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The Public Trust: Real Trust

by

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The Public Trust: Real Trust

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ABSTRACT

An amendment to the Internal Revenue Code in 1960 enabled one type of corporation to be exempt from income tax if it met several criteria. It had to have over 100 shareholders distribute 95% of its net income, be managed by a board of trustees, and behave as a "passive" corporation by and large. The bulk of its funds, although not the entire sum, was to be invested in construction loans, equity positions in property, and long term mortgages.

The purpose of this legislation was ambigious in the beginning. The rules and regulations subsequently enacted were confusing, conflicting and incomplete. As a result, commercial banks, investment banks, developers, and advisors were left to use and abuse a new institution which was structurally vulnerable to exploitation. Regulation of the corporation, even careful evaluation, was made difficult by the lack of clear goals and purpose against which performance could be measured.

In the climate of economic crisis in the mid-1970's, these entities were trampled by high interest rates and low customer demand. They had built inadequate cash reserves to weather the storm. Small investors, the intended beneficiary of the legislation, lost billions in assets, and many of these corporations went out of business.

This paper chronicles the debacle of a misconceived piece of legislation, which was a solution in search of a problem.

Chapter 1

In the Beginning

The original intent of Congressional legislation, in 1960, known as the Real Estate Investment Trust Act was to generate new funds for real estate and to provide the small investor with opportunities previously available only to big investors. These large investors had the benefits of a diversified real estate portfolio and sophisticated real estate analysis. Instead, the REIT legislation led trusting novices into investments which boomed in the late sixties and early seventies and then dramatically crashed in the middle seventies. Along the way, numerous investors, many of them small, lost literally billions of dollars.

The concept of a business trust originated in the late 1800's in Massachusetts. These business trusts were unincorporated associations that had trustees, beneficiaries and business goals, namely profits. The Congressional legislation of the REIT Act[1] enabled these trusts to compete actively for private capital based on their tax free status. This tax free characteristic did have precedents in the mutual funds, formally known as regulated investment companies. Mutual funds allow small investors to ride the stock market trends much like large investors through the diversified portfolio and professional management of the funds. Similarly, Real Estate Investment Trusts, REITS, are supposed to be managed by knowledgeable advisors who invest in an assortment of properties or mortgages, thereby reducing risk.

[1]Congress in 1960 amended the Internal Revenue Code through the Real Estate Investment Trust Act. I.R.C. section 856-858.

The REIT is an unincorporated association, overeen by trustees, that attracts a pool of capital from at least 100 investors. Five or fewer people cannot own more than fifty percent of the trust, thus REITs are designed for small investors who want or are satisfied with minority positions. Trusts are generally considered risk averse entities. But Real Estate Investment Trusts were allowed from the beginning to issue debentures and other forms of debt which can be riskier instruments than common stock, especially if subordinated. Trustees of a REIT act much like directors of operating companies and yet they confer day to day operating responsibility to outside advisors much like a mutual fund. Thus, the REIT is a hybrid: a little like a mutual fund, a little like a public operating company.

The REITs must live under very precise rules regarding their sources of income and how their assets are deployed. In summary, seventy-five percent of their gross income must come from rental income or sale of stocks in other REITs. Another fifteen percent must come from rents, dividend interest, or sale of stocks. Furthermore, not more than thirty percent of their income can come from capital gains from assets held less than four years. Short term capital gains are those that are held less than six months. Long term are held from six months to four years. Property held for more than four years does not have any restrictions. The IRS, thus, defines a special class of long term capital gains just for the REITs.

Additional features of acceptable income peculiar to the REITs include the definition of active versus passive. Rental income must be passive and the REIT and its tenant can not be partners in an operating business. The tenant must be a tenant only, and the REIT is to be a landlord. This rule is meant to prevent the REITs from establishing subsidiaries as tenants and vice versa. But

the passive nature becomes obscure when the REITs invest in construction and development projects. The decisions of what capital improvements to fund are made by these REITs on a daily basis, making the REIT de facto very much like a developer, hardly a passive role if there was one.

Further restrictions on REITs include the limits on where their assets are invested. For example, not more than twenty-five percent of their assets can be in any stock and the trust cannot hold more than ten percent of the shares of any company. Both of these restrictions seem acceptable on the surface. They are intended to ensure the trusts stay in their legislated business and that their position be passive. But a closer look reveals that these limitations can have a major impact on a REIT when either the economy or some of their specific investments go sour. For example, if the REIT had an acceptable twenty-five percent of its assets devoted to stocks but some of its real estate mortgages or properties failed, then the percentage of its assets invested in stocks would by default increase past the legal limit. Similarly, the REIT could hold ten percent of the stock of a company that eventually had to file for Chapter XI. In the process of reorganization, the REIT could find itself owning more than 10%, thus jeopardizing its own tax status. These regulations, then, work when times are good. But when times were bad, as they were in the mid-seventies, the REITs were forced to interpret liberally the many rules and in the process abuse them.

Not all REITs are alike, though. There are three main types. The earliest REITs were *equity trusts*. These entities buy real estate and hold it as an investment. By and large, these REITs are debt free. The REITs' assets are invested in income-producing apartments, shopping centers and other rental properties. Management of the property is undertaken by the REIT's advisor.

During the heyday of the REITs, these trusts performed strongly but only half as strongly as the other forms of REITs, as measured by the stock market prices of their shares. During the precipitous decline of the mid-seventies, these REITs held their value reasonably well and most have survived.

The *mortgage trusts* are divided into short term and long term. These two types of trusts act like banks and finance real estate projects. They make their profits by borrowing cheaply and lending at a higher rate of return. Borrowing can be in the form of selling equity or debt issues or directly borrowing money from commercial banks. While some of the REITs were long term mortgage lenders, the fastest growing sector of the REIT industry invested in short term, construction and development loans. They did this in part because it was most profitable. It was so because the risks during construction and development are higher. When the economy took a deep dive, these were the real estate projects that were hit first and hardest. The second, and perhaps dominant reason the REITs invested so heavily in short term, high yielding mortgages was they were forced to do so in order to compete with other financial institutions for profits and investors.

The REITs got off to a slow start in the early to mid sixties. Inflation was increasing and the relatively fixed income from the REITs' properties provided a decent if not eye-catching rate of return. The REITs were dependable in their earnings and there were no noticeable trust failures.

By 1968, REITs had barely reached ten figures in their total assets. Soon some of the larger REITs, especially the ones sponsored by commercial banks, began experimenting with more speculative, shorter term mortgages. This was the beginning of the rise, and even more dramatically the fall, of the REITs. The riskiness of these REITs was compounded by their growing tendency to

leverage to the hilt.

First they leveraged equity, then they leveraged debt, then they began repeated cycles of debt-equity leveraging. In a matter of ten short years, these "passive" trusts became masters of exploiting a complex strategy of finance. This required keeping a very fast series of financing events moving forward. Namely, the REITs raised equity by having high yielding returns on their debt. This new equity enabled further rounds of debt to be issued, and so on. All would have been fine if the assets behind the equity and the borrowers making payments on the mortgages were solid. But in fact they weren't. Many of the REIT's mortgages went into default during the mid-seventies. The REITs were making loans at very high interest rates. Unfortunately, the projects that had the highest carrying costs were the first to suffer in the economic crisis. These high interest paying projects were the bulk of the REITs' portfolios. The REITs had no choice. Because they were new and had no track record, the REITs had a higher cost of capital than their competitors and thus were forced to look for higher yielding albeit riskier projects.

Exacerbating the problem was the fact that the REITs had all of their investments in real estate. So, unlike commercial banks that had a diversified portfolio of loans, REITs were narrowly positioned and in the highest risk portion of the real estate business at that. This was hardly the secure and profitable investment vehicle that Congress had intended for the "small guy."

The other major goal of Congress was to attract significant new funds into real estate. However, little thought was given to the role the REITs would play within the set of institutions already committed to real estate. The REITs had to compete with many established institutions, most of which had stable, lower cost sources of capital.

Despite this early REITs were in fact reasonably successful. Their profits were substantial and therefore the dividends they were required by law to distribute were hefty. In fact, during the early seventies when wage and price freezes were initiated causing most stock prices to fall, the REITs were the stars of Wall Street because they were forced to pay out ninety-five percent of their income as dividends.

There were, however, many factors which led to the demise of the REITs. The most obvious one, the lack of regulation, has been noted. The scholarly focus on regulatory inadequacies may be a result of the fact that the REITs have often been compared to mutual funds, and indeed there are many similarities. These mutual funds are among the most highly regulated of entities while the REITs are the least regulated of institutions. This paper describes other aspects of the problems with the REITs, the decline of the REITs by 1974 and the re-emergence of the REITs through 1985, the year of their comeback.

Chapter 2

The Test

Under the REITS Act–specifically, Section 856 of the Internal Revenue Code–the rules governing tax exemption are so strict and so tortuous that the costs of qualifying can exceed the benefits. The effort and attention required to live up to ambiguous and often contradictory restrictions and regulations –compounded by the seemingly purposeful obfuscation of the rules by the Internal Revenue Service–probably have contributed significantly to the ultimate collapse of the REITs.[1]

Not the least of the REITs' difficulties have stemmed from the requirement of the Act that they behave very much like corporations and, at the same time, very differently. On the one hand, the rules insist that REITs share with corporations several of the latter's most salient characteristics. Like corporations, REITs are to have associates; to stay in business for an extended time; to have centralized management structures and systems; to be liable for their property; to exist for the purpose of doing business and dividing the profits; and to have ownership represented by freely transferrable shares.

This transferrable beneficial interest in the trust is to be divided among at least 100 people, says the Act[2]; except that the trustees might decide not to transfer shares in order to meet some other qualification for recognition as

[1]This chapter draws heavily on the IRS rulings on REITs which are encoded in I.R.C. Sec. 856-858.

[2]IRC Sec. 856(a)(2), (5).

a REIT.[3] This exception is itself qualified, however, by the law's admonition that, in order to avoid classification as a personal holding company, a REIT must not be more than 50 percent owned, directly or indirectly, by five or fewer shareholders.[4]

On the other hand, according to the Act, if a REIT looks or acts too much like a corporation, it will be treated as a corporation for tax purposes. To avoid corporation status, the REIT should be unincorporated, and its management should be the responsibility of one or more trustees with sole responsibility for running the trust's business and for the disposition of its property.[5]

The Act makes a crucial distinction between the shares of a trust and the common stock of a corporation. Initially, at least, the basis for the distinction seems clear enough from the language of the Act itself: "In general, a trust means an unincorporated trust...the beneficial ownership of which is evidenced by transferable certificates of beneficial interest." Although there seems little possibility of an individual shareholder being held liable for a trust's obligations, the possibility is not explicitly excluded by the language of the Act in Section 1.876. It is possible, though by no means guaranteed, that shareholders are protected against individual liability by the requirement that REIT shares, like all transferrable shares, must be registered as securities.

On top of all these definitions and distinctions, the REIT Act piles layer upon layer of rules, regulations, prescriptions, and stipulations. The would-be realty trust is told what sources it can earn income from; what kinds of assets it can own, and how much of each; and the derivation of the rents it can collect. In

[3]IRC §1.856-1(2).

[4]IRC §856(a)(b); Reg. §1.856-1(a)(5).

[5]I.R.C. §856(a), 856 (a)(1), 856(d)(i).

almost every area in which the Act specifies and defines, however, the Act also creates complexity, confusion, ambiguity, and contradiction; contributing finally to the failure of many REITs and the inadvertent stunting of what promised to be a significant and vigorous segment of the real-estate industry.

Of a REIT's gross income, for example, the Act specifies that only 10 percent may come from unspecified sources. Fully 75 percent of the gross must represent rental income; gains from the sale or other disposition of stock in other REITs; and tax abatements and refunds. Another 15 percent must come from dividend interest; profits from the sale of stocks, other securities, and real property; and rents from real property.[6] The IRS, under the Act, requires a trust to distribute at least 95 percent of its ordinary net income.[7]

In the total profits of a realty trust, capital gains are a major, even a dominant, factor. The realization of capital gains can be used as an index to the REIT's success; indeed, some REIT investment advisors peg their remuneration to a percentage of capital gains.

The REIT Act makes important distinctions among different kinds of capital gains. The Act's Sections 1.856(c)(4)(A) and (B) define an overall limit on capital gains of 30 percent of gross income. The limit can be earned from two kinds of capital gains: short-term gains from the sale of stocks or other securities owned for less than six months; and long-term gains on real property owned for less than four years. While requiring 95 percent of the trusts' ordinary net income to be distributed, the Act makes no stipulation about the distribution of net long-term capital gains.

In calculating capital gains, the full value of the property–its total sale price,

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[6] IRC §856(c).

[7] IRC §57(a)(1) required distribution of 90%, but this has been increased to 95%.

not only the excess of sale price over cost–is counted. In effect, therefore, the Act makes it disadvantageous for a REIT to sell income property it has held for less than four years.

REITs are strictly limited by the Act in the interest they can charge borrowers. Section 1.856-2(c)(2)(h) specifically prohibits "usurious or illegal interest, or fees imposed upon borrowers which are in fact a charge for services in addition to the charge for borrowed money...[which]...shall not be included as interest." The allusion to usurious interest became important in 1969 and 1970, as interest rates everywhere rose to levels that were defined as usurious by many state laws. In California, for example, the usury laws allowed commercial banks and other financial corporations to charge interest rates of ten percent and more, while REITs, like individuals and certain other entities, could not. An attempt to put REITs on an equal footing with competing lenders by means of an amendment to the California constitution was defeated in November 1970.

"Where a mortgage comes from both real and other property," the Act continues, "an apportionment of interest income must be made for the purposes of the 75 percent requirement." The need to allocate interest income is especially difficult for the many trusts with investments in such special properties as motels, hotels, hospitals, and nursing homes, for which mortgage loans customarily cover the costs of very expensive fixtures and equipment along with the costs of land and actual construction, without differentiating between the two. In order to comply with the interest-income provisions of the Act, most trusts investing in or making loans to these kinds of properties restrict their interests to the bricks-and-mortar portion of the total cost.

Rental income[8] is especially perilous for any REIT whose ancillary income

[8] IRC Sec. 856 (c)(5).

approaches the statutory limit of 10 percent of gross income.

The rules governing REITs' rental income are among the most complicated in the Act. The crucial distinction in the eyes of the law between permissible and forbidden rental income is that permissible rental income has to be "passive". The "passive income" requirement was intended by Congress to make it impossible for a REIT to set up a tenant subsidiary corporation or to have any substantial business affiliation with its own tenants. The law deems rental income to be passive if it meets two criteria:[9]

1. The amount of the rental income received by the REIT must be completely independent of the income or the profits that the real estate yields to its tenant. Nevertheless, the rule permited rentals to be pegged to a fixed percentage of receipts or sales. In addition, a lease is permitted to use differing bases to calculate rents for different departments or floors of a retail establishment, providing that the percentages are stipulated when the lease becomes effective. The same Committee report also allows the gross receipts on which rents are to be based to be adjusted for taxes paid, merchandise returned for credit, and similar items.

2. Rental income is not considered passive if it is collected from a corporation of which the REIT owns either 10 percent or more of its voting shares, or 10 percent or more of its total shares. Passive rents also do not include rents from any type of tenant in whose assets or net profits the REIT owns a 10 percent or greater interest.

The Act provides that at least 75 percent of a REIT's total assets should be in the form of real property; cash and other liquid assets, such as receivables;

[9] IRC Sec. 856(d).

and government securities.[10] Receivables included among the REIT's assets, the law specifies, must be derived from the trust's own ordinary operations, not simply bought from another person or institution.

The Act's restrictions on 75 percent of the REIT's assets are a potential cause of inadvertent errors that might make a trust liable to disqualification. A trust might be disqualified, for example, simply for holding in its securities portfolio stocks whose market value comes to exceed 25 percent of the trust's total asset value, regardless of the stocks' book value or the percentage of assets they represented when they were purchased. Under the Act, stocks are assessed at market value, while a good-faith estimate is sufficient for untraded securities and other assets.

The nature of the assets that make up the other 25 percent of a trust's total, the law allows, is not restricted. Nevertheless, the unrestricted 25 percent can only include securities whose value totals no more than 5 percent of the total assets of the trust, while representing less than 10 percent of the outstanding voting shares of any single stock issue.

In order to avoid running afoul of the Act's "10 percent prohibition," most trusts restrict their equity participations to such non-voting securities as warrants, convertible debentures, or even convertible preferred shares. Nevertheless, because many of their investments have been in public entities, whose near-equity interests are closer to the market–and to a market value–than the trusts realize, many REITs have inadvertently risked disqualification on this score. Some trusts have owned warrants and convertibles representing a high percent ownership of the borrower if they were exercised.

The 10 percent-equity restriction can also inhibit trusts from protecting

[10]IRC Sec. 856 (c)(5).

themselves if a borrower seems headed for bankruptcy. In such an event, prudence and normal business practice dictate that the trust take all appropriate steps–including the exercise of its warrants and other convertible interests–to protect its investment. Such a step would be costly, however, if it would give the trust more than 10 percent ownership of the borrower's voting stock, automatically disqualifying the trust under the REIT Act. The REIT's only course of action in these circumstances would be to dispose of the offending shares by the end of the quarter, possibly at a disadvantage, although buyers at such a distress sale might be hard to find.

Even under more favorable circumstances, the 10 percent rule puts the REIT at a disadvantage in the equity market. If the trust cannot come to the end of a quarter owning more than 10 percent of the voting shares of any entity, then even warrants or convertible debentures representing more than 10 percent equity must be sold without being converted. The trust's only other course is to convert or exercise its interest gradually, selling its interest at a rate that maintains its holdings of voting shares under the limit. In any event, if the trust incurs disqualification for exceeding the 10 percent limit at the end of a quarter, it has 30 days' grace to correct its position.

The Act's requirement that a trust's assets pass muster at the end of each quarter can make trouble for trusts that are involved in sizeable private placements or underwritings, which yield large lump-sum payments. In the case of private placements, the trust can usually spread the flow of proceeds over enough time to allow them to be safely invested in qualifying assets; but the proceeds from underwritings are invariably paid at one time, creating potential difficulties.

Most trusts are careful to schedule secondary offerings to coincide with the

retirement of bank borrowings, thus absorbing the proceeds of the offering without changing the trust's asset picture. Trusts may have problems, nevertheless, with the proceeds from large issues of warrants. Since the trust cannot effectively determine when warrants will be exercised and when the proceeds will be paid, a trust may be overwhelmed by a massive exercise of warrants as their expiration date nears.

The REIT Act also considers the special case of a trust that owns an asset in partnership. " In the case of a real estate investment trust which is a partner in a partnership," says the Act, "the trust will be deemed to own its proportionate share of each of the assets of the partnership...." The Act also makes the trust in such a case entitled to its proportionate share of the partnership's income.

This section of the Act gives a REIT the advantages of the partnerships, joint ventures, and other shared investments common in real estate. It also puts the REIT in jeopardy, however, if the partnership should sell property in the ordinary course of business. In that case, the trust will also be seen by the IRS as selling property, a clear infraction of the REIT Act, punishable by loss of REIT tax status.

In regard to income taxation, the law treats REITs and their beneficiaries in very much the same way that it treats mutual funds and their shareholders. The special tax treatment of REITs is detailed in Section 857 of the Act. According to its terms, REITs calculate their taxes exactly as though they were ordinary corporations, then adjust their earnings according to the special guidelines established by the law.

First, from their total earnings, REITs are entitled to subtract their net long-term capital gains, as well as any dividends they have received from other corporations. REITs are not, however, entitled to carry forward losses incurred

in previous tax years to offset current profits. The Act further states:

1. Taxable income does not include any excess of net long-term capital gains over net short-term capital losses; but,

2. Taxable income does include any partially tax-exempt interest on United States government obligations.

3. If a REIT claims a deduction for more than 95 percent of its ordinary net income paid out in the form of dividends to its beneficiaries, the undistributed balance of its ordinary net income is taxable at the rates applicable to corporations; while the distributed dividends will be taxed as ordinary net income to the beneficiaries, without deductions, credits, or exclusions.

4. Any or all of a trust's long-term capital gains, on the other hand, can be distributed and designated as such to the beneficiaries without losing their favored tax status. Net long-term capital gains that are not distributed by the trust to its beneficiaries are subject to a 25 percent tax rate.

5. The REIT regulations include specific qualifications for income to be treated as long-term capital gains. If the real property in question is sold at a profit after it has been owned by the trust for more than six months but less than four years, then the profit is taxable as a long-term gain according to Section 1231 of the Internal Revenue Code. If that same profit, combined with the REIT's other profits from the sale or transfer of securities held for less than six months, totals 30 percent or more of the REIT's gross income, however, the long-term capital gain will be taxed as ordinary income under Section 856(c)(4).

The issue of "passivity" as a qualification for REIT status raises persistent questions and difficulties. According to the Act, a trust is passive if it "...does not hold property primarily for sale to its customers in the ordinary course of business."[11] Subsequent IRS rulings have confirmed that the intention of this rule is to require trusts to hold property for investment purposes.

Confusion arises, however, in the case of so-called "development trusts," which are specifically organized to purchase raw land and add improvements–buildings, for example–that produce income for the trust. Such purposeful and potentially profitable activity certainly appears more "active" than "passive"; nevertheless, the regulations permit trusts to develop and to construct while remaining passive in the eyes of the IRS.

The powers of REIT trustees, detailed in Section 1.856-4(b), also do not apparently accord with the image of the trust as a "passive" entity. Among the activities permitted to the Trustees, according to the Act, along with setting rents and making leases, is the expenditure of capital to improve trust property. Thus the trustees can buy unimproved property and have it developed through the trust, all without causing the trust to lose its "passive" status in the eyes of the IRS. Such blurring of distinctions by the IRS, operating under the terms of the REIT Act, has done little to make the task of trusts, also subject to the Act and the IRS, any easier.

Similarly, trusts are barred by the terms of the Act from subdividing their property for wholesale or retail resale. A difficulty arises, however, in the case of mortgage trusts that sell participations in their loans to other trusts. Such sales of mortgage interests seem to risk violating the prohibition against resale. REITs engaging in these types of interest transfers have usually taken pains,

[11]IRC Sec. 856(a)(4), (1976).

therefore, to establish that the sales were justified by valid considerations other than profit, such as the need to repay existing loans or to build cash reserves to back new borrowing.

A variety of other justifications have also been offered for the sale of mortgage loan participations by REITs. Such sales are vital as controls on the flow of investment funds, it is suggested; or as a way for trusts to participate in investment opportunities that would ordinarily be denied them under the terms of their charters; or as a means of prudent, risk-reducing diversification. In other instances, the IRS has agreed that a REIT is not violating the prohibition against holding property for sale when it grants a tenant an option to buy, providing such an option is incidental to a lease and standard practice in the area. Nor is it a violation of the law for a REIT to resell property on which it has foreclosed a mortgage loan, in which case, it is argued, the acquisition of the property by the trust is involuntary and its resale is only an incidental adjunct to the trust's main business.

It is not sufficient merely for a trust to conform to all these IRS strictures in order to qualify as a REIT for tax purposes: the trust must explicitly seek the tax treatment to which it has become entitled. Once a trust has filed for REIT status, moreover, it can never change its mind; according to the rules, the choice of REIT status is irrevocable. Trusts that incur operating losses, therefore, sometimes file for tax treatment as corporations, which can carry losses forward to offset future profits, while REITs cannot. Even after a REIT's favored tax status has been requested and granted, however, it can be revoked at any time by the IRS for violations of the Act.

For a trust, therefore, it is extremely important to be scrupulous in observance of the IRS regulations established under the REIT Act. The consequences

of disqualification are severe. If a trust loses its REIT status it becomes immediately subject to full taxation as an ordinary corporation; and the corporate levy will fall after the trust will already have paid out the statutory 95 percent of its earnings to its beneficiaries. The corporate tax would be, in effect, subtracted from the capital of the trust. The REIT industry has persistently argued for an amendment to the regulations that would give them a grace period to correct alleged deficiencies; or that would impose the increased tax on only the defective portion of their income. So far, however, the industry has petitioned in vain.

Chapter 3

The Structure

For a would-be sponsor–a bank, perhaps, or an insurance company, or some other organization, inside or outside the real-estate business–the first step toward establishing a REIT is to draw up a Declaration of Trust for submission to the prospective underwriters and the appropriate government agencies. The Declaration of Trust defines the REIT: it establishes the policies it will follow, and the legal and financial terms under which it will exist and operate. The Declaration also specifies the respective rights and responsibilities of the trustees, the financial advisors, and the shareholders. The trustees and advisors are named in the Declaration, subject to the decisions of the shareholders at the first annual meeting.

Once the REIT is established under the Declaration of Trust, the trustees wield the ultimate power over all property investments and other business activities. Indeed, according to the law the trustees can run the REIT with much the same discretion as they would enjoy if it were their personal property. In fact, the trustees do own the trust's property, holding legal title as joint tenants during their individual terms as trustees.

In practice, of course, the very extent of the trustees' powers, prerogatives, and responsibilities makes it impractical for them to operate unassisted. Once the REIT has been set up, most of its management revolves upon the staff. Similarly, many routine investment and other business functions are ordinarily

entrusted to the financial advisor, subject to policies set by the trustees and to the trustees final review. Ultimate responsibility for investment decisions belongs solely to the trustees under the terms of the Declaration of Trust. The trustees may, if they choose, name two or more of their number to an investment committee; but the responsibility for approving transactions may not be delegated by the trustees to any other party.

Most Declarations specify certain minimum requirements for trustees; typically, they must be "not less than 21" years of age, for example, and "of the highest character and integrity." In practice, trustees are usually recruited from the ranks of established real-estate professionals.

The number of trustees–or sometimes a minimum and a maximum number–is fixed in the original Declaration, subject to subsequent amendment. The initial trustees named by the sponsor in the Declaration may be retained by the shareholders at the first annual meeting or replaced. Trustees are elected by a two-thirds vote of the shareholders; a simple majority of the shareholders, at an annual meeting or any special meeting, is sufficient to remove a trustee. All trustees' terms end at each annual meeting. In the period between meetings, the trustees, by majority vote, are empowered to remove sitting trustees, or to elect new trustees to fill vacancies created by death, removal, resignation, or enlargement of the board. Trustees are not required to be stockholders.

To carry on the trust's regular and ordinary business, the trustees elect such officers as they deem necessary and fix their salaries. The trustees also vote on their own compensation, which may include not only their fees, plus any expenses they may incur in connection with their responsibilities, but also such "fringe" benefits or perquisites as free use of recreational property or other facilities belonging to the REIT.

Being trustee of a REIT is not usually a full-time job. Demands on the trustees' time are hardly severe: meetings are held at specified intervals, and the dates are set well in advance. The investment committee, which makes investment decisions subject to ratification by a majority of the board, meets more often than the full board. Committee meetings can be informal, however, and at the members' mutual convenience.

Trustees are permitted to maintain control of their own businesses. Because trustees are often recruited specifically for their experience and demonstrated competence in business areas similar to the REIT's, their own business is likely to be in this area as well. In theory, continuing in their own businesses maintains the trustees' competence, increasing their value as trustees to the REIT.

Once a trustee has been elected by the shareholders, his authority can be neither curtailed or appealed during his term in office. Dissatisfied shareholders have no real control over the trustees short of voting for alternative candidates at the next annual meeting. Trustees are protected against personal liability for their conduct of the REIT's affairs, unless they are found guilty of willful malfeasance, gross negligence, or disregard of their duties in their conduct of the REIT's business.

Shareholders are entitled to quarterly and annual financial reports to keep them abreast of the REIT's progress. Ordinarily, however, shareholders play only a passive role in the business activities of the trust. Their influence is felt mainly at the annual meetings, which are held on dates set by the trustees; or at special meetings, which are called by the trustees or by shareholders representing a specified minimum number of shares, usually a significant fraction of all the shares outstanding. Although the shareholders can act at the meetings to amend the Declaration, even to vote the trust out of business entirely, they usually do

nothing more than ratify the slate of trustees put forward by the sitting board.

It is the financial advisor who actually operates the REIT. In addition to administering the trust's day-to-day investment activities, the advisor consults with the trustees on overall investment and business policy and makes specific investment recommendations. The advisor also negotiates with lawyers, accountants, builders, developers, and other contractors for the various services required by the REIT; and oversees the performance of all contracts.

The terms of the advisor's relationship to the REIT and its trustees are defined in a formal Advisory Agreement. The advisor's compensation, set by the trustees, can take a variety of forms. In addition to payment for ordinary advisory services to the REIT, the advisor is normally entitled by contract to various service fees for such functions as loan closings, registrations, and others. Like the trustees in their sphere, the advisor enjoys a great deal of autonomy in the operation of the trust. Under the terms of the Advisory Agreement, the advisor is legally liable only for acts of bad faith, malfeasance, gross negligence, or disregard of duties.

This seemingly straightforward working relationship is complicated in practice by various commonalities of interest between the advisory organization and the REIT's sponsor organization. In a strict legal sense, all connection between the sponsor and the REIT is dissolved at the moment the REIT is established as an independent entity under its own Declaration of Trust. In fact, however, it is common for the two organizations to remain closely related through overlapping ownership and management, creating the possibility of conflicts of interest, especially when–as is often the case–the sponsor and the advisory organization have overlapping business interests in addition to the REIT. In an effort to limit abuses, the Midwest Securities Commissioners Association's so-called "blue sky"

rulings require that a majority of a REIT's trustees be "unaffiliated" with the trust's sponsor or its financial advisor.

Diagram 1 (following page) illustrates the organizational structure of a typical REIT, PNB Mortgage and Realty Investors, which was established in October 1970. The diagram follows the trust's 1973 prospectus. PNB Mortgage and Realty Investors was a creation of Colonial Mortgage Service Company (Colonial), then one of the largest mortgage banking companies in the country. Colonial is a wholly owned subsidiary of the Philadelphia National Bank (PNB), which is itself a subsidiary of a one-bank holding company called the Philadelphia National Corporation (PNC). The trust gets its investment advice from Colonial Advisors, Inc., which is a subsidiary of the same Colonial that sponsored the REIT in the first place. Colonial Advisors gets legal services from Morgan, Lewis & Coekuis and accounting services from Arthur Young & Company.

PNB Mortgage and Realty Investors has 4,767 shareholders. Of the eight trustees, five can be considered independent; each of the other three is affiliated in some way with the various organizations involved in establishing, advising, and running the REIT. The chairman of the REIT is also one of its trustees; and also the chairman, president, and chief operating officer of both the Philadelphia National Bank and the Philadelphia National Corporation. The REIT's president is another of its trustees, while serving as president and CEO of Colonial Mortgage Service Company, the REIT's sponsor. A third trustee of the REIT serves also as a director on the boards of both PNC and PNB.

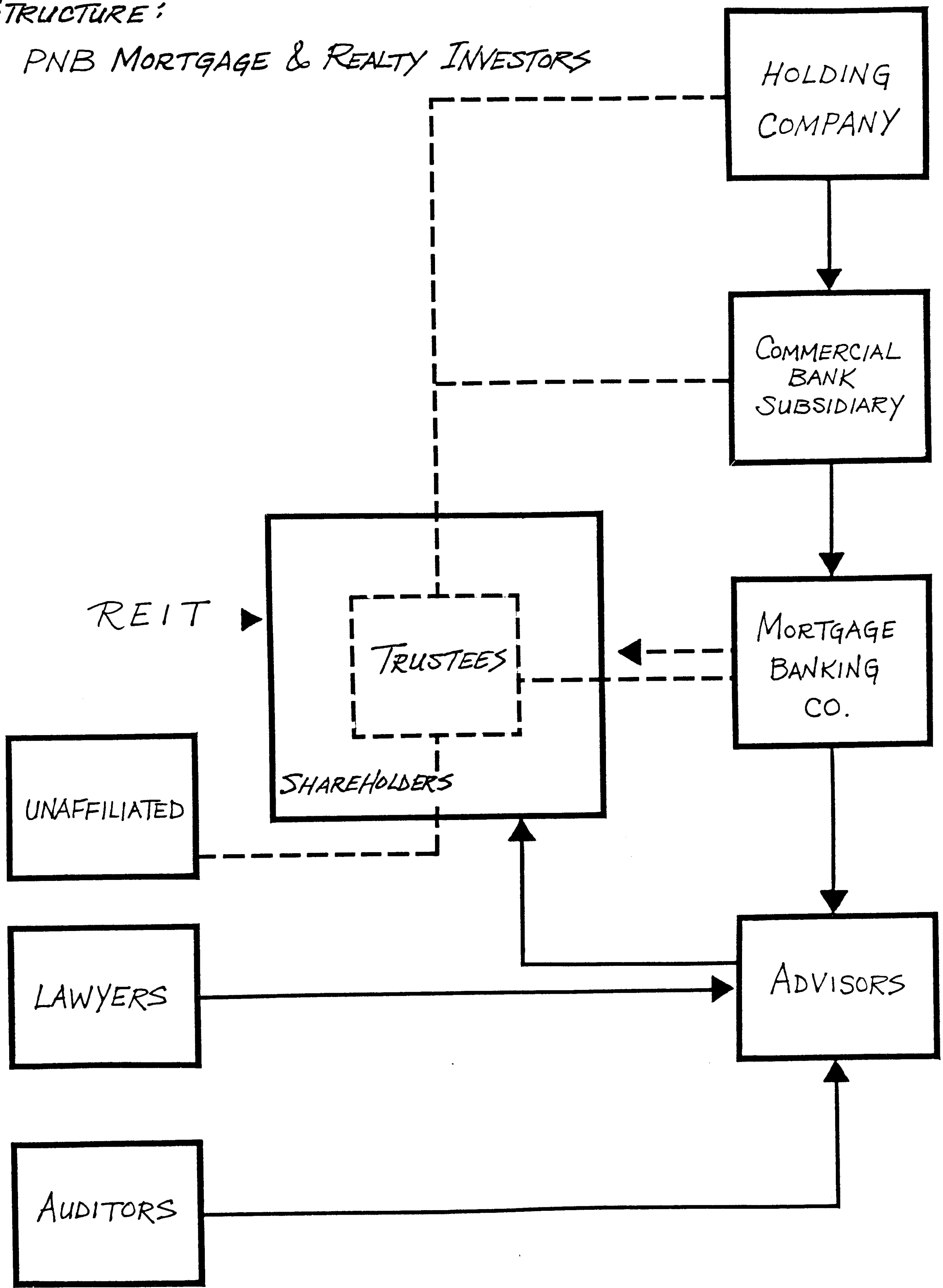
Among the five independent trustees are the head of a real-estate service company, the president of a savings bank, the head of an insurance company, an attorney who was formerly head of an insurance company, and the vice-president

of a regional merchandising corporation. The trust's secretary and treasurer also have positions in the sponsoring company, in the bank that owns the sponsoring company, and in the advisory company that serves the trust.

In such a Byzantine maze of interconnections, the possibilities for conflicts of interest and attendant abuses are obvious, virtually limitless–and perhaps unavoidable. The REIT's financial advisor, Colonial Advisors, is a subsidiary of the Pennsylvania National Bank; a number of the REIT's trustees also have direct or indirect connections–sometimes both–with the bank. The REIT, therefore, will be in direct competition with its own advisors and the bank for investment opportunities and other business advantages. Colonial Advisors, meanwhile, may have other clients that are in direct competition with the trust, which therefore cannot be assured of its advisors' best advice.

Even independent trustees may well have personal real-estate interests that run counter to or compete with those of the trust. In the Colonial case, the REIT's law firm, which counsels the advisory firm on the REIT's affairs while also serving the advisory firm in its outside operations, cannot help but be torn between two masters whose interests do not necessarily coincide. With such fundamental, inherent conflicts of interest built into the structure of the REIT, its shareholders risk having their interests ill-served and being virtually powerless to act effectively in their own behalf.

DIAGRAM 1



Chapter 4

The Strategy

In general, REITs concentrate their capital in three types of real-estate investments: short-term mortgage loans; long-term mortgage loans; and ownership of real property. A particular REIT may devote itself solely or mostly to one type of investment; or it may diversify its investments among two or three types. The language used to define investment policy in Declarations of Trust is intentionally general enough to allow broad latitude to the trust's financial advisors, managers, and trustees.

Realty trusts that concentrate on short-term mortgages are known in the business as "C and D REITS" because short-term mortgages are almost invariably "construction and development" loans. Such loans, with terms that may be as brief as a year or less and are rarely longer than three years, are sought by real-estate developers to support the early phases of their projects.

In such a situation, the borrower may begin with only a small development loan to prepare the site for construction. The site itself serves as the primary collateral for the development loan, which is usually made by a REIT in the expectation of following it with a second loan to cover the construction phase of the project.

The second loan's maturity is calculated to coincide with the completion of construction, when the outstanding balance will be paid out of the proceeds of a new, long-term loan. The source of this long-term mortgage–called a "take-out"

in the trade–may be a life-insurance company, a savings-and-loan association, a pension fund, or another traditional financing institution; or a REIT dealing in long-term mortgage investments.

The REIT making a construction loan takes a first mortgage on the site or the improvements, or both, as collateral. In addition, in order to protect itself against the possibility of losing its investment in the event the developer goes bankrupt, the REIT usually takes prudent steps to insure that the full amount of the construction loan is spent on the project, according to the plans that provided the original basis for the loan.

One precaution usually taken by the REIT is to release the loan amount in installments, either periodically or as landmarks in the work are achieved. If disbursements are scheduled at regular intervals, their amount is usually limited to the actual costs incurred during the preceding period. The REIT usually requires an inspection to certify that the work is on schedule and up to standards before making a disbursement. The careful REIT will also audit the borrower's books to make sure that subcontractors and suppliers are actually being paid as reported.

REITs sponsored by commercial banks were the first to get involved in construction and development loans. After a slow start in the 1960s, short-term mortgage lending by REITs expanded very rapidly. By mid-1971, as Table 1 illustrates, the C and D REITs boasted assets of $3.3 billion–55.5 percent of all REIT assets. Of a total of 113 REITs in operation at that time, 51, or 45 percent, were involved in short-term mortgage loans.

As popular as they quickly became, however, these short-term loans–and the REITs that rushed to make them–also were soon to prove vulnerable to sudden, catastrophic failures. The riskiness of short-term mortgages was anticipated in

the rates of return they offered. In 1970 and 1971, while the prime rate was still about 6 percent, C and D loans were yielding as much as 16 percent–more than 2.5 times the prime.

Long-term mortgages, usually on apartment or commercial real estate, mature in fifteen to thirty years. Such conventional loans never attracted the same interest from REITs as the short-term loans did. The 18 long-term-mortgage REITs in business in 1971 held assets totaling $1.2 billion, only 19.5 percent of all REIT assets.

REITs that specialize in long-term financing often invest also in short-term mortgages. In some cases, the short-term development and construction loans can later be converted directly into long-term, permanent mortgages. Meanwhile, the higher interest rates on short-term loans also offer the advantage of increasing the trust's return to its shareholders.

Equity REITs specialize in the actual ownership of real property–office buildings, for example, or shopping centers, or apartment houses, or just vacant land. The real property may be mortgaged or otherwise encumbered. The ownership may even be in the form of a purchase-leaseback arrangement on the land under a building that the REIT does not own. Whatever the status of its equity, however, the REIT derives rental income from the property.

A REIT can acquire equity interest in any of several ways. A property may simply be bought outright, for cash; or acquired in an exchange of money plus stock. A trust may also accept an equity interest–an "equity kicker" in the parlance of the trade–in a piece of real estate as an inducement to make a mortgage loan to the principal owner. In other cases, a REIT may become the owner of a property through foreclosure on a bad loan or enforcement of a lien. The trust may also buy property for future development in a joint venture, often

with an established builder or developer as the other partner.

In 1971, as Table 1 illustrates, equity REITs owned 23.6 percent of all REIT assets–some $1.253 billion of a total $6.136 billion. Of the 113 trusts in operation, 38 were primarily engaged in owning real property. If the equity holdings of those trusts primarily interested in short- and long-term mortgages were included, the total equity ownership by REITs would be almost doubled.

In addition to the three major forms of REIT investment, two other kinds of loans are significant factors in trust assets. A special-purpose, short- or intermediate-term loan called a "first mortgage on implemented properties" is sometimes sought by a developer who hopes that a successful operating history, however brief, will improve a project's chances for long-term mortgage financing. A REIT may also offer this type of loan as a temporary help to a developer who is having trouble obtaining regular, long-term mortgage financing to pay off a construction loan. In any case, such mortgages usually have terms of less than ten years, and they are not amortized during their term.

A small number of REITs specialize in junior, or second, mortgages, which represent only a small fraction of total lending. Second mortgages are sometimes useful as "wraparound mortgages" in the refinancing of an existing building.

Instead of specializing in one or another type of activity, many REITs elect an eclectic, or hybrid investment approach, spreading their capital among short-term C and D loans, long-term mortgage loans, and equity participations. To the extent that a reverse in one type of investment would not be felt by a REIT's other investments, such diversification would tend to increase the strength and resiliency of the individual REIT and, by the same token, of the REIT industry.

A rise in interest rates might that would depress investments in mortgages, for example, might have little effect on equity investments; while changing demo-

graphic patterns and competitive pressures would have more immediate impact on an equity investment's return from rentals than on the interest income from long-term mortgages. Diversification, both by individual REITs and by the industry, thus worked to counter the problems that soon arose.

TABLE 1
ASSETS OF REALTY TRUSTS - MID-1971
GROUP SUMMARY

Trust Category	No. of Trusts	Assets (Millions $)
Short-Term Mortgage		
Independent	10	$ 916
Mortgage Banker	17	703
Commercial Bank	14	1,709
Miscellaneous Financial	10	578
SUBTOTAL	51	$3,276
Equity	38	1,253
Mortgage, Intermediate	3	238
Mortgage, Long-Term	18	1,189
Private	3	180
TOTALS	113	$6,136

Source: Realty Trust Review, Audit Investment Research, Inc., New York, August 16, 1971, p. 4.

Chapter 5

Institutions See An Opportunity

Following passage of the Real Estate Investment Trust Act of 1960, the organization of REITs began at a slow pace. By March 1962, only five trusts made public offerings of $10 million or more. During the next six years, until June 1968, only three major REIT offerings were made to the public. It was clear that the major potential institutional sponsors–banks, insurance companies, and others–were holding back.

The REIT boom began to gain momentum in 1969 and 1970, when 53 new trusts with initial public offerings of more than $10 million came to market, selling a total of almost $2.7 billion worth of shares–more than six times the total sold in the preceding seven years.[Table 1] By the end of the decade, the major institutional sponsors were apparently catching the REIT spirit, and the enthusiasm was quickly picked up by financial conglomerates, real-estate developers, and other independent entrepreneurs.

If the REITs' time seemed to have come quite suddenly after several years of unremarkable activity, it might simply have taken investors that long to realize that REITs were a good thing. Another factor in the sudden attractiveness of the REITs to both sponsors and investors was certainly the onset of a prolonged period of tight money, which created new opportunities for REITs while making traditional forms of real-estate investments less attractive.

Real estate has traditionally been financed by long-term investments, such

as mortgages and other debt instruments, with fixed interest rates–rates that do not change no matter what happens to economic conditions. As the 1960s drew to a close, however, such long-term investments became unattractive. The highest inflation rates in history made lengthy commitments to fixed interest rates risky; while frequent shortages of credit in the nation's money markets made such long-term lending more difficult. As a result, the institutions that supply long-term capital to the real estate industry were sitting on the sidelines.

In the mid-1960s, meanwhile, the success of some pioneering short-term mortgage trusts, or C and D REITs, suggested to both potential REIT sponsors and investors that there was money to be made. Short-term mortgage trusts became popular on Wall Street as "perpetual money-making machines"[1] through the magic of leveraged ownership. As commercial banks began to get involved in REIT sponsorship, they naturally gravitated toward short-term-loan trusts, which are consonant with their traditional areas of operation. Similarly, insurance companies were likely sponsors of long-term mortgage REITs, because of their familiarity with this kind of financing activity.

The first REIT sponsored by a commercial bank was established in 1969; by the middle of 1971 there were 21 more, and nine of the 25 largest banks in the country had either become REIT sponsors or gone into the business of advising others' REITs. Among the REIT-owning banks were Bank of America and Chase Manhattan. REITs affiliated with commercial banks held approximately one-third of the short-term mortgages held by all REITs; their commitment totaled $1 billion(see Table 1, Chap. 4). The bank-connected REITs' domination

[1]The term "perpetual growth machines" is based on successive equity and debt leveraging to increase trust assets. See, for example, H. Stevenson, "What went wrong with REITs?," Harvard Business School, January 1976.

of the short-term mortgage market was due only in part to their traditional experience and expertise in this field. The banks' easy access to lines of short-term bank credit and commercial paper markets also gave them an advantage in this area over REITs without bank connections.

As the traditional source of more than half of the short-term construction financing required by the real-estate industry, commercial banks were natural candidates to sponsor REITs that would carry on this activity. In 1969 and 1970, as money became scarce and the prime rate passed 8 percent on the way up (Table 2), other business borrowers preempted the available loan funds at commercial banks, which were forced to curtail new construction lending or to sell participations in their construction loans to the REITs that were beginning to arrive on the scene.

The latter course, while freeing their loan funds for their business customers, also demonstrated to the banks that REITs were not subject to some of the banking regulations aimed at limiting the expansion of credit. It required only a short leap of imagination for the banks to conclude that by sponsoring REITs themselves, they could hold onto their real-estate borrowers while operating in a relatively regulation-free environment.

It also did not escape the banks' notice that there were fees to be had for the trouble of managing a trust. Since the standard agreement between REITs and their financial advisors pegged the advisors' fees to the trusts' total invested assets, without reference to liabilities, the banks perceived that the fees could be worthwhile indeed. Indeed, the advisory fee became one of the strongest inducements for banks to sponsor REITs.

Table 3 lists the advisory fees, as a percentage of invested assets, paid by REITs with various types of sponsors. Advisory fees typically varied from 0.5

percent to 1.2 percent of the REIT's invested assets. Banks that set up realty trusts with themselves as advisors generally awarded themselves fees ranging from 1.0 to 1.2 percent of assets–at the top end of the range. Almost 25 percent of the bank-sponsored REITs paid advisory fees on a sliding scale, beginning at about 1.0 percent of assets and rising as total assets reached various specified levels. More than 25 percent of the bank-sponsored REITs paid their advisors "special" fees, including incentive payments, in addition to the basic fee. These special fees were pegged to the net capital gains or net profits achieved by the trust, or to some other measure.

As a REIT sponsor, a commercial bank was assured of another profit as the repository of the trust's funds. To the balance maintained in the bank by the REIT, the bank could also add the balances deposited by the REIT's borrowers. For these clients the bank would also anticipate providing additional, profitable financial services, acting as transfer agent, registering the shares of beneficial interest, and providing credit, collection, and accounting. The bank's real estate lending department would keep profitably busy serving the REIT and its borrowers. In tandem with its REIT, the bank could offer real-estate developers appropriate financing for every stage of their projects. No longer would a C and D loan customer have to go elsewhere for a long-term mortgage commitment.

There were other advantages: In the eyes of the Internal Revenue Service, REITs were not affiliates of bank holding companies; the REIT's annual report was not consolidated with the bank's. Any profit the sponsoring bank earned for advising its REIT, therefore, could go straight to the bottom line as profit.

Through a REIT, the bank could make real estate loans without being inhibited by the regulations that limit other lending institutions. REITS, can do

business wherever they can meet local requirements. Banks, on the other hand, are bound by their charters to operate in a specific state or region; S&Ls are limited to a hundred-mile radius of their home offices.

With their ability to range widely in search of investment opportunities in mortgages and equities, REITs can enjoy the stability that comes with diversification. If the real-estate economy of one city or region declines, chances are that some other city or region will offer alternative opportunities to a mobile lender.

By mid-1971, ten life insurance companies had sponsored REITs. Seven of the trusts specialized in equities and long-term mortgages; only three were in short-term C and D loans. Although the seven long-term mortgage REITs sponsored by insurance companies comprised only about 40 percent of all long-term-mortgage trusts, they held 66 percent of the total assets of these trusts. Five of the 25 largest life insurance companies in the country had sponsored REITs; their trusts were among the 11 largest.

Life insurance companies responded to many of the same factors that encouraged banks to form REITs. The scarce money and high interest rates of 1969-1970 forced many policy holders to borrow against their life insurance. At the same time, many of the insurance companies' mortgage borrowers were having difficulty repaying their loans on time. The resulting shortage of conventional funds for long-term real-estate financing encouraged the insurance companies to sponsor REITs as alternative mortgage lenders. Like the banks, insurance companies considering REIT sponsorship had little worry about establishing adequate lines of credit or selling commercial paper in the markets.

Sponsorship of a REIT also afforded the life insurance companies, as it did the banks, a profitable outlet for the efforts of their able and experienced real-

estate-lending staffs, which had been idled by the lack of activity in their sector of the economy. Advising the REITs also earned significant fees for their sponsors.

Sponsorship of REITs was a natural extension of traditional business practice for mortgage bankers, who were the traditional primary sources for real estate financing in the United States. The activities of the mortgage bankers, prior to the debut of the REITs, went far beyond the origination of mortgage loans to include selling and servicing mortgages for life insurance companies, savings banks, savings and loan associations, pension funds, and other institutions.

Because originating and selling mortgage loans are the mortgage bankers' principal reason for existence, their business activity varies directly with the supply of loan funds. The mortgage bankers, therefore, were severely affected by the scarce money and high interest rates in 1969 and 1970.

