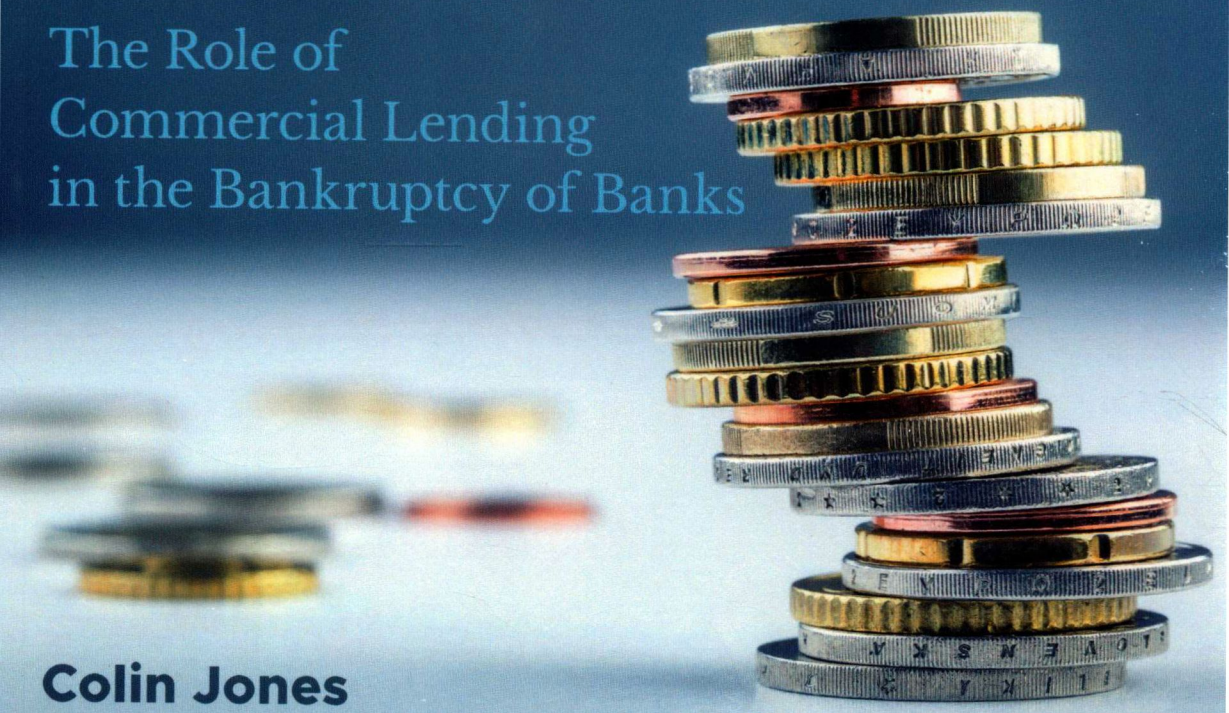
PROPERTY BOOM AND BANKING BUST

The Role of Commercial Lending in the Bankruptcy of Banks



Colin Jones
Stewart Cowe
Edward Trevillion

WILEY Blackwell

A fascinating analysis of the critical role commercial property investment played in the economic boom and bust during the global financial crisis

The unprecedented financial boom stretching from the mid-1990s through 2008 ultimately led to the deepest recession in modern times and one of the slowest economic recoveries in history. It also resulted in the emergence of the draconian austerity policies that have swept across Europe in recent years. *Property Boom and Banking Bust* offers an expert insight into the complex property market dynamics that contributed to the Great Financial Crisis of 2008 and its devastating economic consequences. It is the first book to focus on a woefully underreported dimension of the crisis, namely, the significant role that lending on commercial property development played in the crisis. Among other key topics, the authors explore the philosophical and behavioral factors that propelled irresponsible bank lending and the property boom; how it led to the downfall of the banks; the impact of the credit crunch on the real estate industry generally in the wake of the financial crisis; the catastrophic effects the property bust had on property investors, both large and small; and how the financial institutions have sought to recover in the wake of the financial crisis.

- Provides valuable insights into what happened in previous booms and busts, particularly in the 1970s and 1980s, and how they compare with the most recent one
- Offers an expert assessment of the consequences of the global financial crisis for the banking system and the commercial property industry
- Examines strategies banks have used to recover their positions and manage the overhang of indebtedness and bad property assets
- Addresses strategies the real estate industry have used to recover from the collapse in property values

Written in an accessible style, and featuring numerous insider case accounts from property bankers, *Property Boom and Banking Bust* disentangles the complex, tightly-woven factors that led to the Great Financial Crisis of 2008, while offering powerful lessons for property industry professionals on how to avoid having history repeat itself.

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Property Boom and Banking Bust

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Glossary

APUT Authorised property unit trust – a means by which personal investors can access and invest in the property market.

BASEL III The Basel international agreements relate to common global standards of capital adequacy and liquidity rules for banks. These were first introduced in 1988. Since 2013, the amount of equity capital that banks are required to have has been significantly increased by BASEL III.

