INDUSTRY SPOTLIGHT

The unprecedented activism of the Federal Reserve Board in the American economy will probably be discussed and analyzed for years to come. BNA's Kevin Lambert spoke with celebrated real estate expert Dr. Austin J. Jaffe, a professor of real estate at Pennsylvania State University and consulting economist with the Pennsylvania Association of Realtors, on what the Fed has been doing to end the recession and where the economy is going. Jaffe, who believes the downturn's effects on commercial real estate will intensify, also discussed the origins of the crisis and fiscal tools that policymakers have employed. He specializes in real estate financial analysis, the economics of property rights, the economic effects of legal institutions, the conceptual basis of property, and real estate computerization. Jaffe is the author or co-author of 13 books, including Fundamentals of Real Estate Investment and Real Estate Investment Decision Making.

As 'Old World' of Real Estate Ends, the Makings of Recovery Begin to Take Shape

BNA: Do you feel that the steps that the Federal Reserve Board is taking are correct?

JAFFE: Nobody's job is tougher than [Chairman Ben] Bernanke's at Fed these days. We have a series of crises that have all come together to what people call a perfect storm. The Federal Reserve's options are limited, but [they] were immediately and aggressively used by lowering interest rates to near zero. This is different than the European Central Bank, which has been very slow to lower interest rates to increase liquidity.

[The Fed] has aggressively lowered interest rates after raising them 17 times, I believe, and now they've run out of space because the federal funds rate is now between zero and 0.25 percent. They're now engaging in what is called "quantitative easing" because rates are so low, so they are looking for other tools, such as purchasing 10-year Treasury bills in the open market to lower longer term rates.

There is, of course, always monetary and fiscal policy available and the administration has tried to develop stimulus bills--although the politics have gotten in the way--the program has probably less stimulus than people want.

But the Fed has tried to be innovative, and tried to develop some programs that are new, like TARP [Troubled Assets Relief Program] which has been criticized. We will see more of this. The Fed is actively involved in using TARP funds to buy up securities for two reasons: because mortgage-backed securities are still out there--and remain toxic--and because the yield curve is problematic, since long-term interest rates haven't fallen enough yet. The new initiative, announced [on March 18] promises $1.2 trillion to buy 10-year Treasuries in order to lower interest rates. Ten-year yields dropped 50 basis points in response on the same day.

The Fed usually works in the short term and they expect that with an ascending yield curve-what typically happens is that [when] the yield curve is ascending and when there are periods of increased liquidity, Fed policy is introduced in the short-term Treasury bill market. This is a new initiative in the 10-year market. They operate in the short-term market. When short-term rates fall they expect that long-term rates will fall as well, but long-term rates have been remarkably slow to follow. They fell a bit in recent days, but with the new program, we should expect significant activity. This would also included massive refinancing activities throughout the country.

So the Fed has tried to do a lot of things in a very serious financial crisis and I think that they get good marks.

BNA: What effects do you think that this $1.2 infusion might have?

JAFFE: There are several implications as a result of this new initiative. The Fed has decided to purchase a massive amount of 10-year bonds and replace them in the market with billions of dollars, lowering medium and long-term interest rates. This has been one of the objectives in trying to stimulate home buying, since short-term rates are as low as virtually possible and long-term rates have been sticky downward.

Refinancing by current and non-problematic borrowers are in play now. In effect, the prepayment option held by borrowers--troubled and others--has become much more valuable. The problem is that refinancing by non-troubled borrowers means gains for the borrowers, losses for the lenders, and nothing for most homeowners in trouble.

On the margin, it is possible for a few borrowers eligible for bailout relief under the federal program to now borrow and refinance at lower rates so as to make it easier to stay in their homes, but it is questionable as to how much impact this intervention will have on new buyers.

Much of the impact will be on refinancing households who just received a windfall gain due to the Fed's decision to purchase government bonds and lower longer-term interest rates. This will also have a dramatic effect on the value of the dollar--which is already plummeting since yesterday--and on the prospects for future rates of inflation.