In such a difficult financial climate, REITs were attractive new sources of investment capital for the mortgage bankers. In addition, REITs enabled them to add a wide range of new services. REITs were able to offer initial short-term loans for land purchase and preparation before construction, and long-term "take-out" loans, if necessary, after the project was built. Mortgage bankers were also attracted to REIT sponsorship by the promise of large advisory fees and efficient employment for their staffs of real-estate and mortgage specialists.

All of the 17 REITs sponsored by mortgage bankers were primarily involved in short-term mortgage loans. This concentration on a single part of the mortgage-lending spectrum enabled the mortgage bankers, despite competition from the giant, full-service commercial banks, to command some 20 percent of the total REIT market for this type of loan. (*see Table 1, Chapter 4*).

In mid-1971, approximately one-half the total number of REITS, and a roughly equal proportion of total REIT assets, were associated with financial

conglomerates, real-estate developers, and other independent sponsors. These independently sponsored REITs took a variety of forms, according to the various motives of their sponsors. Most of the sponsors in this group were attracted to REITs primarily by the potential they saw for earning substantial advisory fees. At the same time, the sponsoring organizations gained the advantage of easy access to REIT financing for their own real-estate projects; and access to the REIT's clients as potential customers for the sponsor's services as well.

The following list illustrates the varieties of REIT sponsorship that emerged during the years of active trust formation, and the purposes the REITs served for their sponsors.

1. Two of the largest REITs active in 1970 were Continental Mortgage Investors and First Mortgage Investors. Both were founded in 1961, soon after the passage of the REIT Act, as prototypical short-term-mortgage trusts. By 1969-1970, however, the sponsors of both trusts organized new REITs to deal in intermediate-term mortgages.

2. Typical of the REITs sponsored by financial conglomerates in 1969 and 1970 were C.I. Mortgage Group and Mortgage Trust of America, both short-term-mortgage trusts, organized by City Investing and Transamerica Corporation respectively; and U.S. Leasing Real Estate Investors, an equity REIT organized by U.S. Leasing International.

3. In the medical field, in 1969, American Medicorp, Inc. sponsored Medical Mortgage Investors as a long-term-mortgage and equity REIT to finance hospitals, nursing homes, and other health-care facilities. Hospital Investors, a long-term-mortgage trust organized in 1971, concentrated on

financing hospitals, clinics for multi-specialty group practices, office buildings for medical tenants, laboratories, and nursing homes.

4. A small,specialized REIT, Hotel Investors, was organized in 1969 for the principal purpose of making long-term mortgage loans to hotels and motels.

5. Mobil Home Communities, set up in 1969, invests in equity financing of mobil home parks.

Before 1968, REITs were a rather small factor in the total mortgage market in the United States. The sudden growth of the trusts' piece of the action between 1968 and 1970 was accounted for by the formation of numerous new REITs that absorbed existing mortgage debt from other lending institutions. The REITs were encouraged to buy into outstanding debts by "blue sky" laws, in effect in some states, requiring them to seek participations in existing mortgages.

Most new REITs bought into outstanding mortgages in the construction-loan portfolios of commercial banks. The growth of REIT assets, therefore, did not qualify as a net increase in outstanding mortgage indebtedness. According to the commercial banks' reports to the Federal Reserve Board, the new REITs may have bought as much as $1 billion of the banks' outstanding real-estate loans.

Largely due to the REITs' substantial and growing positions in both short- and long-term mortgages, the mortgage debt held by commercial banks began to decrease in 1968. Graph 1, showing the portions of total mortgage debt held by various lenders from 1965 to 1970, clearly reflects the scarce-money, high-interest periods in 1966 and 1969-70, when the REITs emerged as significant factors in mortgage markets.

By 1971, REITs were making a fairly substantial portion of the total short-term, C and D loans, supplying some $3.2 billion to the real-estate industry. The REITs' share of this segment of the market was increasing as the REITs made loan commitments in increasing volume, reaching as much as $630 million per month in 1971 and growing fast. As construction activity in 1971 grew to $73.5 billion, with total construction lending amounting to about $40 billion, the REIT's accounted for some 10 percent of the financing–an impressive showing for a new player in an old game.

The REITs' success was not altogether cheering for some oldtime participants in the real-estate business. By mid-1971, for example, some major mortgage brokers were complaining that their business had fallen off by 40 percent or more. The REITs were doing such a thorough job of identifying and making lending opportunities that builders and developers no longer felt the need of brokers to introduce them to potential lenders–the lenders were now coming after them.[2] With the short-term-mortgage REITs out beating the bushes for customers, in effect stimulating both borrowing and lending, the shortage of construction funds that frustrated builders and developers in 1967-1970 was turned into a sufficiency of funds in many areas.

In 1971, in fact, Audit Investment Research, the industry's leading independent research organization, alerted small investors to an imminent glut of funds in the short-term mortgage market and counseled caution to prospective investors in short-term REITs. By this time, after just three years in the field, the short-term REITs had already captured 9-12.5 percent of the United States market in these loans. The REITs' success was widely credited to the shortages

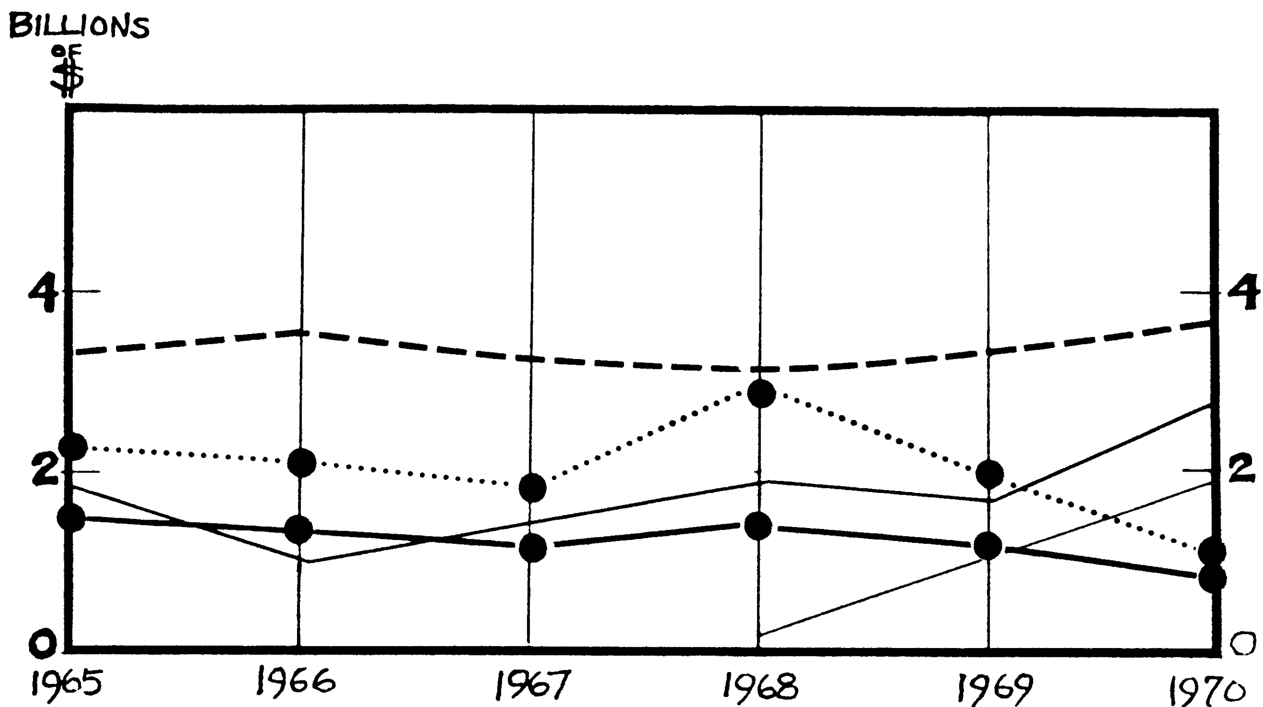
[2]Kenneth Campbell, *The Real Estate Trusts: America's Newest Billionaires*, (New York: Audit Investment Research, Inc., 1971), p.50.

of loan funds felt by the commercial banks. Past experience had demonstrated that bank loan funds are among the earliest pools of money to dry up when money is scarce and the earliest to refill when money is easy. Observers speculated about how the REITs would do when the banks, which paid 3 to 4 percent less than the REITs for their money, were once again flush with funds and looking for loans to make.

GRAPH 1

ANNUAL INCREMENTS IN MORTGAGE DEBT
HELD BY SELECTED INSTITUTIONS

SECURED BY NONFARM MULTIFAMILY & COMMERCIAL PROPERTIES



- - - LIFE INSURANCE COMPANIES
.........COMMERCIAL BANKS
——— SAVINGS & LOAN ASSOCIATES
——— MUTUAL SAVINGS BANKS
——— REAL ESTATE INVESTMENT TRUSTS *

* DATA NOT AVAILABLE FOR EARLIER YEARS.

SOURCE: BOARD OF GOVERNORS OF THE FEDERAL SYSTEM, FLOW-OF-FUNDS ACCOUNTS.

TABLE 1
SUMMARY OF TRUST OFFERINGS - 1961-1971
(millions $)*

	1961	1962-1967	1968	1969	1970	1971
Initial Shares	$98.9	$85.3	$60.5	$880.8	$949.0	$806.1
Convertibles	—	—	12.5	50.0	361.7	180.0
Initial Total	98.9	85.3	73.0	930.8	1310.7	986.1
Secondary Shares	—	72.1	37.6	67.2	37.6	71.9
Convertibles	—	9.5	20.0	151.5	252.0	513.0
Secondary Total	—	81.6	57.6	218.7	288.7	584.9
TOTAL	$98.9	$166.9	$130.6	$1149.5	$1599.4	$1571.0

Source: Kenneth D. Campbell, *The Real Estate Trusts: America's Newest Billionaires,* Audit Investment Research Inc., p. 45, 1971.

*Does not include straight debt

TABLE 2
PRIME RATE CHARGED BY BANKS ON SHORT-TERM BUSINESS LOANS
Averages of daily effective rates

1970	January	8.50
1971	January	6.29
1972	January	5.18
1973	January	6.00
	July	8.30
1974	January	9.73
	July	11.97
1975	January	10.05
	July	7.15
1976	January	7.00
	July	7.25
1977	January	6.25
1978	January	7.93
1979	January	11.75

Source: Board of Governors of the Federal Reserve System, "Annual Statistical Digest: 1970-1979," Washington, D.C., p. 159.

TABLE 3
ADVISORY FEES BY TYPE OF SPONSOR, EXPRESSED AS PERCENTAGE OF TOTAL INVESTED ASSETS FOR A SAMPLE OF 115 TRUSTS (1974)

Affiliation	Total No.	1.3	1.2	1.0	0.96-0.75	0.5	0.18	Sliding Fees	Special
Bank and Bank Related	37	1	6	8	1	1	1	9	10
Life Insurance	9	-	-	-	1	1	-	4	3
Mortgage Cos.	27	-	6	8	1	2	-	6	4
Diversified Holding Cos.	20	-	4	5	3	2	-	5	1
Real Estate Developers	4	-	-	3	1	-	-	-	-
Special Investments	1	-	-	-	-	-	-	1	-
Independent	17	-	3	1	-	1	-	7	5
TOTAL	115	1	19	25	7	7	1	32	23

Source: Nareit 1974 Factbook

Chapter 6

The Flow of Funds

Congress had two ostensible motives for legislating REITs into existence in 1960: to increase the funds available for residential real-estate construction in the United States; and to make investment in real estate accessible to the individual small investor. In practice, these two objectives might have been mutually exclusive to some extent. That is, the best way to direct money to the residential real-estate market might have been to encourage the domination of the field by large, institutional investors, in whose company the small investor was likely to get killed: the best way to attract and protect the small investor might have been through disincentives for the big investors from the field, or from part of it. In the event, however, the question of what might have been is moot: the evidence suggests that neither of Congress' laudable objectives was ever attained because of the REIT legislation.

On the question of whether the REITs encouraged individual small investors to invest in the real-estate markets, little unambiguous quantitative evidence is available. Perhaps the most that can be said with any certainty is that no student of the REIT phenomenon could claim that the trusts provided - or even tried to provide - unsophisticated investors with expert, objective real-estate investment advice. Nor, in the light of the abuses the REITs permitted - even encouraged - could anyone claim that the REITs offered the small investor a measure of investment safety resulting from prudent management of diversified

portfolios.

More good evidence is available on the question of whether the REITs increased the money available for residential construction. The evidence suggests that they did not. The financial institutions' share of total mortgage loans outstanding remained virtually constant from 1968, when REITs made their debut, until REITs' downfall in the mid-1970s. From 1971 through 1973, private financial institutions held a fairly steady 80 percent of total mortgage debt.[Tables 9-11] If REITs had attracted new capital into real estate, the total pool of available mortgage money would have grown, while the share held by the traditional financial institutions would have declined.

Instead, the REITs seem to have enabled the funds' sponsors and advisors to improve their own mortgage portfolios. During the late 1960's outstanding mortgage loans with low, legally mandated interest ceilings were quickly sold to the REITs. Prospective mortgage borrowers with deals the REIT sponsors and advisors found less attractive were simply referred to the trust. As the sponsors' mortgage holdings diminished, the trusts' grew.

In a more general sense, the REITs facilitated the overall redistribution of existing real-estate mortgage funds among a larger number of financial institutions. During the early 1970s, as bank advisors and trust sponsors stopped laying off inferior assets on their REITs, the relative shares of mortgage loans held by commercial banks and REITs tended to move in lockstep as both lenders increased their investments in home, commercial, and multifamily mortgages. Life insurance companies, meanwhile, were steadily diversifying out of mortgage assets and diminishing their shares of outstanding mortgage debt. As outstanding mortgage loans were repaid, the funds were redeployed into other investments. Prospective borrowers, finding that the life insurance companies had less money

for mortgage loans, turned instead to other lenders - commercial banks and REITs.

The REITs probably played no more than a minor, facilitating role in this redeployment of funds by large institutional investors. With or without REITs in the picture, it is reasonable to assume that the same portfolio decisions, including those to reduce mortgage commitments between 1968 and 1975, would have been made. The stock market was booming during much of this period: investors had better things to do with their money than leave it in long-term, fixed-rate mortgages.

In any event, the REITs were simply not big enough, especially in the early years, to have any pronounced effect on the vast mortgage markets. As long as they concentrated their relatively small assets in mortgage loans, the REITs might at best have mitigated the effects of the flight of larger investors out of that market. By the late 1970s, however, the REITs became increasingly committed to equity investments, and any effect they might have had on the availability of mortgage credit diminished to virtually nil.

Even the capital from small investors that the REITs brought into the mortgage markets did not necessarily represent any net increase in available mortgage funds. In many cases, certainly, small investors put into the REITs savings that they withdrew from other depository institutions, some of which were themselves mortgage lenders. New issues of debt and equity securities by the trusts, amounting to more than $1.6 billion in 1971, also tended to draw savings from other mortgage lenders. In all, therefore, the net contribution of the REITs to the supplies of available real-estate investment capital and mortgage credit cannot be equated with the REITs' assets.

A credible estimate of the REITs' overall effect on mortgage credit would

require detailed information on all transactions between the trusts and other financial institutions, and on the extent to which investment decisions were distorted by relations between trusts and their advisors. Some of this information, at least, is available for several years. From 1968 to 1970, the Federal Reserve Bank of Boston and Audit Investment Research, Inc. made careful estimates of the mortgages held by REITs. These estimates, supplemented by other data when necessary, enabled economists at the Federal Reserve Bank of New York to profile the mortgage-lending activities of various types of sponsoring institutions and their affiliated trusts.[1] While the economists' profile does not include portfolio transactions between REITs and unaffiliated intermediaries, such transactions were rare compared with those between REITs and sponsors.

In 1968, the outstanding mortgage debt in the United States totalled $410.1 billion, of which $120.8 billion was for multifamily and commercial real estate. Fully 81.3 percent of the total mortgage debt, including 82.3 percent of the multifamily and commercial portion, was held by private financial institutions. Commercial banks held 16 percent of the total mortgage debt and 19.2 percent of the multifamily and commercial fractions. Life insurance companies held 17.1 percent of the total mortgage debt and 29.1 percent of the multifamily and commercial debt. Of the rest of the mortgages held by private financial institutions, savings and loan associations and mutual savings banks held the bulk. In 1968, then, the share of the total mortgage debt held by the new REITs was negligible.

[1]Korobow, Leon and Richard J. Gelson, *Op. Cit.* Korobow and Gelson's data on mortgage debt outstanding and market shares of banks and life insurance companies have been updated to reflect revisions reported in the 1984 *Flow of Funds Accounts.* In most cases, these changes were fairly minor. However, their estimates of REITs' market shares, where REITs are classified by type of sponsor, have not been revised because these data are not available.

Two years later the situation had changed somewhat. The commercial banks' share of multifamily and commercial mortgages had fallen a full point to 18.2 percent; while REITs sponsored by these same commercial banks were holding 0.6 percent of the total, picking up more than half the holdings dropped by their sponsors.[2] The implication of these statistics is that the commercial banks had started referring applicants for mortgage loans to their REITs, or they had sold their affiliated trusts some of their mortgage assets and reinvested the proceeds more profitably.

The same shift occurred in the holdings of the life insurance companies and their affiliated REITs. As the insurance companies' share of multifamily and commercial mortgage debt slipped from 29.1 to 28.8 percent between 1968 and 1970, the trusts sponsored by the insurers increased their holdings to 0.4 percent. Through the early 1970s, life insurance companies - as well as retirement and pension funds - continued to lighten their commitment to mortgage lending. Their proportion of assets invested in mortgages and their share of the total mortgage debt declined dramatically. In 1971, the insurance companies held 14.5 percent of the outstanding mortgage debt [Table 9]; by 1975 their share was only 11.1 percent [Table 13]. The declining role of the life insurance companies was felt in all mortgage-loan categories: home, multifamily, and commercial [Tables 9-10].

The most dramatic decline in the insurance companies' share of the mortgage market was in multifamily-home loans. Between 1971 and 1973, the amount of outstanding mortgage debt in this category increased by 33 percent, from $70 billion to $93.1 billion. [Tables 14-16] The value of these mortgages held by life insurance companies, however, increased by only 10.8 percent, while the

[2]Korobow, Leon and Richard J. Gelson, *Op. Cit.*

insurers' market share fell from 23.9 to 19.8 percent. [Tables 9, 11]

Despite the defection of the life insurance companies from the mortgage markets, private financial institutions maintained their approximate 80 percent share of total mortgage debt through 1973. [Tables 9-11] The slack in the market was taken up by commercial banks and REITs, which increased their shares of multifamily-home loans during this period. Increasing their holdings by $4.4 billion, the REITs alone more than made up for the share of the total market vacated by the life insurers. [Tables 14, 16] Two years later, the trusts' share of the market in multiple-home mortgages rose from 3.1 to 7.1 percent. [Tables 9,11]

The commercial banks also played a role, increasing their share of multifamily-home mortgages from 5.7 percent in 1971 to 7.4 percent in 1973. [Tables 9,11] Savings institutions, private pension funds, and state and local government retirement funds, however, all substantially reduced their commitments to multifamily-home mortgages. As a result, the private financial institutions' aggregate share of this market fell from 79.1 to 78.8 percent. [Tables 9-11]

In the area of mortgages on commercial properties, the REITs' role in cushioning the effect of the insurance companies' rapid withdrawal from the market was notably effective. Between 1971 and 1973, the total of outstanding commercial mortgage debt rose 35 percent, from $95.8 billion to $131.7 billion. [Tables 14-16] The life insurance companies, however, increased their holdings of these loans by only 28 percent, as their share of total commercial mortgage debt declined from 29.7 percent in 1971 to 27.7 percent in 1973. [Tables 9,11]

To maintain their previous share of the market in commercial mortgages, the life insurers would have had to invest an additional $10.7 billion between 1971 and 1973. Had they done so, their holdings of these mortgages would

have totalled $39.2 billion. Their actual investment fell $2.7 billion shy of the mark [Table 16]; but the shortfall was more than made up by the REITs, which increased their holdings of commercial mortgages by $4.3 billion, increasing their share of this market from 3.3 to 5.7 percent in just two years. [Tables 9,11]

Commercial banks were also enthusiastic buyers of commercial mortgage debt, increasing their share of the market from 27.5 to 29.4 percent between 1971 and 1973. [Tables 9,11] Private pension plans were shy of this market: their holdings actually declined from $1.3 billion to $1.1 billion during these two years. [Tables 14,16] The market shares of other holders of commercial mortgages held relatively steady, as the total share of commercial mortgage debt held by private financial institutions rose from 88.6 percent in 1971 to 91.5 percent in 1973. [Tables 9,11]

In the field of mortgages on 1-4 family homes, however, the financial institutions' share fell from 82 percent in 1971 to 81.4 percent two years later, as the life insurers' share dropped from 7.6 to 5.0 percent. In this case, the commercial banks took the lead in filling the gap, increasing their 1-4 family mortgage commitments by 42 percent [Tables 14,16], and their market share from 14.9 to 16.6 percent. [Tables 9,11] The REITs played a lesser role in this area, more than doubling their holdings from $0.8 billion to $1.9 billion as their share of the market increased from 0.2 to 0.5 percent. [Tables 9,11,14,16]

The importance of the REITs in the mortgage-credit markets peaked in 1973, when the short-term construction and developent loans in which the trusts' mortgage assets were concentrated began to go sour. In December 1973, Kassuba Development Corp., a very large apartment developer, filed a Chapter 11 bankruptcy petition. The ensuing publicity included the news that more than 20 REITs had lent Kassuba money, which they stood to lose. Among the po-

tential losers: First Mortgage Investors, one of the oldest and seemingly most stable REITs, which had loaned Kassuba $47.5 million.[3]

Alerted by the Kassuba disaster, auditors descended on the REITs and began sifting through their books. The ready reserves that the trusts were required to maintain against potential losses were greatly increased. More and more borrowers went belly-up, as conditions in the real-estate marketplace continued to deteriorate during 1974. Some 20 percent of second-home developers went bankrupt, sales at some industrial parks were down by 80 percent, office buildings remained vacant, and condominiums were going begging.[4] Loan losses began to outnumber new loans on the REITs' books.

REIT assets reached more than $21 billion in 1974; they never went higher. Indeed, they declined slightly the following year. [Table 8] Some of the assets were not exactly solid, either. An increasing fraction of the trusts' assets were financed by disadvantageous bank loans. As their financial positions weakened, the REITs found other sources of capital, such as the commercial paper markets, suddenly closed to them. As the real-estate business slid into recession in 1974-1975, some REITs that specialized in short-term construction loans were liquidated.

By the spring of 1974, the REITs that survived had virtually stopped making new loans. More than one-third of REITs' remaining assets were in multifamily and nonresidential mortgages, as the REITs' share of total mortgage debt declined from its high of 2.4 percent in 1973 to a mere 1.5 percent in 1975. [Tables 11,13] Prompted by Federal Reserve Bank officials, commercial banks

[3]Robertson, Wyndham, "How the Bankers Got Trapped in the REIT Disaster," *Fortune*, Vol. XCI, No. 3, March 1975, p. 115.

[4]"The Great Land Bust," *U.S. News and Word Report*, Vol. 78, No. 15, April 14, 1975, p. 153-4.

began belatedly to assist the REITs they sponsored, buying some of their better mortgage assets for much-needed cash.

The life insurance companies, too, continued to withdraw from ownership of mortgage assets. Even the commercial banks, despite their $10-to-12 billion commitment to REITs, did their best to get out of the mortgage-loan business. As a result, between 1973 and 1975, the percentage of total outstanding mortgage debt held by private financial institutions fell from 79.8 percent to 76.3 percent. [Tables 11,13]

Even at the height of their success, however, the REITs' contribution to residential mortgage credit - the ostensible reason for their existence under the REIT Act - was negligible at best. Even at inflated values, REITs' assets were only a fraction of those deployed by the big players in the mortgage markets. The REITs invested only a modest fraction of their modest assets - never more than 12.5 percent between 1968 and 1975 - in the home mortgages they were established specifically to finance. [Table 8]

Of the mortgages on 1-4 family homes that they did hold, moreover, the REITs bought most - 95 percent in 1971, 75 percent in 1972 - from other lenders in the secondary market. [Tables 19,20] When it came to multifamily and commercial mortages, however, the situation was the reverse: the REITs provided the original financing at least 90 percent of the time. [Tables 19-21] Despite their Congressional mandate, REITs actually, made very few residential loans in the primary market, where they made almost all their multifamily and commercial loans. From this analysis, REITs hardly emerge as an important creative force in financing new residential construction, as their Congressional creators hoped they would be.

Had the situation been reversed, with the REITs making most of their mul-

tifamily and commercial loans in the secondary market, while acting as the primary lender for 1-4 family mortgages, the outcome might have been much happier. If the REITs had purchased their nonhome mortgages from other lenders, who would have been required to adhere to prudent regulations, the REITs' loans might have been safer, the industry's untimely collapse in the mid-1970s might have been less complete, and the real-estate recession might have been less severe.

In the event, however, the influence of the REITs was to make the recession worse, not better. To the extent that REIT assets grew at the expense of S&Ls and thrift institutions, both of which earmark a large part of their assets for residential mortgages, the REITs exacerbated an already serious housing shortage and the host of troubles attendant upon it. Between 1965 and 1975, just as the REITs were coming on the scene, the median sales price of new homes in the United States increased by 95 percent, from $20,000 to $39,000. By 1975, housing starts were at their lowest level since World War II; unemployment in the construction trades was running 19.3 percent, almost double the national rate.[5]

If it was the intent of Congress precisely to avoid, or at least to mitigate, these calamities, then surely Congress would have done well to have designed the REIT Act more carefully to achieve its desired objectives. Specific measures might have been adopted to ensure that savings were diverted into the housing market, and that mortgage credit was available.

It is interesting to consider what might have happened if REIT legislation had

[5]Continuation of Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance on Financial Institutions and the Nation's Economy (FINE), "Discussion Principles," Part 2, Dec. 11, 12, 16, 17, 1975. See Insertion by the National Association of Home Builders (NAHB), Dec. 16, 1975, p. 1306.

been designed to encourage institutional investors to buy real-estate assets, thus increasing the availability of mortgage money. In 1965, the financial assets of private pension funds and life insurance companies were $73.6 billion and $154.2 billion, respectively. Ten years later, the private pension funds had grown more than 150 percent to $186.6 billion. Life insurance companies' assets increased 81.4 percent to $279.7 billion. The assets of state and local government employee retirement funds tripled in ten years from $34.1 billion to $104.8 billion. [Tables 1-3]

Without any encouragement from the law, private pension funds in 1965 invested 4.6 percent of their financial assets in mortgages. Ten years later the share was down to 1.3 percent. [Table 2] Mortgages made up fully 38.9 percent of life insurers' financial assets in 1965; only 31.9 percent in 1975. [Table 1] Similarly, 10.9 percent of state and local government employee retirement fund assets were invested in mortages in 1965, and only 7.2 percent in 1975. [Table 3]

Only minor changes in these percentages would have been sufficient to produce major effects in the mortgage markets, and major alterations in the United States housing situation. Had private pension funds been persuaded to commit 10 percent of their 1975 assets to mortgages - less than 20 percent of their commitment to stocks - they would have provided $18.7 billion in mortgage credit instead of only $2.4 billion. [Table 2] If state and local government retirement funds had committed 15 percent of their assets to the same cause, they would have created $15.7 billion in mortgage loans instead of $7.5 billion. [Table 3]

If Congress had acted more purposfully in the matter, it might have written legislation that would have induced these institutions to invest as much of their assets in mortgages in 1975 as they had invested 10 years earlier, simply reversing

the disinvestment that took money out of mortgages during that decade. The effect would have been to increase the pool of mortgage credit in 1975 by $29.7 billion. This increase in available mortgage money would have far exceeded the REITs' total assets, and more than doubled their investment in mortgages. [Table 8]

In other words, if Congress truly wanted to attract more capital into real-estate markets, it would have done better to provide incentives for existing institutional investors to maintain or increase their mortgage lending. Had Congress done this relatively simple thing, it never would have had to create REITs at all.

TABLE 1
COMPOSITION OF LIFE INSURANCE COMPANIES' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	1.5	1.0	1.5	0.9	1.6	0.9	1.7	0.9	1.6	0.8	1.8	0.9
Corporate Equities	9.1	5.9	8.8	5.4	10.9	6.3	13.2	7.2	13.7	7.2	15.4	7.7
Credit Market Instr.	137.8	89.4	145.9	89.9	153.3	88.8	160.7	87.8	167.6	87.6	174.6	86.9
US Gov't Securities	5.3	3.4	5.2	3.2	4.9	2.8	4.8	2.6	4.5	2.3	4.6	2.3
Corp. & Foreign Bonds	61.0	39.6	63.4	39.1	67.2	38.9	70.9	38.7	72.7	38.0	74.1	36.9
Mortgages	60.0	38.9	64.6	39.8	67.5	39.1	70.0	38.2	72.0	37.6	74.4	37.0
Other Assets	5.8	3.7	6.1	3.7	6.8	3.9	7.5	4.1	8.4	4.4	9.1	4.5
TOTAL	154.2	100.0	162.3	100.0	172.6	100.0	183.1	100.0	191.3	100.0	200.9	100.0

TABLE 1 (continued)
COMPOSITION OF LIFE INSURANCE COMPANIES' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	1.8	0.8	2.0	0.9	2.1	0.9	2.0	0.8	1.9	0.7
Corporate Equities	20.6	9.6	26.8	11.5	25.9	10.6	21.9	8.6	28.1	10.0
Credit Market Instr.	182.8	84.9	192.5	82.8	204.8	83.7	217.7	85.4	234.6	83.9
US Gov't Securities	4.5	2.1	4.6	2.0	4.3	1.8	4.4	1.7	6.2	2.2
Corp. & Foreign Bonds	79.6	37.0	86.6	37.3	92.5	37.8	96.4	37.8	105.5	37.7
Mortgages	75.5	35.1	76.9	33.1	81.4	33.3	86.2	33.8	89.2	31.9
Other Assets	10.0	4.6	11.1	4.8	12.0	4.9	13.4	5.3	15.1	5.4
TOTAL	215.2	100.0	232.4	100.0	244.8	100.0	255.0	100.0	279.7	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83*. Federal Reserve Board of ;overnors, Washington, D.C., 1984.

TABLE 2
COMPOSITION OF PRIVATE PENSION FUNDS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	0.9	1.2	0.8	1.1	0.9	1.0	1.0	1.0	1.0	1.0	1.1	1.0
Corporate Equities	40.8	55.4	39.5	52.1	51.1	57.2	61.5	60.6	61.4	60.0	67.1	60.8
Credit Market Instr.	29.1	39.5	31.9	42.1	32.8	36.7	33.8	33.3	34.6	33.8	36.6	33.2
US Gov't Securities	3.0	4.1	2.8	3.7	2.3	2.6	2.8	2.8	2.8	2.7	3.0	2.7
Corp. & Foreign Bonds	22.7	30.8	25.2	33.2	26.4	29.5	27.0	26.6	27.6	27.0	29.4	26.6
Mortgages	3.4	4.6	3.9	5.1	4.1	4.6	4.1	4.0	4.2	4.1	4.2	3.8
Other Assets	2.8	3.8	3.6	4.7	4.6	5.1	5.2	5.1	5.4	5.3	5.6	5.1
TOTAL	73.6	100.0	75.8	100.0	89.4	100.0	101.5	100.0	102.4	100.0	110.4	100.0

TABLE 2 (continued)
COMPOSITION OF PRIVATE PENSION FUNDS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	1.3	1.0	1.6	1.0	1.5	1.0	1.5	1.1	1.7	1.0
Corporate Equities	88.7	68.2	119.7	74.6	97.4	66.4	70.6	50.9	102.1	54.7
Credit Market Instr.	35.0	26.9	38.6	24.1	45.4	31.0	56.9	41.1	75.4	40.4
US Gov't Securities	2.7	2.1	5.7	3.6	8.6	5.9	12.4	8.9	24.9	13.3
Corp. & Foreign Bonds	28.6	22.0	29.4	18.3	32.9	22.4	39.5	28.5	43.9	23.5
Mortgages	3.7	2.8	2.7	1.7	2.4	1.6	2.4	1.7	2.4	1.3
Other Assets	5.1	3.9	0.5	0.3	2.3	1.6	9.6	6.9	7.4	4.0
TOTAL	130.1	100.0	160.4	100.0	146.6	100.0	138.6	100.0	186.6	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of ;overnors, Washington, D.C., 1984.

TABLE 3
COMPOSITION OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	0.3	0.9	0.4	1.0	0.5	1.1	0.6	1.3	0.5	1.0	0.6	1.0
Corporate Equities	2.5	7.3	2.8	7.3	3.9	9.1	5.8	12.1	7.3	13.7	10.1	16.7
Credit Market Instr.	31.3	91.8	34.9	91.6	38.3	89.9	41.6	86.7	45.5	85.5	49.6	82.3
US Gov't Securities	7.6	22.3	7.8	20.5	7.0	16.4	7.3	15.2	7.0	13.2	6.6	10.9
Corp. & Foreign Bonds	17.2	50.4	20.2	53.0	23.9	56.1	26.6	55.4	30.6	57.5	35.1	58.2
Mortgages	3.7	10.9	4.5	11.8	5.0	11.7	5.4	11.3	5.6	10.5	5.9	9.8
Other Assets	0	0	0	0	0	0	0	0	0	0	0	0
TOTAL	34.1	100.0	38.1	100.0	42.6	100.0	48.0	100.0	53.2	100.0	60.3	100.0

TABLE 3 (continued)
COMPOSITION OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	0.7	1.0	1.0	1.2	1.3	1.5	1.8	2.0	1.4	1.3
Corporate Equities	15.4	22.3	22.2	27.5	20.2	23.8	16.4	18.6	24.3	23.2
Credit Market Instr.	52.9	76.7	57.4	71.2	63.1	74.5	69.8	79.3	79.1	75.5
US Gov't Securities	5.4	7.8	5.7	7.1	5.8	6.8	6.2	7.0	7.8	7.4
Corp. & Foreign Bonds	39.0	56.5	43.2	53.6	48.4	57.1	54.9	62.4	61.8	59.0
Mortgages	6.3	9.1	6.5	8.1	7.1	8.4	7.7	8.8	7.5	7.2
Other Assets	0	0	0	0	0	0	0	0	0	0
TOTAL	69.0	100.0	80.6	100.0	84.7	100.0	88.0	100.0	104.8	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of ;overnors, Washington, D.C., 1984.

TABLE 4
COMPOSITION OF COMMERCIAL BANKING SECTOR'S FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Total Bank Credit	309.9	91.0	328.1	90.7	365.7	90.9	405.8	90.8	423.4	90.9	460.5	91.2
US Gov't Securities	66.0	19.4	62.9	17.4	72.4	18.0	75.7	16.9	65.7	14.1	76.4	15.1
Tax-Exempt Obligations	38.8	11.4	41.2	11.4	50.3	12.5	58.9	13.2	59.5	12.8	70.2	13.9
Corp.& Foreign Bonds	1.3	0.4	1.3	0.4	2.3	0.6	2.5	0.6	1.9	0.4	3.0	0.6
Total Loans	203.8	59.8	222.6	61.5	240.6	59.8	268.7	60.1	296.2	63.6	310.8	61.6
Mortgages	49.7	14.6	54.4	15.0	58.9	14.6	65.5	14.7	70.5	15.1	72.8	14.4
Consumer Credit	45.2	13.3	48.2	13.3	51.7	12.9	58.5	13.1	63.4	13.6	65.6	13.0
Bank Loans n.e.c.	96.9	28.4	106.4	29.4	112.9	28.1	126.7	28.4	144.0	30.9	151.2	29.9
Open-Market Paper	2.7	0.8	3.7	1.0	5.8	1.4	5.4	1.2	6.7	1.4	8.2	1.6
Security Credit	9.3	2.7	9.9	2.7	11.3	2.8	12.7	2.8	11.5	2.5	13.0	2.6
Vault Cash	4.9	1.4	5.5	1.5	5.9	1.5	7.2	1.6	7.3	1.6	7.0	1.4
Member Bank Reserves	18.4	5.4	19.8	5.5	21.1	5.2	21.9	4.9	22.1	4.7	24.2	4.8
Other Financial Assets	7.5	2.2	8.5	2.3	9.5	2.4	12.0	2.7	12.9	2.8	13.2	2.6
TOTAL Financial Assets	340.7	100.0	361.9	100.0	402.2	100.0	446.9	100.0	465.7	100.0	504.9	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-88.* Federal Reserve Board of
overnors, Washington, D.C., 1984.

TABLE 4 (continued)
COMPOSITION OF COMMERCIAL BANKING SECTOR'S FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)
(continued)

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Total Bank Credit	511.7	91.0	587.0	91.6	668.3	91.7	733.1	91.6	764.6	91.6
US Gov't Securities	83.6	14.9	90.0	14.0	88.8	12.2	89.5	11.2	119.5	14.3
Tax-Exempt Obligations	82.8	14.7	90.0	14.0	95.7	13.1	101.1	12.6	102.9	12.3
Corporation & Foreign Bonds	3.9	0.7	5.2	0.8	5.6	0.8	6.6	0.8	8.4	1.0
Total Loans	341.3	60.7	401.6	62.7	478.1	65.6	535.7	67.0	533.6	63.9
Mortgages	82.5	14.7	99.3	15.5	119.1	16.3	132.1	16.5	136.2	16.3
Consumer Credit	74.3	13.2	87.0	13.6	99.6	13.7	103.0	12.9	106.1	12.7
Bank Loans n.e.c.	162.2	28.8	188.5	29.4	237.3	32.6	278.4	34.8	266.1	39.1
Open-Market Paper	8.5	1.5	8.3	1.3	7.0	1.0	9.2	1.1	10.3	1.2
Security Credit	13.8	2.5	18.6	2.9	15.2	2.1	13.0	1.6	15.0	1.8
Vault Cash	7.5	1.3	8.6	1.3	10.7	1.5	11.6	1.4	12.3	1.5
Member Bank Reserves	27.8	4.9	25.6	4.0	27.1	3.7	25.8	3.2	26.1	3.1
Other Financial Assets	15.3	2.7	19.5	3.0	22.7	3.1	29.6	3.7	31.6	3.8
TOTAL Financial Assets	562.3	100.0	640.7	100.0	728.8	100.0	800.1	100.0	834.6	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of overnors, Washington, D.C., 1984.

TABLE 5
COMPOSITION OF SAVINGS & LOAN ASSOCIATIONS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Mortgages	108.1	84.8	113.2	85.3	119.5	84.6	128.4	85.4	137.9	86.3	147.3	85.1
Consumer Credit	2.2	1.7	2.3	1.7	2.4	1.7	2.6	1.7	2.9	1.8	3.4	2.0
Demand Deposits & Currency	2.9	2.3	2.3	1.7	2.0	1.4	1.6	1.1	1.4	0.8	1.2	0.7
Time Deposits	—	—	0.1	0.1	0.2	0.1	0.2	0.1	0.2	0.1	0.6	0.3
Fed. Funds	—	—	—	—	—	—	—	—	—	—	—	—
US Gov't Securities	8.2	6.4	8.6	6.5	10.3	7.3	10.7	7.1	10.4	6.5	11.0	6.3
Open-Market Paper	—	—	—	—	—	—	0.1	0.1	0.3	0.2	1.8	1.0
Other Assets	6.0	4.7	6.2	4.7	6.9	4.9	6.8	4.5	6.6	4.1	7.8	4.5
TOTAL	127.4	100.0	132.7	100.0	141.3	100.0	150.4	100.0	159.7	100.0	173.1	100.0

TABLE 5 (continued)
COMPOSITION OF SAVINGS & LOAN ASSOCIATIONS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Mortgages	169.2	84.2	200.0	84.4	227.1	85.0	246.1	84.2	273.5	82.1
Consumer Credit	3.7	1.8	3.5	1.5	6.5	2.4	7.4	2.5	8.2	2.5
Demand Depostis & Currency	0.9	0.4	1.2	0.5	1.0	0.4	1.0	0.3	1.3	0.4
Time Deposits	2.3	1.1	3.4	1.4	2.9	1.1	3.6	1.2	8.1	2.4
Fed. Funds	0.5	0.2	0.9	0.4	2.2	0.8	4.8	1.6	3.8	1.1
US Gov't Securities	13.5	6.7	15.0	6.3	15.4	5.7	14.9	5.1	19.6	5.9
Open-Market Paper	2.8	1.4	3.3	1.4	2.0	0.7	1.8	0.6	2.7	0.8
Other Assets	8.1	4.0	9.6	4.0	10.1	3.8	12.7	4.3	15.9	4.8
TOTAL	201.0	100.0	236.9	100.0	267.2	100.0	292.3	100.0	333.1	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of
ìovernors, Washington, D.C., 1984.

TABLE 6
COMPOSITION OF MUTUAL SAVINGS BANKS' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	0.8	1.4	0.8	1.3	0.8	1.2	0.8	1.1	0.9	1.2	1.0	1.3
Corporate Equities	2.3	3.9	2.0	3.3	2.5	3.7	2.4	3.4	2.5	3.4	2.8	3.5
Credit Mkt. Instr.	55.0	93.1	57.7	93.8	62.7	93.3	67.0	93.6	69.8	93.7	73.5	92.7
US Gov't. Securities	6.3	10.7	5.8	9.4	5.5	8.2	5.5	7.7	5.0	6.7	5.4	6.8
Corp.& Foreign Bonds	2.9	4.9	3.2	5.2	5.3	7.9	6.6	9.2	6.9	9.3	8.1	10.2
Mortgages	44.6	75.5	47.3	76.9	50.5	75.1	53.5	74.7	56.1	75.3	57.9	73.0
Misc. Assets	1.0	1.7	1.0	1.6	1.2	1.8	1.4	2.0	1.3	1.7	2.0	2.5
TOTAL	59.1	100.0	615.5	100.0	67.2	100.0	71.6	100.0	74.5	100.0	79.3	100.0

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	0.9	1.0	1.0	1.0	1.1	1.0	1.1	1.0	1.2	1.0
Corp.Equities	3.5	3.9	4.5	4.4	4.2	3.9	3.7	3.4	4.4	3.6
Credit Mkt. Instr.	82.8	91.9	92.4	91.0	96.8	90.6	99.4	91.1	110.1	90.9
US Gov't. Securities	6.3	7.0	7.7	7.6	7.2	6.7	7.0	6.4	10.9	9.0
Corp. & Foreign Bonds	12.0	13.3	14.2	14.0	13.1	12.3	14.0	12.8	17.5	14.5
Mortgages	62.0	68.8	67.6	66.6	73.2	68.5	74.9	68.7	77.2	63.7
Misc. Assets	2.9	3.2	3.6	3.5	4.7	4.4	4.9	4.5	5.4	4.5
TOTAL	90.1	100.0	101.5	100.0	106.8	100.0	109.1	100.0	121.1	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of overnors, Washington, D.C., 1984.

TABLE 7
COMPOSITION OF FINANCIAL COMPANIES' FINANCIAL ASSETS
1965-1975
(In Billions of Dollars)

Asset	1965		1966		1967		1968		1969		1970	
	$	%	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	2.0	4.5	2.1	4.5	2.2	4.6	2.3	4.3	2.4	3.9	2.7	4.2
Credit Market	42.7	95.5	44.9	95.5	45.5	95.4	50.6	95.7	59.2	96.1	61.3	95.8
Mortgages	4.5	10.1	3.9	8.3	4.3	9.0	4.9	9.3	5.7	9.3	7.4	11.6
Consumer Credit	24.7	55.3	26.4	56.2	26.9	56.4	29.2	55.2	32.0	51.9	32.1	50.2
Other Loans to Business	13.5	30.2	14.6	31.1	14.3	30.0	16.5	31.2	21.5	34.9	21.8	34.1
TOTAL	44.7	100.0	47.0	100.0	47.7	100.0	52.9	100.0	61.6	100.0	64.0	100.0

Asset	1971		1972		1973		1974		1975	
	$	%	$	%	$	%	$	%	$	%
Demand Deposits & Currency	2.9	4.2	3.2	4.0	3.5	3.9	3.7	3.9	3.9	3.9
Credit Market	66.5	95.8	76.0	96.0	87.4	96.1	92.3	76.1	94.9	96.1
Mortgages	8.9	12.8	10.6	13.4	12.5	13.8	10.6	11.0	9.3	9.4
Consumer Credit	34.4	49.6	38.0	48.0	42.6	46.9	44.6	46.5	44.7	45.2
Other Loans to Business	23.2	33.4	27.4	34.6	32.3	35.5	37.2	38.8	40.9	41.4
TOTAL	69.4	100.0	79.2	100.0	90.9	100.0	96.0	100	98.8	100.0

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of overnors, Washington, D.C., 1984.

TABLE 8
COMPOSITION OF REAL ESTATE INVESTMENT TRUSTS' PHYSICAL & FINANCIAL ASSETS
1968-1975
(In Billions of Dollars)

Asset	1968		1969		1970		1971	
	$	%	$	%	$	%	$	%
Physical Assets	0.3	27.3	0.7	25.9	0.9	18.8	1.3	16.9
Multi-family Structures	0.1	9.1	0.2	7.4	0.3	6.3	0.4	5.2
Nonresidential Structures	0.2	18.2	0.5	18.5	0.6	12.5	0.9	11.7
Total Financial Assets	0.8	72.7	2.0	74.1	3.9	81.3	6.4	83.1
Home Mortgages	—	—	0.2	7.4	0.6	12.5	0.8	10.4
Commercial Mortgages	0.7	63.6	1.3	48.1	2.0	41.7	3.2	41.6
Multi-family Mortgages	0.1	9.1	0.5	18.5	1.3	27.1	2.2	28.6
Other Financial Assets	0	0	0	0	0	0	0.2	2.6
TOTAL	1.1	100.0	2.7	100.0	4.8	100.0	7.7	100.0

TABLE 8 (continued)
COMPOSITION OF REAL ESTATE INVESTMENT TRUSTS' PHYSICAL & FINANCIAL ASSETS
1968-1975
(In Billions of Dollars)

Asset	1972		1973		1974		1975	
	$	%	$	%	$	%	$	%
Physical Assets	2.5	18.0	3.3	16.2	4.3	19.7	7.3	34.3
Multi-family Structures	0.8	5.8	1.1	5.4	1.4	6.4	2.4	11.3
Nonresidential Structures	1.7	12.2	2.2	10.8	2.9	13.3	4.9	23.0
Total Financial Assets	11.4	82.0	17.0	84.0	17.5	80.3	14.0	65.7
Home Mortgages	1.2	8.6	1.9	9.4	1.7	7.8	1.4	6.6
Commercial Mortgages	5.0	36.0	7.5	37.1	7.7	35.3	7.0	32.9
Multi-family Mortgages	4.2	30.2	6.6	32.6	6.8	31.2	4.8	22.5
Other Financial Assets	1.0	7.2	1.0	4.9	1.3	6.0	0.8	3.8
TOTAL (Physical and Financial Assets)	13.9	100.0	20.2	100.0	21.8	100.0	21.3	100.0

ɔurce: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve Board of overnors, Washington, D.C., 1984.

TABLE 9
RELATIVE IMPORTANCE OF FINANCIAL INSTITUTIONS IN MORTGAGE LENDING BY TYPE OF MORTGAGE (%)
1971

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	15.8%	14.9%	5.7%	27.5%	13.0%
Savings Institutions	44.6	56.1	38.6	24.8	0.3
Savings and Loan Associations	32.5	42.4	25.0	15.6	—
Mutual Savings Banks	11.9	13.5	13.7	9.3	0.3
Credit Unions	0.2	0.3	—	—	—
Life Insurance Companies	14.5	7.6	23.9	29.7	17.4
Private Pension Funds	0.7	0.5	1.3	1.4	—
State and Local Governments Retirements Funds	1.2	0.9	3.1	0.9	0.6
Finance Companies	1.7	1.8	3.4	0.9	—
REITs	1.2	0.2	3.1	3.3	—
All Private Financial Institutions	79.8%	82.0%	79.1%	88.6%	31.3%
Total Mortgage Assets	100.0%	100.0%	100.0%	100.0%	100.0%

ource: Derived from the *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83*. ederal Reserve Board of Governors, Washington, D.C., 1984.

TABLE 10
RELATIVE IMPORTANCE OF FINANCIAL INSTITUTIONS IN MORTGAGE LENDING BY TYPE OF MORTGAGE (%)
1972

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	16.7%	15.6%	7.0%	28.2%	13.4%
Savings Institutions	45.0	56.9	38.6	25.8	0.2
Savings and Loan Associations	33.5	43.9	25.4	16.5	—
Mutual Savings Banks	11.3	12.7	13.2	9.2	0.2
Credit Unions	0.2	0.3	—	—	—
Life Insurance Companies	12.9	6.1	20.9	28.1	15.9
Private Pension Funds	0.5	0.3	0.7	1.0	—
State and Local Governments Retirements Funds	1.1	0.8	2.7	1.0	0.6
Finance Companies	1.8	1.7	3.9	1.0	—
REITs	1.7	0.3	5.1	4.4	—
All Private Financial Institutions	79.7%	81.7%	78.8%	89.5%	30.1%
Total Mortgage Assets	100.0%	100.0%	100.0%	100.0%	100.0%

ource: Derived from the *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* ederal Reserve Board of Governors, Washington, D.C., 1984.