Fannie Mae Fannie Mae is a US government sponsored enterprise originally set up in 1938. It operates in the 'secondary mortgage market' to increase the funds available for mortgage lenders to issue loans to home buyers. It buys up and pools mortgages that are insured by the **Federal Housing Administration** (see below). It finances this by issuing mortgage-backed debt securities in the domestic and international capital markets.

Federal Housing Administration The Federal Housing Administration is a US government agency created in 1934. It insures loans made by banks and other private lenders for home building and home buying.

Freddie Mac Freddie Mac is a US government sponsored enterprise established in 1970 to provide competition to Fannie Mae and operates in the same way.

lending margins The difference between the rates banks charge to borrowers and that paid (usually) on the wholesale markets or to savers.

limited partnership A partner in a limited partnership has limited liability but normally has a passive role in management. There is also a manager who decides the investment policy of the partnership.

liquidity Liquidity is the ability to transact quickly without causing a significant change in the asset's price. Property tends to be considered illiquid, not least because of the time taken for a transaction.

NAMA The National Asset Management Agency was established in 2009 by the Irish government as one of the initiatives taken to address the crisis in Irish banking. It took over the bad property loans from the Irish banks in an attempt to improve the management of credit in the economy.

OECD The Organisation for Economic Co-operation and Development (OECD) comprises a group of 34 countries that includes all Western countries. It was set up in 1961 to promote policies that improve economic and social well-being in the world.

off balance sheet It refers to the ability to place assets and liabilities off a company's balance sheet.

open ended funds A collective investment vehicle where the number of shares or units can be increased or decreased according to cash flow into and out of the fund.

pre-let A pre-let is a legally enforceable agreement for a letting to take place at a future date, often upon completion of a development.

REIT A Real Estate Investment Trust is a listed company which owns and manages (generally) income producing real estate and which is granted special tax measures (i.e. income and capital are paid gross of tax with any tax being paid according to the shareholder's tax position).

retail fund An open-ended fund that invests funds which are derived from selling units primarily to individual investors.

rights issue A rights issue occurs when a company issues more shares and its existing shareholders have the initial right to purchase them.

securitization This is the practice of pooling assets (often commercial/residential mortgages) and selling, usually bonds, with interest payments to third party investors. The interest payments on these securities are backed by the income from the mortgages.

sovereign debt crisis The failure or refusal of a country's government to repay its debt (interest payments or capital) in full is a sovereign debt crisis.

upward only rent review A typical lease may have points in time in the future when the rent is due for review. An upward only rent review is the term used to describe a situation in which the rent payable following a review date cannot be reduced (even if market rents have generally fallen since the last review).

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1

Introduction

Two shots from Gavrilo Princip's semi-automatic pistol at Sarajevo set in train a complex chain of events that lead to the First World War (Taylor, 1963). Commentators writing on the assassination of Archduke Franz Ferdinand of Austria-Hungary and his wife Sophie on the 28 June 1914 could not have imagined that this 'local difficulty' would rapidly escalate, develop into the world's first global conflict and cost the lives of an estimated 17 million combatants and civilians. It would also sweep away the remnants of three empires, bring about the decline of monarchies, instigate the rise of republicanism, nationalism and communism across large swathes of Europe and change the social fabric forever (Strachan, 2001; Taylor, 1963).

Almost a century later, financial commentators reviewing the failure of New Century Financial, one of the largest sub-prime lenders in the United States, which filed for Chapter 11 bankruptcy protection on the 2 April 2007, could not foresee that that this local problem would escalate and develop into the world's first truly global financial crash and almost see the ending of the capitalist system as we know it. It was to cost unprecedented billions of pounds, euros, dollars and just about every other major currency in attempts to address the issue.

The Great War had a defined start and conclusion. It formally began with the Austro-Hungarian declaration of war on Serbia on 28 July 1914, which then drew in other countries owing to a series of alliances between them. Hostilities formally ceased on Armistice Day on 11 November 1918. But despite that cessation of hostilities, not all the contentious issues were addressed at the ensuing Versailles peace conference. Many consider the outbreak of the Second World War two decades later to be a direct consequence of the flawed decisions made at Versailles (Strachan, 2001; Taylor, 1963).

Fast forward a century and the timing of the global financial crisis (GFC) cannot be quite so precisely stated. There was no single action or event that one can say triggered the crash, nor has there been a point in time – so far – when we can say that the crash is now finally behind us. We can certainly agree that not all financial hostilities have ceased, even a decade on, and we still remain years away from a complete return to normality. Austerity still lingers on for millions, and many governments are still printing money in an attempt to kick-start growth while the living standards for those in the worst affected countries remain at depressed levels. And in a striking comparison with the Great War, one wonders whether decisions made in the heat of the financial battle will not create a lasting peace but merely represent unfinished business prior to another major financial crisis erupting.

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The banks were at the forefront of criticism over the scale of the crisis – and justifiably so – with their lax underwriting standards and their ineffective weak response to the crisis. But at the heart of the problem was the banks' interaction with commercial and residential property, their questionable lending practices, their almost casual disregard for risk and their creation of complex and barely understood financial products which pushed the risk out into an unsuspecting world.

