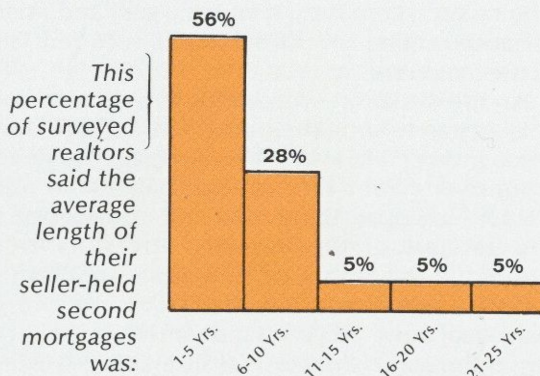
When balloon payments are due, three to five years from now, the financial market may be just as tight as it is today. The problem could be exacerbated in the courts. Although federal courts have upheld the "due-on-sale" clauses, a few state courts have ruled that they are unenforceable.[6] In many California cases,

SELLER-HELD SECOND MORTGAGES

2 Percent of Total Transactions



3 Average Length



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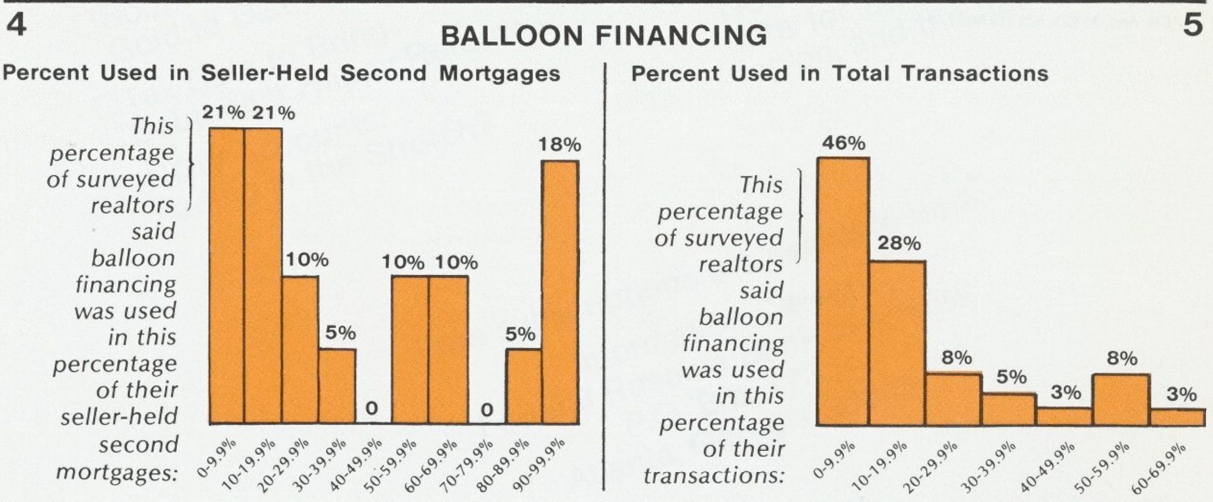
Similarities Between Second Mortgage Financing and REIT Lending

Second Mortgage	REITs
The realtor acts as an agent between the borrower and the lender.	The adviser was essentially an agent who brought borrowers and lenders together.
The realtor profits from volume and value of sales.	The adviser was paid based on the volume and value of sales.
Lenders (sellers) are often not qualifying buyers.	Strict credit analysis was often bypassed.
Realtors would rather see a high sales price with second mortgage financing than encourage the seller to drop his price.	Loans were often made for over 100% of the value of the property because of unrealistic appraisals.
Buyers and sellers are counting on equity appreciation to shelter them from risk.	Lenders used little caution about investments, assuming inflated equity would cover losses from any poor choices.

the court determined that the enforceability of "due-on" clauses, whether it be sale, encumbrance, or a certain date, was justified only if legitimate lender interest is threatened. Lender justifications were the preservation of security from waste or depreciation and avoiding the risk of an uncreditworthy borrower.[7]

A 1979 California case [8] ruled that an institution could not require a balloon payment to be made if the borrower had made timely and full payments leading up to



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the "due-on-date." Lender demands for payment were considered to be unconscionable conduct since the funds, once collected, would just be lent to someone else. Additionally, a 1978 California case [9] found that a private individual could enforce a balloon payment only if the property was damaged or if the borrower's ability to pay had declined. The payment could not be demanded if the lender's only justification was that he "expected the property to be sold before the note went full term and . . . wanted the cash to put into other investments." Sellers may find collecting balloon payments to be more difficult than they perceived at the time of sale.

Summary

The similarities between seller second-mortgage financing and REIT lending are striking (see table, p. 11).

There is a potential for loss to sellers and financial institutions who hold claims on these assets. Those involved are trusting that real estate values will continue to escalate and that the mortgage market will improve. As we have witnessed with the REIT experience, euphoria in real estate investment often provides the incentive to take great risks. Highly leveraged financial positions result in profits on the upside, but work just as hard against earnings on the downside. Sellers who take back second mortgages now are ecstatic about the sale of their homes plus the potential to earn a hefty return on the equity they must finance. But a depressed real estate market could spell serious trouble for the players involved in "creative financing."

— Donald L. Koch
and Delores W. Steinhauser

[1] **1975 REIT Fact Book**, National Association of Real Estate Investment Trusts, pp. 136, 143

[2] Robert Shehan, National Association of Home Builders, April 28, 1981.

[3] Ken Kerin, **The Real Estate Status Report**, National Association of Realtors, May 1980.

[4] "Reagan Housing Plans Generally Approved," **Congressional Quarterly Weekly Report**, Aug. 15, 1981, p. 1471.

[5] Nossiter, Daniel D., "Structural Change — Costly Mortgages Put Crimp in Housing Values," **Barron's**, April 27, 1981, p. 9.

[6] John Gunther, Deputy Director of Litigation, Federal Home Loan Bank Board, May 14, 1981.

[7] Smolker, Gary S., "Legal Corner," **Real Estate Review**, Winter 1981, p. 12.

[8] Larwin — S. Cal Inc. vs. JGB Inv. Co., 101 Cal. App. 3d 626, 640 (1979).

[9] 87 Cal. App. 3d 521, 530 (1978).

[10] Schulkin, Peter, A., "Real Estate Investment Trusts: A New Financial Intermediary," **New England Economic Review**, Federal Reserve Bank of Boston, November/December 1970.

[11] Robertson, Wyndham, "How the Bankers Got Trapped in the REIT Disaster," **Fortune**, March, 1975, p. 168.

[12] **1975 REIT Fact Book**, page 136.

[13] Thomas, Dana L., "Misplaced Trust? Tight Money, Footloose Expansion Plague the Mortgage Funds," **Barron's**, July 7, 1969.

[14] Robertson, Wyndham, p. 115.

[15] "The Damage REITs Have Done to Bank Lending," **Business Week**, March 31, 1975, p. 68.

[16] **1977 REIT Fact Book**, p. 15.

[17] National Association of Real Estate Investment Trusts.

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