TABLE 11
RELATIVE IMPORTANCE OF FINANCIAL INSTITUTIONS IN MORTGAGE LENDING BY TYPE OF MORTGAGE (%)
1973

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	17.6%	16.6%	7.4%	29.4%	13.1%
Savings Institutions	44.6	56.6	37.7	25.7	0.2
Savings and Loan Associations	33.6	44.4	24.5	16.6	—
Mutual Savings Banks	10.8	11.9	13.2	9.1	0.2
Credit Unions	0.2	0.3	—	—	—
Life Insurance Companies	12.0	5.0	19.8	27.7	14.5
Private Pension Funds	0.4	0.2	0.5	0.8	—
State and Local Governments Retirements Funds	1.0	0.8	2.3	1.1	0.7
Finance Companies	1.8	1.8	4.0	1.1	—
REITs	2.4	0.5	7.1	5.7	—
All Private Financial Institutions	79.8%	81.4%	78.8%	91.5%	28.5%
Total Mortgage Assets	100.0%	100.0%	100.0%	100.0%	100.0%

ource: Derived from the *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* ederal Reserve Board of Governors, Washington, D.C., 1984.

TABLE 12
RELATIVE IMPORTANCE OF FINANCIAL INSTITUTIONS IN MORTGAGE LENDING BY TYPE OF MORTGAGE (%)
1974

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	17.8%	16.7%	7.6%	29.7%	13.0%
Savings Institutions	43.5	55.5	36.7	25.3	0.2
Savings and Loan Associations	33.2	44.1	23.8	16.7	—
Mutual Savings Banks	10.1	11.0	12.9	8.6	0.2
Credit Unions	0.2	0.3	—	—	—
Life Insurance Companies	11.6	4.2	19.6	28.1	13.6
Private Pension Funds	0.3	0.2	0.5	0.7	—
State and Local Governments Retirements Funds	1.0	0.7	2.2	1.4	0.4
Finance Companies	1.4	1.4	2.4	1.3	—
REITs	2.2	0.4	6.8	5.2	—
All Private Financial Institutions	77.8%	79.1%	75.8%	91.8%	27.4%
Total Mortgage Assets	100.0%	100.0%	100.0%	100.0%	100.0%

ource: Derived from the *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* ederal Reserve Board of Governors, Washington, D.C., 1984.

TABLE 13
RELATIVE IMPORTANCE OF FINANCIAL INSTITUTIONS IN MORTGAGE LENDING BY TYPE OF MORTGAGE (%)
1975

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	17.0%	15.7%	5.8%	29.4%	12.7%
Savings Institutions	44.0	55.3	39.1	26.7	0.2
Savings and Loan Associations	34.2	44.7	25.3	18.3	—
Mutual Savings Banks	9.6	10.2	13.7	8.4	0.2
Credit Unions	0.2	0.4	—	—	—
Life Insurance Companies	11.1	3.6	19.5	28.4	13.4
Private Pension Funds	0.3	0.1	0.5	0.8	—
State and Local Governments Retirements Funds	0.9	0.6	2.4	1.4	—
Finance Companies	1.2	1.2	1.6	1.2	—
REITs	1.6	0.3	4.8	4.4	—
All Private Financial Institutions	76.3%	76.8%	73.7%	92.3%	26.3%
Total Mortgage Assets	100.0%	100.0%	100.0%	100.0%	100.0%

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve ˈoard of Governors, Washington, D.C., 1984.

TABLE 14
MORTGAGE COMMITMENTS BY TYPE OF FINANCIAL INSTITUTION AND TYPE OF MORTGAGE
($ billions)
1971

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	$ 82.5	$ 48.0	$ 4.0	$ 26.3	$ 4.2
Savings Institutions	232.0	181.0	27.0	23.8	0.1
Savings and Loan Associations	169.2	136.8	17.5	14.9	—
Mutual Savings Banks	62.0	43.4	9.6	8.9	0.1
Credit Unions	0.8	0.8	—	—	—
Life Insurance Companies	75.5	24.6	16.7	28.5	5.6
Private Pension Funds	3.7	1.5	0.9	1.3	—
State and Local Governments Retirements Funds	6.3	3.0	2.2	0.9	0.2
Finance Companies	8.9	5.7	2.4	0.9	—
REITs	6.2	0.8	2.2	3.2	—
All Private Financial Institutions	$ 415.3	$ 264.6	$ 55.4	$ 84.9	$ 10.1
Total Mortgage Assets	$ 520.6	$ 322.6	$ 70.0	$ 95.8	$ 32.2

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve ›oard of Governors, Washington, D.C., 1984.

TABLE 15
MORTGAGE COMMITMENTS BY TYPE OF FINANCIAL INSTITUTION AND TYPE OF MORTGAGE (continued)
($ billions)
1972

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	$ 99.3	$ 57.0	$ 5.8	$ 31.8	$ 4.8
Savings Institutions	268.5	207.6	31.9	29.0	0.1
Savings and Loan Associations	200.0	160.4	21.0	18.6	—
Mutual Savings Banks	67.6	46.2	10.9	10.4	0.1
Credit Unions	1.0	1.0	—	—	—
Life Insurance Companies	76.9	22.3	17.3	31.6	5.7
Private Pension Funds	2.7	1.1	0.6	1.1	—
State and Local Governments Retirements Funds	6.5	3.0	2.2	1.1	0.2
Finance Companies	10.6	6.2	3.2	1.1	—
REITs	10.4	1.2	4.2	5.0	—
All Private Financial Institutions	$ 475.2	$ 298.4	$ 65.2	$ 100.7	$ 10.8
Total Mortgage Assets	$ 596.2	$ 365.1	$ 82.7	$ 112.6	$ 35.8

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve ›oard of Governors, Washington, D.C., 1984.

TABLE 16
MORTGAGE COMMITMENTS BY TYPE OF FINANCIAL INSTITUTION AND TYPE OF MORTGAGE (continued)
($ billions)
1973

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	$ 119.1	$ 68.0	$ 6.9	$ 38.7	$ 5.4
Savings Institutions	301.7	232.7	35.1	33.9	0.1
Savings and Loan Associations	227.1	182.4	22.8	21.9	—
Mutual Savings Banks	73.2	48.8	12.3	12.0	0.1
Credit Unions	1.4	1.4	—	—	—
Life Insurance Companies	81.4	20.4	18.5	36.5	6.0
Private Pension Funds	2.4	0.8	0.5	1.1	—
State and Local Governments Retirements Funds	7.1	3.2	2.1	1.5	0.3
Finance Companies	12.5	7.4	3.7	1.4	—
REITs	16.0	1.9	6.6	7.5	—
All Private Financial Institutions	$ 540.3	$ 334.4	$ 73.4	$ 120.6	$ 11.8
Total Mortgage Assets	$ 676.9	$ 410.8	$ 93.1	$ 131.7	$ 41.3

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve ɜoard of Governors, Washington, D.C., 1984.

TABLE 17
MORTGAGE COMMITMENTS BY TYPE OF FINANCIAL INSTITUTION AND TYPE OF MORTGAGE (continued)
($ billions)
1974

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	$ 132.1	$ 74.8	$ 7.6	$ 43.7	$ 6.0
Savings Institutions	322.5	248.5	36.7	37.2	0.1
Savings and Loan Associations	246.1	197.7	23.8	24.5	—
Mutual Savings Banks	74.9	49.2	12.9	12.7	0.1
Credit Unions	1.5	1.5	—	—	—
Life Insurance Companies	86.2	19..0	19.6	41.3	6.3
Private Pension Funds	2.4	0.8	0.5	1.1	—
State and Local Governments Retirements Funds	7.7	3.2	2.2	2.0	0.2
Finance Companies	10.6	6.2	2.4	1.9	—
REITs	16.1	1.7	6.8	7.7	—
All Private Financial Institutions	$ 577.6	$ 354.2	$ 75.8	$ 134.9	$ 12.7
Total Mortgage Assets	$ 741.1	$ 447.9	$ 100.0	$ 146.9	$ 46.3

ɔurce: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve oard of Governors, Washington, D.C., 1984.

TABLE 18
MORTGAGE COMMITMENTS BY TYPE OF FINANCIAL INSTITUTION AND TYPE OF MORTGAGE (continued)
($ billions)
1975

Lending Institution	Type of Mortgage				
	Total	Home	Multi-Family Resident	Commercial	Farm
Commercial Banking	$ 136.2	$ 77.0	$ 5.9	$ 46.9	$ 6.4
Savings Institutions	352.7	270.8	39.3	42.5	0.1
Savings and Loan Associations	273.5	218.8	25.5	29.1	—
Mutual Savings Banks	77.2	50.0	13.8	13.4	0.1
Credit Unions	2.0	2.0	—	—	—
Life Insurance Companies	89.2	17.6	19.6	45.2	6.8
Private Pension Funds	2.4	0.7	0.5	1.2	—
State and Local Governments Retirements Funds	7.5	2.9	2.4	2.3	—
Finance Companies	9.3	5.8	1.6	1.9	—
REITs	13.2	1.4	4.8	7.0	—
All Private Financial Institutions	$ 610.5	$ 376.2	$ 74.1	$ 147.0	$ 13.3
Total Mortgage Assets	$ 800.8	$ 490.0	$ 100.6	$ 159.3	$ 50.9

ource: *Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1960-83.* Federal Reserve ׀oard of Governors, Washington, D.C., 1984.

TABLE 19
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1971
(millions of dollars)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
COMMERCIAL BANKS				
1-4 Family Homes	12598	1130	13728	1971
Multi-Family	726	6	732	34
Non-Residential	7104	108	7212	242
Farm Properties	1554	68	1622	15
TOTALS	21982	1312	23294	2262
MUTUAL SAVINGS BANKS				
1-4 Family Homes	3540	1874	5414	175
Multi-Family	1870	266	2136	59
Non-Residential	1611	270	1881	36
Farm Properties	14	24	38	0
TOTALS	7036	2433	9469	270
SAVINGS AND LOANS ASSOC.				
1-4 Family Homes	26603	6635	33238	1654
Multi-Family	3711	467	4179	187
Non-Residential	3363	354	3717	173
Farm Properties	94	51	145	0
TOTALS	33770	7508	41278	2013
LIFE INSURANCE COMPANIES				
1-4 Family Homes	333	185	519	37
Multi-Family	1708	149	1857	8
Non-Residential	3744	300	4043	19
Farm Properties	478	2	481	1
TOTALS	6263	636	6900	65
PRV. NON-INSURED PENSION FUNDS				
1-4 Family Homes	40	15	55	235
Multi-Family	35	0	36	270
Non-Residential	170	4	174	67
Farm Properties	0	16	16	4
TOTALS	246	36	281	576
MORTGAGE COMPANIES				
1-4 Family Homes	12487	403	12890	12394
Multi-Family	1960	12	1972	1583
Non-Residential	1967	0	1967	1790
Farm Properties	11	0	11	10
TOTALS	16425	415	16840	15777

TABLE 19
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1971
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
COMMERCIAL BANKS			
1-4 Family Homes	11757	7493	4264
Multi-Family	698	430	268
Non-Residential	6970	5120	1850
Farm Properties	1607	1732	-125
TOTALS	21031	14774	6257
MUTUAL SAVINGS BANKS			
1-4 Family Homes	5239	4001	1237
Multi-Family	2077	481	1597
Non-Residential	1845	927	918
Farm Properties	38	109	-70
TOTALS	9199	5518	3681
SAVINGS AND LOANS ASSOC.			
1-4 Family Homes	31584	15433	16151
Multi-Family	3992	1528	2464
Non-Residential	3544	1422	2122
Farm Properties	145	70	75
TOTALS	39265	18452	20812
LIFE INSURANCE COMPANIES			
1-4 Family Homes	481	2530	-2049
Multi-Family	1849	1140	709
Non-Residential	4024	1730	2295
Farm Properties	480	520	-40
TOTALS	6834	5920	914
PRV. NON-INSURED PENSION FUNDS			
1-4 Family Homes	-180	117	-297
Multi-Family	-234	77	-311
Non-Residential	107	30	78
Farm Properties	12	0	12
TOTALS	-295	223	-519
MORTGAGE COMPANIES			
1-4 Family Homes	496	243	253
Multi-Family	389	14	375
Non-Residential	177	22	155
Farm Properties	1	0	1
TOTALS	1063	279	784

TABLE 19
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1971
(millions of dollars)
(continued)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
REAL ESTATE INVESTMENT TRUSTS				
1-4 Family Homes	10	155	165	17
Multi-Family	193	5	198	0
Non-Residential	579	35	614	0
Farm Properties	0	0	0	0
TOTALS	782	195	977	17
STATE & LOCAL RETIREMENT FUNDS				
1-4 Family Homes	197	192	388	1
Multi-Family	358	69	426	0
Non-Residential	109	20	130	0
Farm Properties	20	3	23	0
TOTALS	683	284	957	1
FEDERAL CREDIT AGENCIES				
1-4 Family Homes	1798	3733	5531	1853
Multi-Family	1372	242	1614	56
Non-Residential	384	42	426	12
Farm Properties	1919	227	2145	542
TOTALS	5473	4243	9717	2464
MORTGAGE POOLS				
1-4 Family Homes	0	3947	3974	197
Multi-Family	0	52	52	8
Non-Residential	0	12	12	6
Farm Properties	0	542	542	227
TOTALS	0	4554	4554	438
STATE & LOCAL CREDIT AGENCIES				
1-4 Family Homes	183	24	207	0
Multi-Family	520	6	526	14
Non-Residential	219	3	222	0
Farm Properties	53	19	72	0
TOTALS	975	51	1026	14
TOTALS FOR ELEVEN GROUPS				
1-4 Family Homes	57788	18292	76081	18534
Multi-Family	12455	1275	13729	2220
Non-Residential	19250	1148	20398	2345
Farm Properties	4143	952	5095	799
TOTALS	93636	21668	115304	23899

TABLE 19
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1971
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
REAL ESTATE INVESTMENT TRUSTS			
1-4 Family Homes	148	81	68
Multi-Family	198	50	148
Non-Residential	614	224	390
Farm Properties	0	0	0
TOTALS	961	355	605
STATE & LOCAL RETIREMENT FUNDS			
1-4 Family Homes	387	303	84
Multi-Family	426	141	286
Non-Residential	130	116	14
Farm Properties	23	43	-20
TOTALS	966	602	364
FEDERAL CREDIT AGENCIES			
1-4 Family Homes	3678	1476	2202
Multi-Family	1558	253	1306
Non-Residential	413	259	154
Farm Properties	1603	893	710
TOTALS	7253	2880	4373
MORTGAGE POOLS			
1-4 Family Homes	3750	157	3594
Multi-Family	44	8	35
Non-Residential	6	6	0
Farm Properties	316	113	202
TOTALS	4116	285	3831
STATE & LOCAL CREDIT AGENCIES			
1-4 Family Homes	207	142	65
Multi-Family	512	11	502
Non-Residential	222	1	221
Farm Properties	72	38	34
TOTALS	1021	190	822
TOTALS FOR ELEVEN GROUPS			
1-4 Family Homes	57546	31974	25573
Multi-Family	11509	4131	7378
Non-Residential	18053	9856	8197
Farm Properties	4296	3518	778
TOTALS	91408	49479	41925

upply of Mortgage Credit, 1970-79, U.S. Department of Housing and Urban Development, Washington, D.C., 1980
ote: Sum of components may not equal totals due to rounding.

TABLE 20
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1972
(millions of dollars)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
COMMERCIAL BANKS				
1-4 Family Homes	17710	1046	18756	2245
Multi-Family	1347	40	1386	93
Non-Residential	10109	149	10257	389
Farm Properties	2007	2	2009	1
TOTALS	31173	1236	32409	2727
MUTUAL SAVINGS BANKS				
1-4 Family Homes	5052	2708	7761	202
Multi-Family	1929	263	2193	59
Non-Residential	2358	251	2609	80
Farm Properties	23	0	23	0
TOTALS	9363	3222	12585	341
SAVINGS AND LOANS ASSOC.				
1-4 Family Homes	36739	9502	46241	2886
Multi-Family	5285	622	5907	425
Non-Residential	4129	404	4532	268
Farm Properties	139	23	162	3
TOTALS	46292	10550	56842	3582
LIFE INSURANCE COMPANIES				
1-4 Family Homes	401	207	607	5
Multi-Family	1826	107	1933	1
Non-Residential	4581	292	4872	13
Farm Properties	676	1	676	0
TOTALS	7483	606	8089	19
PRV. NON-INSURED PENSION FUNDS				
1-4 Family Homes	120	3	123	405
Multi-Family	23	1	24	286
Non-Residential	135	2	136	204
Farm Properties	0	4	5	10
TOTALS	278	10	288	905
MORTGAGE COMPANIES				
1-4 Family Homes	13326	1431	14757	14315
Multi-Family	2698	18	2716	2257
Non-Residential	1534	13	1547	1212
Farm Properties	57	0	57	47
TOTALS	17615	1452	19077	17831

TABLE 20
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1972
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
COMMERCIAL BANKS			
1-4 Family Homes	16511	9383	7128
Multi-Family	1293	499	794
Non-Residential	9869	5444	4425
Farm Properties	2009	1447	561
TOTALS	29682	16773	12909
MUTUAL SAVINGS BANKS			
1-4 Family Homes	7559	4895	2664
Multi-Family	2134	965	1169
Non-Residential	2529	1124	12
Farm Properties	23	11	12
TOTALS	12245	6995	5250
SAVINGS AND LOANS ASSOC.			
1-4 Family Homes	43356	20073	23282
Multi-Family	5481	2371	3111
Non-Residential	4265	1405	2859
Farm Properties	159	54	104
TOTALS	53260	23903	29357
LIFE INSURANCE COMPANIES			
1-4 Family Homes	603	2859	-2257
Multi-Family	1931	1341	590
Non-Residential	4860	1993	2867
Farm Properties	676	597	79
TOTALS	8070	6790	1280
PRV. NON-INSURED PENSION FUNDS			
1-4 Family Homes	-282	132	-414
Multi-Family	-262	84	-346
Non-Residential	-68	97	-165
Farm Properties	-5	2	-7
TOTALS	-617	316	-933
MORTGAGE COMPANIES			
1-4 Family Homes	442	458	-16
Multi-Family	459	29	430
Non-Residential	335	102	233
Farm Properties	10	0	10
TOTALS	1246	589	657

TABLE 20
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1972
(millions of dollars)
(continued)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
REAL ESTATE INVESTMENT TRUSTS				
1-4 Family Homes	47	266	313	111
Multi-Family	327	20	347	0
Non-Residential	913	108	1021	0
Farm Properties	3	0	3	0
TOTALS	1290	394	1683	111
STATE & LOCAL RETIREMENT FUNDS				
1-4 Family Homes	237	96	333	5
Multi-Family	72	29	100	3
Non-Residential	77	124	201	0
Farm Properties	53	4	57	0
TOTALS	439	253	692	8
FEDERAL CREDIT AGENCIES				
1-4 Family Homes	2044	4996	7040	3799
Multi-Family	1444	346	1790	204
Non-Residential	436	59	495	11
Farm Properties	2767	151	2918	776
TOTALS	6690	5553	12243	4791
MORTGAGE POOLS				
1-4 Family Homes	0	4756	4756	157
Multi-Family	0	322	322	9
Non-Residential	0	15	15	6
Farm Properties	0	789	789	151
TOTALS	0	5882	5882	323
STATE & LOCAL CREDIT AGENCIES				
1-4 Family Homes	188	65	253	1
Multi-Family	476	53	529	1
Non-Residential	261	3	264	8
Farm Properties	58	17	74	0
TOTALS	982	138	1120	10
TOTALS FOR ELEVEN GROUPS				
1-4 Family Homes	75864	25076	100939	24129
Multi-Family	15427	1820	17247	3339
Non-Residential	24532	1419	25951	2191
Farm Properties	5783	991	6773	988
TOTALS	121605	29305	150911	30647

TABLE 20
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1972
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
REAL ESTATE INVESTMENT TRUSTS			
1-4 Family Homes	202	119	83
Multi-Family	347	86	260
Non-Residential	1021	309	711
Farm Properties	3	0	3
TOTALS	1573	515	1057
STATE & LOCAL RETIREMENT FUNDS			
1-4 Family Homes	328	294	34
Multi-Family	97	145	-48
Non-Residential	201	54	147
Farm Properties	57	18	39
TOTALS	683	512	171
FEDERAL CREDIT AGENCIES			
1-4 Family Homes	3240	2222	1018
Multi-Family	1586	290	1296
Non-Residential	484	358	126
Farm Properties	2142	1112	1029
TOTALS	7452	3983	3470
MORTGAGE POOLS			
1-4 Family Homes	4599	520	4079
Multi-Family	313	20	293
Non-Residential	9	1	9
Farm Properties	638	127	511
TOTALS	5559	668	4891
STATE & LOCAL CREDIT AGENCIES			
1-4 Family Homes	252	154	98
Multi-Family	527	46	481
Non-Residential	256	6	251
Farm Properties	74	30	44
TOTALS	1110	236	873
TOTALS FOR ELEVEN GROUPS			
1-4 Family Homes	76810	41111	35699
Multi-Family	13907	5877	8030
Non-Residential	23760	10892	12868
Farm Properties	5785	3400	2386
TOTALS	120264	61281	58983

upply of Mortgage Credit, 1970-79, U.S. Department of Housing and Urban Development, Washington, D.C., 1980
ote: Sum of components may not equal totals due to rounding.

TABLE 21
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1973
(millions of dollars)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
COMMERCIAL BANKS				
1-4 Family Homes	18782	925	19708	2010
Multi-Family	1122	24	1146	75
Non-Residential	11484	214	11699	634
Farm Properties	2179	12	2191	4
TOTALS	33568	1176	34743	2723
MUTUAL SAVINGS BANKS				
1-4 Family Homes	5912	1958	7870	161
Multi-Family	2088	275	2363	64
Non-Residential	2484	284	2768	41
Farm Properties	7	0	7	0
TOTALS	10491	2517	13009	266
SAVINGS AND LOANS ASSOC.				
1-4 Family Homes	38441	5862	44303	2759
Multi-Family	4171	539	4710	414
Non-Residential	4024	615	4639	243
Farm Properties	194	3	197	0
TOTALS	46830	7109	53849	3416
LIFE INSURANCE COMPANIES				
1-4 Family Homes	380	247	628	8
Multi-Family	2293	124	2417	1
Non-Residential	6338	408	6746	8
Farm Properties	964	0	964	0
TOTALS	9975	780	10755	17
PRV. NON-INSURED PENSION FUNDS				
1-4 Family Homes	13	6	18	131
Multi-Family	26	4	30	79
Non-Residential	89	23	112	67
Farm Properties	0	3	3	21
TOTALS	127	36	163	297
MORTGAGE COMPANIES				
1-4 Family Homes	12657	1382	14039	14980
Multi-Family	928	11	939	1871
Non-Residential	623	3	626	827
Farm Properties	43	0	43	49
TOTALS	14251	1396	15647	17727

TABLE 21
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1973
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
COMMERCIAL BANKS			
1-4 Family Homes	17698	8954	8744
Multi-Family	1071	815	256
Non-Residential	11065	5862	5203
Farm Properties	2187	1504	683
TOTALS	32021	17134	14886
MUTUAL SAVINGS BANKS			
1-4 Family Homes	7709	5169	2540
Multi-Family	2299	959	1340
Non-Residential	2727	1064	1663
Farm Properties	7	6	2
TOTALS	12742	7197	5545
SAVINGS AND LOANS ASSOC.			
1-4 Family Homes	41545	20999	20545
Multi-Family	4297	1880	2416
Non-Residential	4396	1917	2478
Farm Properties	197	257	-60
TOTALS	50434	25054	25380
LIFE INSURANCE COMPANIES			
1-4 Family Homes	620	2458	-1838
Multi-Family	2416	1370	1046
Non-Residential	6738	1975	4763
Farm Properties	964	651	312
TOTALS	10738	6455	4283
PRV. NON-INSURED PENSION FUNDS			
1-4 Family Homes	-112	116	-228
Multi-Family	-49	47	-96
Non-Residential	45	54	-9
Farm Properties	-18	0	-18
TOTALS	-134	218	-352
MORTGAGE COMPANIES			
1-4 Family Homes	-941	374	-1315
Multi-Family	-932	82	-1015
Non-Residential	-202	40	-242
Farm Properties	-6	0	-6
TOTALS	-2080	497	-2577

TABLE 21
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1973
(millions of dollars)
(continued)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
REAL ESTATE INVESTMENT TRUSTS				
1-4 Family Homes	28	13	41	39
Multi-Family	611	17	628	0
Non-Residential	1175	68	1242	1
Farm Properties	8	0	8	0
TOTALS	1822	97	1919	40
STATE & LOCAL RETIREMENT FUNDS				
1-4 Family Homes	217	302	519	24
Multi-Family	64	71	135	41
Non-Residential	257	252	509	0
Farm Properties	10	114	124	7
TOTALS	547	740	1287	73
FEDERAL CREDIT AGENCIES				
1-4 Family Homes	2351	7396	9748	4315
Multi-Family	2218	701	2920	306
Non-Residential	724	82	806	7
Farm Properties	3664	191	3855	551
TOTALS	8958	8371	17328	5180
MORTGAGE POOLS				
1-4 Family Homes	0	4178	4178	436
Multi-Family	0	268	268	15
Non-Residential	0	7	7	14
Farm Properties	0	552	552	191
TOTALS	0	5007	5007	656
STATE & LOCAL CREDIT AGENCIES				
1-4 Family Homes	345	302	647	0
Multi-Family	500	109	609	0
Non-Residential	200	2	202	0
Farm Properties	59	16	75	0
TOTALS	1103	430	1532	0
TOTALS FOR ELEVEN GROUPS				
1-4 Family Homes	79126	22473	101700	24862
Multi-Family	14022	2144	16166	2866
Non-Residential	27397	1959	29356	1844
Farm Properties	7128	891	8019	822
TOTALS	127673	27567	155240	30395

TABLE 21
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1973
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
REAL ESTATE INVESTMENT TRUSTS			
1-4 Family Homes	1	172	-171
Multi-Family	628	273	355
Non-Residential	1241	549	692
Farm Properties	8	2	6
TOTALS	1879	996	882
STATE & LOCAL RETIREMENT FUNDS			
1-4 Family Homes	495	327	168
Multi-Family	94	163	-69
Non-Residential	509	39	470
Farm Properties	117	14	103
TOTALS	1214	542	672
FEDERAL CREDIT AGENCIES			
1-4 Family Homes	5432	2491	2942
Multi-Family	2613	502	2111
Non-Residential	798	482	317
Farm Properties	3305	1357	1948
TOTALS	12149	4831	7317
MORTGAGE POOLS			
1-4 Family Homes	3743	794	2949
Multi-Family	254	17	236
Non-Residential	-7	2	-9
Farm Properties	361	198	163
TOTALS	4351	1012	3339
STATE & LOCAL CREDIT AGENCIES			
1-4 Family Homes	647	117	530
Multi-Family	609	56	552
Non-Residential	202	9	193
Farm Properties	75	34	40
TOTALS	1532	1532	1315
TOTALS FOR ELEVEN GROUPS			
1-4 Family Homes	76837	41971	34866
Multi-Family	13299	6166	7134
Non-Residential	27512	11994	15518
Farm Properties	7197	4023	3174
TOTALS	124846	64153	60692

upply of Mortgage Credit, 1970-79, U.S. Department of Housing and Urban Development, Washington, D.C., 1980
ote: Sum of components may not equal totals due to rounding.

TABLE 22
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1974
(millions of dollars)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
COMMERCIAL BANKS				
1-4 Family Homes	16128	372	16500	1623
Multi-Family	749	144	893	60
Non-Residential	9844	594	10438	747
Farm Properties	2054	3	2056	0
TOTALS	28775	1112	29887	2430
MUTUAL SAVINGS BANKS				
1-4 Family Homes	3929	1039	4968	228
Multi-Family	1532	261	1793	77
Non-Residential	1578	221	1800	71
Farm Properties	11	0	7	11
TOTALS	7051	1521	8572	378
SAVINGS AND LOANS ASSOC.				
1-4 Family Homes	30932	4824	35756	3093
Multi-Family	3262	433	3695	228
Non-Residential	3588	608	4196	206
Farm Properties	49	0	49	0
TOTALS	37832	5865	43697	3527
LIFE INSURANCE COMPANIES				
1-4 Family Homes	359	179	538	24
Multi-Family	2046	128	2174	5
Non-Residential	6468	351	6819	4
Farm Properties	957	1	958	0
TOTALS	9870	659	10489	33
PRV. NON-INSURED PENSION FUNDS				
1-4 Family Homes	32	25	57	1
Multi-Family	58	6	64	5
Non-Residential	64	12	76	10
Farm Properties	0	0	1	2
TOTALS	154	44	198	17
MORTGAGE COMPANIES				
1-4 Family Homes	13026	880	13906	14886
Multi-Family	595	9	603	639
Non-Residential	748	1	749	620
Farm Properties	7	8	15	19
TOTALS	14375	899	15274	16164

TABLE 22
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1974
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
COMMERCIAL BANKS			
1-4 Family Homes	14877	7890	6986
Multi-Family	832	670	162
Non-Residential	9691	5956	3735
Farm Properties	2056	1478	578
TOTALS	27456	15994	11462
MUTUAL SAVINGS BANKS			
1-4 Family Homes	4740	4307	432
Multi-Family	1716	883	833
Non-Residential	1729	995	734
Farm Properties	0	11	-2
TOTALS	8196	6199	1997
SAVINGS AND LOANS ASSOC.			
1-4 Family Homes	32663	18457	14206
Multi-Family	3467	1518	1949
Non-Residential	3990	1578	2412
Farm Properties	49	104	-56
TOTALS	40169	21658	18511
LIFE INSURANCE COMPANIES			
1-4 Family Homes	514	1872	-1358
Multi-Family	2170	1066	1104
Non-Residential	6815	2265	4550
Farm Properties	958	627	330
TOTALS	10456	5829	4626
PRV. NON-INSURED PENSION FUNDS			
1-4 Family Homes	56	82	-26
Multi-Family	60	33	27
Non-Residential	67	70	-3
Farm Properties	-1	1	-2
TOTALS	181	186	-5
MORTGAGE COMPANIES			
1-4 Family Homes	-980	324	-1303
Multi-Family	-36	4	-40
Non-Residential	126	31	97
Farm Properties	-3	0	-3
TOTALS	-891	359	-1249

TABLE 22
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1974
(millions of dollars)
(continued)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
REAL ESTATE INVESTMENT TRUSTS				
1-4 Family Homes	12	9	21	0
Multi-Family	309	11	320	0
Non-Residential	779	42	821	8
Farm Properties	6	0	6	0
TOTALS	1106	62	1168	8
STATE & LOCAL RETIREMENT FUNDS				
1-4 Family Homes	86	250	336	28
Multi-Family	97	98	195	18
Non-Residential	203	241	444	6
Farm Properties	5	21	26	19
TOTALS	392	609	1001	71
FEDERAL CREDIT AGENCIES				
1-4 Family Homes	2467	8801	11268	2534
Multi-Family	2870	805	3675	395
Non-Residential	355	156	511	20
Farm Properties	4507	388	4895	844
TOTALS	10199	10151	20350	3794
MORTGAGE POOLS				
1-4 Family Homes	0	6305	6305	692
Multi-Family	0	316	316	35
Non-Residential	0	20	20	16
Farm Properties	0	844	844	388
TOTALS	0	7485	7485	1132
STATE & LOCAL CREDIT AGENCIES				
1-4 Family Homes	538	354	891	0
Multi-Family	759	173	932	8
Non-Residential	353	1	354	1
Farm Properties	66	5	71	0
TOTALS	1716	533	2249	10
TOTALS FOR ELEVEN GROUPS				
1-4 Family Homes	67508	23039	90546	23111
Multi-Family	12277	2383	14660	1471
Non-Residential	23982	2247	26229	1708
Farm Properties	7663	1270	8933	1272
TOTALS	111429	28939	140368	27562

TABLE 22
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1974
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
REAL ESTATE INVESTMENT TRUSTS			
1-4 Family Homes	21	56	-35
Multi-Family	320	259	61
Non-Residential	814	524	290
Farm Properties	6	6	-0
TOTALS	1160	845	315
STATE & LOCAL RETIREMENT FUNDS			
1-4 Family Homes	308	237	71
Multi-Family	177	94	83
Non-Residential	438	13	425
Farm Properties	7	74	-67
TOTALS	930	419	511
FEDERAL CREDIT AGENCIES			
1-4 Family Homes	8734	2215	6519
Multi-Family	3280	545	2735
Non-Residential	492	405	86
Farm Properties	4051	1489	2562
TOTALS	16556	4655	11902
MORTGAGE POOLS			
1-4 Family Homes	5612	984	4628
Multi-Family	281	15	266
Non-Residential	4	1	2
Farm Properties	456	189	267
TOTALS	6353	1189	5164
STATE & LOCAO CREDIT AGENCIES			
1-4 Family Homes	891	172	719
Multi-Family	924	41	882
Non-Residential	353	12	341
Farm Properties	71	37	34
TOTALS	2239	262	1977
TOTALS FOR ELEVEN GROUPS			
1-4 Family Homes	67435	36596	30839
Multi-Family	13190	5128	8062
Non-Residential	24521	11851	12670
Farm Properties	7661	4019	3641
TOTALS	112806	57594	55212

Supply of Mortgage Credit, 1970-79, U.S. Department of Housing and Urban Development, Washington, D.C., 1980
Note: Sum of components may not equal totals due to rounding.

TABLE 23
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1975
(millions of dollars)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
COMMERCIAL BANKS				
1-4 Family Homes	14450	236	14686	2932
Multi-Family	767	30	796	27
Non-Residential	9956	165	10121	427
Farm Properties	1889	1	1890	1
TOTALS	27062	431	27494	3386
MUTUAL SAVINGS BANKS				
1-4 Family Homes	4333	1103	5436	235
Multi-Family	1459	343	1805	32
Non-Residential	1325	304	1629	3
Farm Properties	11	1	12	0
TOTALS	7127	1751	8879	269
SAVINGS AND LOANS ASSOC.				
1-4 Family Homes	41242	7167	48409	4726
Multi-Family	3562	393	3955	102
Non-Residential	4910	898	5808	406
Farm Properties	95	13	108	0
TOTALS	49809	8471	58280	5234
LIFE INSURANCE COMPANIES				
1-4 Family Homes	251	126	377	25
Multi-Family	1139	76	1215	0
Non-Residential	5832	310	6143	3
Farm Properties	1075	0	1075	0
TOTALS	8297	513	8810	28
PRV. NON-INSURED PENSION FUNDS				
1-4 Family Homes	3	11	14	10
Multi-Family	90	8	97	25
Non-Residential	123	13	136	21
Farm Properties	0	0	0	0
TOTALS	216	31	247	57
MORTGAGE COMPANIES				
1-4 Family Homes	13992	785	14777	14451
Multi-Family	778	24	802	807
Non-Residential	1159	11	1170	1067
Farm Properties	1	0	1	0
TOTALS	15930	820	16750	16324

TABLE 23
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1975
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
COMMERCIAL BANKS			
1-4 Family Homes	11755	9550	2204
Multi-Family	770	1143	-374
Non-Residential	9694	5964	3730
Farm Properties	1889	1571	318
TOTALS	24107	18228	5880
MUTUAL SAVINGS BANKS			
1-4 Family Homes	5202	4338	854
Multi-Family	1770	970	800
Non-Residential	1626	912	715
Farm Properties	12	14	-2
TOTALS	8610	6244	2366
SAVINGS AND LOANS ASSOC.			
1-4 Family Homes	43683	21606	22077
Multi-Family	3853	1844	2009
Non-Residential	5402	2464	2938
Farm Properties	108	85	23
TOTALS	53046	25999	27047
LIFE INSURANCE COMPANIES			
1-4 Family Homes	353	1780	-1427
Multi-Family	1215	1216	-1
Non-Residential	6140	2493	3647
Farm Properties	1075	646	429
TOTALS	8782	6135	2647
PRV. NON-INSURED PENSION FUNDS			
1-4 Family Homes	4	96	-92
Multi-Family	72	23	49
Non-Residential	115	62	53
Farm Properties	0	0	-0
TOTALS	191	181	10
MORTGAGE COMPANIES			
1-4 Family Homes	326	271	55
Multi-Family	-5	7	-11
Non-Residential	103	42	62
Farm Properties	1	0	1
TOTALS	426	319	107

TABLE 23
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1975
(millions of dollars)
(continued)

	Total Loan Originations	Loan Purchases	Gross Acquisitions	Loan Sales
REAL ESTATE INVESTMENT TRUSTS				
1-4 Family Homes	34	6	40	4
Multi-Family	227	8	235	9
Non-Residential	419	26	445	18
Farm Properties	2	0	2	0
TOTALS	682	40	722	31
STATE & LOCAL RETIREMENT FUNDS				
1-4 Family Homes	146	138	284	87
Multi-Family	147	156	303	21
Non-Residential	110	202	312	25
Farm Properties	7	12	19	7
TOTALS	410	508	918	139
FEDERAL CREDIT AGENCIES				
1-4 Family Homes	2867	10732	13599	6722
Multi-Family	1725	1261	2986	892
Non-Residential	378	160	538	18
Farm Properties	4779	373	5152	1052
TOTALS	9749	12526	22774	8694
MORTGAGE POOLS				
1-4 Family Homes	0	11156	11156	454
Multi-Family	0	594	594	32
Non-Residential	0	17	17	12
Farm Properties	0	1062	1062	373
TOTALS	0	12829	12829	871
STATE & LOCAL CREDIT AGENCIES				
1-4 Family Homes	594	420	1015	7
Multi-Family	749	263	1012	250
Non-Residential	16	0	16	0
Farm Properties	76	0	76	0
TOTALS	1434	684	2118	257
TOTALS FOR ELEVEN GROUPS				
1-4 Family Homes	77913	31881	109793	29652
Multi-Family	10642	3154	13797	2196
Non-Residential	24228	2106	26334	1999
Farm Properties	7934	1462	9397	1443
TOTALS	120717	38604	159320	35290

TABLE 23
ANNUAL GROSS FLOWS OF LONG-TERM MORTGAGE LOANS BY ELEVEN MAJOR LENDING GROUPS FOR THE YEAR, 1975
(millions of dollars)
(continued)

	Net Acquisitions	Repayments	Net Change
REAL ESTATE INVESTMENT TRUSTS			
1-4 Family Homes	36	60	-24
Multi-Family	226	269	-42
Non-Residential	427	592	-165
Farm Properties	2	3	-1
TOTALS	691	923	-232
STATE & LOCAL RETIREMENT FUNDS			
1-4 Family Homes	198	245	-47
Multi-Family	282	120	162
Non-Residential	287	55	232
Farm Properties	12	17	-5
TOTALS	779	437	342
FEDERAL CREDIT AGENCIES			
1-4 Family Homes	6877	6475	4230
Multi-Family	2094	906	1188
Non-Residential	520	223	297
Farm Properties	4089	1745	2345
TOTALS	13580	5521	8060
MORTGAGE POOLS			
1-4 Family Homes	10702	1235	9466
Multi-Family	562	66	495
Non-Residential	5	1	4
Farm Properties	689	145	544
TOTALS	11957	1447	10510
STATE & LOCAO CREDIT AGENCIES			
1-4 Family Homes	1008	280	728
Multi-Family	762	130	632
Non-Residential	16	17	-2
Farm Properties	76	31	45
TOTALS	1861	458	1403
TOTALS FOR ELEVEN GROUPS			
1-4 Family Homes	80142	42117	38024
Multi-Family	11601	6694	4907
Non-Residential	24335	12823	11512
Farm Properties	7953	4258	3696
TOTALS	124031	65892	58113

'*upply of Mortgage Credit, 1970-79*, U.S. Department of Housing and Urban Development, Washington, D.C., 1980
lote: Sum of components may not equal totals due to rounding.

Chapter 7

The Rise

The entrance of the major financial institutions–banks, insurance companies, savings and loans–into the field in 1969 touched off the explosive growth of the REIT industry. From $1 billion, total REIT assets doubled to $2 billion in 1969; then increased by 135 percent in 1970, by 72 percent in 1971, and by 75 percent in 1972. [Table 1] To raise new capital to buy these assets, REITs became significant factors in Wall Street's generally booming business in new issues. [Table 2]; [Chart A]

Between 1968 and 1971, as the total number of new issues increased from 19 to 74 (Table 2), the REITs' gross proceeds from public offerings grew from only $138 million to more than $1.6 billion. (By 1974, when the bloom was definitely off the REIT rose, there were only 12 new REIT issues, raising less than $200 million.) At their most active, REITs very suddenly came to represent fully 12 percent of total public offerings of new stock issues and 4.5 percent of all new bond issues in the U.S.

At the outset of the REIT boom in 1969, almost 90 percent of the primary issues was for shares of beneficial interest, while the remaining 10 percent was almost entirely made up of convertible debt. Straight debt instruments were virtually unused as sources of capital. During the next two years, as the formation of new REITs continued at high speed, convertible debt came to represent a larger share of the new capital, growing as much as fivefold in a single year.

At the same time, straight debt emerged as a modest but real factor in REIT capitalizations. Straight equity offerings, meanwhile, were declining in importance, both relatively and absolutely. ([Table 3]; [Appendix I] lists the monthly amounts of new capital raised by equity and debt from 1969 through 1974.)

The reason for the changes in the relative importance of equity and debt for raising capital is suggested by a comparison of the stock prices of equity and mortgage REITs with the Dow Jones Industrial Average. [Graph B] Beginning at 100 in January 1967, the price of mortgage-trust stocks passed the 400 mark in two years, and equity-trust stocks passed 200, while the Dow was still stuck in the neighborhood of 100, where it started. Evidently, the market was valuing the REITs, especially the mortgage REITs, as growth stocks.

The short-term construction-and-development trusts, the C and D REITs, were the first to be recognized for their potential as growth stocks. According to its annual reports Continental Mortgage Investors, the stellar performer among the three earliest C and Ds, increased its assets from $25 million in 1962 to $400 million in 1971, while its per-share earnings improved at an annual rate of about 20 percent.

This kind of performance which led to the practice known as "equity leveraging," becomes feasible when enthusiasm for a stock raises its market price above its book value–the actual value of the share of the company's assets represented by a share of stock. Under such conditions, equity becomes readily saleable, as the booming sales of REIT stocks during this period illustrate.

In theory, at least, equity leveraging should have been followed soon by debt leveraging. Robust equity sales had so lowered the debt-to-equity ratios of the REITs that new debt could be sold without raising the ratios to unacceptable levels. The potential for combined equity and debt leveraging led to REITs

being described as "perpetual growth machines"[1]

As early as 1969, however, investors' faith in the "perpetual" quality of the REIT stocks began to falter as the prices of mortgage trust shares dropped rather sharply, then proceeded on a disconcertingly bumpy road. Investors began to believe that REIT stocks, just like all stocks, entailed risks as well as rewards. Wall Street decided that what the REITs ought to do was to switch to selling convertible bonds instead of the straight, simple kind. [Table 3]

A convertible bond, in short, gives its owner the right to collect interest on the debt it represents, like an ordinary bond; as well as to buy an amount of the company's common stock at a certain price. Most convertible bonds carry with them the right of the issuer to buy them back–to call them–at some premium over the face value, as well as the buyer's right to return them to the issuer for shares of stock.

The REITs' willingness to issue convertible bonds in huge quantities has provoked analysis from a number of commentators. In general, it has been pointed out, companies use convertible debentures for very specific reasons:

> ...convertibles tend to be issued by the smaller and more speculative firms. They are almost invariably unsecured and generally subordinated. Now put yourself in the position of a potential investor. You are approached by a small firm with an untried product line that wants to issue some junior unsecured debt. You know that if things go well you will get your money back but, if they do not,

[1]The term "perpetual growth machines" or any variant thereof, is one to which many writers have referred. It is based on successive equity and debt leveraging to increase trust assets. See, for example, Howard H. Stevenson, "What went wrong with REITs?" Harvard Business School, Boston, MA 1976; and Kenneth D. Campbell, "The Real Estate Trusts: America's Newest Billionaires", "Chapter 6, Audit Investment Research, Inc., New York, 1971.

> you could easily be left with nothing. Since the firm is in a new line of business, it is very difficult to assess the chances of trouble. Therefore you don't know what the fair rate of interest is. Also, you may be worried that once you have made the loan, management will be tempted to run extra risks. It may borrow additional senior debt or it may decide to expand its operations and go for broke on your money. In fact, if you charge a very high rate of interest, you could be encouraging this to happen. What can management do to protect you against a misestimate of the risk and to assure you that its intentions are honorable? In crude terms, it can give you a piece of the action. You don't mind the company running unanticipated risks, as long as you share in the gains as well as the losses.
>
> Convertible securities and warrants make sense whenever it is unusually costly to assess the risk of debt or whenever investors are worried that management may not act in the bondholder's interest.[2]

In the event, the REITs followed Brearly and Meyers' scenario almost to the letter, selling extraordinary quantities of convertibles–debentures and warrants between 1969 and 1972. The REITs' use of convertibles to raise capital was encouraged by the underwriters, for whom convertibles promised rich rewards for relatively slight additional risks. Normally, the underwriting "spreads" on bonds—are less than 100 basis points, or 1 percent. On the REITs' convertible bonds, however, the underwriters were able to take spreads of more than 200 basis points, or 2 percent. Indeed, in 1971 the average underwriting spread for a sample of convertible offerings was 319 basis points, or 3.19 percent, while the

[2]Brealey, Richard A., and Stewart C. Meyers, *Principles of Corporate Finance*, New York: McGraw-Hill, Inc., 1981), p. 516.

largest spread was 600 basis points. [Table 4]

In ordinary circumstances, convertible debentures are often considered "cheap debt" because they typically yield less than ordinary, "straight debt" instruments. The investor is compensated for the lower face yield by the call-option "sweetener"– the right to convert the debenture into common stock. The value of the call option is approximately the difference between the face yield of the convertible debenture and the face yield of an ordinary debenture, aside from slight discrepancies due to imperfections in the market. The debtor issuing the debenture, meanwhile, saves money on the lower yield.

In the case of the REITs' convertibles, however, investors were persuaded by a superb Wall Street marketing effort that the REITs were hot enough to justify spreads of 300 to 400 percent between the conversion price and the stock price at issue, instead of the typical spread of perhaps 20 percent of the stock price. Convinced of the stock's premium value, the investors were willing to accept greatly reduced yields on the debenture's bond portion. Neither the premium nor the saving accrued to the REIT, however; both were absorbed by the underwriters.

The underwriters also profited more than generously from the REIT warrants, options to buy stock at a specified price. Warrants are most often used in private placements; they are often packaged with stocks or bonds, or issued to investment bankers as compensation for their underwriting services. By 1973, REITs had sold packages of stocks and warrants worth a total of $1.5 billion. This activity in warrants provided another opportunity for the underwriters to make profits.

Finally, the underwriters profited from unusually generous rewards for underwriting the REITs' common stock issues. Ordinarily, the underwriting compen-

sation for a common stock issue valued at between $10 million and $20 million would be about 5 percent[2], less for larger issues, which can be handled by the underwriters with correspondingly greater efficiency. In fact, however, the compensation collected by REIT underwriters averaged about 8 percent, despite an average issue size exceeding $20 million.[Table 5] Of the Builders Investment Group's issue of $60 million, for example, the underwriters got 8.2 percent for their services, twice the usual compensation for an issue of this magnitude.