This book seeks to lay bare the role of property – primarily commercial – in what became known as the global financial crash, explaining the rationale behind the banks' lending decisions and highlighting the changing emphasis on property on the part of both investors and lenders. While many excellent books have been written extolling the faults of the banking system and exposing the gung-ho policies of the bankers, fewer have looked at the specific role real estate played in the crash. This book addresses that omission.

This chapter begins by looking at how sub-prime lending evolved and not only led to the demise of the lenders of this product in the United States but also brought the international banking system to its knees in the GFC. It then explains the historical commercial property market context to the banking collapse and in particular the dynamics and role of property cycles. The next section discusses the role of commercial property in the macroeconomy, highlighting the interaction between the two. In the following section, the emergence of investment short-termism is considered with its potential consequences. The penultimate section explains some prerequisites for the analysis of property market trends presented in subsequent chapters. Finally, the book structure is explained in detail.

Sub-prime Lending Enters the Financial Vocabulary

While the housing market downturn in the United States was the critical event which ultimately lead to the onset of the global financial crash, the residential property markets played a less significant role in the rest of the world. As we will read in later chapters, it was exposure to the commercial property markets and an over-reliance on 'wholesale' funding via global capital markets that precipitated the crisis in the United Kingdom and other Western economies. However, to set the scene on the contributing factors to the global crash, it is important to explain why sub-prime lending was such an issue and how problems in that market spilled over to the derivative markets and thence to the wider world.

Prior to 2007, few commentators beyond the United States had heard of the term 'sub-prime'. Events would soon propel the term into the forefront of common usage, but in a less than flattering way. Sub-prime lending, at the outset, was the consequence of a genuine attempt to broaden the scope of mortgage provision in the United States and promote equal housing opportunities for all. Unfortunately in their quest to engage the wider population, lenders targeted more and more inappropriate customers: those with a poor credit history, those with job insecurity or even those without a job. Not for nothing were these loans called NINJA loans (no income nor job nor assets). It is useful to look at the US experience in some detail.

These sub-prime mortgage loans generally took the form of a '2–28' adjustable rate mortgage involving an initial 'teaser' mortgage rate for two years followed by a upward

resetting of the mortgage rate for the remaining 28 years. The mortgages were sold on the premise of rising house prices and customers were offered the prospect of refinancing the mortgage (possibly with a mainstream lender) at the end of the initial two-year period if they could demonstrate an improvement in their financial position and credit rating. Regular repayment would support the household to rebuild its credit rating. Not all could, of course, and borrowers in that category would remain on a sub-prime mortgage but at considerably higher mortgage rates.

It was the sheer scale of the sub-prime market that propelled the crisis into one of major proportions. Sub-prime mortgages were relatively rare before the mid-1990s but their use increased dramatically in the subsequent decade, accounting for almost 20% of the mortgage market over the period 2004–2006, and that percentage was considerably higher in some parts of the United States (Harvard University, 2008). But it was not just the volume of sub-prime mortgages in force that was the problem: it was the number of mortgages which were due to have reset rates in 2007 and 2008. Not only would these mortgagees face higher rates from the reset but general interest rates were rising, compounding the problem.

Even before the full impact of the housing market downturn became evident, defaults on the sub-prime loans were rising. By the end of 2006, there were 7.2 million families tied into a sub-prime mortgage, and of them, one-seventh were in default (Penman Brown, 2009). In the third quarter of 2007, sub-prime mortgages accounted for only 6.9% of all mortgages in issue yet were responsible for 43% of all foreclosure filings which began in that quarter (Armstrong, 2007).

The effect on the US housing market was profound. Saddled with a rising number of mortgage defaults and consequential foreclosures by the lenders, house prices collapsed. Once these house price falls had become entrenched in the market, further defaults and foreclosures occurred in recently originated sub-prime mortgages where the borrowers had assumed that perpetual house price increases would allow them to refinance their way out of the onerous loan terms. A growing number of borrowers who had taken out sub-prime mortgages and/or second mortgages at the peak of the market with 100% mortgages found themselves carrying debt loads exceeding the values of their homes. In other words they had *negative equity* in their homes, meaning their homes were worth less than their mortgages, rendering refinancing impossible. It also made selling the homes difficult because the proceeds would fall short of outstanding debt, forcing the sellers to cover the shortfall out of other financial resources, which many did not have. If they tried to sell and were unable to make good the deficit, the loan was foreclosed and the house sold. Sub-prime default rates had increased to 13% by the end of 2006 and to more than 17% by the end of 2007. Over the same period, sub-prime loans in foreclosure also soared, almost tripling from a low of 3.3% in mid-2005 to nearly 9% by the end of 2007 (Harvard University, 2010).

By September 2008, average US housing prices had declined by over 20% from their mid-2006 peak. At the trough of the market in May 2009, that fall had increased to over 30% (Jones and Richardson, 2014). This major and unexpected decline resulted in many borrowers facing negative equity. Even by March 2008, an estimated 8.8 million borrowers – almost 11% of all homeowners – were in that category, a number that had increased to 12 million by the end of the year. By September 2010, 23% of all US homes were worth less than the mortgage loan (Wells Fargo, 2010). As the housing and mortgage markets began to unravel, questions were being asked about whether

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