TABLE 1

REIT INDUSTRY ASSETS

Year-end	Billions
1961	$0.3
1962	0.4
1963	0.5
1964	0.6
1965	0.7
1966	0.8
1967	0.9
1968	1.0
1969	2.0
1970	4.7
1971	8.1
1972	14.2
1973	20.2
1974	21.2

Source: National Association of Real Estate Investment Trusts: Annual Factbooks

TABLE 2
NEW CAPITAL RAISED THROUGH PUBLIC SECURITIES OFFERINGS
OF REAL ESTATE INVESTMENT TRUSTS
1961-1974

EQUITY SHARES

	Number of Issues	Dollar Volume (in millions)	Share of Public Offerings of all New Equity Issues (in percent)
1961	10	98.9	2.9
1962	9	70.8	4.4
1963	4	23.7	2.1
1964	7	29.3	1.0
1965	4	10.9	0.6
1966	3	5.4	0.2
1967	1	0.3	0.0
1968	15	110.6	2.6
1969	44	958.4	12.0
1970	37	972.7	11.6
1971	43	883.2	7.1
1972	38	596.7	5.2
1973	32	402.7	4.0
1974	9	72.2	2.0

Source: Office of Economic Research, Securities and Exchange Commission

TABLE 2
NEW CAPITAL RAISED THROUGH PUBLIC SECURITIES OFFERINGS
OF REAL ESTATE INVESTMENT TRUSTS
1961-1974

DEBT SECURITIES[1]

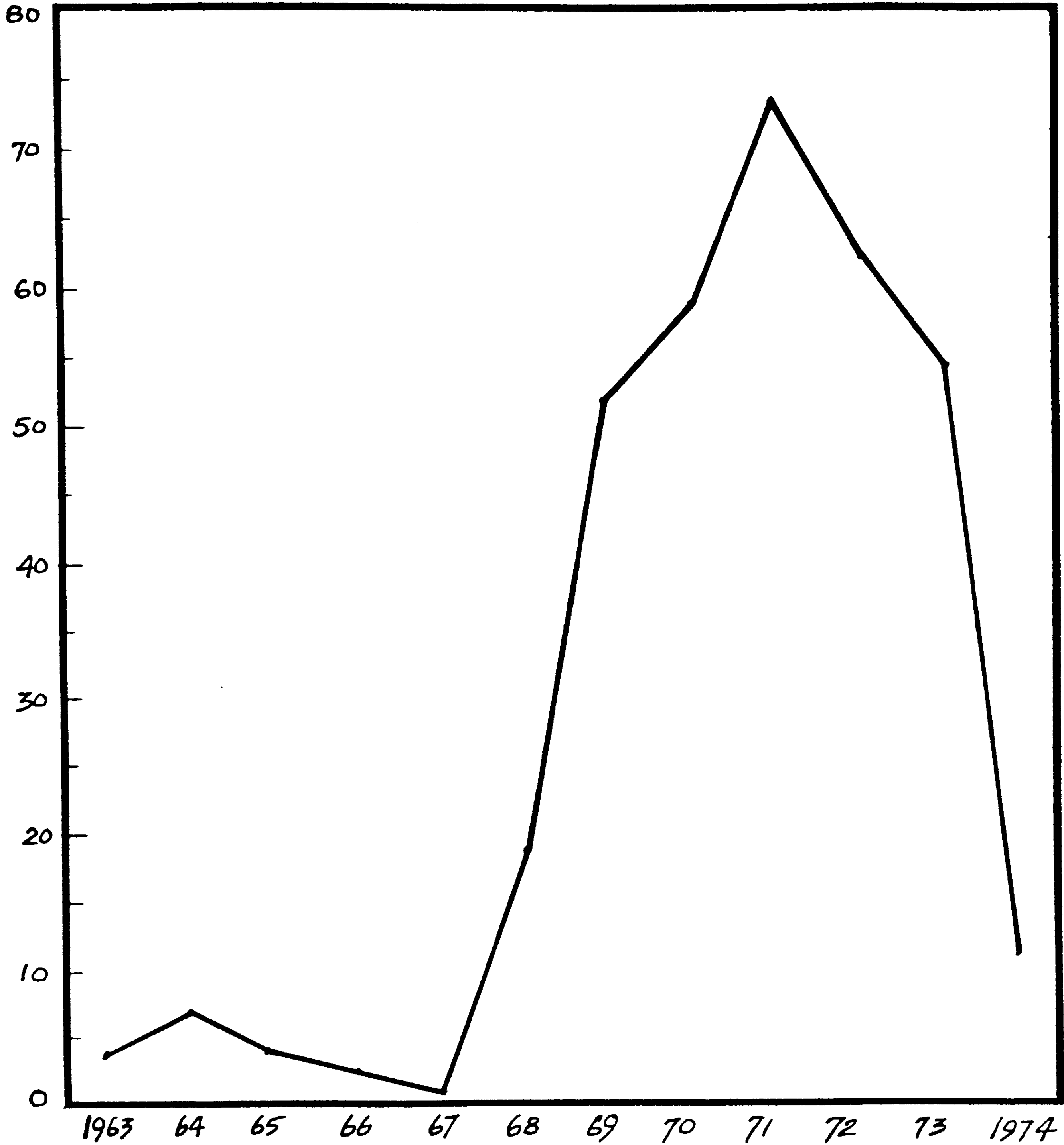
	Number of Issues	Dollar Volume (in millions)	Share of Public Offerings of all New Equity Issues (in percent)
1961	*	–	–
1962	*	–	–
1963	*	–	–
1964	*	–	–
1965	*	–	–
1966	*	–	–
1967	*	–	–
1968	4	27.5	0.3
1969	8	120.9	0.9
1970	22	605.7	2.4
1971	31	763.3	3.3
1972	25	521.0	3.1
1973	23	578.0	4.5
1974	3	115.0	0.8

*None Issued.
[1]Includes both convertible and nonconvertible debentures.

CHART A

NEW CAPITAL RAISED THROUGH PUBLIC SECURITIES OFFERINGS BY REITs: 1963-1974

No. of ISSUES



SECURITIES AND EXCHANGE COMMISSION
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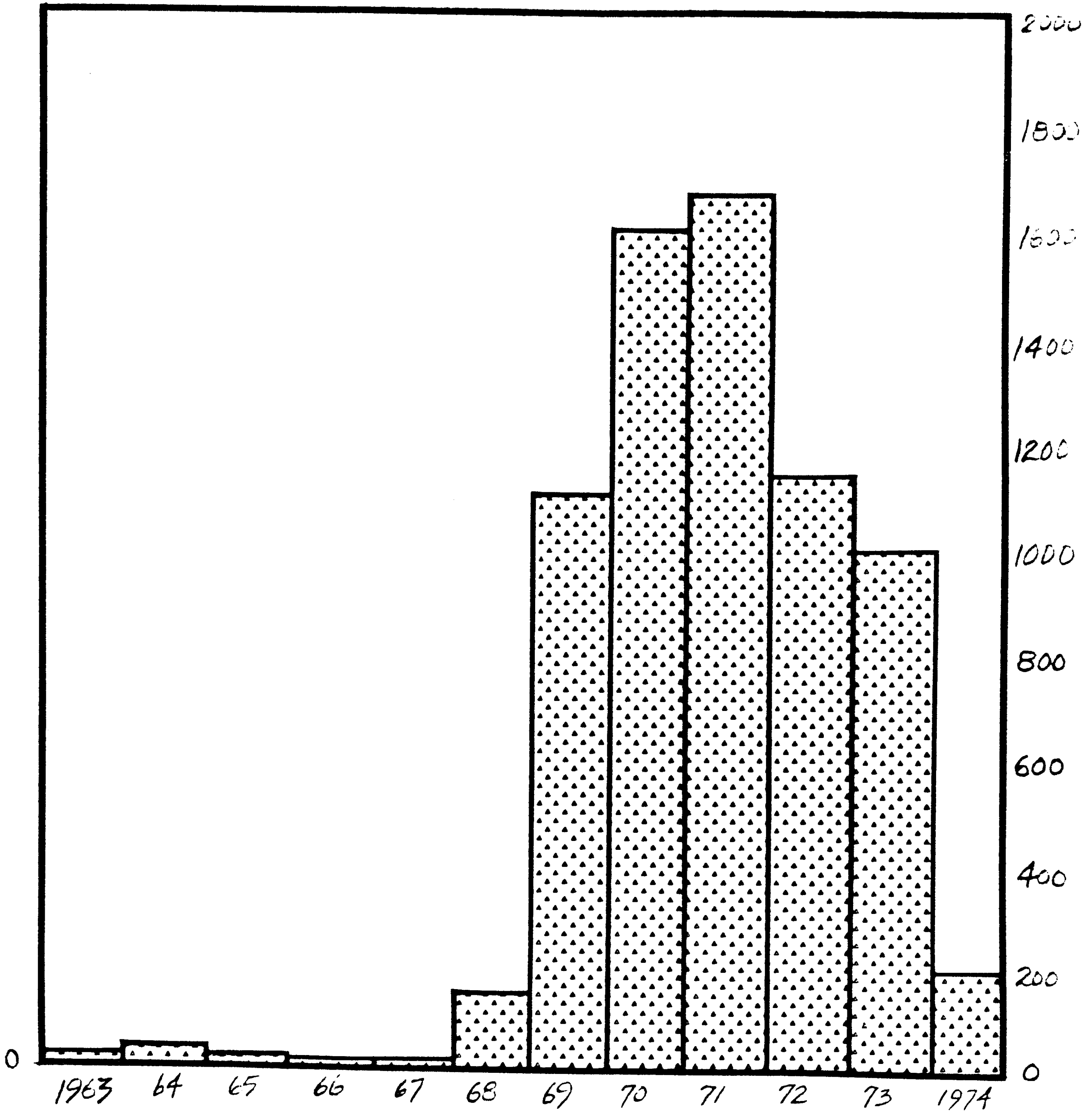
CHART A (cont.)

NEW CAPITAL RAISED THROUGH PUBLIC SECURITIES OFFERINGS BY REITs: 1963-1974



SECURITIES AND EXCHANGE COMMISSION
OFFICE of ECONOMIC RESEARCH

TABLE 3

REAL ESTATE INVESTMENT TRUST REGISTRATIONS 1969-1974
($ millions)

Type of Security	1969	1970	1971	1972	1973	1974
Equity Shares	958.4	970.7	877.7	593.4	402.7	128.5
Convertible Debt	109.4	575.7	607.8	186.0	60.0	20.0
Straight Debt	11.5	30.0	155.5	335.0	518.0	115.0
All Securities	1,079.3	1,576.4	1,641.0	1,114.4	980.7	263.5

Note: Includes REIT securities registered for cash sales only.
Source: Office of Economic Research, Securities and Exchange Commission

TABLE 4
NEW UNDERWRITTEN OFFERINGS BY REIT'S: 1971
CONVERTIBLE DEBENTURES

Name	Exchange Listing	Amount of Offering ($ millions)	Underwriter's Spread (in %)
Mortgage Trusts			
Atico Mortgage Inv.	NYSE	18.0	3.5
Beneficial Standard Mtg. Inv.	NYSE	18.0	3.0
Capital Mortgage Inv.	NYSE	25.0	2.2
Colwell Mortgage Trust	NYSE	15.0	3.5
First Pennsylvania Mortgage Trust	NYSE	30.0	2.5
Galbreath First Mtg. Inv. (Nationwide Mtg. Inv.)	OTC	15.0	6.0
Midland Mortgage Inv.	NYSE	15.0	3.5
Sutro Mortgage Inv. Trust	NYSE	15.0	3.5
Mixed			
Connecticut General Mtg. and Rlty Inv.	NYSE	75.0	1.2
First Union RE Equity and Mtg. Trust	NYSE	20.0	3.5
Hotel Investors	ASE	15.0	2.5
Massachusetts Mtg. and Realty	NYSE	50.0	1.2
Realty Income Trust	ASE	20.0	4.5
B.F. Saul REIT	NYSE	17.0	4.0

Office of Economic Research
Securities and Exchange Commission

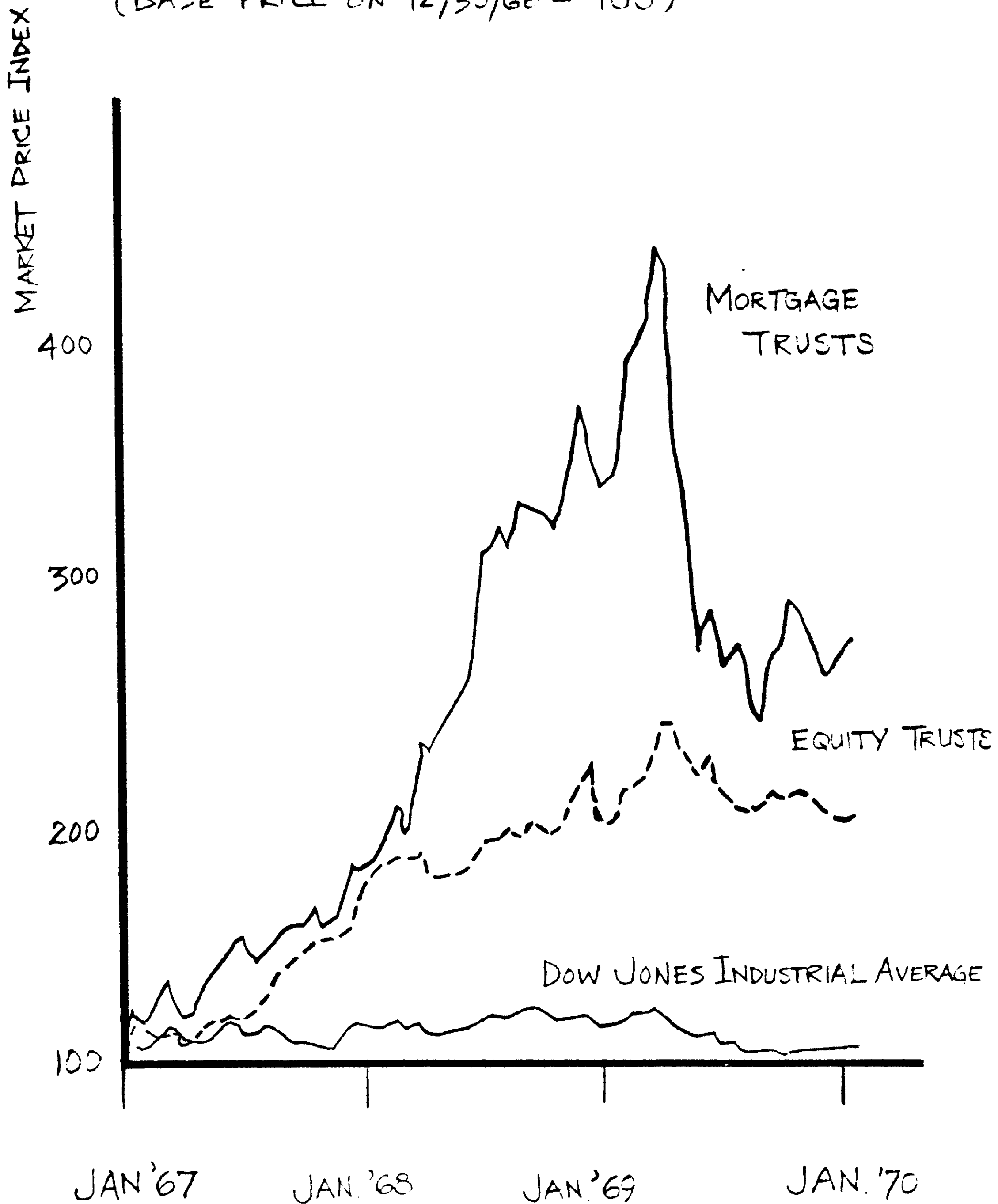
Table 5
NEW UNDERWRITTEN OFFERINGS BY REIT'S: 1971

Name	Exchange Listing	Amount of Offering ($ millions)	Share Offering Price (dollars)	Underwriter's Spread (in %)
Mortgage Trusts				
Baird & Warner Mtg. & Rlty Inv.	OTC	12.5	20,000	6.5
Cabot, Cabot Forbes Lant. Tr.	NYSE	25.0	20,000	5.5
Dominion Mtg. & Rlty Trust	OTC	6.0	12,000	10.0
First Wisconsin Mtg. Inv.	NYSE	30.0	25,000	7.6
Gulf South Mtg. Inv.	ASE	15.0	20,000	8.5
Hamilton Inv. Trust	OTC	25.0	20,000	8.5
Heitman Mtg. Inv.	ASE	10.0	10,000	6.0
ICM Realty	ASE	23.0	23,000	7.6
Larwin Mtg. & Realty Trust	ASE	60.0	20,000	8.0
Lomas & Nettleton Mtg. Inv.	NYSE	37.2	41,375	5.3
National Mtg. Fund	NYSE	12.4	11,000	10.2
North American Mtg. Inv.	NYSE	20.6	26,750	5.0
Property Capital Trust	ASE	15.8	21,000	6.8
Realty Refund Trust	ASE	20.0	20,000	8.5
Texas First Mtg. Inv.	OTC	20.0	20,000	8.2
USF Investors	OTC	50.0	25,000	8.2
Equity Trusts				
Arien Property Inv.	OTC	16.5	16,500	8.0
Continental Illinois	NYSE	25.0	25,000	5.6
First Fidelity	OTC	7.5	15,000	9.0
GREIT Realty Trust	ASE	8.8	17,500	8.3
Washington REIT	ASE	5.8	11,500	8.4
Wisconsin REIT	OTC	7.2	11,000	10.0
Mixed				
American Realty Trust	ASE	9.6	9,625	9.5
Builders Inv. Group	NYSE	60.0	25,000	8.2
Clevetrust	OTC	50.0	20,000	8.5
Gulf Mortgage & Realty Inv.	NYSE	40.0	20,000	8.2
HNC Mortgage & Realty Inv.	OTC	15.0	20,000	5.0
Hospital Investors (Atlanta National)	OTC	25.0	20,000	8.5
Investors Realty Trust	ASE	18.0	15,000	9.0
HJB Prime Inv.	ASE	15.0	20,000	6.7
NW Mutual Life Mtg. & Rlty Inv.	NYSE	50.0	20,000	5.0
Realty & Mtg. Inv. of the Pacific	OTC	25.0	20,000	6.5
State Mutual	NYSE	25.0	20,000	5.5

Source: Audit Investment Research.

GRAPH B

PAINE WEBBER INDEX
(BASE PRICE ON 12/30/66 = 100)



SOURCE: PAINE WEBBER JACKSON CURTIS INDEX for 1967-70.

APPENDIX TO CHAPTER 7

RAPID GROWTH – HOW THE CAPITAL WAS RAISED

NEW CAPITAL RAISED THROUGH NEW SECURITIES OFFERINGS

1969 ($ million)

Month	Shares	Debt	Total	Number of Issues
January	7.4	28.4	35.8	6
February	17.5	0.5	18.0	2
March	38.2	92.5	130.7	6
April	70.6	6.2	76.8	3
May	9.7	28.0	37.7	7
June	91.1	20.0	111.1	6
July	32.8	48.0	80.8	5
August	36.4	24.3	60.7	6
September	159.6	56.9	216.5	6
October	145.0	29.0	174.0	8
November	287.2	0	287.2	9
December	76.6	0	76.6	5
Grand Total	972.1	333.8	1305.9	69

Source: Office of Economic Research, Securities and Exchange Commission.

NEW CAPITAL RAISED THROUGH NEW SECURITIES OFFERINGS

(cont.)

1970 ($ million)

Month	Shares	Debt	Total	Number of Issues
January	57.4	71.6	129.0	5
February	70.5	101.0	171.5	6
March	88.0	77.0	165.0	7
April	105.0	70.0	175.0	7
May	0.9	0	0.9	1
June	142.8	45.2	188.0	3
July	117.8	25.5	143.3	5
August	70.8	–	70.8	3
September	63.3	–	63.3	3
October	175.5	166.0	341.5	11
November	48.2	48.0	96.2	6
December	73.0	57.0	130.0	8
Grand Total	1013.2	661.3	1674.5	65

NEW CAPITAL RAISED THROUGH NEW SECURITIES OFFERINGS

(cont.)

1971 ($ million)

Month	Shares	Debt	Total	Number of Issues
January	65.8	42.0	107.8	8
February	25.6	25.0	50.6	3
March	90.0	50.0	140.0	3
April	52.6	63.0	115.6	8
May	18.8	198.3	217.1	7
June	110.8	15.0	125.8	8
July	119.5	77.0	196.5	8
August	25.0	32.0	57.0	3
September	25.3	60.0	85.3	5
October	71.8	75.0	146.8	5
November	152.5	93.0	245.5	10
December	202.5	78.0	280.5	12
Grand Total	960.2	808.3	1768.5	80

NEW CAPITAL RAISED THROUGH NEW SECURITIES OFFERINGS

(cont.)

1972 ($ million)

Month	Shares	Debt	Total	Number of Issues
January	81.5	70.0	151.5	7
February	102.9	80.0	182.9	8
March	25.0	77.5	102.5	6
April	65.0	35.0	100.0	3
May	58.3	72.5	130.8	9
June	35.4	37.8	73.2	8
July	84.9	15.5	100.4	7
August	12.0	3.0	15.0	3
September	3.3	–	3.3	1
October	–	95.0	95.0	4
November	109.4	25.0	134.4	6
December	50.5	50.0	100.5	5
Grand Total	628.2	561.3	1189.5	67

NEW CAPITAL RAISED THROUGH NEW SECURITIES OFFERINGS

(cont.)

1973 ($ million)

Month	Shares	Debt	Total	Number of Issues
January	40.2	80.2	120.4	7
February	71.6	85.0	156.6	8
March	16.6	75.9	92.5	6
April	82.4	68.0	150.4	8
May	23.1	89.0	112.1	7
June	12.9	10.3	23.2	5
July	2.0	–	2.0	1
August	39.9	100.0	139.9	6
September	–	–	–	-
October	34.2	35.0	69.2	4
November	27.4	115.0	142.4	7
December	52.4	5.3	57.7	4
Grand Total	402.7	663.6	1066.3	63

NEW CAPITAL RAISED THROUGH NEW SECURITIES OFFERINGS

(cont.)

1974 ($ million)

Month	Shares	Debt	Total	Number of Issues
January	21.4	–	21.4	2
February	1.1	50.0	51.1	2
March	1.5	15.0	16.5	2
April	–	5.0	5.0	1
May	15.0	–	15.0	1
June	30.3	50.0	80.3	4
July	–	10.0	10.0	1
August	–	–	–	-
September	27.0	–	27.0	1
October	32.3	10.0	42.3	4
November	–	–	–	-
December	–	–	–	-
Grand Total	128.6	140.0	268.6	18

Chapter 8

The Beneficiaries

Thanks to their rare ability to inspire investment, the REITs quickly raised a lot of money, which they lost little time in translating into assets. Between 1968 and 1974, total REIT assets grew twentyfold, from $1.03 billion to $21.02 billion. [Table 1], most of it in loans for land acquisition, development, and construction. These REIT loans, which amounted to only $260 million in 1968, grew to $4.25 billion in 1971, and to $10.98 billion in 1974. In only seven years, the REITs grew by an astonishing 4,123 percent.

In the same period, other REIT loans, including mortgages on completed projects, as well as second mortgages, increased by 3,983 percent; while equity investments lagged behind, increasing a mere eightfold. At the outset of their existence, the REITs were putting their money into lending, rather than into outright ownership; they evidently believed that simple, well leveraged debt was a surer bet for making money than the capital appreciation that would accrue to a property owner.

While their assets were growing, the REITs, unfettered by regulatory requirements that they stick close to home, were also extending their geographic reach. The distribution in the 10 top states of loans and investments by 172 REITs, representing 90 percent of total REIT assets, illustrates the geographic range of their activity. [Table 2] The most striking feature of the distribution: of the 172 REITs covered by the data, 127 were operating in Florida, 121 in Texas,

102 in Georgia, and large numbers in the other states. Such data suggests that many of the REITs were operating in more than one state.

The top ten states absorbed about two-thirds of the total capital invested by the 172 REITs. The ten states were not equally attractive to the REITs, however. Florida alone accounted for fully 18 percent of all the loans and investments made by the 172 trusts, which put 50 percent of their total capital into the "Sun Belt" states.

Not surprisingly, the REIT's Sun Belt investments followed the general pattern of economic activity in those burgeoning states, heavily favoring the residential and commercial sectors of the real estate industry, while investing relatively lightly in Sun Belt industrial property. [Table 3] More than half the total investment was in residential real estate, of which 18.7 percent was in condominiums and 22.8 percent in rental housing. The 45.2 percent of total investment that was in commercial real estate was almost equally shared among four categories: office buildings; shopping centers; hotels and motels; and others. Industrial property absorbed only 3.1 percent of the investment in commercial real estate.

The preponderance of the growth in REIT investment was represented by loans for land acquisition, development, and construction, with construction alone accounting for fully 70 percent of these loans. More than one-third of all construction lending by REITs was for condominiums; 22 percent was for rental units. Thus, a total of 57 percent of the REITs' investments in construction was invested in precisely those types of buildings that experience has shown to be the most economically unstable and volatile, and therefore the most risky for investors [Table 4].

Such investment practices, while they may have made the REITs vulnerable to the vicissitudes of the most volatile segment of the real-estate market, also

quickly propelled them to a major position among financial institutions involved in lending for land acquisition, development, and construction. Indeed, from almost nothing in the mid-1960s, the REITs' share of the United States short-term C&D mortgage market increased to 12.3 percent in 1970, then almost doubled to 23.4 percent in just three years. [Table 5] In the field of C&D loans, in fact, the REITs outgrew the commercial banks, which only doubled their holdings of C&D loans between 1970 and 1975, while the REITs were quadrupling theirs.

Whether or not the entry of the REITs into the existing C&D loan market stimulated a net increase in the total activity of that sector is a controversial question. Did the REITs win their share of the market totally at the expense of other lenders, such as the commercial banks? Or did the REITs satisfy a demand for new lending capacity that the commercial banks could not supply quickly enough, thus enlarging the total market? Or - another alternative - did the REITs offer the commercial banks, acting as REIT sponsors and advisors, a channel for making investments that the banks would not choose to make in their own names, thus expanding the total C&D mortgage market in a dubious direction?

There is evidence to suggest that the commercial banks in fact did not choose to direct their own real-estate departments into the same investments they advised for their REIT trustees; and that the investments into which the banks encouraged the REITs to venture alone, especially multi-family housing, land acquisition, and development, were the riskiest areas in the construction and development sectors of the mortgage business. In terms of total investment in C&D loans, by June of 1974 REITs ranked right behind commercial banks and savings and loan associations. Of a total investment of $38.2 billion, the com-

mercial banks held $17.0 billion, the S&Ls held $10.5 billion, and the REITs held $9.1 billion. [Table 6]

When the aggregate totals are broken down by sectors of the C&D loan market, however, the rankings change significantly. The REITs held only a modest share of the loans for single-family and 2-to-4 family homes - only $1.2 billion, versus the banks' $6.5 billion; but the REITs led the market in the multifamily homes and condominiums sectors, holding $4.4 billion in loans, compared to $3.5 billion held by the banks. In the other construction areas, mostly commercial and industrial construction, the REITs' share of the loan market corresponded more closely to their share of the total, while for land acquisition and development, REITs made a disproportionate share of the loans.

While the REITs were becoming major actors in the relatively risky and volatile short-term C& D mortgage market, they were playing a much more modest and declining role in the safer, steadier market for long-term mortgage loans. By 1974, out of a total $478.5 billion held by all long-term lenders, REITs accounted for a mere $3.5 billion - less than 1 percent. [Table 7] Within the long-term mortgage market, the REITs were most lightly committed in loans for one-to-four-family homes, which is the most important segment of the long-term mortgage market. The largest share of the REITs' long-term mortgage portfolio was devoted to commercial and industrial properties, in which they held more than 2 percent of the loans in 1974.

The relatively high risk of the REIT's real-estate investment pattern, with its heavy concentration of short-term C&D loans, was compounded by the lack of other, leavening interests in the total REIT portfolio. Thus, the REITs had about half of their total assets in C&D loans, and 100 percent of their assets in real-estate. Other major real-estate lenders benefited from the diversification of

their total loan commitments. The commercial banks, for example, held some $17 billion in C&D loans, dwarfing the REITs in this field and making the banks by far the largest C&D lenders in the field. At the same time, however, the banks balanced their C&D exposure with almost $100 billion in long-term mortgages, while committing only part of their total assets to real estate loans and spreading the bulk of their assets among a variety of alternative investments. For the potential investor, a REIT clearly included elements of risk that were minimized by investments in other real-estate financial institutions; or in other competing investment vehicles, such as mutual funds.

TABLE 1
DISTRIBUTION OF ASSETS (INVESTMENTS) FOR ALL REITS, 1968-1974
($ in billions, year-end data)

Description	1968	1969	1970	1971	1972	1973	1974
Land Development & Construction Loans	0.26	0.85	2.58	4.25	7.56	10.92	10.98
Other Loans	0.12	0.26	0.64	1.51	3.07	4.19	4.90
Property Owned	0.55	0.70	0.95	1.35	2.48	3.31	4.28
Other Assets	0.10	0.22	0.56	0.61	1.07	1.77	1.64
TOTAL ASSETS	1.03	2.03	4.73	7.72	14.18	20.19	21.02

Source: NAREIT Factbook, various editions.

TABLE 2
REGIONAL CONCENTRATION OF REIT FUNDED LOANS & INVESTMENTS (Year-end 1974)

TOP TEN STATES

State	Percent of all REIT funded loans and investments	Number of REITs
Florida	17.98	127
Texas	10.36	121
California	9.80	99
Georgia	5.69	102
New York	4.67	78
Virginia	3.57	75
Maryland	3.17	69
Colorado	3.08	84
Illinois	3.02	73
Ohio	2.92	75
TOTAL FOR 10 STATES	64.26%	

Source: NAREIT Factbook, 1975, page 96
(Data from published financial statements and questionnaire responses of 172 REITs.)

TABLE 3

DETAILED BREAKDOWN OF TYPES OF INVESTMENTS
(Year-end 1974)

		Percent of REIT Investments
	Mobile Home Parks	1.1%
RESIDENTIAL	Condominiums	18.7%
	Other Owner Occupied	8.9%
	Rental	22.8%
	Office Buildings	12.4%
COMMERCIAL	Shopping Centers	13.1%
	Hotels-Motels	9.1%
	Other	10.6%
	Industrial	3.1%
	Total	100.0%

SOURCE: NAREIT Factbook, 1975.
Based on survey of 172 REITs controlling 90 percent of all REIT assets.

TABLE 4
REIT CONSTRUCTION LOANS BY TYPE OF CONSTRUCTION
(Year-end 1974)

	Percent
Condominiums	34.8%
Rental Units	22.0%
Office Buildings	10.3%
Shopping Centers	8.1%
Single-family Homes	8.0%
Hotels-Motels	7.3%
Other Commercial	6.9%
Mobile Home Parks	1.0%
Industrial	1.6%

SOURCE: NAREIT Factbook, 1975.
Based on survey of 172 REITs controlling 90 percent of all REIT assets.

TABLE 5

Share of Market Construction, Land and Development Loans
($ billions)

	1970	1971	1972	1973	1974	1975
REITS	$2.387	$4.171	$6.534	$11.363	$12.399	$9.456
Commercial Banks	9.020	10.972	14.303	19.983	19.832	20.097
Total All Lenders	19.380	27.119	36.414	48.613	56.368	51.523
REITS as % of Total	12.3	15.4	17.9	23.4	22.0	18.3
REITS as % of Commercial Banks	26.5	38.0	45.7	56.9	62.5	47.1

Source: U.S. Department of Housing and Urban Development, Monthly Mortgage Lending Survey.

TABLE 6
CONSTRUCTION LOAN HOLDINGS
(billions of dollars)

	Total	1-4 Family Homes	Multi-family	Other Construction	Land and Development
Commercial Banks	17.0	6.5	3.5	7.0	4.3
Savings and Loans	10.5	5.7	2.7	2.1	2.2
REITs	9.1	1.2	4.4	3.5	3.3
Mutual Savings Banks	1.2	0.3	0.6	0.3	0.3
Life Insurance Companies	0.4	0.006	0.07	0.3	0.3
Total for Five Lender Groups	38.2	13.7	11.3	13.2	10.4

Source: Department of Housing and Urban Development releases reporting results from monthly surveys of mortgage lending. Commercial bank figures do not include construction loans which are included in a commercial and industrial loan category not secured by a mortgage.

TABLE 7
LONG TERM MORTGAGE HOLDINGS – 1972-June 1974
(Billions of Dollars)

			1-4 Family			Multi-family
	1972	1973	1974	1972	1973	1974
Savings and Loans	160.8	182.4	191.2	17.7	19.5	20.9
Life Insurance Companies	21.5	19.8	18.9	16.7	17.8	18.2
Commercial Banks	51.2	59.1	62.7	2.5	2.8	3.0
Mutal Savings Banks	45.9	48.4	49.0	10.2	11.5	12.1
REITs	0.4	0.2	0.2	0.5	0.9	0.9
Total For Five Lender Groups	279.8	309.9	322.0	47.6	52.5	55.1

Source: Department of Housing and Urban Development releases reporting results from monthly surveys of mortgage lending. Commercial bank figures do not include construction loans which are included in a commercial and industrial loan category not secured by a mortgage.

TABLE 7
LONG TERM MORTGAGE HOLDINGS – 1972-June 1974
(Billions of Dollars)
continued

			Nonre-siden-tial			Total All Types
	1972	1973	1974	1972	1973	1974
Savings and Loans	14.2	16.6	18.2	192.7	218.5	230.3
Life Insurance Companies	30.2	34.8	36.9	68.4	72.4	74.0
Commercial Banks	25.4	29.9	31.6	79.1	91.8	97.3
Mutal Savings Banks	10.0	11.5	12.3	66.1	71.4	73.4
REITs	1.6	2.3	2.4	2.5	3.4	3.5
Total For Five Lender Groups	81.4	95.1	101.4	408.8	457.5	478.5

Chapter 9

The Fall of REITs

The fall of the REITs was almost symmetrical with their rapid rise. At the beginning of 1973, while the Dow Jones Industrial Average stood only slightly above its 1966 level, a leading Wall Street firm's index of equity trust stocks stood at twice its 1966 level; the index of mortgage REITs had reached 400 percent of its 1966 level. Two and one-half years later, the Dow Jones was still around its 1966 level; but by this time so were the REIT indexes.[Chart A][1]

As the prices of REIT stocks declined [Table 1], so did their dividends. The dividends lagged, however, so there was a paradoxical period of rising dividends and falling stock prices. In 1973, for example, REIT stock prices fell rapidly; while REIT dividend payments totalled $600 million, up fully $136 million from the previous year's level. [Table 2] In 1974, as stock prices continued to soften, the REITs still managed to pay $277 million in dividends in just the first six months.

The depth and suddenness of the REIT's decline was accentuated by the heights to which they had risen. During their heyday, from 1961 to 1972, a study by San Diego State University professor Brian M. Neuberger indicates, the REITs did better than outperform the stock market. According to the professor's comparison of the REITs' record with the Standard and Poor 500 Composite Index, the REITs also outperformed stocks on the basis of their

[1] For this chart Dow Jones Industrial was indexed to 100 on December 30, 1966.

"beta" rating–a measure of an individual stock's sensitivity to movements in the market as a whole. According to this test, REITs were significantly less risky as investments than the common stocks included in the S&P index.[2]

When the REITs' decline began in earnest after 1972, the trusts behaved quite differently, according to their types, their terms, and their sponsors. There were significant differences in the behavior of equity trusts, subordinate land trusts, long-term and short-term trusts, and hybrids that mixed two or more activities under the same institutional umbrella. There were also differences between trusts of the same type with different kinds of sponsorship. Among the sponsors were commercial banks, mortgage banks, and various other financial institutions. In addition, there were a number of independent trusts, operating on their own without sponsorship from larger corporations.

The different performances of the various REIT models during the decline can be seen clearly by a comparison of the performance of a $100 investment in each from the end of 1972, just before the REIT boom began to go bust, to the end of March, 1975. Invested in equity REITs–those specializing in the outright ownership of real property–the $100 investment would have lost almost half its value, declining to $52. During the same period, the same investment in a portfolio of REITs making long-term mortgage loans would have dropped to just $26, losing 75 percent of its value. Worse yet, a $100 investment in short-term, C&D REITs would have shrunk to $16. [Tables 3A, 3B] Among the C&D REITs, those sponsored by commercial banks fared especially poorly: a $100 investment in these trusts at the end of 1972 would have lost 89 percent of its

[2] Testimony of Prof. Brian Neuberger of San Diego State University, before Senate Committee on Banking, Housing, & Urban Affairs, Hearings on Sec. 2721, 94th Cong., 2nd Sess., 297 (1976), pp. 49-50. (Henceforth referred to as "Hearings on REITs.")

value by the first quarter of 1975, when it would have been worth a mere $11.

A fundamental reason for the precipitous decline of all sectors of the REIT market between the end of 1972 and the early part of 1975 was simply that the REITS were paying fees to their advisors, distributing dividends to their shareholders, and–most egregious of all–raising capital, on the basis of assets which were generally insubstantial or shakey.

A particularly revealing picture of the REITs' decline is provided by a breakdown of the trusts' incomes at two moments during the period in question. For both classes of REITs–the short-term C&D trusts and the equity and long-term trusts–the changes in every income category between the second quarter of 1972 and the same period two years later were both dramatic and suggestive. [Tables 4A, 4B] In that short period, for example, the hard-hit C&D trusts' net income as a percentage of total gross income shrank from almost 50 percent to a mere 1 percent. For the equity and long-term trusts, meanwhile, the same index had dropped from 47 percent to 23 percent.

The cause of this precipitous drop in the net income category was the commensurate growth in the interest the REITs were paying on their non-convertible debt. For the short-term C&Ds, this expense rose from about 26 percent of gross income in the second quarter of 1972 to about 70 percent in 1974. By this time, interest payments and reserves to cover anticipated losses accounted for more than 87 percent of the REITs' gross income. For the same period, the long-term and equity trusts' interest payments increased from 17 percent of gross income to 47 percent; they were well-off only by comparison with their short-term cousins.

These rapidly increasing fractions of total REIT income earmarked for interest payments look all the worse in light of the rapid growth of gross income for all types of REITS. Indeed, during this two year boom period, the average

quarterly gross incomes of REITs in both classes, short-term as well as long-term and equity, more than doubled. For investors, however, the good news about gross income was evidently more than offset by the average 600 percent increase in interest payments, because investors bid the REIT stocks down on good news.

It is clear that the REITs had plunged deeply–perhaps over their heads–into debt. At the close of 1973, REITs held assets in the form of short-term mortgages amounting to almost $11 billion; but the trusts' short-term borrowing added up to $10.5 billion. The REITs had borrowed $6.5 billion from the banks, which also gave the REITs lines of credit to back their own commercial paper to make up the balance. The banks' lines of credit, in turn, were backed by the REITs' non-interest-bearing deposits equal to at least 10 percent of the credit lines. As the REITs found it increasingly difficult to raise capital by the sale of their own securities, and as their activities became increasingly skewed toward short-term lending the REITs came to depend increasingly on their own commercial paper, and on the banks that backed it with lines of credit.

For their part, the banks, flush with funds looking for investments during the years from 1970 to 1973, were only too happy to accomodate the REITs' growing appetite for credit. More than $5 billion was made available to REITs by the country's ten biggest banks, including Citicorp, Chase Manhattan, Chemical, and Bankers' Trust. Their generosity was generously rewarded: the REITs were required to pay 30 percent more than the prime rate– the interest rate the banks charged their best, most worthy customers– for the money they borrowed. As long as the REITs were riding high, the high interest was nothing to worry about. The trusts passed their interest costs right along to their customers, the real-estate developers; and the developers, in turn, could in those happy days

simply add their increased costs–and a little more–to the price tags on their products.

With the banks' encouragement, and more lendable money than there were investments worth lending money to, the REITs began to make real estate deals that the banks themselves would not have considered. An 1975 article in [Business Week] described the situation of a REIT called BIG, the eighth largest in the industry, known for its creativity in swapping assets to hide its credit problems. When BIG finally came up cash short and had to scramble for an infusion of capital, an official of one of its largest creditors told the magazine, "If you look at BIG's assets, you can get pretty discouraged." Of the loans in BIG's portfolio, the officer noted, "I can remember when I was a bank officer rejecting loans. I thought I had killed some of them....Many of these loans were never viable in the first place."[3]

Things began to turn sour for the overextended REITs in 1974, when the Arab oil embargo and the Federal Reserve Board's anti-inflation measures combined to hoist the prime interest rate to 12 percent. The banks simply raised the rate to the REITs; the REITs simply passed the bill to the developers; the developers added the increase to their prices; and the prices kept the consumers away in droves.

Many developers, with few sales to pay the inflated costs for labor and materials, as well as the usurious interest rates for the money borrowed from the REITs, either went out of business, or went broke, or both. For most REITs, the revenge of the marketplace was not quite so swift or so sure, but their discomfort was real nonetheless. With few exceptions, the short-term C&D REITs, with about 75 percent of all REIT assets, were in very hot water. As their

[3] *Business Week*, July 25, 1975, p. 48.

borrowers defaulted on their loans, the C&Ds were left holding the bag as the owners of unfinished projects that were prohibitively expensive to finish, neither saleable nor rentable, and not worth what they cost. As the real estate market deteriorated, the REITs experienced increasing difficulty in renewing or rolling over most of their $4 billion outstanding in commercial paper. In order to stay afloat, therefore, the trusts were forced to replace their own commercial paper with direct bank loans, calling on the banks to convert their back-up lines of credit into actual loans.

Not all REITs were hit equally hard. Indeed, while the C&D REITs, specializing in short-term loans, were devastated, REITs specializing in equity–direct ownership of real-estate–and in long-term mortgages were able in most cases to continue to make money. In some cases, these more solid REITs even managed to improve their profitability during the general decline of the industry. As the dust of the decline was settling, in the first quarter of 1976, 49 trusts, representing approximately 25 percent of all REIT assets, were still able and willing to pay dividends to their investors.[4]

To identify the characteristics that made the difference, enabling some REITs to continue to prosper during hard times while other REITs suffered disastrous declines, Professor Brian Neuberger, at San Diego State University, has employed an analytical tool called Multiple Discriminate Analysis (MDA). Digesting tremendous amounts of raw data, MDA enables researchers to define significant differences in performance between subgroups and then to identify specific variables that are associated with these differences. Dr. Neuberger's criterion for differentiating between successful and unsuccessful REITs was whether

[4] *Ibid.*, p. 63.

the trust increased its net income during the 1973-1975 period.[5]

At the outset of his work, using MDA, Dr. Neuberger was able to select a group of characteristics that, taken together, would account for more than 92 percent of the variation in success among the C&D REITs. The significant characteristics were: debt structure, growth pattern, leverage, and overall size. Among these four characteristics, debt structure proved to be the most important factor in predicting earnings performance.

According to Dr. Neuberger's MDA, the earnings performance of a trust was inversely related to the percentage of the trust's non-convertible debt to its total capital. That is, trusts that carried a relatively large amount of non-convertible debt, measured against their total capital, performed less well than trusts that were relatively free of such debt. In addition, different kinds of non-convertible debt seemed to have different implications for REIT earnings. Fixed-rate, short-term bank debt was better for earnings, it appeared from this analysis, than bank revolving loans, which have interest rates that fluctuate according to the prime interest rate. REITs with high percentages of these floating-interest-rate loans found themselves in great difficulty in the mid-1970s.

Dr. Neuberger was also able to distinguish successful trusts on the basis of their leverage–the ratio of their debt to their capital equity. The results of the MDA suggest that high leverage–that is, a relatively high debt-to-equity ratio–can produce high profits in a booming market, when risks are low, because leverage acts to magnify gains. Leverage is undiscriminating, however: in bad times, when risks are high, it magnifies losses. Not surprisingly, REITs that were relatively highly leveraged also were relatively vulnerable to disaster.

The Neuberger analysis also identified some less expected predictors of REIT

[5] *Ibid.*, p. 65.

performance. Among these was growth rate: the REITs that grew faster than average tended also to earn more money in the process. But only up to a point. While fast-growing trusts posted good earnings, large trusts did not. In other words, the REITs would have been well advised to obey a paradox: grow fast and stay small. No sooner would a fast-growing REIT achieve a notable size than its earnings per share would begin to decline.

Further analysis suggests that there was nothing inherently self-limiting or self-defeating about rapid growth of REITs. Indeed, the real problem proved to be not the speed with which the trusts grew, but the fact that in many cases the growth was more apparent than real. Some of the short-term C&D REITs managed to appear a lot more profitable than they actually were. These REITs took advantage of the standard business practice of including in project-development budgets, which are used to determine the amount to be loaned, the initial interest payments that the developer was obligated to make during the construction phase of the project.

Construction-and-development loans are ordinarily structured in such a way that only interest is paid during construction, with the entire principle coming due upon completion of the project, when a long-term mortgage can be secured. The C&D trusts were able to take advantage of this standard practice to improve their apparent profitability by reporting as earned income the interest payments they collected from the construction loans they made to developers. In effect, they were insuring that any project, regardless of how shakey and ultimately unprofitable it might be, would appear to be profitable during the one or two first years.

Only later, after the illusory income had been paid out in real cash as dividends, or fees, would it become obvious that some of the projects financed

in this way were in fact not profitable investments for the REITs; were not credit-worthy projects in any sense. As the short-term loans matured, and the principal–including the borrowed money used to pay the early interest– plus any unpaid interest came due, the bad loans defaulted. The imprudent REITs were left holding the empty bag, their cash flows impaired, unable to make their own dividend payments.

As an example of a REIT that got into precisely this kind of difficulty, Neubergers[6] describes the case of a trust that enjoyed the sponsorship and advice of a major insurance company. In 1973 and 1974, the trust departed from its earlier practice of concentrating on long-term mortgages, increasing its short-term loan commitments fourfold. This sudden involvement in construction and development loans coincided with the months of extremely tight money, so the trust paid dearly in interest for the capital to finance its expansion into the precarious C&D mortgage market. Using interest-rate data from the Federal Reserve Board to estimate the cost of debt capital during the period in question, it seems that at least some of the trust's new business was costing it more in interest rates than it was yielding in rates of return on the shareholders' equity. [Table 5]

Much of the trust's new debt was in the form of revolving loans from banks, at rates ranging from 11.0 to 13.65 percent. [Table 5][7] The trust's return on its equity, meanwhile, was only about 8 percent. In addition, the switch to C&D loans from long-term mortgages significantly increased the REIT's risk, as indicated by a measure called Percent Risk Impact–the percentage of the trust's net income that would be lost if 1 percent of its loans defaulted on their interest

[6] *Ibid.*, p. 72.

[7] *Ibid.*, pp. 72-73.

payments. Percent Risk Impact rises directly with both the volume and the interest rate of the debt. In the case of the REIT in question, as it borrowed more at higher rates of interest between October 1973 and July 1974, its Percent Risk Impact rose from 2.3 to 3.53, an increase of more than 50 percent in less than one year.[Table 5] Even these assessments were based on the assumption that the trust was borrowing at the lowest available rates. In fact, the cost of money to the REIT under these circumstances was probably much higher than the lowest rate for the period; therefore the PRI given actually understates the case.

Even as the shareholders' risk was increasing, the same REIT was experiencing other economic woes. Net income declined by 13.5 percent, while the share price fell 44.6 percent, indicating uneasiness on the part of investors. Fees to advisors, however, increased 13.7 percent.

In Dr. Neuberger's study, the case described above was typical of 17 REITs, all specializing in short-term C&D loans. All indulged in the same headlong portfolio expansion, without a prudent regard for the shareholders' interests. And all encountered trouble when the going got rough.

The evidence from Dr. Neuberger's study and elsewhere suggests that "creative accounting" abuses were a common practice among REITs, especially those trying to make their money in the risky, short-term C&D business. First, the REITs were reporting the interest they were paying themselves as earned income. Then they were paying out this illusory income in real fees to advisors and real dividends to shareholders. Finally, they were using their apparently credible earnings and dividend records to support their applications on Wall Street for more debt capital, with which to make more loans. In this circular game of deception, everyone was happy, everyone was apparently winning–until the cir-

cle broke. Because too many of the loans made by the C&D REITs were not adequately backed by truly productive assets, the game was bound eventually to turn winners into losers. The evidence suggests that the source of the problem was to be found in the conflicting interests of the REITs' sponsor-advisors, which were a continuing invitation to uncontrolled abuse. [8]

[8] "Abuse" implies conspiracy and illegal intent, which cannot be proved conclusively by analysis of commonly available financial data, of the kind used in this work. Conclusive proof would require a detailed examination of all relevant trust transactions. Such records are not available to independent researchers.

Chart A

TABLE 1

SAMPLED REAL ESTATE INVESTMENT TRUSTS LISTED ON THE NEW YORK STOCK EXCHANGE, 1974

Trust Name	1974 Prices High	1974 Prices Low
B.T. Mortgage	20-3/8	3
Builders Investors	27-3/8	1-3/8
Chase Manhattan	42-1/2	3-7/8
Citizens & Southern Rlty.	14	1
Colwell Mortgage	25	1-1/2
Continental Mortgage	7-3/4	3/8
Diversified Mortgage	7-1/4	13/16
Equitable Life	22-5/8	10
Great American Mtg.	32	1
IDS Realty Trust	26-7/8	9-1/2
Justice Mortgage	24-7/8	2-5/8
Lomas & Nettleton Mortgage	35	11-7/8
Midland Mortgage	12-7/8	1-3/4
Saul Realty	12-1/2	2-3/4
State Mutual Investors	16-1/8	1-3/4
Sutro Mortgage	12-3/8	2

Source: Audit Investment Research

TABLE 2

DIVIDENDS PAID BY REITS

Period in Which Div. Check Sent	No. of REITs Paying a Div.	Total Distributed
1972		
Jan.-Mar.	105	$98,299,746
Apr.-Jun.	118	110,426,077
Jul.-Sep.	123	120,325,857
Oct.-Dec.	128	135,236,695
1973		
Jan.-Mar.	135	146,177,534
Apr.-Jun.	138	147,353,238
Jul.-Sep.	142	151,068,780
Oct.-Dec.	140	155,260,523
1974		
Jan.-Mar.	135	145,527,884
Apr.-Jun.	128	131,965,885
Jul.-Sep.	108	79,934,049
Oct.-Dec.	84	64,786,999
1975		
Jan.-Mar.	59	38,70,190
Apr.-Jun.	57	36,612,520
Jul.-Sep.	53	33,982,380
Oct.-Dec.	48	29,652,268
1976		
Jan.-Mar.	49	30,858,900

Source: Audit Investment Research

TABLE 3A

VALUE OF REIT STOCK

	Type of Trust				
Date	Equity	Subordinate Land	Hybrid	Long-Term	Short-Term
December 1972	100%	100%	100%	100%	100%
June 1973	94%	88%	89%	88%	89%
December 1973	82%	75%	66%	66%	70%
June 1974	73%	50%	48%	41%	42%
December 1974	49%	23%	23%	20%	18%
March 1975	52%	29%	25%	26%	16%

Source: Neuberger's Testimony, Senate Hearings p. 60.

TABLE 3B

VALUE OF REIT STOCK (continued)

	Short-Term Mortgage Trusts Sponsored by:			
	Commercial Banks	Mortgage Banks	Independent	Miscellaneous Financial
December 1972	100%	100%	100%	100%
June 1973	87%	88%	85%	91%
December 1973	65%	64%	67%	75%
June 1974	35%	40%	34%	44%
December 1974	11%	16%	9%	13%
March 1975	11%	20%	12%	14%

Source: Neuberger's Testimony, Senate Hearings, p. 61.

TABLE 4A

INCOME DISTRIBUTION OF SHORT-TERM TRUSTS, 1972-1974

Item	Second Quarter 1972	Second Quarter 1974
Interest Expense (Non-Convertible Debt)	26%	70%
Interest Expense	6%	2%
Depreciation and Operating Expense	3%	4%
Advisor Fee	14%	6%
Loss Provision	2%	17%
Net Income	49%	1%
Total Income	100%	100%

TABLE 4B

INCOME DISTRIBUTION OF EQUITY AND LONG-TERM TRUSTS, 1972-1974

Item	Second Quarter 1972	Second Quarter 1974
Interest Expense (Non-Convertible Debt)	17%	47%
Interest Expense	8%	4%
Depreciation and Operating Expense	18%	17%
Advisor Fee	9%	5%
Loss Provision	1%	4%
Net Income	47%	23%
Total Income	100%	100%

Source: Neuberger's Testimony, Hearings on REITs, p. 57.

TABLE 5

TITLE

	Revolving Loans	Cost of Debt	Return on Equity Capital	Risk Impact
October 1973	$4,200,000	11.05%	8.00%	2.31%
January 1974	3,500,000	12.35%	8.08%	2.64%
April 1974	12,500,000	11.37%	8.87%	2.63%
July 1974	18,000,000	13.65%	7.96%	3.53%

Source: Hearings on REITs, testimony of Prof. Neuberger of San Diego State University, p. 73.

Chapter 10

The Context of Disaster

While many REITs certainly courted disaster by their methods of operation, they were also in the wrong place at the wrong time, at the front of a general economic stampede that was heading for a cliff. The economy in general and the real-estate sector in particular, were affected by a variety of problems over which the REITs individually or collectively had little or no control. Among these:

High interest rates. Most REITs had borrowed capital at interest rates that were pegged to the prime rate. In many cases the REITs were obligated to pay 130 percent of the prime. As lenders, on the other hand, in order to maintain a profitable spread between the price of their borrowing and the price of their lending, and to cover their high advisory fees, the REITs had to charge even higher interest rates.

In their enthusiasm, the REITs–along with almost all other market observers–failed to predict the course of prime interest rates. As the prime passed 10 percent, the REITs began to get into trouble. When the prime rose to 11 and then 12 percent, and their effective borrowing cost rose to 14-1/2 and 15-1/2 percent, the REITs had to charge their borrowers 16 to 17 percent interest just to break even. Not many real-estate projects in 1974 could survive a 12 percent interest rate for any length of time; fewer could pay 16 to 17 percent. In addition, several states had usury laws, which prohibited interest rates from exceeding an

artificially low rate. In Florida, where more REIT loans were made than in any other state, the maximum rate was 15 percent; in Texas, 18 percent.

Material Shortages. In the construction business, as in few others, time is money. The interest clock ticks away inexorably, and in ther mid-1970s, with the prime at 12 percent and a stiff premium tacked on, interest added up at an insupportable rate. Construction was seriously delayed in 1973-75 by widespread materials shortages. In many areas of the country, for months at a time, staple items such as nails, bricks, glue, bath fixtures, and steel reinforcing rods were virtually unavailable, while borrowers–those that could–kept on paying.

Material Cost Increases. Along with shortages came steep increases in the costs of the things without which buildings cannot be built. Passed on to consumers all along the line, the increasing costs of materials resulted in buildings whose actual construction costs far exceeded the projections on which their budgets–and their construction loans–had been based. Projects that could still be finished often came in at prices their intended customers could not afford.

Tight Mortgage Money. A severe drought that dried up the pool of money available for long-term mortgages in 1973 and 1974 made it difficult for potential customers to buy houses, apartments, and other commonly mortgaged real estate. The money shortage also made it difficult for developers to arrange "take out" mortgages on completed projects. Without such financing to allow them to get their money out of completed projects, developers were impeded from putting together new ventures.

Sewerage Problems. In the first flush of environmental awareness, many local jurisdictions, as well as state and Federal agencies, had promulgated new, more complex and costly sewer standards. In some cases, especially those in which the costs of the sewer systems were somehow passed on to the developer or the

ultimate property owner, the increased costs acted as a depressant on sales.

The Energy Crisis. The advent of real shortages of fuel at the gas pump, and the steep rise in the price of what fuel was available, severely dampened consumer enthusiasm for housing in the countryside, where much of the REIT investment was. Rather, there was talk of a return to the relatively energy-efficient cities, avoiding long commutes and high home heating costs. Few REITs, however, concentrated on investing in center-city housing.

These problems of the general economy certainly had their adverse impact on the REITs, as well as on the other sectors. The REITs were also affected by factors inherent in the real-estate industry. The real-estate industry observes the truism that construction gets hit first and hardest in a recession; the institutions that finance construction and development get hurt as their debtors default.

At best, the real-estate business tends to progress in cycles of alternating boom and bust. In good times, customers are anxious to buy and bankers have plenty of money that they are only too anxious to lend; builders, understandably, are optimistic. After a brief prosperity, however, the seemingly inevitable result of all this good news is bad news: overbuilding, a glutted market, and, finally, a precipitous decline in real-estate values.

The first sign of trouble is an increase in "FOR RENT" and "FOR SALE" signs. Then borrowers slip into delinquency on their mortgage payments. Sooner or later, some of the delinquencies slip into real defaults; the lenders, reluctantly, foreclose on builders who can't pay their debts, becoming the unhappy owners of surplus real estate. The lenders are increasingly saddled with a growing burden of loans that aren't earning, maturing debts that are not being paid, and buildings–even unfinished ones–that cannot be rented or sold.

This pattern was clearly playing itself out in 1974 and 1975. The housing

industry had racked up more than 2 million housing starts in each of the preceding three years. With plenty of new housing overhanging the market, conditions within the industry were right for the worst housing slump since World War II, regardless of any influence from the general economy.

There were other factors peculiar to the REIT industry, however, that tended to amplify the down phase of the normal real-estate- industry cycle and the trouble in the general economy. A major problem for the REITs, especially in bad times, was the limit the Internal Revenue Service put on the amounts of income the REITs could earmark to cover anticipated loan losses. Because REITs did not emerge as major factors in the real-estate industry until the late 1960s, they did not have adequate experience on which to base credibly reliable data on "normal" rates of losses in their loan portfolios. Without such data for at least five years, the IRS was unwilling to allow the REITs to designate more than they had actually lost in the preceding year as reserves against projected future losses. If they had been able to reserve additional income for this purpose, the REITs would have been able to reduce – or at least defer – their tax liability. (As it turned out, of course, the increased reserves would have been more than justified by the REITs' ultimate losses.)

The question of estimating potential loan losses became troublesome for the REITs in another context as well. According to a ruling by the Midwest Securities Commission Association, a regional regulatory agency whose decisions are often followed nationally, a REIT's advisor was responsible for the REIT's expenses in excess of a fixed amount. Any surplus, no matter how inadvertent, in the reserve held for anticipated loan losses, or any income that was not accrued on problem loans, would be charged to the account of the REIT's advisor. In effect, then, the REITs were hamstrung in their efforts to increase their provisions

for anticipated losses.

This limitation had an immediate impact on the REITs' cash flows, in some cases turning them from positive into negative. In 1974, many of the trusts, whose books necessarily reflected the standard accounting practice of accruing anticipated losses, were forced to pay out more in dividends than their books–minus the accrued losses–indicated that they had earned. A trust with a net income of $10 million and projected potential loan losses of $6 million, for example, would report on its books a net income of $4 million, which would be the maximum available for distribution to shareholders.

According to the IRS, however, in its tax calculations the trust could only deduct from taxable income a much lower reserve against anticipated loan losses: perhaps $1 million, if that was the amount of actual loan losses the trust had experienced in the preceding year. In that case, the IRS would calculate the net income of the REIT as $9 million. Of this, under the terms of the REIT Act the IRS would require at least 90 percent, or $8.1 million, to be distributed to shareholders, despite actual net earnings of less than half as much. The only way to make such a payout would be to eat into capital–in effect, to return part of the shareholders' investments as dividends.

Under the accounting rules insisted on by the IRS, it was even possible for a REIT to report a real loan loss for the preceding year and still be required to pay dividends or lose its trust status under the tax laws. Such a paradoxical situation could arise, for example, if the REIT described above, with $10 million in net income, also had $12 million in actual loan losses from non-earning loans, write-offs, and foreclosures; while the IRS allowed only $1 million for anticipated losses. In this case, by generally accepted accounting methods the trust would report a deficit of $2 million in its net income account; but, by the IRS's rules,

the impecunious REIT would still have to distribute 90 percent of $9 million, or $8.1 million, in dividends.

No matter how it juggles its numbers or deludes investors and regulators, no company can long continue to return its shareholders' capital without bleeding itself dry; the REITs were no exception to the rule. It availed them not that their books showed earned income from interest on loans that they were, in effect, paying themselves. They could not hope to come up with enough real money to disburse this income in the form of hard-cash dividends.

The vaguaries of the tax system began to have a mischievous effect on the REITs in the mid-1970s, as the cyclical downturn in the real-estate industry forced increasing numbers of REIT-financed projects toward default on the way to downright bankruptcy. The cycle affected good and bad projects, but a high percentage of REIT investments were especially vulnerable because they were fundamentally faulted. Even as the market corrected the downturn, delaying new construction until inventories were reduced, the REIT investments promised to be the last to recover–if they could ever recover.

Because of their fundamental weakness, from December 1973 to April 1976, REIT assets slipped into non-earning status at a rapid rate, from a low of 1.8 percent of total assets all the way to 54.5 percent. In one two-year period, the increase in non-earning assets of all REITs grew at the average rate of $400 million per month.[Table I]

For the short-term C&D REITs, the growth in defaulted loans was ominous, or worse. In the highly leveraged short-term trusts, the actual equity of the shareholders represented only about 20 percent of total assets; four or five times as much was borrowed. When non-earning assets reached 20 percent of a REIT's portfolio, therefore, the defaulted portion equalled 100 percent of shareholders'

equity. All the shareholders actually owned, therefore, was non-earning assets.

In June 1975, out of 131 REITs, only 29 had non-earning assets amounting to less than 24 percent of shareholders' equity. Fully 66 of the trusts boasted non-earning assets in excess of–as much as 500 percent in excess of–shareholders' equity. In short, these REITs, fully half of the group, were worth less than nothing.[Table 2] Even these dismal statistics are based on very generous definitions of non-earning assets, according to the liberal accounting practices applied to the REIT industry. Things may actually have been much worse.

Accurate and complete inventories of the REITs' non-earning investments during the period of the trusts' decline have never been compiled, and the raw data can no longer be assembled. According to a survey of published 1975 data by the National Association of Real Estate Trusts, however, the non-earning investments were concentrated in condominiums, representing 23.4 percent of the total; rental housing, representing 16.0 percent; and land development, 13.8 percent. Some 21 percent of the non-earning assets could not be identified for this survey. [Table 3]

Another analysis, by Audit Investment Research, Inc., indicated that some 25 percent of the defaulted loans were for non-primary housing: second homes and condominiums, and land development in resort areas. About 15 to 25 percent of the non-earning assets were in rural projects.

The growth in non-earning assets–the decline in earnings, –was especially disappointing to the small investors, for whom the REIT vehicle had been specifically advertised by its inventors and supporters as a safe, modest entry into the profitable world of real-estate investment, heretofore open only to the rich. Small investors were attracted to REITs by the promise of secure income with the potential for capital gains in addition. They were encouraged to believe

that REITs invested in solid, income-producing projects. Evidently, they were misled. What kinds of properties did the C&D REITs actually finance?

An example of one type of development favored by the C&D REITs was what the vacation trade likes to call "an offshore destination resort" in the romantically named Palmas del Mar, in Puerto Rico.[1] The developer was Sea Pines Company, which had established its credentials as a responsible operator with the successful, if environmentally controversial, Hilton Head Island, in South Carolina. In 1969, on the east coast of Puerto Rico some 50 miles southeast of San Juan, Sea Pines began by acquiring an old coconut plantation that included no less than six miles of Caribbean coastline, complete with balmy tradewinds to mitigate the unfailing tropical sun. Sea Pines ultimately assembled 2,777 acres, paying an average of approximately $4,500 per acre.

It was, boasted the company: "a place so removed from the problems and frustrations of the urban environment that its fascinating blend of beauty and leisure must be sampled to be truly understood. In terms of character and feeling, it is closer to Portofino, Barbella, or St. Tropez."

The developer invested heavily in infrastructure and amenities to appeal to prospective customers. There was, first of all, the kind of lavish master plan without which no self-respecting resort community can launch itself. There was a new harbor, dredged from the development's coastline; a main inn and separate villas; tennis and golf facilities, an airport, even a 297-acre tropical jungle. There were major expenditures, too, for such mundane necessities as utilities, roads, and telephone service.

When sales began in January 1974, homesites were priced from $14,000 to

[1]Kenneth Campbell, "REIT Problem Loans: What's Ahead" and "REITs . . . What's Ahead," Seminar Papers, *Hearings on REITs*, p. 338.

$116,000, with the villas priced at $50,000 to $130,000.[2] Despite the sudden onset of the energy crisis, Sea Pines was able to report 185 homesites and 191 villas sold in the first two months. As the economies of the mainland and the island declined, however, so did sales. By the end of the first year, cash flow was a trickle.

In February 1975, Sea Pines announced that it was restructuring the development's debt, deferring or reducing its interest payments, and, essentially, walking away from Palmas-Del-Mar. Sea Pines' largest lender, a REIT called Chase Manhattan Trust, which had invested an estimated $60 million of the total $90 million borrowed by the developer, was left with an option to buy 50 percent of Palmas-Del-Mar after January 1976 at a token price. In May 1976, Sea Pines took a $13 million writeoff on its "idyllic site."[3]

Another typical C&D REIT investment was a resort community in Sandestin, Florida, where an Atlanta developer, Evans & Mitchell Industries, acquired 1,700 acres of Florida panhandle landscape, 60 miles from Pensacola, with frontage on the Gulf of Mexico and the Intercoastal Waterway. EMI got the land for approximately $1000 per acre, taking out a purchase money mortgage for $2.15 million, paying only $267,000 down.

Like all resort community developers, EMI had a plan: an equal balance between permanent and seasonal residents, served by such niceties as a golf course and a 64,000-square-foot club looking out over the bay. Townhouses, villas on the fairway, and houses with patios were offered as condominiums for $50,000 to $65,000.[4]

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[2]Campbell, *Hearings*, op. cit., p. 339.

[3]*Ibid.*, p. 339.

[4]*Ibid.*, p. 345.

EMI's big backer was the same REIT, Chase Manhattan Trust, that backed Sea Pines in Puerto Rico. Chase Manhattan invested $13.5 million in the Florida project; another REIT, Cabot, Cabot & Forbes Land Trust, put in $6 million. As an extremely active and ambitious developer with several projects in addition to Sandestin, EMI had a healthy appetite for capital, consuming more than its equity financing and short-term debt could satisfy. After restructuring its debts with its major lenders in April 1974, EMI filed for Chapter 11 bankruptcy in August.[5]

Not all the investments made by C&D REITs were as bad as these, or as doomed to failure as these appear, at least in retrospect. It is clear from these examples, however, that there were at least some REIT investments that were beyond saving by any economic upturn, or change in the international oil trade, or easing of inflation. It is also possible to see in these examples some of the inherent problems that characterized too many of the investments of the C&D REITs. The sheer size and complexity of these projects, for one thing, made it inevitable that it would take years for them to get out of trouble, if they ever could.

In general, too, the real estate involved in these dubious investments was egregiously overpriced. Overpricing, in this sense, is defined purely in terms of the market: if it costs too much for people to buy, it is overpriced. Sandestin was never able to make sales; while Palmas-Del-Mar quickly exhausted the buyer enthusiasm that ignored prices at the start. Overpricing was even more characteristic of smaller projects, according to surveys by Audit Investment Research. In many cases, the high prices of these projects were due to the inclusion of expensive features that prospective buyers could not pay for.

[5] *Ibid.*, p. 345.

Most of the projects that gave the REITs trouble had carrying charges ranging from 12 to 15 percent per year. Such carrying charges represented deductions from the project's future value, making it all the more difficult for a project to catch up to its own indebtedness.

Faced with such daunting red ink, REIT boosters argued that constantly, inexorably rising land and building costs would eventually rescue even their most improbable projects because their replacement costs–what it would cost to build them again–would eventually rise to equal what it cost to build them in the first place. When carrying costs were added into the equation, however, inflation in real estate replacement costs would have had to approximate 20 percent per year in order to justify the original costs of the projects the REITs were financing. Sustained inflation rates of 20 percent or more were not likely, however; certainly they were not desireable.

The problem of cyclical oversupply that is characteristic of the real-estate market in general was compounded in the case of the REITs by the particular kinds of real-estate they were building. Between 20 and 25 percent of all REIT loans were for condominiums; approximately 15 percent for apartment buildings; and some 20 percent for land and recreational developments. These categories of real-estate development are among the most erratic, volatile–and therefore the most speculative for investors–in the industry.

The high risks associated with land development and condominium and apartment construction are in large part due to the fact that they entail heavy initial investments in the construction of large numbers of housing units and other facilities. An apartment house or condominium, or a modestly scaled resort development, can easily begin with 100 or 200 units, perhaps more; indeed, very few began with less. The developer faces high costs, and high exposure to

risk, from almost the first day. The developer of a single-family-home project, on the other hand, can proceed almost one house at a time, as the market indicates, without investing heavily in inventory or committing himself to the full cost of the planned project.

Condominiums were especially problematic investments because they were a new form of housing ownership in many markets. The complexities of condominium ownership, management, and maintenance proved difficult to understand or to accept for many potential buyers.

Yet another source of vulnerability for the REITs' investments was their concentration in a few markets in certain parts of the country, most notably in the so-called Sun Belt, which was undergoing a general economic awakening during the period of the REITs' emergence. Florida, Texas, and California were favorite states for REIT investment, just as they were favorites of other investors and Americans looking for new areas in which to live and work.

Many of these typical problems afflicting REITs are illustrated by the case of Associated Mortgage Investors, which in 1974 earned the unhappy distinction of having been the first of the troubled trusts to ask the court for protection as a bankrupt. The management company assigned by the court to manage AMI's loan portfolio found more than $80 million invested in vacant land, apartment buildings, recreational vehicle parks, and resort developments. More than 75 percent of the loans were in trouble. Among them: a $6 million loan made in a rural area in California. The project promised to build–and sell–5,000 to 6,000 houses in fairly short order. The real-estate record of the area revealed, however, that no more than 400 or 500 houses per year had ever been absorbed by the local market.[6]

[6] *Ibid.*, p. 732.

Increasing competition among REITs in the early 1970s made the trusts more willing to take risks to make deals. The more loans they made, the more earned interest the REITs could report, and the bigger the REITs appeared. In the process of relaxing their standards in order to chalk up more loans, however, the REITs were also making themselves more vulnerable any reverses that might be in store.

Some REITs began to make construction loans without takeouts– contractual commitments for long-term loans to pay off the construction loans and enable developers to recover their investments and their profits without waiting out the life of the project. Under ordinary circumstances, a takeout becomes effective when the construction of a project is complete and rentals have reached a specified percentage of capacity. Firm takeout commitments are required by law as a condition for construction loans by commercial banks and savings-and-loan associations. REITs, however, are permitted to make loans without prior arrangements for takeouts, and they charge higher interest on such loans, suggesting the greater risk involved.

Instead of third-party takeouts, some REITs resorted to a device called a standby takeout: a mortgage commitment made by the trust itself in the expectation that it would never be used, but written just in case a regulation takeout could not be arranged. Standby takeouts, unlike the standard kind, usually have short terms and high rates, making them attractive only in desperate situations. For the REITs, the standby takeout was a transparent improvisation designed to fatten their loan portfolios with projects of dubious merit.

The extent to which loans were granted without takeout commitments is illustrated by the record of First Wisconsin Trust. In December 1971, only 16 percent of First Wisconsin's construction loans had been granted without

takeout commitments. Little more than a year later, fully 86 percent of the trust's loans lacked the support of takeout commitments.[7]

As interest rates rose and long-term mortgage money got scarce, the lack of real takeout commitments on REIT-financed projects became a problem. Builders without takeout commitments paid interest 3 to 5 percent above the prime rate on their construction loans, during construction and after completion of their projects, until long-term financing could be arranged. With the prime rate already above 10 percent–sometimes several points above–the premium interest rate came to exceed the ability of most projects to earn, even if they were generating healthy cash flows. As a result, even solid income-producing real-estate began to fall behind on interest and principal repayment on their C&D loans from the REITs.

The tendency for the REITs to lend money to projects that had not secured long-term mortgage commitments also meant that in many cases a REIT was deprived of a second lender's opinion of a project's value, most often in just those dubious cases where a second opinion would have been most valuable. Viable projects had relatively little trouble finding regular financing, even in times of tight mortgage money. It was the least credit-worthy projects, of course, whose builders would be least likely to risk looking for long-term financing, especially if they could get standby takeouts from the C&D REITs.[8]

With their easy-going attitude toward lending, the C&D REITs were perfectly in character in relying heavily on outside consultants to do the crucial on-site inspections of projects they were thinking of lending money to. Inevitably,

[7] *Ibid.*, p. 335.

[8] Howard H. Stevenson, "What went wrong with the REITs?" *Harvard Business School*, January 1976, pp. 4-5.

the lenders remained unaware of many inherent problems that their consultants somehow didn't notice, while the REITs were too busy beating the bushes for more borrowers to oversee properly those they already had.

In the same spirit many REITs used cost projections, budgets, and other financial data supplied by loan applicants without making thorough attempts to verify the figures. Such lackadaisical behavior tempted developers to work backwards from the bottom line in their loan applications, first deciding how much they wanted to borrow, then adducing costs to justify the total. Appraisals used to substantiate loan applications were routinely inflated out of any connection with the real value of the property. Cash-flow projections were structured for the purpose of securing loans.

In some cases, REITs permitted developers with whom they were closely affiliated to submit appraisals that included the estimated value of their land after the proposed development. At best, such appraisals were only speculations, and the developers were tempted to overstate the value-to-be. In the West, especially, raw land was bought or optioned at a value of as little as $300 per acre, and appraised for loan purposes at $6,000 to $8,000. In the event of a foreclosure, however, the real-estate would have to be liquidated at something closer to the $300 price. The security of the loan, therefore, depended almost entirely on the developer's eventual success, instead of being based prudently on the developer's potential failure.[9]

Developers were also encouraged to define their projects in fanciful terms–an apartment building was invariably described as a "luxury townhouse concept"–in order to justify financial predictions based on rental or sales prices that were above the market. Such exaggerated appraisals led to excessive loans, compared

[9] *Ibid.*, pp. 2-3

to the real value of the projects. In these deceptions, as long as failure did not force either the lender or the borrower to face the real world, both parties were apparent winners. The developer got a bigger loan than his project deserved–if it deserved any loan; while the REIT got to report another sure-fire investment and claim the interest and fees. In some cases, indeed, developers were thus able to borrow more than the entire value of their projects, relieving them of any stake in their success.

In charge of their loan operations, the REITs generally had inadequate numbers of inexperienced people. Many REIT employees were beginners in real-estate, recruits from other industries, who could be confused, overwhelmed, or simply deceived, by canny and experienced developers. Many of the REITs' credit officers came into the business during the 1950s and 1960s, when lending activity was less feverish, and when it was virtually unheard of for a big building project to default on its loans. In most REITs, too, there simply were not enough officers to oversee the business. One major bank, which sponsored a REIT in addition to maintaining its own in-house real-estate department, had only eight professionals managing both operations–a total portfolio value of more than $3 billion.[10]

[10] *Ibid.*, pp. 4-5

TABLE 1
MONTHLY SUMMARY OF REIT NON-EARNING INVESTMENTS — ALL REITS

		Investment Assets	
Month	Trusts	Nonearning	Total
December 1973	130	$ 130	$ 17,000
May 1974	112	1,025	16,945
September 1974	118	2,150	18,039
October 1974	130	2,787	18,782
November 1974	130	3,160	18,823
December 1974	131	3,555	18,979
January 1975	131	3,863	18,957
February 1975	131	5,051	19,191
March 1975	131	5,788	19,287
April 1975	131	6,567	19,311
May 1975	131	7,131	19,298
June 1975	131	7,389	19,214
July 1975	131	7,961	19,100
August 1975	131	8,287	19,135
September 1975	131	8,842	19,060
October 1975	131	9,195	19,122
November 1975	131	9,429	18,890
December 1975	131	9,535	18,873
January 1976	131	9,668	18,618
February 1976	131	9,771	18,350
March 1976	131	9,896	18,466
April 1976	131	10,039	18,408

Source: National Association of Real Estate Trusts, 1976 Factbook.

MONTHLY SUMMARY OF REIT NON-EARNING INVESTMENTS — ALL REITS
(continued)

		Monthly Change	
	Percent		
Month	Nonearning	Percent	amount
December 1973	1.8	—	—
May 1974	6.05	—	—
September 1974	11.9	—	—
October 1974	14.8	+29.6	+$ 637
November 1974	16.8	+13.4	+373
December 1974	18.7	+12.5	+395
January 1975	20.4	+8.7	+308
February 1975	26.3	+30.8	+1,188
March 1975	30.0	+14.6	+737
April 1975	34.0	13.5	+779
May 1975	37.0	8.6	+564
June 1975	38.5	3.6	+258
July 1975	41.7	7.7	+572
August 1975	43.3	4.1	+326
September 1975	46.4	6.7	+555
October 1975	48.1	4.0	+353
November 1975	49.9	2.5	+234
December 1975	50.5	1.1	+106
January 1976	51.9	1.4	+133
February 1976	53.3	1.1	+103
March 1976	53.6	1.6	+125
April 1976	54.5	1.4	+143

TABLE 2

NON-EARNING ASSETS TO SHAREHOLDER EQUITY RATIO
(June, 1975)

Ratio	Number of Trusts	Cumulative Number of Trusts
0-24%	29	29
25-49%	19	48
50-74%	12	60
75-99%	5	65
100-124%	9	74
125-149%	12	86
150-174%	5	91
175-199%	5	96
200-299%	14	110
300-399%	13	123
400-499%	2	125
500-over%	6	131

Source: National Association of Real Estate Investment Trusts, 1975 Factbook.

TABLE 3
SURVEY OF REIT NON-EARNING ASSETS (February 1, 1976)

Type of Construction	Non-Earning Assets ($ millions)	Total of Survey Total
Mobile Home Parks	77	0.8%
Condominiums	2221	23.4%
Single-Family Homes	416	4.4%
Rental Housing	1513	16.0%
Office Buildings	481	5.1%
Shopping Centers	336	3.5%
Hotel-Motel	531	5.6%
Other Commercial	478	5.0%
Industrial	123	1.3%
Unspecified Land and Development	1302	13.8%
Unidentified	1995	21.1%
TOTAL:	9471	100.0%

Source: NAREIT 1976 Factbook.

Chapter 11

Sponsors of Disaster

Among the factors that contributed to the downfall of the REITs in the mid-1970s, none were more instrumental than the financial institutions that sponsored the REITs and profited greatly from their success, while it lasted. REIT sponsorship was most attractive to the commercial banks, which effectively came to own most of the industry. The emergence of the commercial banks as the preeminent backers of REITs began in earnest late in 1969, and became full-blown when Bank of America Corporation and Chase Manhattan Corporation sponsored REITs in June and July of 1970.

Between 1972 and 1974, while the total assets of the REIT industry were increasing by a robust 135 percent, the commercial banks' share of the industry was burgeoning by 970 percent, seven times as much. In a 1974 survey of the industry, 16 of the 50 largest REITs in the country were sponsored by banks. [Table1]

By the end of 1975, according to the National Association of REITS, of the total assets of $19.4 billion held by the 261 REITs in operation, 54 percent was financed by the commercial banks. Forty-three percent of the bank financing was in the form of term loans and revolving credits; 11 percent was in the form of bank lines of credit that had been called upon by the REITs. The REITs themselves had ownership of only about 19 percent of their total assets. Of the balance, 4 percent was financed by commercial paper, 9 percent by subordinate

debt, and 11 percent by mortgage loans on real property.[1]

Close connection with the commercial banks fostered the rapid growth of the REIT industry, and afforded the newborn trusts access to plentiful capital resources. The advantage was definitely mutual: like bees to honey, the banks were drawn to the REITs by the generous advisory fees. Following the pattern established by the mutual funds, the REITs generally paid their advisors between 1 percent and 1.2 percent of invested assets for management services. In addition, the typical trust paid bonuses for good results: high returns on shareholders' equity, high capital gains, etc. With the promise of such fees and bonuses, the advisors were encouraged to lead the REITs to increase their investments, even to go deeply into debt in order to enlarge their portfolios, without being overly careful of the quality of their investments. The more investments, the more fees.

For the commercial banks as trust sponsors, the fees they got for advising their REITs were almost pure profit. A survey by Audit Investment Research[2] found many cases in which the advisors' profits amounted to 60 to 70 percent of their total fees. Only 30 to 40 percent of their fees paid their total costs for providing investment advice, underwriting and monitoring loans, and providing other services.

As profitable as REIT sponsorship proved to be for the banks, it involved relatively little risk or cost. Setting up a trust required no major capital investment from the sponsor; virtually the only risk was that the offering of shares in the trust would not attract enough interest from investors to get the REIT off to a running start and to validate the sponsor's reputation in the financial community. In the early 1970s, REITs' returns to their bank sponsors contributed

[1] Rate Statistics, National Association of Real Estate Investment Trusts, Annual Survey, 1975.

[2] "REIT Advisory Fee Plans," Audit Investment Research, Inc., (1974), p. 5.

as much as an estimated 5 percent of the banks' total earnings.[3]

In addition to the fees and bonuses they earned for advising the REITs, the banks' handsome total returns from REIT sponsorship were ~~largely derived from~~ a variety of ancillary business activities. It was not unusual, for example, for the banks' advisory subsidiaries to arrange low-cost REIT financing for developers in the expectation of selling the developers insurance or other services as part of the package.

A bank's advisory subsidiary could also influence a REIT to borrow from the bank, regardless of more favorable financing options that might be available; or to maintain excessive cash balances on deposit in the bank, to the bank's benefit and the REIT's detriment. The advisor could also require developers and others doing business with the REIT to maintain deposits at the bank. Finally, the bank would have the inside track to sell the trust it was advising a variety of banking services at non-competitive prices.

The period of tight money in 1969 gave banks and bank holding companies an incentive to use REITs to avoid the effects of interest ceilings. Under Regulation Q, the limits on interest rates applied to large certificates of deposit, as well as to ordinary savings and time accounts of less than $100,000. These constraints made it difficult for banks to attract sufficient deposits to provide lendable funds for all would-be borrowers. Developers and other real-estate interests were competing with non-real-estate borrowers for the available supply of money. Free from the onerous interest-rate regulations, REITs were able to sell equity or long-term debt, to issue commercial paper, and to borrow from banks and other financial institutions. These financing devices enabled the REITs to attract loan funds to satisfy the demand from the real-estate industry, freeing

[3] Prof. Brian Neuberger's testimony, Hearings on REITs, p. 44.

available bank funds for loans to non-real-estate borrowers.

Commercial banks and the REITs they sponsored also profited mutually in the boom period from 1971 to 1973 by writing standby takeout commitments for each other's projects. The generous fees for these modest efforts were virtually pure profit. The banks profited again with little or no expense by charging the REITs for lines of credit, which the REITs used to back their own issues of commercial paper.

The REIT-sponsoring commercial banks and their bank holding companies were able to profit at the expense of their own REITs because REITs–unlike all other entities advised or controlled by the banks–are permitted to borrow from the banks, while reporting their earnings separately. Bank holding companies also advise investment companies, or mutual funds, for example, but mutual funds rarely if ever leverage their investments; and when they do, they generally issue preferred stock instead of incurring bank debt. Other bank subsidiaries, such as mortgage-banking and consumer-loan companies, consolidate their financial reports with their parent companies'. The REITs, however, were quite separate entities; the sponsoring banks seldom owned significant amounts of the stock of their trusts. In directing the REITs' affairs, then, the sponsoring, advising banks were in effect enjoying the use of other peoples' money.

Some observers, including Kenneth D. Campbell, the president of Audit Investment Research, have suggested that the REIT boom of the early years of the 1970s was only the most recent manifestation of popular delusions and the madness of crowds, like the Dutch tulip craze or the South Sea Bubble of past centuries. The behavior of REIT sponsors, investors, and other participants in the episode, according to this view, is only explicable in terms of a blinding euphoria of greed, instead of in terms of cool economic calculation of rational

self-interest. The REIT mania is thus understandable as a result of the optimism engendered by the Housing Act of 1968, which set a national housing construction goal of 26 million units in ten years. REITs, therefore, were simply Wall Street's response to the vision of 2.6 million housing starts per year, a patriotic gesture to meet a national goal.

The rest, was salesmanship: as underwriters discovered that REIT shares could be sold to investors all too ready to believe in self-enrichment schemes, they began to compete with each other to offer trusts with the most impressive sponsorship, the greatest promise of profit, the most credible prospects of longevity. The banks and other financial institutions, encouraged by their advisors in the investment banking community, were persuaded that REITs were the hottest new investment vehicle on the road to riches, going fast and getting faster, and that they–the banks– should go along for the ride.

For the banks that served the REITs in the dual role of sponsors and advisors, however, there was a clear and perfectly rational profit motive for embracing the REIT idea. As the advisor of the biggest of the REITs during its first three years in operation, for example, Chase Bank earned total fees of $16.5 million. Assuming that one-third of the total fees represented profits, Chase netted $5.5 million during the years of the REIT's fastest growth. While the gross profit was very small in comparison to Chase Bank's total earnings, it figured much more significantly as a percentage of the total profits of Chase's real-estate department; it is in this light that the profits of REIT advisors should be viewed. The bank personnel responsible for advising REITs were, in effect if not in fact, attached to the banks' real-estate departments. [4]

In that organizational context, robust profits from advisory fees would look

[4]Campbell, *Hearings on REITs*, op. cit., p. 343.

very good on an employee's record, and would improve the employee's chances of moving up in the bank, as well as in the real-estate department. With individual careers riding on the production of advisory fees, the pressure on the personnel advising REITs became intense. In a July 25, 1975 interview in *The Wall Street Journal*, Wells Fargo's R. Holdman was quoted as saying: "...the biggest culprit in getting us into our current problem (regarding the REITs) was the volume goal that we all set to work to fulfill during the years 1971 through 1974."

The banks got trapped in the REIT quagmire one step at a time, lured each step of the way by the promise of rich rewards. During the early years of the boom, in 1972 and 1973, the banks were beguiled by the attractions of commercial paper as a fund-raising device. Commercial paper–secured notes, sold to investors either directly or through brokers, with maturities ranging from 30 to 270 days – was mostly issued by the larger REITs, which could establish the credit ratings necessary to make the paper marketable. Most of the commercial paper issued by the REITs was supported by lines of credit from commercial banks, which required the REITs to keep 10 percent of the value of the notes on deposit lieu of fees.

This requirement, in addition to the expenses of marketing the notes, added to the expense of issuing commercial paper to raise money. The REITs normally paid approximately 0.5 percent above the prime rate on commercial paper [Table 2], affording them a comfortable margin as long as the total cost of the notes did not exceed 7 percent, while the REITs were earning 10 percent on their mortgage lending. As the prime rate rose, raising the rates the REITs had to pay on their commercial paper, however, the trusts' profits suffered sharply.

Their problems were compounded when the weakness of many REIT assets became evident. The major credit rating services, such as Standard and Poor,

Moody's, and Fitch's, lowered the REITs' ratings, making it increasingly difficult for the trusts to market their commercial paper. By June 30, 1974, the total value of outstanding commercial paper, which had been $3.97 billion just six months earlier, had fallen to $1.6 billion. As a share of total REIT borrowing, commercial paper had dropped from 28 percent to 10 percent. The commercial-paper borrowings of the Chase Bank's trust, the biggest of the REITs, fell from $429 million at the end of August 1973 to $180 million just a year later.[5]

The void left by the drop in commercial paper issues was filled by bank lines of credit, which were converted into short-term bank loans. [Table 3] The banks had little choice but to grant their REIT's applications for credit; if their sponsors would not come to the trusts' aid, who would? Because they are convertible into short-term loans, lines of credit may be appropriate borrowing devices for short-term C&D REITs. By the same token, however, they were inherently inappropriate for the long-term investments the REITs were using them for in 1974.

The bank's lines of credit extended to the REITs were also used to back the REITs' commercial paper. The banks' incentive to extend the lines of credit was simple enough: they wanted the "compensating balances," which were pegged at 10 percent of the potential borrowing represented by the lines. As for the possibility that the REITs would ever convert their lines of credit into actual loans–the banks assumed it was unlikely to happen.

It did happen, however: the rapid decline in the value of outstanding commercial paper during the first half of 1974 was almost perfectly balanced by the rise in bank lines of credit that had been converted into loans. [Table 3] As the REITs ran into financial troubles, some banks, especially the smaller ones, tried

[5] *Ibid.*, p. 346.

to call their loans. The REITs, deeply in debt, could not repay, especially since in many cases the loans the REITs had made to builders were themselves in default, or at least delinquent. Trying to make the best of the situation without forcing the REITs into the bankruptcy courts, many of the banks, led by the larger ones, converted the REITs' loans into revolving credit agreements. [Table 4]

Most of the larger REITs first got into revolving-credit agreements in 1974. By mid-1975, $7.8 billion out of the total $10.6 billion owed to the banks by the REITs was in the form of revolving-credit debt, which had totalled a mere $0.9 billion just two years before. These revolving-credit agreements represented 74 percent of the trusts' total indebtedness to the banks.

As conditions in the REIT industry deteriorated, even the revolving credit agreements were no longer reassuring enough to the banks. The credit agreements began to be written with increasingly stringent restrictions and increasingly brief terms. In the mid-70s some loans were written for only eight months. In some cases, the price of a revolving credit agreement was a promise by the trust not to make any new loan commitments, or not to pay dividends more often than annually, instead of quarterly. The banks also required the REITs to limit their non-accrual loans and to maintain some minimum net worth.

The revolving credit agreements did not ordinarily require the REITs to maintain compensating balances: the trusts needed all the cash they could get just to pay current expenses and unfunded commitments. On interest, however, the lenders were not so understanding. Rates of 130 percent of the prime rate became the rule. The prime rate reached 12 percent as the REITs were experiencing their worst difficulty, then rose still higher. The result for the REITs was borrowing costs in excess of 15.5 percent. Almost from the first, the inter-

est burden was more than most of them could bear, and many of the REITs defaulted almost immediately on their obligations.

Those C&D REITs that managed to keep their heads above the financial quagmire into which the industry was sinking owed their survival to the willingness of their creditors to keep them afloat. For the most part, the banks helped these survivors by acquiring some of their assets, either through outright purchases or swaps. In the swap, the troubled REIT traded some of the loans they had made on income-producing properties for some of the government-insured loans the banks had made. With the government-insured loans in their portfolios, the REITs were able to tap other sources of credit. With an FHA/VA loan, guaranteed by the government, for example, a REIT could take advantage of Title 12 of the Federal Reserve Act to discount a mortgage company note at the Federal Reserve for 90 days.

The advantage in this type of transaction was that the REIT improved its liquidity, picking up cash to maintain its assets and obligations, without suffering any net diminution of assets. The disadvantage was that the REITs were giving up their most marketable loans–the only ones the banks were interested in swapping for. The effect was to increase the ratio of non-earning assets to total assets remaining in their portfolios, bringing the REITs even closer to bankruptcy.

In other cases, banks simply bought assets from the strapped trusts as an important part of the controlled liquidation of trust assets. When Fidelity Mortgage Investors ran into difficulty, for example, it offered $3 million of its assets for sale at book value to the banks from which it had borrowed money.[6] Fidelity

[6] First Boston Research, "Impact on Bank Earnings of REIT and Real Estate Loans", "*Hearing on REITs*", p. 218.

Mortgage agreed on a 3-to-1 ratio between sales price to debt repayment for the best of the loans it was offering. Of the $3 million if received for its assets, therefore, Fidelity Mutual returned $1 million to the banks to repay loans, keeping $2 million to add to its cash reserves. When lower-quality assets were sold, FMI or other debtors had to agree to less attractive terms; in some cases, the ratio of sales price to debt repayment was 1:1–all the proceeds were retained by the banks to pay down the REITs' credit balances.

When a REIT advisor was a subsidiary of a bank holding company it was not unusual for the bank holding company; the bank and the REIT advisor; and the affiliated REIT, to swap assets and to forgive indebtedness among themselves. Bank-connected advisors had other ways they could help their REITs: outright cash payments; reduced fees for advisory services; putting up the compensating balances required by the banks for extending lines of credit; or simply paying the REITs' loan losses above a certain level.

It was not altruism that impelled banks to assist their trusts. The Federal Reserve Board, for one, viewed with concern the crisis in REIT commercial paper, when many banks became worried about the serious problems in the industry and moved to cancel lines of credit, causing several of the larger REITs to have difficulties redeeming their commercial paper as it matured. Andrew Brimmer[7], formerly a member of the Federal Reserve Board, has said that the Board actually gave the commercial bankers explicit instructions to protect the REITs from failure. The motive imputed to the Board was a desire to switch REIT borrowing smoothly from commercial paper to the conventional banking system.

[7]Quoted in Richard R. Byrne, "Reit's: Their Past, Present, and Future," Unpublished Thesis, Rutgers University, New Brunswick, NJ, June 1975, p. 68.

The Federal Reserve denies that it made any attempt to influence the REITs' fate or fortunes. Whoever tried to help the REITs, however, apparently assumed that the trusts were in a fix merely because they had the misfortune to encounter a recession and tight money. Believing this, it was also possible to believe that all that was needed for the REITs' recovery was an upturn in the national economy.

For the banks, there was a clear, imperative self-interest in helping the REITs to survive the commercial paper crisis. The banks already had heavy investments in the REITs; if they did not think enough of their investments to back them with additional funds, who would? If no additional investors were found, many REITs would be forced into bankruptcy, taking many of their borrowers with them. Some banks were so heavily invested in REITs that the simultaneous failure of many REITs would have bankrupted the banks as well. Citibank and Chase, for example, each had $800 million invested in their REITs, compared to total capital of $2075 million and $1446 million respectively. Bankers Trust's REIT investment was $600 million, compared to total capital of $576 million. Of its total capital of $718 million, Chemical had $800 million in REITs.[8]

In the process of trying to help the trusts out of trouble, the banks themselves incurred significant losses from principal amounts that were simply written off and interest payments that were either deferred or waived outright. In a report prepared for its clients, the investment banking firm of Drexel Burnham & Co. estimated the extent of the damage to the banks' balance sheets.[9] If the nine major banks with the greatest involvement in the REITs had fully accounted for all their REIT-connected losses in 1975, according to Drexel Burnham's survey,

[8]Drexel Burnham & Co., "Bank Loans to REITs: Problems and Prospects," Hearings on REITs, p. 319.

[9]*Ibid.*, p. 320.

the average reduction in earnings per share as a result of principal write-offs was 30.5 percent; the average loss from the opportunity cost of interest due but not received was 6.9 percent. All told, the loss in earnings per share averaged 37.4 percent. First Chicago, the big loser, declined 73 percent in per-share earnings; while Morgan only declined 16.9 percent. [Table 5]

The damage–and the abuses that led to the damage–was mostly limited to the short-term C&D REITs and the commercial banks that sponsored and advised them. The other REITs, the equity and long-term-mortgage trusts, and other trusts that were not sponsored by the banks, were not nearly as hard hit during the downfall of the REIT industry. The trusts sponsored by large insurance companies, for example, were much less willing than the bank-sponsored REITs to invest in short-term construction and development loans, or in volatile, high-risk housing schemes, such as condominiums. Instead, these REITs concentrated their investments in high-quality permanent first mortgages; equity ownership of real properties; and commercial properties, like office buildings and shopping centers.

As a result, the insurance companies' trusts maintained lower, safer ratios of debt to equity; higher stock prices; and higher yields than the banks'. By putting their money into permanent first mortgages, the insurance companies' REITs were investing in projects that had already been completed. The C&D REITs favored by the commercial banks, in contrast, were betting on developers' plans, hopes, and good faith, with all the risks that such investment entails. When they did lend to developers, furthermore, the insurance-company REITs made sure that permanent takeout commitments were firmly in place. They could be quite sure, then, that the money to pay off the development loan would be waiting when the project was completed.

The trusts sponsored and advised by insurance companies also enjoyed the advantage of their sponsors' widespread involvement in many aspects of the national real-estate industry; especially their intimate experience in the thousands of local markets that really make up the national industry. The bank-sponsored trusts, on the other hand, suffered from the limited geographical range of their sponsor-advisors, whose primary banking activities were limited by government regulation to a single local market. Most of the bank-sponsored REITs, therefore, concentrated their lending in a few well-known, overworked markets, and made all decisions from their home offices.

TABLE 1
50 LARGEST REITS

Rank	Name of Trust	Total Assets (millions)	Trust Types
1	Chase Manhattan Mtg. & Realty*	$940	C
2	Continental Mortgage Investors	851	C
3	First Mortgage Investors	684	C
4	Guardian Mortgage Investors	479	C
5	Great American Mortgage Investors	479	C
6	Connecticut General Mortgage & Realty	470	I
7	Citizens & Southern Realty Investors*	461	C
8	Builders Investment Group	429	C
9	Lomas & Nettleton Mortgage Investors	410	C
10	Diversified Mortgage Investors	403	I
11	D.I. Mortgage Group	373	C
12	IDS Realty Trust	346	C
13	B.F. Saul REIT	343	I
14	Equitable Life Mtg. & Realty Investors	341	I
15	Cousins Mtg. & Equity Investments	327	I
16	Barnett Mortgage Trust*	308	C
17	Corporate Property Investors	298	I
18	Mass Mutual Mtg. & Realty Investors	297	I
19	Continental Illinois Realty*	296	C
20	MONY Mortgage Investors	278	I
21	Wells Fargo Mortgage Investors*	278	C
22	BankAmerica Realty Investors*	264	I
23	Alison Mortgage Investment Group	251	I
24	North American Mortgage Investors	250	C
25	Northwestern Mutual Life Mtg.	244	I

Source: *American Banker*, 10/20/74

TABLE 1 (continued)

Rank	Name of Trust	Total Assets (millions)	Trust Types
26	Tri-South Mortgage Investors*	244	C
27	Security Mortgage Investors	234	I
28	First Wisconsin Mortgage Trust*	232	C
29	Fidelity Mortgage Investors	213	I
30	Cabot, Cabot, & Forbes Land Trust*	213	I
31	Reitman Mortgage Investors	211	C
32	Larwin Mortgage Investors	200	E
33	C.I. Realty Investors	200	E
34	Wachovia Realty Investments*	195	C
35	American Century Mortgage Investors	191	C
36	Institutional Investors Trust	190	C
37	General Growth Properties	189	E
38	Colwell Mortgage Trust	188	C
39	Mortgage Trust of America	187	C
40	Continental Illinois Properties*	184	E
41	Capital Mortgage Investments	182	C
42	Cameron-Brown Investment Group*	176	C
43	First Pennsylvania Mortgage Trust*	172	C
44	B.T. Mortgage Investors*	169	E
45	Independence Mortgage Trust	162	C
46	UMET Trust	160	C
47	Atico Mortgage Investors*	160	C
48	Gulf Mortgage & Realty Investments	159	E
49	State Mutual Investors	158	E
50	PNB Mortgage & Realty Investors*	150	E

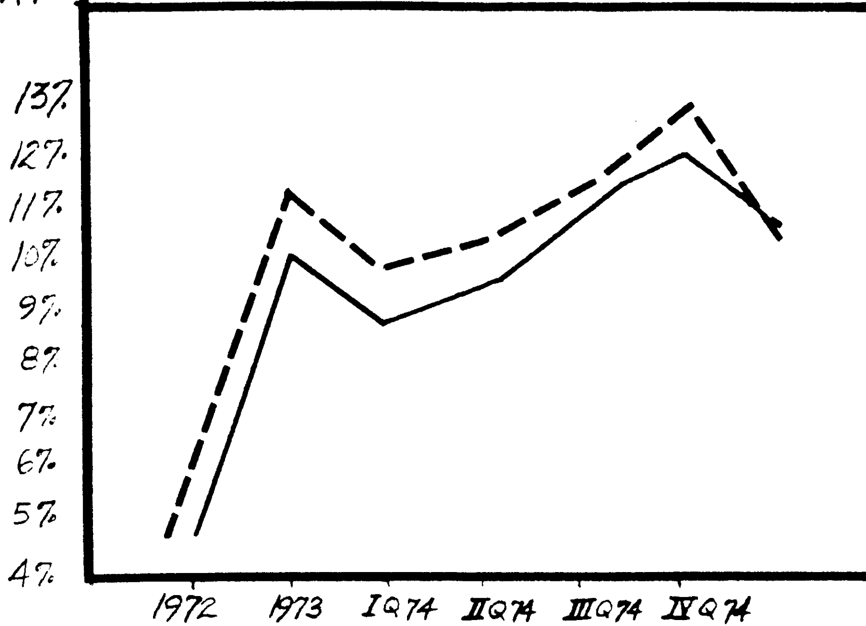
TOTAL ASSETS (50 REITs) $14,834

Trust Types
C: Short-term construction and development mortgage loans
I: Intermediate-term mortgages
E: Long-term mortgages and/or equity investments in real estate

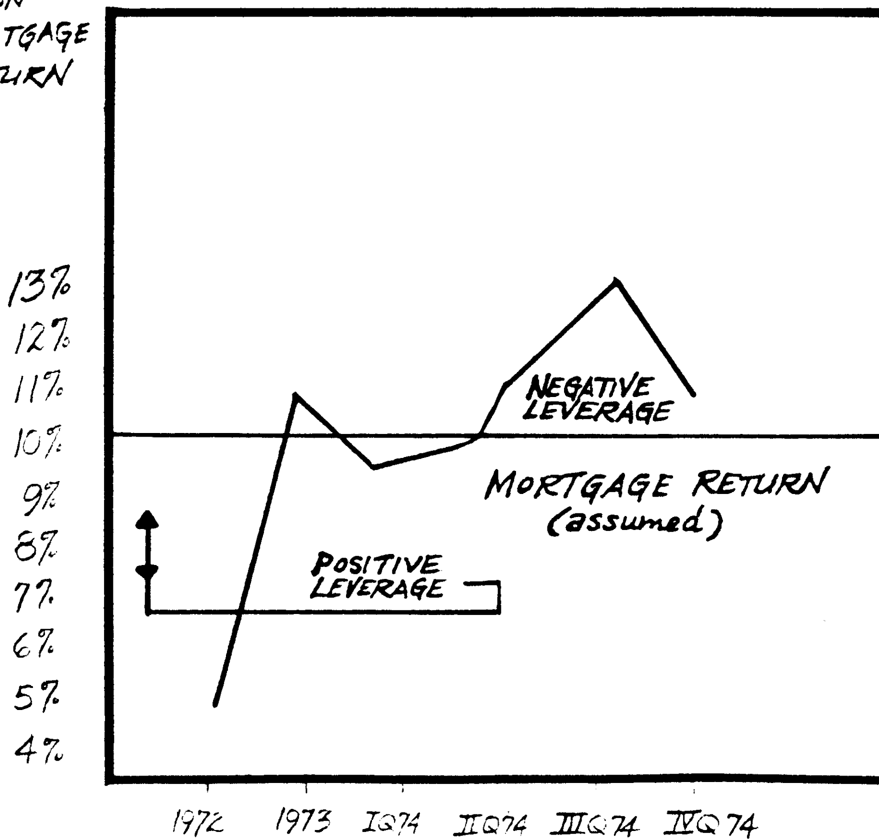
*Commercial bank-sponsored REITs

TABLE 2

COMMERCIAL PAPER RATE AND PRIME RATE 1972-1974



COMMERCIAL PAPER LEVERAGE ON MORTGAGE RETURN 1972-1974



SOURCE: WREITer's DIGEST, DECEMBER 1974.

TABLE 3

TOTAL COMMERCIAL PAPER AND BANK LINES
(in billions)

	6/30/73	6/30/74	Change
Commercial Paper Outstanding	3.97	1.56	-2.41
Bank Lines in Use	5.02	7.09	+2.07
Total Available Bank Lines	10.08	9.45	-0.63

Source: REIT Statistics, National Association of Real Estate Investment Trusts, Annual Survey 1973.

REIT Statistics, National Association of Real Estate Investment Trusts, Annual Survey 1974.

TABLE 4
ANALYSIS OF BANK LOANS TO THE REIT INDUSTRY
(in millions)

Period	Total REIT Assets	Bank Short-Term	Bank Revolving	Total Bank Debt	% Bank Debt To REIT Assets
71/1	2,361	192	0	192	0.1
71/2	5,352	516	7	524	9.0
71/3	6,160	584	7	592	9.6
71/4	7,148	804	8	812	11.3
72/1	8,360	991	8	1,000	11.9
72/2	10,294	1,489	40	1,536	14.9
72/3	11,705	2,041	56	2,098	17.9
72/4	13,313	2,410	357	2,768	20.7
73/1	14,653	2,064	620	3,484	23.7
73/2	16,044	3,838	964	4,803	29.9
73/3	17,684	4,571	1,499	6,070	34.3
73/4	19,021	4,687	1,584	6,271	32.9
74/1	19,856	5,826	1,663	7,490	37.7
74/2	20,265	7,406	2,259	9,666	47.6
74/3	20,351	7,471	3,473	10,944	53.7
74/4	20,048	5,998	5,104	11,102	55.3
75/1	19,214	3,842	6,986	10,029	56.3
75/2	18,607	2,846	7,767	10,613	57.0

Neuberger testimony, Hearings on REITs, op.cit., p.41.

TABLE 5

COMBINED EFFECTS OF PRINCIPAL WRITE-OFFS, AND "OPPORTUNITY COST" OF INTEREST NOT RECEIVED FROM REIT LOANS ON THE EARNINGS PER SHARE OF NINE MAJOR BANKS (UNTIL JUNE 1975)

(Percent decline in EPS as a result of:)

	Principal Loss Effect	Interest Income Effect	Combined Effect
Bank America	15.9%	3.6%	19.5%
Citicorp	18.8%	4.1%	22.9%
Chase Manhattan	24.7%	5.8%	30.5%
Morgan	14.1%	2.8%	16.9%
Manufacturers Hanover	25.3%	5.1%	30.4%
Chemical	42.0%	12.5%	54.5%
Continental Illinois	51.3%	10.5%	61.8%
First Chicago	59.2%	13.0%	72.2%
Security Pacific	23.3%	4.9%	28.2%
Nine Bank Average:	30.5%	6.9%	37.4%

Source: Drexel Burnham & Co., Hearings on REITs, p. 320.

Chapter 12

The Failure of Regulation

The lack of adequate regulatory safeguards and of institutions to oversee the behavior of realty trusts was largely to blame for the collapse of the REIT industry in the 1970s and the consequent injury to thousands of investors. Congress in its wisdom endowed REITs with the same tax advantages theretofore reserved to mutual funds; but Congress' wisdom did not extend to giving REITs the mutual funds' regulatory protection.

Mutual funds–regulated investment companies–were protected by the regulatory provisions of the Investment Company Act and the Investment Advisors Act, both enacted in 1940. Among the legislative impulses that led to these acts was Congress' desire "to ensure that investors who entrusted their funds to investment companies would not be subject to undue risk due to imprudent financial structures, self-dealing, and conflicts of interest generated by those charged with the management of fund assets. By contrast, REITs were not in 1960, nor have they been at any time since then, subject to comparable regulatory safeguards."[1]

In fact, Martin notes, Section 3(c)(b) of the Investment Company Act exempted from the provisions of the Act companies investing in real estate or mortgages secured by real estate. The Securities and Exchange Commission interpreted this provision to apply to most REITs. The use of "Blue Sky" laws to

[1]William L. Martin, "Federal Regulation of Real Estate Investment Trusts: A Legislative Proposal," *University of Pennsylvania Law Review*, Vol. 127, pp. 317-318, 1978.

regulate REITs has been attempted by some states, but most have found these laws inadequate to the task.

The REITs would have been well-served by a variety of regulatory measures, including some originally devised for mutual funds, and others especially designed for the special conditions of the REITs. In the event, however, the REITs did not even get the benefit of the ordinary regulations applied to more traditional corporations and financial institutions. REITs are like mutual funds, for example, in the way their managements are structured and in the objectives they are created to pursue. Both aggregate capital from relatively large numbers of relatively small individual investors, seeking thus to afford small investors the advantages usually available only to large investors, while minimizing their exposure to risk. Like mutual funds, too, REITs are managed by outside investment advisors, under contract. The advisors are in effect the managers of the business, guiding the investment and financial decisions of the trustees, and generally managing the day-to-day activities of the company.

The REITs, it is clear, wanted regulation in at least four important areas. They shared with the mutual funds the need for measures to guard against conflicts of interest in the transactions between the realty trusts and their advisors; to maintain proper relationships when both advisor and trust were represented by the same law firm; as well as to insure that the agreements between REITs and advisors were proper in all respects. The REITs, in addition, proved to require strict measures to curtail the temptation - apparently an overwhelming one - to take imprudent risks, especially to leverage their debts too heavily.

Instead of strong, explicit, systematic regulation at the federal level, however, the REITs were subject to an inconsistent, often unintelligible, and essentially haphazard patchwork of federal and state statutes and rules, together with self-

imposed regulations devised by the REIT industry. Self-regulation of the realty trusts included primarily those provisions of the contracts between REITs and their advisors that restricted activities that might involve self-dealing or other improper behavior. Such contract provisions commonly stipulated that transactions involving the trust and its advisor or any affiliate of its advisor required the approval of a majority of the trustees unaffiliated with the advisor or its affiliates.

The standard Declaration of Trust - the instrument creating a REIT - also specified that transactions between the REIT and its advisor or its advisor's affiliate should be "fair and reasonable" to the shareholders; and should be as advantageous to the REIT and its shareholders as similar transactions conducted at arm's length.[2] To achieve these results, the standard Declaration included specific clauses requiring the advisor to act as a co-lender on equal terms, pari passu; or to give the trust the right of first refusal on any investment that the advisor was considering for itself.

As reasonable and effective as these measures may have sounded in theory, however, in actual practice they were ineffectual. The regulations included no punishment for trustees who failed in their responsibilities to make sure that all transactions between REITs and advisors were "fair and reasonable." If the trustees failed to notice improper dealings, or failed to look for them in the first place, no agency or mechanism was created to protect the interests of the trust and its shareholders, much less to hold the errant trustees responsible for their misfeasance, malfeasance, or just plain nonfeasance. Quite the contrary, indeed: virtually all Declarations of Trust included specific language explicitly exculpating all trustees and advisors from liability for their actions in connection

[2] *Ibid.*, P. 325

with the REIT, except in cases where intentional or "gross and reckless" errors could be proved.[3]

Requirements for "pari passu" dealings and rights of first refusal in relations between REITs and advisors were far from universal.[4]

State regulation of REIT management and operations largely follows the policy statement adopted in 1970 by the Midwest Security Commissioners Association (MSCA). The principal features of the MSCA statement include a requirement that the majority of any REIT's trustees be independent of any affiliation with the REIT's advisor or any affiliate of the advisor. Also included was a prohibition against any purchase or sale of any trust asset by any trustees, officers, or advisors of the trust, except under certain specified circumstances; and even then only with the approval of a majority of the unaffiliated trustees.

These regulations, too, were largely feckless, because they were not adopted by most states, and because they were far too limited in their scope to embrace many of the most prevalent conflict-of-interest situations and other abuses. The MSCA policy, for example, applied only to new security offerings by the REITs. The rules did not apply to REIT financings through commercial paper and

[3] *Ibid.*, p. 326

[4] By 1978, only seven states (Alaska, Iowa, Kansas, Missouri, Tennessee, Wisconsin, and Wyoming) and the American Stock Exchange had enacted rules modelled on the Midwest Security Commisioners Association, (MSCA), guidelines. Six other states (California, Florida, Idaho, Michigan, Mississippi, and Washington) had adopted rules more limited in scope, without any provisions for self-dealing transactions. (Where they did exist, often only one or the other was included, creating serious lapses in effective protection of shareholders' interests. "pari passu" provisions were often written to require advisors, as ostensible co-lenders, to put up as little as 10 percent or less of a loan, making their participation little more than window dressing. Finally, the non-affiliated trustees' required scrutiny of investment activities involving REITs and their advisors in potential conflicts of interest was often more sham than real, since the number and complexity of the activities to be overseen far outstripped the trustees' available time, energy, and inclination.

bank lines of credit; the very situations in which self-dealing and other conflicts of interest were most likely to arise. The MSCA policy also ignored the inherent conflict of interest in the sale of services to the REIT by its advisor and its affiliates - the same sales that were the main reason why many REITs were created in the first place - or the common occurrence of a REIT competing with its advisor or its advisor's affiliate for a lending opportunity. For protection against such opportunities for abuse, the MSCA relied totally on the ability and inclination of the independent trustees. With their limited independence, their limited financial expertise, and the limited time and attention they could or would spend on their trust, the efficacy of the trustees in this regard was definitely limited.

The states had two other legal safeguards against improper behavior by REIT trustees or advisors. Laws requiring "duty of care" could have had significant application to the trustees' conduct of corporate affairs and supervision of the trusts' management. "Duty of loyalty," contained in other laws, would have required REIT trustees, as corporate directors and officers, to act in good faith in all transactions involving the REIT and its assets, and to demonstrate good faith and fairness in all personal dealings with the REIT.[5]

These legal concepts, however, according to William L. Martin II[6], had little practical application to the situation of REITs and their trustees, and little effect in regulating conflicts of interest, self-dealing, and other abuses involving REIT trustees, advisors, and officers. The concept of "duty of care" was traditionally limited in its application to bank directors; "duty of loyalty" did not apply to independent REIT investment advisors, who were not officers or

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[5]Martin, *op. cit.*, p. 331

[6]*Ibid.*, p. 330

employees of the corporation. Many of the major REITs, in addition, were established and governed under the laws of Massachusetts, which limits the liability of REIT trustees to cases in which "gross negligence" can be proved. Under the protection of such a statute, REIT trustees could be held accountable only for relatively flagrant, clear-cut offenses of which they could be shown to have had actual knowledge. In effect, therefore, trustees were virtually immune from accountability for abuses under their ostensible stewardship.

Most of the Federal laws applying to the operation of REITs are found in the Securities Act of 1933 and the Securities Exchange Act of 1934. The provisions of these acts applying to disclosure by corporate directors apply equally to REIT trustees. Under these provisions, all trustees, but especially those who purport to be independent, are required by law to investigate and to insist on disclosure of all conflicts of interest or instances of self-dealing in which the relationship between the REIT and its advisors is materially involved.[7]

Despite the laws' positive requirements that trustees diligently determine the adequacy and accuracy of full disclosure, there was still room for abuses. The trustees' duty under the law, for example, only applies to the REITs' original offering documents; it does not require the trust to make subsequent disclosures to its shareholders or potential investors as circumstances change.[8] The courts have been unwilling to hold independent REIT trustees liable for abuses, therefore, merely on the grounds that they failed to investigate or to require full disclosure of conflicts of interest or self-dealings.

Ironically, there was at least one law on the books that might have forced the REITs to adhere to strict standards of fiduciary responsibility, if it had been

[7] *Ibid.*, p. 333.

[8] *Ibid.*, p. 333.

applied. The law in question is the Investment Company Act, whose Section 36(a), designed to bolster the position of independent directors, requires strict disclosure by advisors in all transactions where there exists so much as the possibility, much less the actual fact, of any conflict of interest, however slight. Acting on such disclosures, the independent directors are required to give careful consideration to all relevant factors before deciding whether to permit such a transaction.

In cases involving investment companies, courts have consistently ruled that Section 36(a) makes independent directors liable not only for their own self-dealing, but also for their negligent failure to ferret out self-dealing by advisors, officers, and non-independent directors. Section 17 of the Investment Company Act goes further, requiring review and approval by the Securities and Exchange Commission of many kinds of transactions between a mutual fund and its advisors.[9] Intended to regulate mutual funds, however, the Investment Company Act was never extended to include the funds' close cousins, the REITs; which therefore escaped the salutary surveillance of the Federal courts and the SEC in these matters. As a result, REIT advisors frequently neglected to disclose important facts involving real or potential self-dealing and other conflicts of interest to the trustees; who had no need to be overly concerned about being kept in the dark, since they were virtually immune from liability for abuses about which they could not be shown to have known.

The Investment Company Act pays particular attention to the problem of advisory fees in mutual funds. The Act prescribes detailed rules for the companies, their directors, and their advisors in setting fees and making contracts for advisory services. However, REITs and REIT advisors were not similarly

[9] *Ibid.*, p. 344

regulated. In fact, there were no Federal laws directly addressed to the troublesome question of REIT advisory fees. In only a single case, and only in 1978, the SEC brought an action against a REIT advisor, charging failure to disclose what it called "exorbitant" profit margins in its fees. As a result of this lack of regulatory zeal, predictably, the most prevalent abuse of REIT management was in this very area.

Even the strictures applied by law to ordinary corporations were almost entirely lacking. Ordinary corporations, for example, publish the salaries and other compensation paid to top management, directors, and officers in a form that enables shareholders and other interested parties to make informed judgements. REITs, however, disclosed only their aggregated management costs, in which operating expense, other expenses, salaries, and profits were lumped together. With no more information to go on, shareholders were unable to make rational evaluations of the remuneration that was being paid to advisors.

If shareholders were effectively kept at a distance from the process by which advisors' fees were determined, the advisors themselves were not. The preponderance of advisors' representatives on many REIT boards ruled out the kind of arm's-length bargaining over compensation that is standard practice in ordinary business situations. The advisors were quite free to influence the setting of their own fees and bonuses, and to make other decisions regarding the REIT's affairs, with more of an eye to the advantage of their own corporations than to the well-being of the REIT.

Nor did the common law protect the shareholders' interests. Indeed, under common law, the contract between the REIT and its advisor, and the fees agreed on for advisory services, were subject only to the most limited review by the

courts. In the case of Sane v. Brady[10], the court held that approval of a contract by the majority of shareholders constituted convincing evidence that the fee set by the contract is neither unreasonable or excessive.

Another potential regulatory influence was the limitations on advisory fees included in the Statements of Policy issued by the Midwest Securities Commissioners Association. The policy statements, belatedly promulgated in 1970, set limits on the total operating costs of REITs, and on the fees they could pay their advisors. The limit on total annual expenses, not counting interest, was 1.5 percent of the REIT's total invested assets, without deducting liabilities. Advisory fees were limited to 1.5 percent of assets less liabilities; or 25 percent of the REIT's net income before payment of advisory fees; whichever was higher.[11]

According to the MSCA formula, a REIT with $200 million in total invested assets, $100 million in liabilities, and $4 million in net income would pay a maximum of $1,500,000 in advisory fees (1.5 percent of assets less liabilities); while total expenses, including the advisory fee but excluding interest expense, could not exceed $1.5 million.

The MSCA policy was aimed directly at the problem of advisory fees, and its explicit terms seemed to make abuse difficult, if not impossible. Since liabilities - including leveraged debt used to purchase assets - was deducted from total assets in calculating advisory fees, advisors could not inflate their fees by urging the REIT into heavily leveraged investments. Under the alternative method of calculating fees, since fees could not exceed 25 percent of net income, advisors could not increase their own profits simply by recommending imprudent, un-

[10] *Ibid.*, p. 353.

[11] Roy Schotland, "Real Estate Investment Trusts," in "Abuse on Wall Street," by Twentieth Century Fund Steering Committee, Quorum Books, Westport CT, 1980, p. 181.

profitable, or excessively risky investments. Improved advisory fees were thus directly tied to improved REIT net income. The apparent effect of these MSCA regulations was to marry the advisors' profits to the profits of their REITs.

Martin, among others, has explained the failure of the MSCA policy statements to control the rampant abuses in the REIT industry. First was the failure of more than a few states and one stock exchange to adopt the MSCA standards. As late as 1974, several years after the MSCA had spoken, five of the ten largest REITs were ignoring its standards.[12]

Even within the standards, according to Martin, "...under certain circumstances, it [was] quite possible that an advisor to a trust that was earning no income on its investments and that was only modestly leveraged would nevertheless have an incentive to increase the trust's borrowings and invest the proceeds, notwithstanding the quality of the additional investments or the prudence of increased debt leverage."[13]

The same critics also point out that the MSCA limits do not include non-fee compensation received by REIT advisors. Among the excluded, but lucrative, sources of income: income from borrowers connected with loan origination; and Income received by the advisor or an affiliate of the advisor for services involving acquisition, operation, maintenance, protection, or disposition of trust properties.

In practice, the MSCA guidelines were simply abrogated when it suited the affected parties. When the REIT business became unprofitable, and the guidelines spelled huge operating losses for the advisors, many REITs simply agreed to underwrite their advisors operating deficits. In effect, then, the REIT ad-

[12]Martin, *op. cit.*, p. 355.

[13]Martin, *op. cit.*, p. 356.

visors were insured against losses in bad times, without giving up any of their generous profits from good times. It was, for the advisors if not for the advisees, a no-lose situation.

Finally, notes Martin, the MSCA policy proposed formulas for fixing the maximum fees for advisors. As substitutes for the kind of "reasoned evaluation" that should go into any deliberation on appropriate fees for advisory services, the limitations were at once too approximate and too rigid to be very satisfactory.[14]

The REITs' inherent propensity for taking risks - sometimes imprudent risks - was another problem area in which regulation would have been helpful. In this area, too, the Investment Company Act protects mutual funds, restricting the leveraged debt that a regulated investment company can incur. Section 18 of the Act, for example, prohibits open-end investment companies from issuing senior securities. The same section limits borrowing from banks by both open- and closed-end companies to a fixed percentage of the amount by which the a companys' assets exceed its total bank debt. Section 18 was included in the Investment Company Act after an SEC study[15] showed a decided negative relationship between a fund's leveraged debt and its overall performance.

Despite the lack of diversity, and the consequently greater risk, that characterized the REITs' assets compared to those of the mutual funds, it is remarkable - and unfortunate - that no such law as Section 18 applied to realty trusts. The only control on excessive debt leveraging by REITs was the MSCA policy guideline against "unreasonable" borrowing. The MSCA did not offer any definition of "unreasonable." The only other restrictions were those written into the Declarations of Trust by REIT sponsors, who were hardly disposed to hold themselves

[14] *Ibid.*, p. 356

[15] *Ibid.*, p. 370

to the highest standards of responsible borrowing. Indeed, Declarations of Trust permitted REITs to burden themselves with debt-to-equity ratios as high as 8:1.

REITs were also vulnerable to conflict-of-interest problems because of their common practice of permitting one law firm to represent both the REIT and its advisor. Indeed, it was typical for the same firm to include the REIT's sponsor and its supposedly independent trustees on its client roster. Representing all sides in any conflict that might arise among the REIT's leadership, the law firm could not possibly fulfill its obligations to protect the legitimate interests of its clients simultaneously.

The potential for conflict in the not-uncommon case of a dispute involving a REIT and its advisor, with both parties represented by the same law firm, is suggested by Schotland:

> ...the REIT's counsel would know that the advisor controlled the REIT and, thereby, the lawyer's continued employment. But even if the lawyer feared that certain actions might cost him the REIT as a client, he would be concerned about the loss of only one account: the REIT. If the same law firm represented both the advisor and the REIT, actions interpreted as unwarranted solicitude for the REIT's interests could lead to the loss of both accounts.[16]

If the scenario seems obvious, it was evidently missed by the Securities and Exchange Commission, the Midwest Securities Commissioners Association, and the American Bar Association, none of which indicated by any action that the interests of both the REIT and its advisor could not be represented fairly by the same lawyer.

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[16]Schotland, *op. cit.*, p. 204

Chapter 13

Conflicts

Abused and exploited by their sponsors, advisors, and trustees; and neglected by the regulatory agencies with the mandate and the jurisdiction to protect them; the REITs were practically doomed to disaster.

Certainly the banks were the most culpable factors in the REITs' decline, since it was the banks that sponsored the REITs in many cases, and thus had the primary responsibility — in both the moral and the fiduciary sense — to protect them. In fact, however, most bank-sponsored REITs owed their very existence to their sponsors' appetites for generous fees for advice and other services. The nature of the bank's interest in their REITs was indicated by the fact that few of the banks invested very heavily in the REITs they themselves started. While such a hands-off practice might appear admirable in some sense, it also indicated that the banks did not anticipate that the largest profits would come from the increasing values of the trusts; instead, they looked for the best returns to come from fees.

The fees were assured because the REITs' sponsors, or their affiliates or subsidiaries, were invariably the REITs' advisors as well. This cozy certitude was never so much as challenged by the REITs' supposedly independent trustees, who sat right across the table from the sponsors' representatives at board meetings. Effectively in control, the bank-sponsors dictated REIT policy, influenced REIT investments in order to increase their own profits, encouraged imprudent

leveraging in a push for apparent growth, and avoided accountability to the REIT shareholders in whose name they purported to act.

The banks' lack of rigorous interest was indicated also by their failure in most cases to insist on first-rate management for the REITs. Despite the fact that the REITs' managements were inevitably going to be handling immense amounts of other peoples' money, under high pressure; and despite the fact that the shareholders whose money the REITs were using had been assured that their interests were protected by the banks' own highly competent managements; in fact, REIT managements were often selected without adequate care and allowed to manage without adequate controls.

Meanwhile, to make the REITs as attractive as possible to potential investors, the shares were commonly touted heavily, often with dubious claims. A banker described the steamy atmosphere on Wall Street:

> The stock market was dull in 1969 and 1970, with few attractive issues. REITs provided the market sex appeal during this relatively dry period. The selling pitch was earnings - leverage, greater earnings per share - higher stock values. Magically, an income security turned into a growth stock....the way to increase per share earnings was to borrow and increase investments. The Wall Street pressure for this result was tremendous.[1].

With this go-go atmosphere prevailing in 1965, two revenue rulings[2] made it legal for a REIT's trustees to do double-duty as officers, employees, or shareholders of the REIT's advisory organization. Specifically, the first ruling allowed

[1]Schotland, *op. cit.*, p. 168

[2]Rev. Rul. 65-65, 1965-1 CUM. BULL.

a REIT's trustee to be an officer, an employee, or a direct or indirect proprietor of an independent contractor whose sole business was the servicing of the REIT's real-estate loans. The second ruling allowed a REIT's trustee also to be an employee, officer, or stockholder of a supplier of "legal or investment advisory services to the trust pertaining to the trust property." In effect, these rulings encouraged conflicts of interest among REIT trustees: a trustee with loyalties divided between the stockholders and the REIT's advisory organization might well find himself torn between competing interests.

Despite their potentially conflicting interests, however, the trustees enjoyed extraordinary latitude. Indeed, their powers were broad enough to overcome the legal strictures against "active" development dealings by a REIT, which was designated by law as a "passive" investor. With the power to set rental terms and to enter into leases, combined with the power to use capital for improvements to REIT property, the trustees were perfectly positioned to transform passive investment vehicles into active development trusts, buying unimproved property, developing it, and then renting or leasing it.

Section 1.856-4(b)(3)(1)(d) of the Internal Revenue Code, for example, required REIT trustees to contract out the management and operating services for REIT-owned property, as well as services provided to tenants of the property; but allowed the trustees to manage the trust itself. As managers of their trusts, of course, the trustees were in a position to make unilateral decisions on capital expenditures. And Section 263 of the Internal Revenue Code specifically defines capital expenditures to include payments for new construction or permanent improvements intended to increase property values.

These powers clearly put the REIT trustees in the position of active real-estate developers, rather than merely passive investors. In their active role,

the REITs became much more risky for their investors than they were intended to be as passive entities. Without fair warning, REIT investors were actually engaging by proxy in relatively high-risk real-estate development schemes.

The availability of generous advisory fees to trustees acting in a dual capacity provided the trustees with an incentive to commit trust resources to speculative property development, violating the spirit of the trusts' original mandate as passive entities and exposing their shareholders to unanticipated risks. The standard REIT advisory-fee, intended to compensate outside investment advisors for management services, became a major conflict of interest in the common case of a trustee who was simultaneously an employee of the sponsor-advisor. In such an incestuous relationship, proper arm's-length negotiation of fees was doubtful. Since the standard basis for computing advisory fees was the total value of a REIT's assets, the trustee-advisor was encouraged to urge the REIT into debt in order to buy assets and bolster fees.

Even such a clear-cut conflict of interest was not necessarily blameworthy, however, if the investment activities and advice of the trustee-advisor were in the best interests of the REIT shareholders. Presumably, one way to assure an identity of interest between the trustee and the shareholders would have been for the trustee himself to become a major investor in the REIT. In actual practice, however, the investments of most advisors in their REITs were too small to create any compelling common interest.

The potentially conflicting interests of REIT trustees, and their potential for reaping generous profits from advisory fees without investing significantly in the REIT, were often concealed from the REITs' shareholders by obscure and incomplete disclosure of management expenses. REIT prospectuses and other reports to shareholders commonly omitted any breakdown of total management

fees to show actual costs borne by the advisors and the advisors' profits. Without such information, shareholders were unable to make proper judgements of their REITs' true operation, management, and financial situation.

As Schotland notes, quoting an industry observer:

> Unhappily, very few REITs are reporting to their shareholders on a regular basis the results of operations of their advisor. When this is done, it is usually contained in proxy statements supporting expense-only fees. Thus the REIT shareholder remains largely in the dark about how the dollars of advisory fees are actually being spent. Perhaps it will take some evolution toward greater maturity among REIT trustees to elevate disclosure standards in this area.[3]

The issue of advisory fees was described in a 1975 survey of industry fee practices, conducted by Audit Investment Research:

> [The question is whether] fees were not $100 or $110 million too high during [the REITs'] halcyon days.
>
> Some trustee boards have implicitly answered that question in the affirmative by requesting their advisors to stay on the job with little or no fee. In effect, they are asking the advisor to give back some of the profits it earned in the lush days....
>
> A second group of answers comes in reaction of trustee boards to the ancillary question of whether advisors should make profits from their trusts in these troubled times (when shareholders are seeing red ink and banking no dividends)....

[3]Schotland, *op. cit.*, p. 183.

A third group of answers has come from the trustees who have decided to internalize management and operate without an investment advisor....

The industry's trauma has raised this $100 million question forcibly. It will not go away.

About $170 million...is needed to operate the REITs whereas the higher expense ratios in the most profitable heydays of the REITs in early 1973 would produce $280 million in annual expenses.[4]

The clear answer to the question initially posed by Audit Investment Research: REITs typically paid their advisors profits of some 65 percent for investment guidance that was often not worth such a generous permium, if any.

Over-generous advisory fees were only one prevalent abuse in the REIT industry. There were also hefty fees for non-advisory services: fees paid by the REITs to their advisors and other consultants for originating and servicing mortgages and for managing REIT properties; as well as fees exacted from the REITs' borrowers for sundry services such as loan commitment, placement, and brokerage. These bounteous fees for non-advisory services, moreover, were usually reported as part of an aggregated total expense figure, without any indication of who got paid how much for what. Both the REIT shareholders, who are paying the fees, and the independent trustees, who hire the advisors and negotiate their fees, therefore, lack complete information on advisors' costs and profits.

For the same reasons, the available information on the fees paid by REITs for advisory and non-advisory services is often fragmentary and unreliable. The

[4]Audit Investment Research, REIT Advisory Fee Plans - 1975: The $100 Million Question, Quoted in Schotland, ibid, p. 179.

well-substantiated data that do exist, however, tend to support the inference that fees were typically substantial, sometimes difficult to justify, and often improperly diverted from the REITs assets. In 1973, for example, IDS Realty paid its advisor — a subsidiary of the same parent company, Investor Diversified Services — fees totaling $2,463,000, not counting fees connected with an issue of subordinated debentures, out of a total operating income of only $5,940,000. In the following year, total fees amounted to $4,176,000 out of total income of $7,500,000. The total assets of the trust ranged from some $50 million at the beginning of 1972, to an average of about $180 million in 1973, to about $300 million in 1974. In 1973, IDS realty paid fully 41 percent of its total operating income in total fees to its advisors; in 1974, the percentage swelled to 56 percent. [see Table 1, Table 2].[5]

While these figures make it clear that total fees were blatantly disproportionate to income, the most striking impropriety is in the munificience of the non-advisory fees diverted from the REIT to an outside advisor affiliated with the sponsor. In effect, the trust's income was being diverted from its shareholders to its sponsors.

IDS was hardly an isolated case. In 1972, another REIT, Justice Mortgage Investors of Dallas, was able to reward its advisors with $754,406 in origination fees from its borrowers; as well as more than half as much in ordinary advisory fees; despite the fact that the REIT's total assets were less than $15 million at the beginning of the year and $42.5 million at the end. A year later, with its assets grown to an average $70 million, Justice Mortgage Investors paid advisory fees of $951,000, while generating origination fees of $809,000.

There was more from Justice Mortgage: "incentive" fees to its advisors of

[5]Schotland, *op. cit.*, p. 186, Table adapted.

$36,000 per year. And more: $46,000 in 1972 and $133,000 in 1973 to the advisor's insurance affiliate in premiums paid by Justice's borrowers to insure their loans. In all, Justice's advisor and the advisor's affiliate recieved about 4 percent of the REIT's average net assets in 1972, and almost 3 percent — of greatly increased assets — the following year.[6]

The most suspect of the fees for other than advisory services, those most susceptible to abuse and conflict of interest, were those charged by a REIT's own trustees or trustees affiliates for services to the REIT's borrowers or prospective borrowers, services that were required as a condition of the loan. It is customary, for example, for the borrower in a real-estate loan to bear the lender's costs for such services as brokerage appraisal. When the service is required to be provided by an officer or trustee of the lender, however, the situation is inescapably and fundamentally tainted. The same officer who is charged to protect the REIT from potential damage from unwise investments is also in a position to profit only if the loan is made.

In the case of Associated Mortgage Investors, for example, the chairman of the REIT's advisory firm also owned a firm that prepared and reviewed budget projections for projects under consideration for loans from Associated Mortgage. In 1972, this service earned the chairman's firm $215,000 from Associated's borrowers and prospective borrowers. Another Associated trustee was the head of a service company that performed "brokerage appraisals" for Associated's borrowers and prospects to the tune of $97,000 in 1972.[7]

At Alison Mortgage, three of the trust's officers were also partners or associates in the law firm that acted for the trust in many of its loan closings,

[6] *Ibid.*, pp. 186.

[7] *Ibid.*, p. 187

for which the law firm earned $103,703 in fees from Alison's borrowers in 1973. The law firm of the chairman of the advisor to Dominion Mortgage billed the REIT's borrowers $146,700 in 1972 and $278,087 the following year. A trustee of North American Mortgage, that same year, got his law firm $259,000 in fees from North American's borrowers; two officers of Republic Mortgage's advisory firm did almost as well by their law firm.[8]

Fees in most cases were not contingent on profits or any other measure of actual performance, but were keyed simply to the total assets of the REIT, including even uncommitted funds. Under these conditions, advisors stood to make handsome profits in fair weather and foul; and the greatest profits of all came from spurring the REITs to headlong growth and the unrestrained use of leveraging. The REITs and their advisory firms were not slow to see where their advantage lay and to prosecute it to the fullest. The results were profit margins for advisory services alone that often exceeded actual costs by 60 percent or more. When fees for non-advisory services were added, the total remuneration of advisors reached extreme proportions. [Table 3]

The claim has been made that the REIT advisors were entitled to fat profits during the boom years to indemnify them against the high risks of the real estate business and the certainty of lean years to come. Such self-serving rationalizations are belied, however, by the high fees and profits realized by many advisors even during the REIT industry's disaster years during the 1970s. As Schotland points out in the most convincing detail, the persistent profitability of REIT advisory services through good times and bad often entailed a certain amount of financial legerdemain and deception.

Continental Mortgage (CMI) paid its advisors, a partnership headed by two

[8] *Ibid.*, p. 187

brothers named Wallace, fees of almost $88 million in 1975. In previous years the fees had come to approximately $10 million per year. In March 1976, CMI filed for bankruptcy, revealing that fully 90 percent of its outstanding loans were no longer paying interest. According to a complaint filed by the Securities and Exchange Commission in 1978, the Wallaces' advisory firm had concealed for two years the trust's "true" financial condition, which would hardly have justified such generous fees — or any fees at all.[9]

In another SEC civil action, in September 1975, First Mortgage (FMI), its advisors, and certain of its officers, including its founder and chairman of the board, were charged with failure to disclose significant facts about the REIT, as required by law. According to an article in *Forbes* that year, FMI had taken care to conceal defaults and other problems, in order to be able to boast of increased earnings each quarter. Specifically, the SEC charged that FMI had: set up a dummy corporation to funnel new loans from FMI into projects that were already in trouble with their existing loans; offered large loans at below-market interest rates to developers who would agree to take over troubled FMI-financed projects; and hired appraisers to exaggerate the value of FMI-financed projects. On the basis of such transparent deceptions, and despite the hard fact that half its loans were in default, in 1974 FMI paid advisory fees — to a firm more than one-third owned by its founder-chairman and his brother, another FMI trustee — of more than $5 million.[10]

By mid-1974, suffering from tremendously reduced cash flow and shareholders' equity, many REITs reformed their fee policies in a desperate effort to survive. The 1970 Midwest Commissioner guidelines that had governed advisory

[9]Schotland, *op. cit.*, p. 188.

[10]*Ibid.*

fees for many REITs were largely abandoned. Most REITs either abandoned their reliance on outside consultants and created internal management offices, or limited their payments to outside advisors to reimbursement for actual expenses. Some trusts, including those sponsored by Chase Manhattan, Manufacturers Hanover, and First Wisconsin, elected not to reimburse their advisors at all.

The Investment Company Act of 1940's prohibition against self-dealing between REITs and their outside advisors without prior clearance from the SEC was effective against one kind of potential abuse — the direct sale of property between REITs and advisors — that was rarely, if ever, attempted. The law failed utterly, however, to check the kind of self dealing that was rampant in the REIT industry. In other kinds of transactions between trusts and their advisors, the law only required that the terms be fair, with the REIT required to prove fairness only when the transaction is challenged. Understandably, there were few successful actions against REITs on the score of self-dealing, despite the well-known prevalence of self-dealing in the industry.

For many REITs, self-dealing began in the pages of the initial prospectus, issued in compliance with the laws of many states to provide potential investors with honest information about the uses to which their money, faithfully entrusted, is to be put. The purpose of the prospectus, clearly, was to protect investors from acting blindly; but in the hands of profit-seeking sponsors, in many cases REIT prospectuses became glib, glossy catalogues for insider deals.

In its initial prospectus in May 1972, for example, U.S. Bancorp Realty and Mortgage Trust promised investors to begin its investment career with an insider deal that would buy a group of industrial, office, and commercial real estate from the Dan Davis Corporation, of which some 97 percent was owned by Dan Davis

and his wife. The same Dan Davis was nominated and served as a trustee of U.S. Bancorp Realty and Mortgage Trust; he later resigned. According to the prospectus, the purchase price for the properties, $14,139,340, was "determined by arm's length negotiations between the Trusty and Dan Davis," as well as an independent appraisal; and included "an expected return to the Trust on its investment," as well as a gross profit of $6.36 million to Dan Davis. Davis, an insider, received 56 percent of the trust's total initial assets of $25 million.[11]

Inadequate protection against such flagrant self-dealing was usually provided by the terms of the REIT's Declaration of Trust and its prospectus, which curtailed but did not altogether rule out purchases, sales, or loans between the trust or its advisor and the trustees, officers, or employees of the REIT. The strengths and weaknesses of the regulatory devices are illustrated by Chase Manhattan's Mortgage and Realty Trust. The REIT, like many others, stipulated in its prospectus that purchases, sales, or loans could not take place between the trust and its trustees, its officers or employees; or between the trust and any officer, director, or employee of the trust's advisor, an affiliate of the advisor, or an independent contractor of the trust.

There was, however, a very significant exception to the apparent prohibition: transactions between the trust and its advisor — in this case the Chase Manhattan Bank, the REIT's sponsor — were allowed if the terms of the deal were properly disclosed, if they were approved by a majority of the trustees; or by a majority of of the investment committee (excluding members affiliated with a party to the transaction other than the REIT) after the trustees had agreed that the transaction was fair and reasonable. The rules also required an independent appraisal of the property being transferred.

[11] *Ibid.*, p. 196

The extent to which a REIT was liable to become nothing more than a mechanism for self-dealing is illustrated by the case of Flatley Realty Investors, a small equity trust organized in 1972 by Thomas J. Flatley, a Boston real-estate developer. Flatley was a trustee of his REIT; he was also its president and treasurer. At the same time, Flatley was president, treasurer, director, and sole stockholder of an entity called Gibbs Management Corporation,[12] "The Trust," it insisted, "had retained the Management Company as an independent contractor...."

According to a prospectus issued in 1974, when Flatley Realty Investors' total assets amounted to more than $30 million, Flatley himself was active in the acquisition and development of properties for his own account, and was likiely therefore to be competing directly with the REIT of which he was founder, trustee, president, and treasurer. The REIT did not have first refusal rights on investment opportunities. "It may...be more profitable to Mr. Flatley," the prospectus politely allowed, "to take an investment opportunity for his own account or the account of the Operating Company [Gibbs Management] rather than presenting it to the Trust."

The prospectus also noted that Flatley Realty Investors could buy property and sell property and lend money to and from Flatley, Gibbs Management, and other companies with which trustees, officers, management, or employees of the REIT and its advisors and affiliates were connected. Finally, even the unaffiliated trustees of the REIT, according to the prospectus, were permitted to do business as individuals in competition with Flatley Realty; "and therefore," allowed the prospectus, "it is possible that situations may arise involving a

[12] *Ibid*, p. 198. . .

conflict of interest."[13]

In fact, the Flatley Realty situation was a conflict-of-interest minefield in which abuses were impossible to avoid. There was an inherent conflict of interest every time the trust made a loan to Flately or to Gibbs Management; or paid either an advisory or service fee; or borrowed money on its advisor's advice to increase the trust's assets, also increasing the advisor's fee; or paid Flatley or the advisor their fees.

The abuses began with the initial establishment of Flatley Realty Investors, when Thomas Flatley provided an initial investment of $3,081,000 in shares and warrants and realized a taxable profit of $344,485 on the transfer of some properties. The tax was not paid by Flatley, however, but was deferred pending the disposal of the properties by the REIT, when the tax would be paid out of the proceeds — paid, in effect, by the shareholders.

Also in 1972, according to the prospectus, Flatley Realty bought the land under an apartment complex in Taunton, Massachusetts; then in 1973 sold the land back to its owner, who immediately resold the land and the buildings on it — this time to Flatley's own company. The REIT also made generous loans to Flatley and to companies in which he held an interest. In 1972, in association with a commercial bank, the REIT made Flatley a construction loan of $1 million, The following year, the REIT made two more construction loans to a development company in which employees of the Flatley company owned an interest; and a $160,000 loan to a limited partnership in which the same developer was the general partner. The prospectus assured any cynical readers that all these transactions had been duly approved by a majority of the REIT's independent trustees, "and are considered by those trustees to be on

[13] *Ibid.*, p. 198.

terms fair and reasonable to the Trust and in no event less favorable to the trust than terms available for comparable investments with parties not so affiliated."

In fact, as long as the fairness of the transaction was reasonably assured, the law smiled on those provisions of trust instruments or corporate organizational documents that permitted self-dealing by trustees or corporate directors. As far as the law was concerned, there was nothing necessarily wrong with, for example, dealings between a REIT and a bank owned by officers of the REIT's advisory firm, who also happened to be trustees of the REIT. In such cases, which were the rule rather than the exception, of course, the oversight responsibilities of the supposedly independent trustees were severely strained, to say the least. It must have been difficult for these trustees, even assuming that they were disposed to be truly disinterested, to uphold the abstract interests of the REIT and its shareholders against the interests of their colleagues and friends and of the sponsor.

The prevalence of flagrant abuses in regard to fees and self-dealing was encouraged by the laxity and neglect practiced by the regulatory agencies charged with oversight of the REIT industry. The REIT Act had been passed in great haste in Sept., 1960; Congress was in too big a hurry to get the legislation on the books to be too fussy about some of the details, so the REIT industry was born without the built-in regulatory safeguards that protect other investment vehicles, such as mutual funds, from many abuses. Congress also neglected to assign any agency, such as the Securities and Exchange Commission, to oversee the new industry. The only regulations protecting the newly enabled REITs and their shareholders from abuse, therefore, were the regulations that apply to all publicly held companies.

By default, then, regulation of the REITs was left to the states, which had

been regulating insurance companies and a number of other institutions for decades. REITs, however, turned out to be difficult creatures for the states to regulate effectively. The most important vehicle for state regulation of the REITs turned out to be the Midwest Securities Commissioners Association (MSCA), which included officials from 24 states. Policy statements emerging from the MSCA's administrators became the core of regulation of the REIT industry in those states that cared to follow the lead. By 1978, according to Schotland, only eight states had formally adopted the MSCA's policy recommendations; and several REIT security offerings in member states had violated MSCA dicta.

Even full compliance with MSCA policies would not have completely forestalled abuses, however, because the policies fell far short of offering the kind of safeguards the situation required. A 1970 requirement that REIT prospectuses make full disclosure of self-dealing, for example, dealt only with past occurrences, without requiring additional disclosures of self-dealing subsequent to the establishment of the trust. The disclosure requirement also failed to include the profits of REIT advisors among the data that should be available for scrutiny by shareholders and regulators.[14]

In 1970, the MSCA actually moved to weaken some of its most stringent regulations. The requirement for independent appraisals of mortgaged property, and for appraisals to be approved by the state securities administrator, were deleted. So were the limits on advisory fees and on debt leveraging, which had been adopted in 1961 and had become increasingly useful with time.

Indeed, in New York and some other states, state regulations inadvertently encouraged self-dealing. The New York State regulation provided that a REIT's

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[14] *Ibid.*, p. 210.

initial prospectus must specify the investments into which the initial shareholders' money was to be put. Sponsors, especially those who already had real-estate investments they were anxious to get rid of, could easily transfer their unwanted investments to the REITs. This was the course followed in the case of U.S. Bancorp Realty & Mortgage Trust, cited above.

At the Federal level, where more effective regulation might reside, Congress' initial failure to provide specific safeguards for REITs left only three agencies with any real hope of controlling abuses: the Internal Revenue Service, the Federal Reserve Board, and the Securities and Exchange Commission. The IRS' main weapon against abuses was the threat of revoking an offending REIT's tax-exempt status. If a REIT was providing its own advisory and management services, it could be defined as an "active" trust in terms of the REIT Act and treated as an ordinary corporation for tax purposes. The same result would follow an IRS finding that a REIT had failed to pay out 95 percent of its net income in the form of dividends to shareholders. In such a case, the IRS was not even obliged to allow the REIT to rectify the error. By not allowing the REITs to hold adequate reserves to provide for loan losses, the IRS was actually forcing the trusts into a dangerous position that would lead to widespread failures as economic conditions for REITs and their investors turned increasingly perilous in the 1970s.

The Federal Reserve's purview on the REITs derives from their authority over bank holding companies, which control the banks that sponsored many of the major investment trusts. Even before the REIT model had been devised, the Federal Reserve had taken steps to guard against the abuses that might develop if banks strayed from straight banking into untraditional activities. Among other activities prohibited by the Fed's rules were participation by bank affiliates in

bond issues on which the affiliate had advised the issuer; and the use of a bank or bank holding company by a closed-end investment company that had been advised by the bank or bank holding company.

Bank holding companies were required to give their shareholders consolidated annual reports of all their subsidiaries. When it came to REITs, however, the Federal Reserve Board seemed to develop a blind spot. As far as the Fed was concerned, banks were free to sponsor REITs, lend them the dignity and putative integrity of their names, and act as their advisors in relationships that fairly demanded the closest imaginable self-dealing, without being required to consolidate and report the REITs' financial activities and performance with the banks'.

When the bank-sponsored REITs began to get into financial difficulty in 1973-1974, moreover, the Federal Reserve Board went even further in serving as a de facto marriage broker-counsellor, encouraging the banks to bail out the trusts. The Federal Reserve Board has staunchly denied that it was directly involved in the decisions of any individual banks in this regard; but Andrew Brimmer, a former member of the FRB, asserts, "The Fed gave commercial bankers instructions not to let the REITs fail."[15] Of the three Federal agencies charged with examining banks — the Controller of the Currency, the Federal Deposit Insurance Commission, and the Federal Reserve Board — none apparently found it curious that as late as September 1975, when the REIT industry was virtually flat on its back, not a single major bank had admitted suffering a loss on a loan to a REIT.

The Securities and Exchange Commission, under the terms of the Securities

[15]Richard Byrne, "REITs: Their Past, Present and Future." Rutgers University, Brunswick, NJ, 1975 (Stonier Thesis File), p. 56.

Act of 1933, had the authority — and the obligation — to require REITs to disclose all significant facts to their shareholders and the public as a condition for registering their shares for sale. Among the material information contemplated by the disclosure requirement, presumably, would have been any instances of conflict of interest and self-dealing.

In 1972, nevertheless, the SEC's Real Estate Advisory Committee was complaining that REIT prospectuse where chronically deficient in disclosure. The committee asked for more information on a broad range of salient topics: the capability of the REIT's management, and its previous performance; what kinds of investments the REIT proposed to make, and what criteria would be used to make investment decisions; the qualifications of the REIT's investment advisor; the expected performance of the REIT's investment portfolio, including anticipated cash flows, vacancy rates, rent rolls, etc.; and rational assessment of the real risks involved.

Having complained of these significant deficiencies in REIT disclosure, however, the SEC's advisory committee neglected to call for immediate corrective action. It was satisfied to ask instead for further study of the issues. "On the whole," notes Schotland, "the SEC has been less than dynamic in either pursuing breaches of legal requirements or callikng for new safeguards." Specifically, Schotland writes:

> ...the SEC made grave charges against First Mortgage Investors but dropped them upon receiving assurances that the REIT would behave better in the future, and did not demand reimbursement for stockholders' losses resulting from past misconduct. In may 1975 the SEC undertook a vast investigation of the now-bankrupt Continental Mortgage Investors, which led to the filing of suit nearly three

years later.

> Apart from those two proceedings, the SEC role in protecting investors and the public interest in this unusually conflict-ridden, huge speculative bubble has consisted of three measures: (1)setting up the 1972 advisory committee that considered REITs as an incidental aspect of the problems in wealthy investors' tax shelters; (2)in February 1975, after the disaster had struck, initiating an economic staff study compiling data (taking inventory, so to speak, of the horses that were gone from the barn) but supplying no conclusions or policy recommendations; and (3)in spring 1976, soon after "asset swaps" began to proliferate, taking the important and valuable step of strengthening disclosure requirements.[16]

Given the SEC's well-deserved reputation for vigor, its record in this sphere has been disappointing, despite the importance of REITs not only to investors themselves (and investors in REITs seem at least as entitled as other investors to active SEC oversight) but also, considering the effects of the REIT bust on the construction industry and real estate markets, to the public interest.

[16]Schotland, *op. cit.*, p. 207.

TABLE 1

	1972	1973	1974
Advisory Fee		$928,000	$1,926,000
Nonadvisory Fees Paid	$898,000	$1,533,000	$2,289,000*

(*) With an additional $2,274,000 paid to an affiliate for the advisor for distribution of subordinated debentures and debenture registrar fee.

TABLE 2

ADVISORY INCOME BREAKDOWN AS PERCENTAGES (IDS)

	1973	1974
Total fees as a percentage of total operating income	41%	56%
Total fees as a percentage of total assets	1.36%	1.39%
Advisory fee as a percentage of total fees	37.9%	45.21%
Non-advisory fee as a percentage of total fees	62.1%	54.79%

Source: Schotland op. cit, page 186, Table adapted.

TABLE 3

REIT ADVISORY FEE PROFIT MARGINS (PRETAX INCOME OF ADVISORS FROM THIS FEE, AS PERCENT OF THIS FEE; NO OTHER FEES INCLUDED)*

	1969	1970	1971	1972	1973	1974	1975	5-Year or 6-Year Composite
Lomas & Nettleton								
a. Percent			66.3	68.6	68.6	69.1	64.5	57.9
b. Total year-end invested assets (millions)			$180	$321	$378	$335	$339	
Great American Mortgage								
a. Percent				22.5	21.8	25.2	8.0	
b. Total year-end invested assets (millions)				$246	$426	$466	$390	
Diversified Mortgage								
a. Percent	38.7	40.1	38.0	37.2	36.8	6.3		
b. Total year-end invested assets (millions)				$288	$343	$381		
NJB Prime								
a. Percent					59.1	23.9		
b. Total year-end invested assets (millions)					$94	$109		

*From Schotland, *op. cit.*, p. 184.

Chapter 14

The Tender Trap

The disasters which befell the REIT industry in the 1970's were directly related to the sometimes unorthodox and often inventive ways in which REITs raised and managed money. In some ways, REITs resembled other kinds of financial institutions — they served as financial intermediaries, like commercial banks and insurance companies; they were conduits for income, like mutual funds; and they were real-estate investors, like countless other individuals and corporations. When it came to raising and managing money, however, the REITs were in a class by themselves.

There was nothing outwardly unusual about the REITs' way of raising capital, by selling securities representing debt — in the form of long-term bonds or debentures, or short-term commercial paper — or equity. What set the REITs apart was their extensive use of leveraging of both equity and debt, in succession. This leveraging technique, according to the industry's promoters and the true believers, made the REITs into perpetual-motion money makers.

Equity Leveraging The trick to equity leveraging was simply to market new shares in a corporation at a price above the book value of the existing shares. If, for example, a trust had 100,000 shares outstanding with a book value of $10 per share, equity leveraging might involve the sale of an additional 100,000 shares at $20 each, without any change in the face value of the shares. Each of the 200,000 outstanding shares resulting from this maneuver would have a book

value of $15: the proportionate interest of each original shareholder would be reduced, but the book value of his shares would be increased.

In some cases of this kind, to be sure, investors were justified in paying twice the book value for REIT shares. There were trusts whose underlying value was actually worth more than the aggregate book value of their shares, because their assets had appreciated since they were acquired, while they remained on the books at their original values; or because the book values of the assets had been depreciated more rapidly than their actual physical deterioration. Investors might also have been willing to believe, for good and sufficient reasons or for no reasons at all, that the future performance of the REIT would eventually justify the payment of a generous premium over the book value for the shares. If the average stock in the market was paying investors 10 percent of its book value per year, a REIT that promised to return 20 percent would command a price in the neighborhood of twice its book value.

During the REITs' boom years, investor enthusiasm boosted REIT share prices, making it relatively easy for trusts to raise huge amounts of capital by marketing additional, heavily leveraged equity. In their haste to take advantage of what seemed like a capital bonanza, however, many REITs succumbed to the temptation to exaggerate the real values of their real estate. Some REITs, to be sure, owned property that was worth more on the market than its book value. Since real estate is inherently difficult to evaluate precisely until it is actually sold, however, REITs found it irresistably easy to convince credulous investors into believing that perfectly ordinary, even undesireable properties were veritable gold mines. The selling was even easier when, as was usually the case, the investor was hundreds or thousands of miles away from the little piece of paradise he was sinking his money into.

The future potential of REIT investment was also easy to make more of than was actually there. If it was true that some REIT investments did outperform the market, producing extraordinary returns, it was also true that such happy anomalies tended to be self-correcting: successful real estate projects inspired emulators; booms were almost inevitably followed by busts, as the latecomers produced oversupplies, knocking prices and profits into a cocked hat. Florida, Texas, and California were among the areas famous for repeated cycles of boom and bust. While they were overstating the virtues of dubious real estate investments, zealous REIT promoters were also quick to understate the risks that often went along with such developments. More realistic assessments of risks would probably have dampened investor enthusiasm for many REITs.

REITs lent themselves to obfuscation salesmanship because of a very important difference between their assets and those of other investment vehicles, such as mutual funds. The simple fact that a mutual fund's assets are stocks and bonds that are traded daily, publicly, in a well-regulated and orderly market, means that mutual fund shares can be accurately and unarguably valued at any time by any investor with enough initiative to pick up a newspaper. A REIT's only assets, on the other hand, are in the form of real estate — buildings, or land — that cannot be accurately valued at any given moment. There is no single market, no universal medium of exchange. A real-estate asset is worth what it sells for when it is sold, and until it is sold there is no way to be sure what the price might be.

For a potential investor, therefore, a REIT is a much more problematic creature than a mutual fund. Instead of a straightforward calculation of share value, the investor must use other factors to tell him if the REIT is a good investment. In actual practice, since REITs were a new entry in the market and

had little history to go on,investors tended to put their faith in the reputation of the trusts' sponsors and underwriters. Names like Morgan Stanley and Chase Manhattan were enough to inspire faith in multitudes of prudent investors.

Another element of deception in equity leveraging of REITs was the assurances offered by many promoters that the shares they were touting were "growth stocks"; by which unwary investors were supposed to understand that they were playing in the go-go game characteristic of the market in certain volatile issues. Typical of true growth stocks is their lack of significant dividend returns to investors. Growth companies ordinarily reinvest available capital to feed their rapid growth; the money that might otherwise be paid out in immediate dividends is conserved and invested instead in the company's future. By retaining earnings instead of paying dividends, volatile, high-risk growth companies also build up reserves against inevitable reverses.

By law, however, REITs were obliged not only to pay dividends, but to distribute fully 95 percent of their net income to their shareholders. Because they were practically barred from using retained earnings to fuel expansion, REITs should not have been confused with conventional growth stocks. Nevertheless, enthusiastic REIT promoters often oversold their shares as both income and growth investments, with low risk to boot. As it turned out, of course, REITs proved to be high-risk investments for both income and growth.

Debt Leveraging Equity leveraging's complement, debt leveraging depends on a REIT borrowing money at interest rates lower than the rates of return the REIT can earn on the assets it buys with the proceeds. The result is increased income to the REIT, and ultimately to the shareholders. The effect of debt leveraging can be illustrated by the case of a REIT that buys an asset valued at $100, paying $50 out of its cash reserves and borrowing the other $50 at 7

percent interest. Of the $10 return the asset pays the trust, the trust pays $3.50 in interest on its loan. The remainder, $6.50, provides the trust's shareholders a 13 percent return on the $50 of equity invested in the asset.

The REIT may decide to repeat the maneuver with even more leverage. If it buys another $50 asset with a 10 percent return, borrowing another $50 at 7 percent to finance the purchase, the REIT's gross income will increase to $15 (10 percent of $150), while its total interest expense will be $7 (7 percent of $100). The shareholders, who still have only $50 of equity in the combined asset, receive the remaining $8 of income, a 16 percent return. By leveraging its debt, therefore, the REIT has significantly increased its rate of return on shareholders' equity.

The almost inevitable effect of raising the rate of return on shareholders' equity, of course, is to make the REIT's shares more attractive, driving their price up. With the increase in the price of the shares, without a commensurate increase in their book value, comes an opportunity for another round of equity leveraging by issuing new shares. The new shares would not dilute the per-share book value, since they would be backed by the new asset; but they would lower the trust's debt-to-equity ratio by increasing the total equity holdings in the REIT.

In practice, the effect of improving its debt-to-equity ration was to enable a REIT to borrow money more cheaply — an invitation to debt leveraging. The low-cost debt could then be invested in high-return assets, further enhancing the REIT's per-share earnings, inviting further equity leveraging. In this manner, taking full advantage of the opportunities to leverage both debt and equity, a REIT could truly come to resemble a bottomless well of wealth.

In itself, neither debt nor equity leveraging is in the least illegal, immoral, or

even strange: the urge to sell shares at the highest price and to borrow at the lowest is close to human nature. In the REITs' case, however, the aggressive use of leveraging was often pursued with an almost total disregard for the real values of the trusts' underlying assets and an exploitation of the names and reputations of the trusts' sponsors and underwriters.

Ultimately, inevitably, as the hollowness of the REITs financial facade became apparent, their flimsy leveraging structures collapsed. A major factor in the failure of many REITs to survive in difficult economic environments was the fact that REITs, despite their debt-leveraging operations were actually paying as much as 3 percent more for borrowed money than their competitors, the commercial banks. Magnified by the much higher debt-to-equity ratios maintained by the banks, the difference in interest rates translated into a lower return on equity for REIT shareholders.

A typical REIT might maintain a 2:1 ratio of debt:equity, paying 9 percent interest on its debt. On assets valued at $100, the REIT would have a debt of about $66, paying about $6 in annual interest. If the asset yielded 10 percent annually, or $10, the $4 remaining after interest payments would equal a 12 percent annual return on the shareholders' equity of approximately $33. (Assuming it conformed to the IRS' strictures, the REIT would pay no tax on the income.)

If a bank owned a similar asset, and maintained the same ratio of debt to equity as the REIT, but paid only 6 percent interest, its interest payment would amount to almost $4, leaving a little more than $6. If the bank paid corporate income taxes of 50 percent, the net return on shareholders' equity would be $3, or 9 percent of $33. In this case, evidently, the tax-free REIT would outperform the taxpaying bank.

In the event, however, banks typically maintain debt:equity ratios much

higher than 2:1 — more like 9:1. Under these conditions, with a $100 asset the bank would have a $90 debt, and at 6 percent its annual interest payment would be $5.40 out of the asset's yield of $10, leaving the shareholders $4.60, or only $2.30 after taxes, as a return on equity. Because the shareholders' equity is only $10, however, the rate of return is actually 23 percent, almost twice the return from the tax-free REIT.

Even if the REIT were to maintain a 9:1 debt:equity ratio, like the bank, its disadvantageous interest rate, applied to the much greater debt, would reduce its tax-free return to only 19 percent of shareholders' equity — less than the bank's. The REIT could equal or slightly best the bank competition only at debt:equity ratios of 13:1 or 14:1, if it could find lenders who would go along with such a perilous and imprudent course.

The only way the REITs could realistically hope to compete with the banks for the affection of investors looking for high returns was to look for assets that would provide better than 10 percent returns. The banks and other REIT competitors, of course, were also on the lookout for high-paying assets with reasonable risks. In this race for the gold-edged investment opportunity, the REITs often found themselves in competition with their own sponsors and advisors, who in most cases were under no obligation to serve their REIT's interests before their own.

The REITs, therefore, had no choice but to go after glamorous but problematic propositions that the banks, as well as other more prudent investors, would not touch. Commentators on the REIT industry and its problems have persistently failed to give due weight to the role of high interest rates in forcing the REITs to seek endless growth through high-risk investment strategies, out of a desperate need to outperform the banks and other competitors with lower

interest burdens.

The reason the REITs had to pay higher interest rates than the banks, and therefore to accept higher risks in their investment portfolios, is simply because the REITs were perceived, quite correctly, as inherently riskier investments than commercial banks in the first place. REITs were new and untested in the marketplace; they did not conform to the traditional form and demeanor of a sober investment vehicle. REITs, like any one-crop farming system, were also much more vulnerable to market reverses than more diversified investment vehicles. To make them still riskier, the REITs' one crop — real estate — is notoriously risky, speculative, and vulnerable to corruption and chicanery.

The REITs also paid at least one extra point in interest above the rate they would otherwise have had to pay because of their system of pegging advisors' fees to total assets. By giving their advisors a fixed percentage of all assets, the REITs in effect made the fees a part of the cost of borrowing money, practically indistinguishable from the investors' point of view from interest. If the advisors' fees were at least 1 percent of assets, as they typically were, therefore, an asset yielding a nominal 10 percent was actually yielding 9 percent.

The REITs' difficulties in competing with the commercial banks for investment dollars were most apparent when the REITs went to the same commercial banks, as they often did, to borrow money. The banks cheerfully loaned the REITs money, charging them a spread of 3 percent or so over the prime rate for the priviledge of borrowing from the competition. If the REITs sold commercial paper instead of borrowing from the banks, the banks got their piece of the action anyway: the commercial paper had to be backed by credit from the banks, which had to be backed in turn by non-interest-bearing deposits. In addition to the interest they had to pay on their commercial paper, therefore, the REITs

were paying the banks 10 percent or so in interest they were not earning.

The REIT's problems in finding high-yield, high-risk investments were exacerbated by the legal requirement that they pay out 95 percent of their net earnings in the form of dividends to shareholders. The practical effect of this requirement was to make it necessary for the REITs to maintain almost all of their net income in cash, ready to be paid out. The REITs were constantly in danger of being caught short of cash; they had to rely on short-term borrowing, at high interest rates, to make their dividend payments. Ironically, in order to raise more funds in the capital markets, the REITs had to improve their earnings, which could often be done only at the expense of their cash flow. In effect, the REITs were forced to dig themselves ever deeper into the hole.

Chapter 15

Misconceptions

Most critics of the REIT phenomenon have tended to blame the industry's problems on its most obvious flaws - conflict of interest, poor management, negligence–or on the bad luck of being the right idea at the wrong economic time. A more searching and far-reaching analysis of the REITs and where they went wrong, however, raises fundamental issues that are overlooked in the search for someone or something to blame. What public purpose, if any, did the REITs serve? Were they a necessary or effective means to this end? In what context would REITs have been the right idea? Was the REIT Act a proper legislative expression of Congress' impetus and intent in passing it? Are the purposes for which the REITs were originally designed still valid in today's very different circumstances? If so, will any other social or economic invention do the job, now that the REITs are in eclipse? All these questions should be answered.

Two salient features distinguish REITs from other corporate entities and offer a starting point for any discussion of the industry's appropriateness and relevance. Alone among all corporations, REITs are required by law to distribute 95 percent of their earnings to their shareholders; and, if they meet this requirement, their income is exempt from corporate taxation. Each of these characteristics, conferred by law, has its political and economic justification and its legislative history, which must be understood before any valid assessment of REITs can be made.

For the REITs' freedom from corporate taxation, three possible justifications suggest themselves. Such special treatment might manifest the intent of Congress to encourage the flow of investment capital into this particular sector of the real-estate industry. Or the REITs could be the beneficiaries of a selective effort to do away with the so-called double taxation of corporate income. Finally, tax exemption might be evidence of the populist purpose of Congress to facilitate the participation of small investors in an area of economic activity formerly accessible only to wealthier individuals and institutions.

The ostensible, original intent of Congress to encourage the flow of capital to the real-estate construction industry can be surmised from the language of the REIT Act:

> ...This is particularly important at the present time because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels. At the present time the financing of these real estate equities and mortgages is dependent largely on government-guaranteed money, and investments by special groups, such as insurance companies and pension trusts.

In divining the real intent of Congress, it is important to note that the explanatory language of the REIT Act does not assert what it seems to imply: that there is an actual shortage of new construction. In fact, the available statistics on new home construction at that time would make such a claim difficult to support [Table 1]. Had it been possible to claim that the entire real-estate industry was suffering from a capital shortage, the obvious appropriate remedy would have been tax relief for all segments of the industry, not only the

new REITs. President Eisenhower had vetoed a REITs bill in 1956 precisely because it created an incentive for taxpaying elements of the real-estate industry to convert to tax-free status.

According to the testimony of the Act, in enabling the REIT model, Congress intended to encourage new sources of private- sector investment in real-estate development in order to dilute the concentration of capital from government-supported sources or from the part of the private-sector spectrum described as "special groups," seemingly the large institutional lenders. If this was Congress' concern, it is legitimate to question whether the granting of tax exemption to a new investment vehicle was the best way to do the job. The practical advantage - virtually the only advantage - of creating a new tax-exempt institutional form was that it avoided the intellectual and political effort of designing and enacting new laws to change existing patterns of business to achieve the same end.

Otherwise, the establishment of the tax-free REIT as a means to achieve Congress' ostensible purpose was fraught with problems. By establishing a new and unique form of corporate entity, with peculiar rules and procedures, Congress in effect defeated its own purpose, creating obstacles for the new investment it wished to promote, delaying any potential availability of new capital to the construction industry. At the same time, the unfamiliarity of the REIT concept made adequate and appropriate regulation difficult, creating the conditions for the abuses that ultimately brought about the REITs' downfall.

The creation of REITs also had unpredictable effects on existing segments of the real-estate industry. Congress could not, even if it had tried, predict with any degree of certainty what the effects of the tax-free investment vehicle would be on traditional real-estate financing institutions, such as commercial banks and insurance companies. No assessment was made, either before the fact or

after, of how much investment capital the REITs would divert from existing, traditional funding institutions, and how much new capital they would attract into the real-estate industry from previously unavailable sources - e.g. from the small investors to whom REITs were supposed to appeal.

Whatever problems the REITs entailed would tend to persist: once an institution is created by Congress, it takes on a life of its own; it is long lasting. Whatever Congress meant to do when it established REITs, it had no plan to abolish REITs once that purpose was accomplished. It is not in government's political nature to bring down the curtain on an institution with employees, shareholders, and powerful interests. Like every other vested interest in a democratic society, REITs inevitably developed powerful voices to lobby in their behalf. At best, therefore, the REIT model was a permanent solution to a transient problem. If all Congress wanted to do was to channel private capital from non-traditional sources into the real-estate industry, or any industry, the creation of a permanent new tax-exempt industry was probably not as useful as some other methods, such as accelerated depreciation and tax-exempt bonds, that would be faster, surer, and more flexible.

A second possible justification for exempting REITs from income taxation was that taxation of REITs' income would constitute double taxation. According to this theory, REITs are fundamentally, inherently different from ordinary manufacturing companies, for example, that invest directly in productive plants and equipment and then pay taxes on the income produced by these investments. REITs, by contrast, invest only in securities that represent claims on the income from productive assets - real estate, in this case - on which taxes have already been paid. A tax on the REITs' income would therefore represent a second tax on the same income, which would be unfair.

In asserting the double-taxation rationale for tax exemption, the REIT Act compares the real-estate trusts to mutual funds:

> ...The omission of the corporate income tax in the case of distributed earnings, which present law provides for regulated investment companies (i.e. mutual funds), secures for investors in these companies essentially the same tax treatment as they would have received if they had invested directly in the operating companies. H.R. 12559 extends this same kind of tax treatment to real estate investment trusts specializing in investments in real estate equities and mortgages as distinct from the stock and security holdings of the regulated investment companies. Thus this secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in regulated investment companies.

In the case of the mutual fund, this argument runs, the investor can buy stocks and bonds directly or through buying shares in the mutual fund that owns these stocks and bonds. Since he does not pay corporate taxes on dividend and interest income in the former case (the corporation, of course, pays whatever taxes are due on its profits) he should not do so in the latter case either. The income of the mutual fund should pass, untaxed, directly to the investors, who will then pay personal income taxes on their profits. What is good enough for mutual fund investors, the argument concludes, should be good enough for REIT shareholders too.

The claim of analogy between REITs and mutual funds is less than con-

vincing to many observers. Most REITs, they point out, either own income-producing properties directly; or specialize in mortgage lending to such non-corporate entities as partnerships or sole proprietorships. In either case, no corporate income tax has been imposed on the income received by the REIT; and the imposition of corporate income taxation on the REITs' income would hardly constitute double taxation.

The REIT Act actually seemed to recognize the dissimilarity between REITs and mutual funds on this score of double taxation:

> ...It has sometimes been argued that real estate investment trusts differ from regulated investment companies in that the income of the latter already has been subjected to income tax while the income of the former has not. This refers to the fact that the dividend income of the regulated investment company already has been taxed as a part of a corporation's income before it was received by the regulated investment company while the rental income received by the real estate trust has not.

Perhaps recognizing that its first two justifications for REIT tax exemption were less than persuasive, the REIT Act finally advanced its third and best argument. The reason for exempting the REITs from corporate income taxes, said the Act, was to foster the success of an investment vehicle that - like mutual funds - would enable investors of modest means to claim a share of the investment profits that had always been available to wealthy individuals and institutions through direct investment in conventional limited partnerships and sole proprietorships. Implicit in this argument was the notion that the promotion of real-estate investment by investors of modest means was a valid objective

for public policy; and, conversely, that the concentration of real-estate investment among individuals and investments with money was a social problem that required a legislative solution.

Whatever virtues the REIT may have possessed as public policy, it seems clear that there was little need for such a device as an alternative to partnerships and sole proprietorships. In fact, the role of such non-corporate financial structures in the real-estate market, in the late 1950s or since, has been practically inconsequential. In every real-estate activity - land development, construction, market, leasing, mortgage financing, etc. - the role of limited partnerships or sole partnerships has long been insignificant compared to the dominant part played by institutions.

In the real-estate world, the most important institutions include mutual savings banks, commercial banks, life insurance companies, and savings and loan associations. In 1950, these four major financing sources held a total of 61.5 percent of all mortgage debt in the United States. Much of the remaining 38.5 percent was accounted for by other institutions, including government agencies, pension funds, and mortgage banks. Private individuals held only a very small share of the mortgage debt. [Table 2]

After a decade during which the total mortgage debt almost tripled, by 1960 the "big four" mortgage holders had increased their share to 76.2 percent. As the total mortgage debt doubled again by 1970, the big four further increased their share to 78.7 percent. By this time, total mortgage debt in the United States was almost $500 billion; of which the REITs, which were supposed to inject significant amounts of new money from modest investors into the real-estate industry, had only $6 billion - slightly better than 1 percent. [Table 2]

From these statistics it is evident that if small investors needed some spe-

cial inducement to take advantage of the opportunities available in real-estate investment, REITs were not the right instrument for the job. If there were small-investor dollars looking for a way to get into the real-estate business, moreover, the stocks of commercial banks, insurance companies, and other traditional real-estate lenders were readily available in amounts to suit any investor's pocketbook. If investors of modest means could not invest in the partnerships and sole proprietorships that a relatively few wealthy investors use to participate in real-estate lending and ownership, this is only one of many differences - and certainly not the greatest or the most onerous - that distinguish the rich from the rest of the world.

If small investors still required tax advantages and professional management to bring them into real-estate investing, the simplest and most equitable way to provide these advantages might have been to exempt from corporate income taxation the real-estate investments of the traditional institutional financiers. In the 1950-1971 period, the major financial institutions included large and fast-growing holdings of mortgage loans among their assets. Savings and loan associations, which exist primarily to make mortgage loans, of course headed the list with virtually 100 percent of their assets devoted to that purpose. Even commercial banks, which had only 29.6 percent of their assets in mortgage loans in 1950, had 34.4 percent of their assets in that category two decades later, while mutual savings banks had 76.6 percent and life insurance companies had 34.4 percent.[Table 3] Relatively minor adjustments in the taxation of these traditional mortgage lenders - the least of them many times more significant as a channel for real-estate investment than the REITs could ever be - would have afforded small investors most of the advantages ostensibly afforded them by the REITs, without the problems entailed by creating a new and untested entity in

the financial marketplace.

The forgoing discussion leads to the conclusion that the tax exemption granted to REITs by Congress was neither necessary, appropriate to its ostensible purpose, nor justified by its rationale. The available evidence suggests that REITs were not well-designed or likely to mobilize additional capital resources for the real-estate industry, to avoid double taxation, or to make a critical difference to the investor of modest means.

The enactment of an inappropriate remedy for a problem that probably did not exist required an all-out lobbying campaign in Congress. This lobbying effort, instigated and backed by wealthy real-estate investors, was intended not to attract modest investors to share the rewards of real-estate investment, but to provide tax-sheltered investment opportunities for the wealthy.

The REIT lobbying effort was a response to the inability of wealthy investors to shelter their income from other real-estate investments. In the years after World War II, real-estate syndicates proliferated, mostly in the major cities of the eastern United States, absorbing large amounts of capital that had accumulated during the war. The syndicates were designed to profit from the pent-up demand for new housing and other real-estate development that had been deferred during the war. They were also intended to serve as tax shelters of a sort.

To minimize the corporate tax, many of these syndicates were set up as corporations in which the investor would put up only 20 percent of his stake in cash, while contibuting four times as much in the form of bonds or debentures.[1] As the syndicate received income from its real-estate operations, the profits would be passed through to the investors as a "return of capital" to retire the

[1] "Realty Investment Trusts and the Potential Investor," Richard H. Swesnick, speech published in REITs: The First Decade, edited by John T. Hall, Mequon, Wisconsin (1974) p. 19.

outstanding debt securities. This portion of the investor's income, therefore, was exempt from Federal income tax. The syndicate, however, was liable for corporate income taxes on its income, as well as on the eventual profits from the sale of the income-producing property.

In an attempt to avoid these taxes at the corporation level, investors in the 1950s turned increasingly to limited partnerships as real-estate investment vehicles.[2] Limited partnerships not only generated income undiminished by corporate income taxes, they also permitted the partnerships' cash flow, derived from the depreciation, to be paid directly to the partners. Despite their advantages, partnerships also created problems of their own. For one thing, partnerships were limited in the extent to which they could incur debt. For another, the unlimited liability of general partners for any and all debts the partnership managed to incur made borrowing a dangerous business and partnership less than carefree.

Limited partnerships also had the decided disadvantage of being illiquid. No formal, open market exists for partnership interests comparable to the stock markets that are available to investors in corporations. Transferring interests in limited partnerships was often difficult, even impossible.

A further inconvenience of the limited partnership was that most of them were set up for a single purpose, to purchase and own a particular piece of real estate. Thus established, a partnership was rarely precisely suitable for another deal. Any attempt to reconfigure an existing partnership for a new venture would be dauntingly complex and might subject the resulting entity to taxation as an active real-estate corporation rather than a partnership. An investor who wanted to diversify, therefore, was obliged to go through the rigamarole of joining

[2] *Ibid.*, p. 18.

multiple partnerships.

To these inherent liabilities of the limited partnership was added the threat that the tax exemption enjoyed by such combinations would be abolished by the Internal Revenue Service. Endangered real-estate investors got behind the REIT idea as an ideal alternative to protect themselves from taxation. The assertions that the new vehicle would somehow benefit the real-estate industry by bringing it new capital, or benefit the small investor, were mostly propaganda, to win political support for the REIT idea.

There is no inherent linkage between REITs' corporate tax exemption and the requirement that 95 percent of the trusts' net income should be passed through to investors. The two characteristics were coupled in the REIT Act to validate the claim by REIT supporters that the new investment vehicle was truly designed to benefit the small investor. The income passalong feature was designed to appeal to the investor with modest cash flows and cash reserves, the investor who depends on the income from his investments to meet living expenses. This small investor, according to the prevailing view, cannot afford to invest his capital in a corporation that will indefinitely defer his dividends in the form of retained income.

The political appeal of such doctrine was not in the least lessened by the fact that it was largely specious. In theory, and probably in fact, the market will adjust the price of a corporation's shares to reflect whether income has been paid out or retained. The position of the small investor, therefore, is not materially altered by retaining the net income imputed to his shares, as long as he has the right to realize that income or its equivalent by selling shares. Whether he takes advantage of that right or keeps his shares, his net worth is the same.

Indeed, in *Principles of Corporate Finance*, Brearly and Myers[3] have argued persuasively that the required payout of net income actually reduces the investment value of the corporation and its shares; the investors are actually better off if earnings are retained. The reason: investors pay higher taxes on dividends than they do on long-term capital gains. It has been shown in earlier chapters that the health of the REIT would be improved if it were permitted to retain earnings instead of passing almost all net income along annually. Retained earnings could buffer the corporation against bad times, when a fund of retained earnings could save the REIT an expensive and time-consuming trip to the Wall Street money markets. In the early 1970s, for example, REITs were in the paradoxical position of paying out dividends, as required, even as they were incurring increasing costs for capital in the money and bond markets. The stock markets were effectively closed to them as sources of new capital; while the prices of their own shares, reflecting their declining financial positions, were sinking fast.

If there was no valid reason for the initial creation of an investment vehicle that would be exempt from corporate income taxes and that would pass 95 percent of its net income directly to its shareholders - no reason except the self-interest of the REIT's sponsors - there is no reason for the REITs' continued existence today. REIT advocates are unable to adduce any valid, convincing public purpose that is served by the REITs. The President's Committee on Urban Housing, in its 1968 report advocating the construction and rehabilitation of 26 million housing units in 10 years, considered in great detail the roles to be played by the financing institutions that would be crucial to such an effort. REITs were not even mentioned.

[3]Brearly, *op. cit.*, p. 324, ff.

Recent experience demonstrates that, while they serve no discernable public purpose, REITs provide the opportunity for exploitation. They have most often been used to enrich the rich and to hurt, not help, the unwitting small investor, even as they undermine the banking system. As long as the REIT model continues to exist in the law, the possibility exists that the industry will outlive the inhibiting effects of its current reputation and resume its mischievous ways.

TABLE 1

NEW RESIDENTIAL CONSTRUCTION EXPENDITURES
(in billions of current dollars)

	Private	Public	Total
1950	$15.5	$0.4	$15.9
1955	18.2	0.3	18.5
1959	19.2	1.0	20.2

Source: Department of Housing and Urban Development Hearings before the Subcommittee on Housing and Urban Affairs of the Committee on Banking and Currency of U.S. Senate, March 21 and 22, 1968.

TABLE 2
MORTGAGE DEBT OUTSTANDING BY TYPE OF HOLDER, 1950-1971
(Selected Years)(in Millions — Percentages in Brackets)

Year	Total	Mutual Savings Banks	Commercial Loans	Savings and Companies	Life Insurance	Others*
1950	72,800	7,054	10,431	13,657	16,102	25,536
	(100.0)	(9.6)	(11.0)	(18.8)	(22.1)	(38.5)
1955	129,988	17,457	21,004	31,461	29,445	30,621
	(100.0)	(13.4)	(16.2)	(24.2)	(22.7)	(23.6)
1960	206,800	26,935	28,806	60,070	41,771	49,218
	(100.0)	(13.0)	(13.9)	(29.0)	(20.2)	(23.8)
1965	326,100	44,617	49,675	110,306	60,013	61,489
	(100.0)	(13.7)	(15.2)	(33.8)	(18.4)	(18.9)
1970	450,400	57,948	72,882	150,562	73,345	94,686
	(100.0)	(12.8)	(16.2)	(33.4)	(16.5)	(21.0)
1971	499,900	61,978	82,515	174,385	74,700	106,322
	(100.0)	(12.4)	(16.5)	(34.9)	(14.9)	(21.3)

* Government agencies, individuals and other institutions (pension funds, mortgage bankers, et. al.).

Source: National Association of Mututal Savings Banks, "National Fact Book of Mutual Savings Banking," New York, 1972, p. 52.

TABLE 3
MORTGAGE LOANS AS A PERCENTAGE OF SAVINGS BY INSTITUTION,
1950-1971 (Selected Years)

Year	Mutual Savings Banks	Commercial Loans	Savings and Companies	Life Insurance
1950	35.5	29.6	97.7	30.0
1955	62.0	45.4	97.8	39.9
1960	74.1	42.9	96.6	43.6
1965	85.0	37.0	99.9	48.8
1967	83.8	35.0	97.8	49.9
1969	83.8	39.9	103.4	48.8
1970	81.0	36.0	102.7	47.5
1971	76.1	34.4	100.0	45.3

Source: National Association of Mutual Savings Banks, "National Fact Book of Mutual Savings Banking," New York, 1972, pp.45, 52; Board of Governors, "Federal Reserve Bulletin," Washington, D.C., February, 1972, pp. A39, A40, A52; Institute of Life Insurance, "Life Insurance Fact Book," New York, 1971, p.80.

Chapter 16

Making A Comeback

Risen from the ashes of the thoroughly discredited REIT industry of the 1970s, the much-reformed industry of today has drawn approving notices from many of its former critics "Unlike their highly leveraged, inexperienced cousins who were massacred 10 years ago in short-term lending," says a *Business Week* reporter, "today's REITs are generally better managed and financed."[1] After the rampant excesses of the past, writes Joanne Lipman in the *Wall Street Journal*, today's REITs have become attractively and properly prudent about speculative lending. Today's prospective REIT investor, Lipman notes, can confidently choose between two different types of REITs, each aimed and managed toward a specific, legitimate investment objective. Equity REITs, which count heavily on appreciation in the values of the properties in which they invest, offer better protection against inflation; while mortgage REITs offer dependable yields but little opportunity for growth.[2]

William Balch, of the *National Real Estate Investor*, is especially enthusiastic about a relatively recent innovation in equity REITs: the finite-life trust, which features a fixed date for the liquidation of its equity interests. As liquidation approaches, Balch believes, the market price of the REIT's shares will inevitably approach the true market value of the underlying properties. As this adjustment

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[1] *Business Week*, "The Redesigned REIT is bringing Investors Back Again," April 16, 1984

[2] Lipman, Joanne, "Real-Estate Investment Trusts Cultivate Fresh Image and New Crop of Investors," *The Wall Street Journal*, June 18, 1985

occurs, REIT investors will be relieved of the uncertainty about share values that stems from the inherent uncertainty of property values when sale of the property is not imminent.[3]

The reforms and innovations that have been noted approvingly by knowledgable REIT observers in the trade press only suggest the even more pervasive and dramatic changes in investment strategy adopted by many of the older REITs that survived the mid-70s debacle. As early as 1976, for example, Connecticut General Mortgage and Realty began reducing its commitment to short-term mortgage loans. As these loans matured, Connecticut General reallocated the funds to more stable investments: direct equity ownership, partnerships in equities, and purchase-and-leaseback arrangements. The REIT's new investment posture earned it an A rating from Standard & Poors, and enabled it to place $40 million in unsecured debt with six institutional lenders in 1978, only two years after the new policies were instituted.[4]

One of the very newest REITs, EQK, which made its debut in the market in March 1985, has clearly been designed specifically to allay the fears of investors who know what went wrong with REITs the last time around. J. Steven Manolis, Managing Director at Salomon Brothers, set up EQK as a finite-life trust to buy three specific properties, hold them for twelve years — no more, no less — then sell them. To reassure potential investors, Manolis selected top-quality properties that were virtually fully occupied. He also pegged the management fees that EQK would pay to the price of its shares rather than to the value of its properties, giving management no incentive to pile up risky investments, but

[3]Balch, William, "New Wrinkles Revive Popularity of REITs: Self-Liquidation Feature Increases their Credibility," *National Real Estate Investor*, Vol. 26, No. 9, September 1984

[4]*Business Week*, "A REIT Breakthrough to the Capital Markets," January 9, 1978

every incentive to build solid values.[5]

Despite the significant attempts of many REITs to address the problems that threatened to kill the entire industry just a few years ago, there is still a legitimate question whether the real-estate investment trust is a viable, valid institution. From the point of view of consumer protection, certainly, the REIT today is only marginally safer than its precursor of a decade ago. If some potential investors today are more sophisticated than they were then, many — perhaps most — are not. (Indeed, as the REIT debaçle fades into ancient history, a new generation of investors has emerged with no more idea of what happened in the 1970s than a child of the 60's has of the Depression.)

Similarly, while there are many investment bankers who address themselves only to educated investors, there are also many — perhaps more — who pitch investment schemes at the less sophisticated consumer. With sponsors still in control of the way REITs are organized and structured and the way they make their investments, there is no guarantee that the troublesome features of the old trusts will not persist in some of the new ones.

Even if REITs were thoroughly reformed, however, it is not at all certain that they would be able to operate effectively in the real-estate environment of the 1980s. Real-estate markets have changed, and financial institutions have been forced to change right along with them or get out of the real-estate business. There are now more institutions making real-estate investments than there were ten years ago; therefore there is more competition for prime properties to invest in and for prime talent to manage the investments. As mixed-use properties have become more popular the size and complexity of development projects have grown; and limited partnerships and syndications have emerged as effective

[5] *Fortune*, "A REIT to Right All Wrongs?", Vol. 111, No. 3, February 4, 1985, p. 25

devices for aggregating sufficient capital to satisfy the gargantuan appetites of such projects for investment.

The initial emergence of the REIT as a vehicle for assuring adequate investment in housing can be understood as a response to a unique set of circumstances, which were the product, in turn, of a unique historical development that began half a century ago. In the early 1930's, as the shadow of Depression lengthened across the land, the Federal government created a number of institutions — among them the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation — and a much greater number of regulations, all to a single end: to make sure that enough money would be available to fund mortgage loans for residential construction. Among the most significant innovations was Federal control of interest rates on savings, with thrift institutions — the savings-and-loans — allowed to pay slightly higher rates and required to channel most of their assets into residential mortgages.

As inflation, accompanied by nominal interest rates, began to climb in the 1960s and continued to climb at an accelerating pace in the 1970s, the mortgage-lending system established in the 1930s began to break up. Borrowers, lenders, and regulators alike came to believe that rapid price inflation might be a permanent fact of economic life. If so, then ordinary bank deposits, the traditional source of mortgage lending funds, were no place for the smart individual investor to be. If nominal interest rates in the marketplace were higher than the government-controlled rates that banks and S&Ls could pay on deposits, what sane citizen would leave his savings to languish in the bank or the savings-and-loan?

As savers withdrew their money from depository institutions in favor of investments offering market rates, investment banks were quick to oblige. In the

late 1970s and early 1980s, money-market funds became the safe investment for smart investors. Assets of money-market funds burgeoned from less than $11 billion in 1978 to more than $200 billion in 1982.[6] The inescapable result of wholsale disintermediation — withdrawal of funds from depository institutions — was a dramatic drop in mortgage lending, and a concomitant drop in housing construction.[7]

In the search for investments that would keep up with inflation, the banking institutions and other traditional mortgage lenders were not far behind the individual investors. If land values and rents were rising with the inflation index, then direct ownership of real-estate was a better investment than fixed-rate mortgage loans. The only mortgage loans that made much sense in an era of infinite inflation were the kinds whose variable rates were periodically pegged to the inflation index, or renegotiable at regular intervals.

Other institutions were drawn to equity real-estate investments. Pension fund managers were increasingly receptive to a new investment, as their traditional favorite of the 1960s and 1970s — corporate stocks — took a beating in the 1974 recession. The Federal government, worried by the poor performance of pension funds and by the volatility of their asset values compared with those of life-insurance companies, showed the pension fund managers the way to go with the Employee Retirement and Income Security Act of 1974 (ERISA). The act required pension funds to diversify their investments. What more attractive vehicle for diversification could fund managers find in the 1970s than real

[6]Downs, Anthony, "The Triple Revolution in Real Estate Finance," *Real Estate Review*, 13, No. 1, 1983, p.21

[7]Hale, David D., "What Financial Deregulation is Doing to the U.S. Economy," *The Banker*, 133, No. 692, October 1983, p. 30.

estate?[8]

Real estate investments by pension funds have indeed increased in the past 10 years, although not as much as some observers predicted in 1974. In 1976, according to Money Market Directories, which conducts an annual survey of senior officers of the largest United States corporate and government pension funds, just under 60 percent of the respondents thought real-estate investments could make a consistent contribution to their fund's performance. By 1981, those favoring real-estate investment had increased to 83 percent.[9]

Actual increases in real-estate investment by pension funds have come more slowly, however, beginning — but only very slowly — in 1980[10], and concentrating conservatively in equities rather than mortgages. By 1981, according to the 205 respondents to the Money Market Directories survey, pension-fund investments in real-estate equities averaged 5.8 percent of total portfolio assets, representing an average investment of $25 million per fund. A year later, the funds owned an average of $37 million each in real-estate equity, representing 6.5 percent of their assets. In 1983, 248 funds reported average real-estate investments of $44 million. A year later, as the number of respondents rose to 279, the average investment was $55 million. By then, however, the percentage of the funds' total assets represented by real-estate equity had eased to 5.1 percent.[11]

Despite the funds rather timid entry into real-estate investment, many brokers, pension-fund advisors, and other experts expect them to have a major

[8]Fogler, H. Russell, "20% in Real Estate: Can Theory Justify It?" *Journal of Portfolio Management*, Vol. 10, No. 2, Winter 1984

[9]*Pension World*, "Real Estate Investing by Pension Funds," 17, No. 9, 1981

[10]Lewis, Stephen E., "U.S. Pension Funds Join Hunt for Prime Property; Foreign Investors Still Acquiring Real Estate," *National Real Estate Investor*, Vol. 22, No. 10, September 1980

[11]*Pension World*, "Real Estate Investing by Pension Funds - 1984," 20, No. 9, September 1984

impact in the future, venturing into mortgage as well as equity investments.[12] The apparent slackening of interest in real-estate assets by the funds over the past year or two is attributed by these observers to a number of factors: the relatively strong performance of alternative investments, especially stocks and bonds; the easing of inflation; and the overbuilding of nonresidential structures during a surge of construction activity between 1978 and 1982.[13]

If these experts are right, and pension funds get into real estate in a big way, there should be no shortage of mortgage money or equity capital for a long time. Pension fund assets are expected to exceed $5 trillion by 1995.[14] Even a fractional percentage of such huge assets would have a tumultuous effect on the availability of mortgage credit and on the demand for prime real-estate investment opportunities.

While the heralded entrance of the pension funds into the real-estate markets was postponed, waves of inflation and disintermediation continued to rock the banks and S&Ls in the late 1970s. Federal regulators rode repeatedly to the rescue. In mid-1978, they authorized the S&Ls to offer a $10,000 savings certificate with a term of six months and a yield pegged slightly above the rate offered by Treasury bills. While this innovation had the desired effect of stimulating deposits in S&L's, or at least slowing the disintermediation, it also took the lid off the price the S&L's had to pay for deposits. At the end of 1978, fully 80 percent of the liabilities of all S&Ls were subject to fixed interest rates. Three years later, only 27.7 percent of liabilities were protected by fixed rates.

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[12]Fossett, Fran, "1984: Industry Leaders Predict Plenty of Money; Strong Office Leasing, Bolstered Retail Sector Foreseen," *National Real Estate Investor*, Vol. 26, No.2, February 1984

[13]Stephens, Paula S., "Pension Funds Coming Back into Realty Market, Following Quiet Year for Domestic, Foreign Investors," *National Real Estate Investor*, Vol. 25, No. 10, September1983

[14]*Pension World* (1984), Op. Cit.

The S&Ls' assets, meanwhile, were roughly 66 percent invested in fixed-rate, long-term, low-yielding residential mortages.[15] With fixed, low rates on their assets and eternally rising rates on their liabilities, the thrift institutions were squeezed, as the saying goes, between a rock and a hard place.

The Federal government offered more regulations. The thrift institutions' discretionary control over their assets was increased; though not, according to some observers, enough to make a decisive difference. Late in 1979, in an effort to put the brakes on what threatened to become runaway inflation, the Federal Reserve instituted major changes in its conduct of monetary policy. The Fed's new strategy entailed setting targets for growth in the money supply, regardless of the inflation rate. The next year, in the Depository Institutions Deregulation and Monetary Control Act, Congress commanded the gradual phaseout by 1986 of all ceilings on interest rates on deposits.

Even as these government interventions were affecting real-estate markets, the erratic behavior of interest rates and the continuing jumpiness of prices made mortgage lending — especially long-term lending — increasingly risky. Lenders resorted to new devices that shifted risks to borrowers. In many cases, traditional mortgage lenders were no longer willing to incur the risks associated with being the sole financial backers of major projects. Would-be entrepreneurs were forced to sell some of their own equity in their projects to raise the capital they needed.

The more difficult it became for developers to raise capital, the more capital they needed. Inflation drove up the costs of labor, materials, land, and professional services, as well as the cost of money. Taxes and utilities and other

[15] Colton, Kent W. and David F. Seiders, "Financing the Housing Needs of the 1980s," *Federal Home Loan Bank Board Journal*, 15, NO. 7 1982

operating costs also rose. At the same time, projects became bigger — and more expensive — than ever.[16] In the absence of easy mortgage loans, developers needed institutional backers. Institutional backers became institutional partners. Everyone wanted to get in on the game; everyone wanted to make money in real-estate. The REITs were no longer playing on an empty Monopoly board.

As new institutional players have been getting into the real-estate game, changing the rules in the process, traditional mortgage lenders have begun to diversify their own formerly specialized operations. For the S&Ls and other traditional mortgage lenders, diversification is the only response to the classic squeeze between rising costs for new funds and large portfolios of low-rate, long-term liabilities. The thrift institutions find themselves unable to make enough new investments in traditional residential mortgages, even at higher rates of interest, to cover losses on long-term investments made in balmier times.

Of 42 of the largest United States savings and loan associations surveyed in 1983 by Robert Charles Lesser & Co., a real-estate management-consulting and market-research firm, fully 86 percent were involved in joint-venture partnerships. Nearly 70 percent were involved in mortgage banking; 52 percent in real-estate development; and 20 percent in syndication.[17] Not much of this would have been considered activities befitting a proper savings and loan a few short years ago.

The recent diversification of S&L real-estate investments has had unsettling effects on the residential mortgage field, to which the S&L's formerly devoted

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[16]Lewis, Stephen E., "Major Projects Require Institutional Partners, Says Developer; Sees Pension Fund Move Imminent," *National Real Estate Investor*, Vol. 22, No. 10, September 1980

[17]Leinberger, Christopher B., "S&Ls in Transition: New Real Estate Routes," *Mortgage Banking*, 44, No. 3, 1983

virtually all their investment resources. It is probably safe to say that every S&L dollar that goes into one of these unorthodox investments is a dollar withdrawn from the mortgage pool. As S&Ls have diversified their real-estate activities, their share of the total outstanding mortgage debt has declined from 43.8 percent in 1976 to 40.5 percent in 1981. At the same time, the share of total residential mortgage debt held by mutual savings banks fell from 10.2 to 7.2 percent.

Hand-in-hand with the pension funds, life insurance companies have also found their way into nontraditional real-estate investments. The insurers' initiation came about because the pension funds, to save themselves the costs of doing it themselves, hired the insurers to manage their real-estate assets. As the funds, encouraged by Federal regulations, invested increasingly in real estate, the insurance companies' management fees became increasingly lucrative. In the late 1970s, looking for profitable investments to absorb their new income, the life insurance companies invented a hybrid, hyphenated creature called the construction-permanent loan.

As its name suggests, the new lending device married the construction loan — often at fixed rates — with the pemanent loan in a single package. With the new loan, developers for the first time could predict their interest costs during the delicate construction phase of a project, without trying to read future interest rates in a crystal ball. One-stop shopping for start-to-finish financing also allowed developers to save significantly on legal, origination, and appraisal fees. For their part, the insurance companies profited handsomely from the increased volume of loans at gratifying yields, while they increased their risk exposure by financing entire projects.[18]

[18]Poe, Ronald F., "Life Insurance Companies Plunge Into Construction Lending," *Real Estate Review*, 9, No. 4, 1980, p. 72-5

The diversification of S&Ls and life-insurance companies into the construction-loan market has come largely at the expense of commercial banks. Between 1982 and 1984, according to a survey by the American Banking Association (ABA), commercial banks with assets under $100 million lost 14 percent of their construction-loan business to S&Ls and their subsidiaries; and another 1 percent to insurance companies. Bigger banks, with assets between $100 million and $500 million, lost nearly 19 percent of their construction-loan business to savings and loans and approximately 5 percent to insurance companies. Large banks, with assets up to $2,500 million, lost 14.6 percent of their market to savings and loans, 2.5 percent to insurance firms. The largest banks, the survey found, lost 6.5 percent of their construction loans to S&Ls, 5.8 percent to insurance companies, and 10 percent to pension funds, conglomerates, and other intermediaries.[19]

Most of the commercial banks told the ABA that their losses were due to their new competitors' offers of fixed-rate construction loans and/or bundled construction and permanent loans. Only some of the largest banks tended to ascribe their competitors' success to below-market, fixed-rate construction loans. In any case, the commercial banks were quick to respond to the invasion of their construction-loan territory by the S&Ls and the insurance companies by going after the thrift institutions' traditional business in residential mortgages. Between 1976 and 1981, as the thrift institutions' share of the residential-mortgage market was declining, the commercial banks' share was increasing from 14.3 to 16.1 percent.

[19] *ABA Banking Journal*, "The Nonbanks Encroach on Construction Loans," 76, No. 7, 1984. The survey was conducted in late 1983, and the sample was comprised of 535 commercial banks

For the commercial banks, residential-mortgage lending promised attractively high returns as well as opportunities to deepen and strengthen their identification with local communities. The commercial banks also found a comfortable role for themselves in the growing secondary market for residential mortgages, serving as intermediaries between borrowers and ultimate lenders. For this activity the commercial banks earned healthy origination and servicing fees, incurred minimal risks, and gained a leg up on marketing checking accounts, personal loans, credit cards, and other profitable bank services.[20]

As the forgoing review of the recent history of real-estate mortgage financing suggests, today's REITs operate in an environment that is very different — and very much more difficult and dangerous — than the wide-open field of the 1970s. It is certainly appropriate to ask whether the REIT, even in its reformed, 1980s model, is an appropriate investment vehicle for the new landscape. The first question that must be asked is whether REITs will be able to command enough investor confidence to raise the very large amounts of capital required to operate in the 1980s market. Until that fundamental question is answered, it would be putting carts before horses to worry about whether the REITs will be able to best the new competition for projects and properties of worthwhile quality and for the people to manage them successfully.

There are some signs that REITs are coming back strong: in the first six months of 1985, trusts raised $880 million in equity capital; 19 new trusts were born.[21] It is not clear, however, that investors are truly convinced. Some of the

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[20]Tenges, Robert E., "Secondary Mortgage Market Can be the Better Way for Banks," *ABA Banking Journal*, 71, No. 7, July 1979; and Quinn, Richard M. and David A. Cramer, "Refinancing can Redouble Profits for Mortgage Lenders," *ABA Banking Journal*, 75, No. 4, April 1983

[21]Lipman, Joanne, "Real Estate Investment Trusts are Enjoying a Rebirth, but New Issues

new trusts were unable to raise as much initial capital as they wanted. Many, including EQK, which was designed specifically to allay investor uncertainty, have subsequently traded at well below the prices at which they were initially offered. What acceptance the new REIT offerings have enjoyed in the marketplace, moreover, has apparently been among individual, retail buyers rather than more sophisticated investors.

Responding to a 1984 survey by Alex Brown & Sons, portfolio managers admitted to serious misgivings about REITs. They noted, for example, that the liquidity of REIT investments, which is often touted as protection against sudden swings in underlying asset values, may be less of an advantage than it seems, because it is largely offset by the propensity of REIT share prices to swing with general stock prices. The managers also complained that REIT assets were generally of less-than-institutional quality.

For institutional portfolio managers, the REITs' relatively small size was a problem: sizeable purchases or sales of shares could not be made without producing large-magnitude movements in the market.[22] At the beginning of 1985, there were 60 REITs with assets of less than $50 million; another 23 trusts had assets of between $50 million and $99 million; 17 had assets of between $100 million and $199 million; only 9 had assets between $200 million and $499 million; and a mere 2 had assets in excess of $500 million.[23]

Both of these troublesome issues — the size of REITs and the quality of their assets — were met head-on by the architects of two new trusts, EQK

Have Growing Pains," *The Wall Street Journal*, June 25, 1985, p. 63

[22]See *Strategic Real Estate*, "Qualified REITs Improve Investment Performance But Still Plagued by Negative Historical Perception," 6, No. 4, April 1984

[23]See *NAREIT Factbook*, National Association of Real Estate Investment Trusts, Washington, D.C., 1984. Assets are valued on gross book basis.

Realty Investors and ICM Property Investors. In an effort to make potential institutional investors comfortable, both funds set out to achieve significant size at their births. EQK Realty set out to raise an initial $185 million; ICM Property wanted to open for business with $125 million.[24] Both proposed to invest only in top-quality real estate. ICM was able to raise only $115 million in initial capital[25], while EQK was almost immediatly criticised for having a poorly thought-out management fee and for being generally boring and overpriced.[26]

The REITs' relatively small size may well prove a disadvantage in more than their inability to absorb large investments. When it comes to competing for assets, REITs in the 1980s will be competing for the first time with very large financial institutions. In earlier days, between 1970 and 1974, the REITs had only as much as 20.2 percent and as little as 16.5 percent of their total assets in equities. REITs were not major players in the market for equity in quality properties. Instead, the REITs specialized in making mortgage loans that were too risky for the banks and S&Ls.[27]

Now, however, the REITs are competing head-on with the pension funds and S&Ls for high-quality equity assets. Between 1978 and 1983, equity has never been less than 53 percent of total REIT assets. In this new environment, competing not only with pension funds and S&L's but also with syndicators and foreign investors, the REITS are bidding on blue-chip assets at inflated prices. Even if they have the resources to stay the course, the REITs will

[24] *Fortune, Op. Cit.* and Lipman, Joanne (June 25, 1985), *Op. Cit.*

[25] Lipman, Joanne (June 25, 1985), *Op. Cit.*

[26] Westerbeck, Mark, "REITs Making Comeback Among Funds," *Pensions and Investment Age*, 13, No. 1, January 7, 1985, p. 13

[27] Schulkin, Peter A. and David M. Petrone, "The C&D REIT Experience and the Risks of Construction Lending," *The Journal of Commercial Bank Lending*, 61, No. 4, 1978

certainly be tempted to lower their sights, to that segment of the market where the assets are cheaper and the only real competition is from syndicators, whose ability to assemble investment capital is unmatched by an ability to analyze properties. These syndicators have been hailed as the "new REITs," because they supposedly offer the small investor a safe entry into the real-estate market. In reality, however, to the extent that they pay inflated prices for properties they do not fully understand, the syndicators — and their investors — are extremely vulnerable to any downturn in the market.[28]

If they can't buy the equity assets they want, the REITs may try to build them, seeking higher returns in the construction-loan market. Here too, however, the REITs will meet competition that was not there when they had the field pretty much to themselves a decade ago. This time, too, the competition — the life insurance companies and the S&Ls — has some very real advantages that the REITs will be hard put to overcome.

In a game that demands huge amounts of money just to get in, not to mention to play and to win, the enormous financial assets of the life insurance companies can be decisive. In 1983, the financial assets of life insurance companies amounted to almost 20 percent of the total financial assets of all private, nonbank financial institutions. REITs' financial assets, by comparison, amounted to a mere 0.2 percent of the assets of all private, nonbank financial institutions; and equalled only 1.2 percent of the life insurers' assets. For REITs, as for commercial banks and most other institutions, the cost of funds is decided in the volatile short-term money markets. With their enormous financial assets derived from their other businesses, however, life insurance companies can offer

[28]Lewis, Stephen E., "More Investors Being Drawn to Partnerships; Industry Maturing, Becoming More Institutionalized," *National Real Estate Investor*, 23, No. 9, 1981

long-term loans at fixed rates and be assured of making profits. The growing share of the construction loan business commanded by the insurance companies is ample evidence of the competitive advantage they enjoy.

The savings and loan associations enjoy a more subtle, intangible advantage in competing with REITs for development projects. Many S&Ls have deep, long-standing ties to the communities in which they do business. Local developers, especially those with relatively risky projects, or with propositions that sound plausible only to an understanding ear, often prefer to deal with local lenders. The savings and loan may in fact be better able to evaluate a project in its own backyard than a giant financial institution far away would be.[29]

Faced with what may prove to be unbeatable competition in the upper end of the real-estate markets, the new REITs may be tempted or forced to try to set up shop again at the other end, where they used to do business and where they got into trouble before. All that may be left for them, however, may be the risky deals: land loans; loans without takeouts, presales, or preleases; and loans in unfamiliar areas.

If it can't stand against the competition, the REIT as an institution may simply disappear, to reappear in a different form to serve a different function in a different real-estate market. Recently, some real-estate developers have been experimenting with a new form of REIT as a device for avoiding domination by large financial institutions. These developers suggest that a new entity, called a single-purpose REIT, be created by the developers for the sole purpose of making a permanent mortgage commitment on a particular new project. The

[29]However, S&Ls have played active development roles outside their communities as well, sometimes making commitments that have not been altogether prudent. They too have been likened to REITs. See Stephens, Paul S. (1983), *Op.Cit.*

loan would carry a below-market interest rate, in return for which the trust would take a "kicker" — a share in the ownership of the project. An alternative version of the single-purpose REIT would be set up by the developer with a committment to buy the project upon completion. Such a commitment would presumably assure the developer of construction financing from conventional sources that he would not otherwise be able to get.[30] If they were ever to graduate from developers' pipe-dreams into reality, such self-serving, single-purpose REITs would inevitably invite abuses.

Faced with competition for capital and for investment opportunities, the new REITs also face competition for talented management. The huge institutions that have entered the real-estate arena have absorbed great numbers of experienced, talented managers with the skills necessary to carry out ambitious projects successfully. The REITs still bear the stigma of their troubled past. There is little incentive for a successful manager to go to work for a REIT. According to one knowledgeable observer of the real-estate scene:

> Presently, few REIT managements are appropriately skilled in the requisite talents to achieve investment distinction in the real-estate markets of the 1980s. The critical missing elements — strategic planning and property investment analysis — are in short supply in the real estate sector, but particularly for the REITs.[31]

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[30] *Realty*, "'Single-Purpose' REITs Seen As Growing Financing Tool," Feb. 12, 1985, p. 7

[31] Roulac, Stephen E., "Strategic Challenges for REITs in the Eighties," *The Real Estate Securities Journal*, Spring 1983, p. 67

Chapter 17

The Birth of the New REIT

The 1980's have spawned new REITs. In fact during 1985 alone the REITs will raise over a billion dollars in public offerings. These REITs have many similarities and some differences with the old REITs of the 70's. Three of the "best of the 80's" are discussed.

Grubb and Ellis Realty Income Trust was founded in 1985 from the proceeds of a 25 million dollar public offering. It typifies the smaller new trusts of the 80's.

G&E was sponsored by Grubb and Ellis, a 27 year old New York Stock exchange company. The sponsor is the largest real estate services company in America that is still independently owned. During 1984 its mortgage loan placements exceeded one billion dollars. Its services include mortgage brokerage, property management, asset management, consulting services to institutional investors, and commercial space brokerage services. The company has over 3000 employees and agents in over 100 offices in Arizona, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Illinois, New York, Oregon, Texas, Utah, Washington and in the United Kingdom. Geographical focus is not its goal.

A subsidiary of the sponsor, Grubb and Ellis Realty advisors will provide the day to day management for G&E REIT.

The purpose of G&E REIT is to invest in office buildings, shopping centers, retail facilities, industrial plants, warehouses, and even apartment buildings. Not

wanting to be all things to all people, it won't invest in single family residences or construction loans. These investments although not excluding equity participation will emphasize mortgage loans, land purchase-leasebacks, and from time to time equity investments in income producing commercial properties. The orientation of the REIT is clearly to provide mortgages for commercial properties that are already income producers.

Unlike many of the newer REITS, G&E did not have a set of properties identified before it raised money. This is not surprising if one views the REIT as an opportunistic arm of its sponsor which already has many types of subsidiary affiliates and appears to want "one more" to use when business opportunities arise that don't lend themselves efficiently to one of the pre-existing affiliates.

The REIT intends to provide an array of mortgages including first mortgages, leasehold mortgage loans, and junior mortgage loans including wraparound mortgages. Following the trend of the 80's, the REIT will seek equity kickers and will even require mortgage payment increases if commercial tenant net income levels are higher than expected. In the event that equity enhancements are part of the terms of the mortgage, lower interest rates will probably be negotiated by the commercial borrowers. This will result in lower dividends to the REITs shareholders in the early years but higher capital gains in the later years.

Another characteristic of this particular REIT is that it will specifically seek borrowers who will take mortgages that require interest payments only until the end of the mortgage when a lump sum (or balloon) payment will be required. This type of mortgage has the advantage of keeping the constant debt service to a minimum. (In fact if equity kickers are included, resulting in lower interest terms for mortgage, then debt service will be competitively low, a real bonus for the property owner). This low debt service will yield higher operating incomes for

the property owners and consequently should mean lower risks for the property and concomitantly the lender. There is a major caveat though. Lump sum repayments usually require the owner to build a "nest egg" from which to make this payment. Short of this, he must sell the property when the loan principal becomes due. If the economic environment is not a healthy one, he may have difficulty. Therein lies the risk to the mortgager lender, G&E REIT. So, much like many REITs in the seventies, G&E is investing in mortgage debt in possibly risky ways: namely, new unproven projects, junior loans, wide geographical distribution, and mortgage debt structures that don't emphasize conservative cautions.

It is interesting to note that while the REIT did not have pre-selected properties as many of the newer REITs do, it planned on investing all of its assets during its first twelve months of operation. Furthermore, G&E REIT admitted up front that it might invest in properties adjacent to those of its sponsor G&E Realty and vice versa. This could create situations where the REIT would finance buildings next to the sponsor's property whereby the latter's real estate value would be enhanced by the mere virtue of the added development. This would be even further magnified by the possibility of joint participation in the mortgage by both parties. At the very least, this set of possibilities gives the appearance of the REIT being just a convenient tax-exempt tool for the "parent" (sponsor) company.

An additional feature of G&E REIT is its intended liquidation in 10 years. In fact the REIT will not likely make new mortgage commitments after its fifth year, except for investments in properties in which it already has commitments. A significant benefit to the REITs shareholders will accrue from this strategy since in the second half (5 years) of the REIT, dividends will be primarily capital

gains rather than ordinary income (of the first five years).

G&E has another "au courant" twist. Shareholders will be allowed the option of taking their dividends or reinvesting them in more shares of the REIT. This is an attractive opportunity for the REIT, especially since it has promised not to borrow funds to increase its lending capability. Presumably this aversion to debt leveraging can provide added safety to the shareholders - a feature noticeably missing in the REITs of the seventies.

In another superficial attempt to limit risk, G&E will not invest more than 30% of its assets in any one project. If up to 30% of its income derived from a project that failed, the likelihood of the REIT failing is of course high, though. Yet, on the positive side, G&E is positioned to offer variable rate mortgages as well as to write interest and equity kickers into the terms of its loans.

The issue of potential conflict of interest is a large and looming one. The REITs of the eighties all concede this in a variety of ways. The potential for conflict of interest to arise has been somewhat contained by G&E through a number of provisions:

- it will not invest more than 10% of its assets in unimproved land or non-income producing property.
- it will invest in mortgages up to a maximum of 90% of the property's value.
- it will not invest more than 50% of its assets in properties where an "affiliate" has an interest.

In order to pare down potential conflicts of interest G&E has pre established fees and incentives to its advisor. The advisor will be paid a fee for services

up to 8% of the adjusted net income of the REIT after, and only after, the shareholders have received at least a 10% dividend. Additionally the REIT will not incur operating expenses of more than 2% of invested assets or 25% of net income, whichever is less. This puts a cap on the amount of money the advisor has at its disposal. Any exceptions to this formula must not only be approved by a majority of unaffiliated directors but must also be submitted to the shareholders.

As far as fees go, the advisor is amply provided for. The annual fee for operating services is 8%. In addition there is a pre-established 1% loan origination fee paid to the advisor from developers who place loans with the REIT. When properties are sold by the REIT, a 15% incentive fee will be paid based on net gains. Most surprising, if the REIT changes advisors without cause, the first advisor (also sponsor) still will get the 15% incentive fee when property is sold or refinanced. Courts have repeatedly shown that cause is difficult to prove. In sum, the advisor appears to have the closest thing to a guaranteed income that a "consultant" can have.

Finally, it should be noted that the G&E REIT has agreed that there would be a majority of unaffiliated directors on their board. However, although three of the four founding directors are not officially affiliated with the REIT or the advisor, one of these 3 "unaffiliated" directors uses the parent Grubb and Ellis's commercial brokerage services in his own business. This is hardly a clear unaffiliation. So for practical purposes one-half of the directors have common business interests broader than their role as directors of G&E REIT. So G&E REIT, which is an incorporated entity unlike most REITs, seems destined to continue the conflict of interest patterns of its predecessors.

Mellon Participation Mortgage Trust is a medium-sized REIT with approximately $ 80 million in assets. Sponsored by Mellon Real Estate Investment Management, a wholly-owned subsidiary of Mellon Bank, it has few differentiating features from the mainstream older REITs. Hence, it appears to have been able to raise its money on the basis of the blue chip name of its sponsor and its sponsor's parent. Mellon Bank is the eleventh largest commercial bank in the U.S. While this REIT shares a few features of the 80's REIT's, such as finite life, its major drawing card is its name, which projects security and financial prudence.

Further enhancing the value of name recognition, the affiliated trustees of Mellon REIT are complemented by unaffiliated trustees from large brand name Wall Street firms. The Mellon Participation Mortgage Trust has eight trustees. The Chairman (and trustee) is Robert Kinney who is also president of Mellon Real Estate Investment Management Corporation, the advisor to the REIT. Prior to this position he was with Merrill Lynch's institutional asset management group under which the real estate investment management group operated. The president of the board of trustees is also an executive vice president of the advisor corporation, Mellon Real Estate Investment Management Corporation. He too was with Merrill Lynch before joining the advisor. Elmer Oniffrey, a vice president of the advisor, is also a trustee.

Irving Cohen, an independent trustee, is an executive vice president of E.F. Hutton and prior to that was with Security Pacific, a prominent financial institution on the West Coast. Mercer Jackson is a second unaffiliated trustee. He was an executive vice president of the National Association of Real Estate Investment Trusts, the large association that represents the REIT industry. His career includes stints with the U.S. Department of Housing and Urban Devel-

opment and various staff positions with the U.S. Congress. Arthur Karlin, a third independent trustee, is also with E.F. Hutton, while Patrick McCarthy is a Chancellor of the University of Maine. McCarthy is also an urban planner, which apparently qualifies him to be a trustee of a real estate trust. Finally, of the independent trustees, is James Mooney who is an executive vice president of Landowner Associates, a respected and quite prominent real estate consulting firm. Thus the trustees are a blue chip "face" for the REIT.

Mellon Participation Mortgage Trust, as its name suggests, is primarily focused in mortgages but more specifically in mortgages with equity enhancement rights including participations in property appreciation and income generated by the property over predicted levels.

The REIT will invest most heavily in first mortgages, at least 60%, but also in land purchase-leasebacks, junior mortgages, wraparounds, and accrual mortgages. Accruals allow some of the interest rate payments to be accrued to the end of the mortgage or even paid in a lump sum. The REIT can require this money to be put in escrow by the property owner but this may not in fact be required of any mortgage, thereby increasing the risk.

The bulk of the REITs assets will be invested in mortgages in commercial property such as retail space, offices, warehouses, industrial sites, medical buildings and research parks. The REIT expects to include residential and construction loans and to avoid having ownership of property unless through purchase-leasebacks or the bankruptcy takings. The trust, refreshingly, will not invest in a project in which its advisor, or any of its trustees, have any ownership.

This does not remove the conflict of interest potential though. The advisor, for example, will be allowed to invest in properties adjacent to the REITs and vice versa, which could enhance the advisor's real estate value. The advisor

has over 80 properties worth over half a billion dollars scattered throughout the U.S. Their heaviest concentration is in the West and Southeast, the very area hit hardest during the mid seventies recession.

The advisor is on a one year contract to service the REIT and can be fired with or without cause on two months notice. Their fees are ample enough to accept this "risk." The advisor will select mortgages to invest in. These borrowers will pay the REIT a 1%-1.5% commitment fee. The REIT will in turn pay the advisor a 1.5% acquisition fee (thereby coming out even at best or losing up to .5%). The advisor will also get a .5% administration fee on assets up to 45 million with a smaller percent of additional assets plus an additional .5% of the value of the mortgages based on a 10% capitalized cash flow. When investments are sold the advisor will be paid a 1% disposition fee plus 10% of the gains minus the 1% they had been paid as disposition fees. So the advisor has a hybrid payment structure. He is guaranteed a certain amount based on just the size of the trust (not its profitability) but receives additional incentive fees if the trust is successful.

The Mellon Participating Mortgage Trust does intend to liquidate in ten years. New investments are not likely to be made in its second five year period. However if reasons prevail to prevent this ten year termination (for example a particularly good or bad economic climate) the REIT will automatically be self liquidated in twenty years.

The advisor has the right not only to work with competing real estate groups, but it admits that it may offer deals to other groups first that could be suitable to Mellon REIT. The only protection for the Mellon REIT that the advisor offers is that it won't work for another REIT until 60% of Mellon's funds have been invested. The advisor does offer some comforting service though. In ad-

dition to the traditional real estate project evaluation that they (and others) do, this advisor has sophisticated computer models that enable it to compare any individual mortgage possibility with a wide number of competing mortgage investment opportunities. Only those which are favorable to the average investment possibility, as defined by the model, will be made. While economic models do not preclude bad decision making, it should provide a level of sophistication in deal analysis that the REITs of old claimed they had, but really did not.

This REIT, as in the old days, promises to be a bit too much of "all things to all people." Its goal is to concurrently provide current income, plus capital appreciation through an investment portfolio that will be secure, based on the geographical diversification of the mortgages and sophisticated management by the advisor. While it will invest approximately 60% of its money in the more secure first mortgages, it will finance up to another 25% in wraparounds, up to 10% in accruals, the riskiest. No project, however, will garner more than 25% of its assets. To further assuage the shareholders fears, it promises to use independent, certified appraisers for each of its deals.

On balance, Mellon Participating Mortgage Trust, based in New York, sponsored by a Pittsburgh-based financial holding company, and poised to make investments in the high growth regions of the U.S. is a very close sister to the REITs of the seventies with just a few modifications. The investors that are drawn to this entitity appear to be attracted mostly by the sponsor's name, certainly not by the historical track records of similar entities.

The most prestigious REIT to be formed is EQK. It is also the largest new trust.

EQK Realty Investors I, a Massachusetts business trust, was formed to acquire substantially unleveraged income-producing properties with an asset base of $185,010,000. It is the largest new trust to be formed since the seventies. The Trust will retain its properties for a period of approximately 8 to 12 years and, after the twelfth year, will dispose of any remaining properties within a period of approximately two years. The REIT will be closed-end (i.e., it will not issue any additional shares without the approval of holders of three-quarters of the shareholders. By and large, it will not make any additional real estate investments beyond its first three acquisitions and will distribute to its shareholders the net proceeds from each sale or financing of properties. Consequently, the REIT will be self-liquidating. The REIT, as required by law, will make quarterly distributions of all available cash flow generated in each year from operations.

The advisor to the trust EQK Partners is its original sponsor and was formed two years before the trust itself. EQK Partners is interesting in that it was formed by two of this country's strongest real estate entities to acquire and manage deals. The fact that it took these two powerhouses several years before they could launch their REIT reflects the apathy of the capital markets until very recently toward REITs. It is plausible that with the Dow Jones reaching record highs in 1985, that Wall Street salesmen see real estate investment vehicles as ripe for another run.

EQK's parentage is unassailable. EQK Partners is 50% owned by a subsidiary of The Equitable Life Assurance Society of the United States and 50% owned by Kravco Partners, Ltd. Equitable and Kravco, Inc. are each 50% owners of Kravco Company, a major manager of shopping malls and other com-

mercial real estate in the United States that was formed in 1983 out of what once was Kravco, Inc.'s property management and development business. Equitable is the third largest life insurance company in the United States and manages more than $19 billion in real estate investments, of which more than $8 billion are invested in real estate equities.

Equitable has been active in real estate investments for over a century. Real estate managed by the Assurance Company includes over 50 million square feet of office space, about 40 million square feet of shopping mall space, a similar number of square feet of industrial park space, and 48 hotels with over 20,000 rooms. Equitable and its subsidiaries employ over 40 real estate professionals who oversee analysis, acquisition, management and operations review for real estate investments.

Kravco Company is a major manager of shopping malls and other commercial real estate in the United States. Kravco Company manages more than 40 malls and shopping centers with a combined gross leasable area in excess of 26 million square feet. It also manages over 3.3 million square feet of office and industrial space. The company works in 15 states.

EQK Partners makes recommendations concerning the REIT's investments and administers the REIT's day-to-day operations, subject to the supervision of the trustees, a majority of whom are unaffiliated with the advisor. For performing these services, the advisor receives (a) initial fees for organizing the trust and for the trust's acquisition of the properties described below, (b) a subordinated annual portfolio management fee based on the sum of the aggregate market value of the REIT's outstanding shares, as reflected on the New York Stock Exchange, and the outstanding balance of its long-term indebtedness, (c) a real estate disposition fee and (d) a subordinated incentive disposition fee.

The Declaration of Trust provides that the number of trustees must be a minimum of five and a maximum of 12, a majority of whom must be unaffiliated. There are seven trustees, including four unaffiliated trustees. Trustees continue in office until the next annual meeting of shareholders. Vacancies may be filled by a majority of the remaining trustees, except that a vacancy among the unaffiliated trustees must be filled by a majority of the remaining unaffiliated trustees, or by the REIT's shareholders. Any trustee may be removed with cause by all the remaining trustees, or with or without cause by holders of a majority of the outstanding Shares.

The Declaration of Trust provides that shareholders will not be subject to any liability for the acts or obligations of the trust, which is in effect saying the trust is like an incorporated entity. In fact the Declaration virtually requires that each written agreement of the REIT contain a provision to that effect.

The terms under which the advisor works includes clearly spelled out fees. The REIT will pay three fees to the Advisor: a) an initial fee equal to 1% of the purchase price of each of the Properties; b) an annual portfolio management fee equal to .85% of the sum of the average daily per share closing prices of the Shares on the New York Stock Exchange, multiplied by the average of the total number of Shares outstanding on each day plus the average daily outstanding balance of the Trust's long-term indebtedness; c) a real estate disposition fee equal to 2% of the gross sale of each property sold. While b) is a novel form of fee it has met with a mediocre reception on Wall Street. On the surface, this type of fee appears to mirror the quality of work done by the advisor, which is a good way to calibrate fees. But experience has shown that the stock market price of a REIT's shares can ignore the real health of the REIT or the value of its assets.

However, that caveat aside, the REIT has more experienced and senior members on its board of trustees than the 1970's REITs did. While EQK is a newly organized entity and has no operating history, the trustees and the executive officers as a group have substantial real estate investment experience. The trustees collectively have ultimate control over the management of the Trust and the conduct of its affairs. Unaffiliated trustees will at all times comprise a majority of the trustees and of each committee of trustees. The term of a trustee is one year and of course the trustees elect the officers of EQK Reit.

Some of the trustees include:

Myles H. Tanenbaum who is President of EQK Partners, the advisor. Prior to that time, he served as Executive Vice President of Kravco, Inc.

Henry C. Beck, Jr. is the Chairman of the Board of Directors of Henry C. Beck Company, a general building contractor.

Robert F. Froehlke is Chairman of the Board of Equitable.

Howard Gittis is a partner in the law firm that is counsel to the REIT and also the advisor. This clear area of potential conflict of interest has not been addressed by even this prestigious board of trustees.

Alton G. Marshall is Chairman of the Board and Chief Executive Officer of Lincoln Savings Bank and was President of Alton G. Marshall Associates, Inc., a real estate investment firm. He was also President and a director of Rockefeller Center, Inc.

Russell E. Palmer is Dean of the Wharton School of the University of Pennsylvania.

Raymond H. Wittcoff is a director of Equitable.

Phillip E. Stephens has been Senior Vice President of EQK Partners from its inception.

Mr. Tanenbaum and others own one third of Kravco Partners, Ltd., a 50% partner in the Advisor. Mr. Tanenbaum owns over a quarter of the common stock of Kravco, Inc., a 50% partner in Kravco Company. Trustees are responsible to the REIT's shareholders as fiduciaries and are required to perform their duties in good faith. However, the Declaration of Trust provides that no trustee or officer shall be liable for his or the trust's actions, except arising from his own bad faith, willful misfeasance, gross negligence or reckless disregard of his duties. The Declaration of Trust also provides for indemnification of the trustees and officers against expense or liability in any law suit against him or the Trust.

Typical of a REIT's board during the seventies, the trustees and officers of this Trust are permitted to engage in other similar business activities and are not required to present to EQK any real estate investment opportunities presented to them. So in sum, the conflict potential is still strong and the remedy for abuse (court action) is doubtful.

Not surprisingly, the trust is subject to potential conflicts of interest arising from its relationship with the advisor and its affiliates. With a view toward protecting the interests of the EQK REIT's shareholders against such potential conflicts, the Declaration of Trust provides that a majority of the trustees (and a majority of each committee of trustees) must be unaffiliated, and all transactions between the trust and the advisor or any of the affiliates of the advisor must be approved by a majority of the unaffiliated trustees. This is simply in keeping with normal SEC rules, although these rules are not binding on the REITs. Moreover, the annual renewal of the advisory contract between the trust and the advisor requires the approval of a majority of the unaffiliated trustees, who may terminate the advisory contract at any time on 60 days' notice.

The Trust acquired Harrisburg East Mall from an affiliate of the Advisor.

The Trust acquired Peachtree-Dunwoody Pavilion from an affiliate of the underwriter that acted as an intermediary in passing this property to EQK. The terms of these acquisitions were not based on arm's-length negotiations, and in the case of Harrisburg East Mall, the trust and the seller were represented by the same legal counsel. The terms of these acquisitions were approved by all the unaffiliated trustees. To give credit where credit is due, EQK hired Landauer Associates, Inc., an independent and respectable real estate appraisal and consulting firm, to make appraisals showing that the current fair market values of the real estate exceeded the purchase prices.

In addition,the amount of the fees payable to the advisor who will perform property management services for the EQK trust were not determined by arm's-length negotiation. The fees, however, were approved by all the unaffiliated trustees.

As has been discussed, there is generally no limitation on the right of the advisor or its affiliates to engage in any other business where there may be conflicts of interest. For example, the advisor intends to sponsor future real estate partnerships or REITs that may own properties that are competitive with EQK and affiliates of the advisor may act as managers of these properties.

The REIT is not prohibited from selling any of its properties to the advisor or its affiliates. A majority of the unaffiliated trustees and a majority of shareholders must approve these sales, which must be accompanied by an independent appraisal of the real estate.

The REIT and the advisor are represented by the same legal counsel and retain the same accountants. When disagreements occur between the trust and the advisor, then and only then will EQK retain separate counsel. This is very much a case of closing the barn door after the horses have fled.

On the one hand, the Trust limits itself to 3 properties, all of which are known up front and are of high quality. But then it provides a "contingency" to make additional investments if it elects to.

Apart from its initial investments in the three sites, the trust may make additional real estate investments involving the expansion of existing improvements or purchase and develop additional sites that are in the immediate vicinity of the three primary sites. Prior to making additional investments, a majority of the unaffiliated trustees must determine how and whether the project will affect the original three sites and the value of the REIT's assets as a whole. This simply serves to forewarn the unaffiliated trustees that they have extra responsibility. If investments other than the original three are made, the REIT maintains that it will do so without diminishing the routine dividends that the initial investors will be collecting. In addition, EQK limits itself in its subsequent investments to a maximum of 50% of its then asset base.

The Trust may borrow (secured or unsecured) to make distributions to its shareholders, to make permitted additional real estate investments, and to obtain working capital such as for the repair and maintenance of properties in which it has invested. The Declaration of Trust prevents EQK from borrowing more than 75% of its total asset value.

EQK's three properties are all high quality prime locations and almost fully rented: The Peachtree-Dunwoody Pavilion office park includes seven multi-tenanted, general purpose office buildings which have a total building area of about 800,000 square feet. The Pavilion is located at a major intersection in the center of suburban Atlanta. The Pavilion is approximately 34 acres with parking and was acquired by Equitable in 1978. Equitable added five buildings by 1984. Equitable Real Estate Investment Management, Inc., a wholly owned

subsidiary of Equitable, had been the manager and would continue to do so after EQK's purchase, for another five years minimum.

Castleton Commercial Office Park is a large multi-use office complex of 47 single- and multi-tenanted office buildings, mixed-use office/warehouse buildings plus food facilities in the northeast section of Indianapolis near two major interstates. EQK will buy all but two of the existing buildings, which comprise 1.2 million square feet of space. A future office building of approximately 35,000 square feet will be purchased by EQK REIT when it is completed.

Approximately 78% of the total net rentable area of Castleton is designed for use as office space and the balance is used for both office and warehouse purposes (including related purposes, such as operation of light manufacturing, product assembly, showroom and distribution facilities). Castleton Commercial Office Park is located on 128 acres of land and man made lake with ample parking. Once again, an affiliate of the seller will stay on as property manager, but only for a guaranteed two years.

Harrisburg East Mall is a sixty-two acre regional mall shopping center situated near the central business district of Harrisburg, Pennsylvania, the state capital. The two-story Center has 900,000 square feet and is tenanted by three major department stores, J.C. Penney, Hess's and John Wanamaker. The Kravco Company, one of the 50% owners of EQK Partners (the advisor), developed the property in 1969 and will continue to manage it for at least five years after the EQK purchase. This clearly establishes the link betwen the advisor using the REIT as a tool to enhance its own property, in this case by having the REIT buy the property and guarantee the seller additional operating income for at least five years.

EQK, a large blue chip REIT of the eighties may indeed provide a mechanism

for the small investor to participate in quality real estate ownership, but it does not protect the investor from conflict of interest. In fact, the investors could just as easily have bought shares in Equitable. The net gain to the economy or society is certainly not evident.

The three exemplary REITs of the eighties indicate that the investor memory is a short one. Over a quarter of a billion dollars flowed into these three groups during a six month period. Yet many of the risks of the past are still ignored. The lack of regulation, the potential for conflict of interest abuses, and the uncompetitive nature of the trusts have not changed. The changes are primarily in the finite life of the newer trusts, the emphasis on higher quality deals, and the aversion to debt that each trust shares. So while the risks may have in part diminished, they are still lurking beneath the surface to contribute to another crisis when economic conditions are again shaky.

It is hard to change, let alone dismantle an institution even if it doesn't serve a good purpose.

The conclusion to be drawn from the evidence presented here is that the REIT as financial institution could disappear completely from the scene without being missed by real-estate investors or consumers. REITs served no valid and necessary function for either real estate or investment. As the marketplace reacted to the emerging news of the REITs' flaws, the total assets held by the trusts declined from $21 billion during the go-go days of 1974 to just over $7 billion. The index of REIT share prices, calibrated so that 1972 prices equal 100, had plunged to a mere 17 by late 1975. Most REIT stocks were selling below their book value.[1]

Despite the industry's well-deserved difficulties, however, a number of REITs

[1]NAREIT, "Investment in the Eighties: The REIT Concept," Washington, D.C., 1981, p. 8 .

have survived to witness at least a partial revival of their fortunes. From 17 in 1975, the share-price index rebounded to 38 by mid-1980, then to 43 by 1983. Dividends, which reached their nadir in 1974, almost doubled by 1980 to total $210 million.[2]

The industry's generally improved outlook reflects the strengthened financial position of the surviving REITs, which inspired the *Boston Globe* to announce in a headline: "REITS MAKING A STRONG COMEBACK."[3] One sign of the sounder financial footing of the reborn trusts was the fact that by early 1980, the REITs total mortgage holdings represented less than 35 percent of the industry's total assets; 60 percent of total assets were in equity investments.

Boasted NAREIT, the industry's trade association: "Bank borrowings and commercial paper comprise less than 39 percent of total liabilities. Long-term, low rate mortgages on trust-owned properties, on the other hand, amount to 41 percent of all liabilities. In fact, the industry debt-to-equity ratio is 1.5 to 1, a substantial improvement from the year-end 1976 ratio of 5 to 1."[4] By 1982, total REIT shareholder equity, $3.8 billion, was a healthy 11 times the amount set aside to cover potential losses from bad investments.[5]

Indeed, by 1981 REITs had regained sufficient financial health to do better than either the Dow Jones and the Standard and Poor's share price indices. The following year the Dow Jones Industrial Average outperformed the REIT index by 19.6 to 16.2 percent; but the REITs, paying a 9.9 percent dividend, did better overall by their investors.[6] By April 1983, one respected investment advisor was

[2] *Ibid.*

[3] *Boston Globe*, April 25, 1982, p. 62

[4] NAREIT, *op. cit.*, p. 24.

[5] *Ibid.*, p. 25.

[6] "REITs: Raising the Roof." Article in *Newsweek* (April 4, 1983) by Jane Bryant Quinn. p.

quoted as advising its clients to "pick up REIT stocks on the downswing." Schotland, perhaps the most prominent critic of the REITs during their most culpable period, assured the world, "Anyone staying away from REITs because of the 1970s disaster is fighting the last war."[7]

While they may admit that everything was not always as it should have been in the industry, insiders like to point to the evidence suggesting that REIT self-regulation has been a success. "The REIT industry," NAREIT president Allan H. Glidden boasted in 1982, "is a wiser and chastened industry which [sic] has learned a lot of things about development and construction and has put its own controls on how investments should be made."[8]

It is also a leaner industry: many banks and insurance companies who rushed into the REIT business when the boom was on, have prudently withdrawn when business turned bad. Chase's REIT, forced into bankruptcy in 1979, has been reborn and rechristened as the Triton Group Ltd., an independent, publicly held company that no loonger operates as a REIT. In other cases, bank- and insurance-company-sponsored REITs have been reconstituted as independent entities; some have departed the real-estate business entirely, in favor of other, perhaps less exciting pursuits.

Among those REITs that have weathered the storms, industry supporters point to salutory reforms in management style and technique as symptoms of new virtue. In the 1970s, some 75 percent of all REITs depended on outside advisors; today that percentage is less than half as high. With the decline in

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[7] *Ibid.*

[8] Boston Globe, *op. cit.*, p. 62

the use of consultants has come a drop in management fees.[9]

The surviving REITs have also learned to be more prudent with their investments. Permanent takeouts are now required before construction loans are approved. Equity ownership has assumed a much greater importance in the spectrum of REIT activities: 92 REIT's were recently counted as specializing in property ownership; while the 20 trusts counted as continuing to concentrate on mortgage lending are confining their activities to well-established borrowers and engaging in joint ventures that include equity participation. Many trusts are now characterized as owners of "prime real estate projects with rapidly appreciating values."[10]

In the effort to restore the faith of investors, some REITs in the 1980s are offering new kinds of trusts. Among the innovations: REITs that are self-liquidating, returning both principal and profits to the investors in eight years; trusts whose profits rise with the rent rolls of the apartment buildings they invest in; trusts tailored for Individual Retirement Accounts; trusts designed to appeal to the most upright investors, such as university endowments.[11]

Apparently, the new REITs are enjoying considerable success in overcoming their bad image and record in the marketplace. While many institutions seized the opportunity to divest themselves of REITs, or otherwise distance themselves from disaster, other institutions have more recently begun to reinvest in REITs, either by buying large amounts of stock, or by outright acquisition of trusts. Northwestern Mutual Life Insurance Company and Equitable Life Assurance Society, two major insurers, have both acquired the REITs they originally spon-

[9]NAREIT, *op. cit.*, p. 35

[10]Newsweek, *op. cit.*, p. 70

[11]Leslie Wayne, "The Return of the REITs," *New York Times*, 5 December 1982, p. 2, Sec. D

sored. Prudential Insurance Company has bought Connecticut General Mortgage and Realty Investments; while the British National Coal Board bought the Continental Illinois Real Estate Investment Trust.

The reformed REITs are beginning to find renewed access to the traditional capital markets they had been excluded from during their downfall. The REITs of the 1980s, both survivors of the 1970s and new entities, are selling stocks and bonds to fuel the rapid growth of their earning assets. [Table 1]

"There will be more emphasis on size," John A. Cervieri, managing trustee of Property Capital Trust told *The New York Times* in December 1982. "Those that don't grow just won't be able to compete successfully. The advice to smaller REITs that lack access to capital that would enable them to compete in the big leagues: "Merge or liquidate."[12]

For big-time operators, real as well as would-be, REITs are once again a good reason to go into the marketplace to raise capital. American Hotel & Realty Corporation, a REIT sponsored by the Bass Brothers, Texas oil billionaires, raised more than $113 in its first public offering, using much of the proceeds to acquire hotels from the Bass Brothers.

Mortgage REITs, the leaders in both the rise and fall of the industry, are once again rising to prominence, emerging as the biggest trusts, commanding a substantial share of the total assets of all REITs. It is the mortgage REITs again, as it was in the 1970s, that are the most profitable class of trusts. It seems inevitable that the mortgage trusts are ready for another period of strong growth.

Of the five largest REITs — all of them publicly held — four are overwhelmingly devoted to mortgage lending. Only one — albeit the largest, Gen-

[12] *Ibid.*, p. 2 (sec. D) col. 5 and 6.

eral Growth Properties, is primarily involved in equity participation. General Growth is 100 percent invested in ownership; but Lomas & Nettleton is 91 percent in mortgages; Wells Fargo is 51 percent in mortgages, MONY Mortgage is 85 percent in mortgages, and Mass Mutual Mortgage & Realty is 83 percent in mortgages. The superior profitability of mortgage trusts is clear: General Growth boasts a rate of return of less than 0.5 percent, earning $2.1 million on an asset base of $478.3 million. The smallest of the trusts, Mass Mutual, scored an 11.5 percent return, earning $23.2 million on assets of $202.6 million. The other mortgage trusts did similarly well. [Table 2]

On the one hand, the mortgage REITs, with their history of mischief and mayhem, seem poised for a resumption of their former strong growth. If so, the resurgent REITs may well be encouraged to resume their former practices, including debt and equity leveraging, that got them into trouble in the first place. On the other hand, however, the regulatory mechanisms that are the major defense against abuses in the REIT industry have changed little from the 1970s, when the regulatory process proved wanting in so many respects. Without meaningful revision and strengthening of both federal and state REIT statutes and regulations, there are not many obstacles in the way of another outbreak of overbuilding, uncontrolled lending, and other abuses, with their certain retribution.

There is no doubt that the REITs have every incentive to get into dubious practices. While outside advisors run fewer of the REITs of the 1980s, they include the larger growth- oriented reits. The fees of these managers remain linked to the size of total assets, placing a premium on growth at all costs. The incestuous ties among sponsors, advisors, and trustees are still a hallmark of realty trusts. Trusts still share law firms with their advisors, setting the

stage for conflicts of interest. Debt leveraging, unrestricted, is still a dangerous temptation. Investors, especially those looking for an easy killing, are once again being tempted to believe that the REITs promise high income and high capital appreciation, without much risk.

"If the times were right," warned *Newsweek*, "there is nothing to stop the construction REITs from leaping over the brink again."

The search for adequate preventive regulations to keep the REITs from repeating the past leads Schotland, perhaps the leading commentator on the industry, to advance a number of suggestions. "Congress needs to enact a variant of the Investment Company Act tailored to the special characteristics of the REITs," Schotland says.[13] Specifically, he notes that the use of outside managers has done little to help and much to hurt the interests of both the trusts and their investors; outside management might well be prohibited by the kind of legislation Schotland recommends.

In particular situations where outside management is desireable, Schotland believes, the consultants should be required to disclose fully any potential or actual conflicts of interest. Because it is inevitable that REITs will be in competition with their outside advisors, as well as with their own sponsors, Schotland adds, such devices as "pari passu" and "right of first refusal" should be standard equipment for REITs. Shareholders should be privvy to accurate reports of an outside advisory firm's costs and profits. The independent trustees, meanwhile, should be revitalized as an active, preventive force, required to oversee all transactions carefully. The trustees would be assured of the conditions necessary to do their job properly; and they would be legally liable for misfeasance or malfeasance in discharging their crucial responsibilities.

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[13]Schotland, *op. cit.*, p. 213

At the same time, total assets should be done away with as the basis for calculating management fees, in order to eliminate the constant temptation to use excessive leveraging and to pile up low-quality assets. Instead, fees should be on a sliding scale, keyed to the profits actually realized by shareholders.

There is also a need to safeguard REITs and REIT shareholders against the banks and insurance companies that traditionally sponsor REITs. Self-dealing all but inevitably entails abuse of the relationship that should exist between a trust and its sponsor. Full disclosure and independent appraisals as part of all REIT dealings, would do much to remove the suspicion of misbehavior that clouds trust-sponsor relationships. To regulate the relationship between REITs and their law firms, Schotland wants the American Bar Association to take a hard look at the propriety of the same firm representing trusts and their advisors or sponsors.

From the evidence presented in this investigation of the REIT situation, however, it seems clear that Schotland's proposals, while they are unexceptionable as far as they go, simply do not go far enough. Their major shortcoming is that they fail to comprehend the underlying competitive forces that condition the REITs' behavior and their ultimate success. As long as these fundamentals remain uncorrected, it is unlikely that the problems that plague REIT activity can be effectively corrected.

A most important, though subtle, fact of life in the REIT industry as it emerged in the 1970s was the separate financial reporting of the realty trusts and their sponsors, usually the large bank holding companies. With consolidated reports, any financial advantage accruing to the bank at the expense of its REIT would be immediately apparent. More important, such a trade-off would have no net effect on the overall performance of the consolidated operation; the

bank would have no reason, therefore, to beggar its REIT to enrich itself or its affiliates.

A final reform, seemingly superficial but actually addressing the consumer-abuse problems of the REITs, would forbid sponsors to lend their own names to their REITs. This simple measure would deprive over-enthusiastic salespeople of one of their most potent selling tools, with which they persuade unsophisticated investors that a high-risk REIT has all the rock-solid safety and risk-free return of a well-known, strictly regulated bank or insurance company.

All these seemingly innocuous, matter-of-course reforms — most of them accomplishing nothing more than forcing the REITs to reveal their true financial nature and performance to their shareholders and the public — would probably be serious in their effect on the REIT industry. Only creative financing and accounting, in combination with questionable marketing, create the illusion that REITs are hot investments, suitable for unsophisticated profit-seekers. As this paper has demonstrated, the simple fact is that, when their conditions are accurately disclosed, REITs are inherently uncompetitive: their true profitability is inferior to that of alternative investments that have to pay less for debt capital; while REIT assets lack the clearly established market values of mutual fund shares.

The indeterminate values of REIT assets are what make it possible for REITs to indulge in excessive leveraging; while the REITs' relatively low profitability made such techniques necessary for survival. Without leveraging, or with leveraging limited to reasonable levels, the only REITs that could be sure of surviving would be those lucky enough to hit a run of abnormally good investments.

It is a fair assumption that REITs could not survive in the full light of day, without slight-of-hand bookkeeping or slight-of-tongue salesmanship. If in-

vestors and sponsors were accurately and fully informed on such crucial matters as the true values in all REIT transactions, the fees and profits garnered by REIT advisors, and the real nature and worth of REIT assets, they would be able to make less euphoric appraisals of the REITs. Such appraisals would lead to the inescapable truism that in well-functioning capital markets, safe dividends and sure capital appreciation do not often accrue to the same stock at the same time. Stripped of such unrealistic expectations, judging REIT investment prospects in the cold light of day, investors and sponsors would be led to consider the real implications of the cripplingly high cost of capital paid by the REITs.

Ultimately, investors would be forced to conclude that as long-term prospects, REITs are at a severe disadvantage in comparison with commercial banks or insurance companies. Either REITs and their investors have to accept higher risks to achieve a given rate of return, or they must settle for lower returns from a given level of risk. In the highly competitive investment markets, therefore, REITs — when they are completely understood for what they are — are not viable as investment vehicles. With the understanding that full disclosure and rational, effective regulation are necessary conditions of doing business, potential realty trust sponsors would similarly conclude that REITs are not attractive opportunities.

In a rational world, therefore, REITs would not survive.

The more fundamental problem of the REITs, though, is that they never had a real purpose, a clear goal. Consequently, their performance could not be easily monitored, evaluated, measured.

REITs are neither fish nor fowl.

In sum, ambiguity leads to abuse. It was not the high interest rates, the

conflict of interest relationships, the debt-equity leveraging, or the institutional competition per se that hurt the REITs. It was the overlap and intersection of these problems on an aimless institution which couldn't be fine tuned to meet objectives.

The REITs neither substantially increased the flow of funds into real estate nor gave small investors access to sophisticated, profitable investments previously available to only big investors. Yet a complex institution has evolved with a life of its own. Institutions are hard to change, even harder to dismantle. Incentive mechanisms such as tax incentives can be fine-tuned, recalibrated, enhanced, or abandoned if their purpose isn't being served or is no longer valuable. The REITs Act created a bold new institution when elegant refinements to traditional incentives would have been more powerful.

TABLE 1

ANNUAL SUMMARY OF PUBLIC OFFERINGS AND PRIVATE PLACEMENTS OF REITS SECURITIES
($ million)

	Number of Offerings	Total Value
1975	5	0.4
1976	10	88.3
1977	8	91.9
1978	12	91.5
1979	18	109.1
1980	30	350.7

Source: REIT Fact Book, 1980 Supplement, NAREIT, Washington, D.C.

TABLE 2
THE BIGGEST PUBLICLY HELD REITS

Name	Total Assets (millions)	Type of Investments	Location	Profits for 1981 Fiscal Year (millions)
General Growth Properties	$ 478.3	100 % properties	Des Moines	$ 2.1
Lomas & Nettleton Mortgage Investors	278.4	91% mortgages 9% properties	Dallas	10.2
Wells Fargo Mortgage & Equity Trust	223.7	51% Mortgages 49% properties	San Francisco	11.9
MONY Mortgage Investors	209.0	85% mortgages 15% properties	New York	7.6
Mass. Mutual Mortgage & Mass. Realty Investors	202.6	83% mortgages 17% properties	Springfield, MA	23.2

Source: National Association of Real Estate Investment Trusts 1981 Factbook

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