The magnitude is amazing. This action put $1.2 trillion dollars--after all of the [recent] deficit spending--of newly borrowed money into the market.

I think the financial system is responding in the ways that we always thought it would respond. It's just that it was frozen for a long time and that's a bit unusual.

BNA: On March 15, Federal Reserve Chairman Ben Bernanke gave an rare interview on *60 Minutes*, saying that the financial situation should stabilize this year, with the beginnings of an economic recovery occurring in 2010. What did you think about that?

JAFFE: My understanding is that he made a decision to go to the public--Main street as opposed to Wall street--and I've always been troubled by this dichotomy--but my understanding is that Bernanke went on to talk to people in middle-class America to indicate that the future was not grim and that they are making progress and some things are working.

There are some suggestions that the financial system is recovering. For example, the spreads on credit swaps are lowering. The cost of borrowing for mortgages is falling. I think the financial system is responding in the ways that we always thought it would respond. It's just that it was frozen for a long time and that's a bit unusual.

BNA: So like anything frozen it takes a while to thaw properly?

JAFFE: It certainly does. When the future is uncertain, people don't know what's going to happen. Over the last 20 years recessions have been shallow and short. This one is deeper and is also accompanied by a rapid decline in household wealth. This isn't just about some people in manufacturing losing their jobs, this is also about a decline of pension fund wealth and the decline of household savings and retirement plans and so on, beginning with the declining house prices.

BNA: You mentioned a dichotomy between Main Street and Wall Street?

JAFFE:I'm always troubled by this. I think it's not as productive as people think. Main Street would be in trouble if we didn't have any banks. The financial system was at risk for a while and most people believe that we're not going to have recovery until the financial institutions are stable. So I think the interests of Wall Street and Main Street are not as diverse as some people think.

BNA: How much government help do you think the economy needs?

JAFFE: The question is, how much is enough? There's never enough, because there's an unlimited number of people who want bailouts. Now cities want bailouts, different industries want bailouts. It is clear that we need some sort of aggressive stimulus action because monetary policy has done almost as much as it can. Everyone agrees that there's some kind of fiscal policy needed, therefore there's not much disagreement about the need to run deficits in the short run and spend money on stimulus. There has been plenty of discussion about the way they have done it and the kinds of things they've funded.

My guess is that there's plenty of government spending to be done. The administration seems not to worry about what it means to run huge deficits. People are worried that in the future that this might lead to the depreciation of the dollar, this could mean inflationary expectations, but I think that with the seriousness of the issues right now, those problems will have to be dealt with in the future. Right now they're trying to get the economy up and running.

BNA: Most of our troubles can be said to have come from human greed and error. What steps, regulatory or otherwise, should we take to prevent this from happening again?

JAFFE: This isn't the first time we have seen a financial crisis due to the motivation of private individuals. Every decade there's something and there's always some policies to prevent repeating it, but the game moves on and [merely gets] played differently.

In this case we have a number of players that--without question--behaved badly, but it's very complicated because financial innovation gave rise to the ability to securitize these mortgages. There was an unlimited hunger for new mortgages that could be securitized. Because there was so much liquidity after 2001, the markets were flushed with resources, there was money everywhere, and, given the ability to securitize this, people were interested in these new instruments.

There was a money machine set up to do this and as long as asset values continued to rise the reality was postponed for the future, because with rising asset prices people could refinance even if they couldn't cover the mortgages. And if they didn't want to refinance they could sell it, they could flip properties and get bailed out. So the fact that they were agreeing to mortgages where there were huge resets and huge adjustments in two years with adjustable rate mortgages (ARMs) and option ARMs, that wasn't particularly pressing as long as asset prices continued to rise. So when they stopped rising--even when they didn't fall--then it was a problem. And a lot of the mortgage writing for people who couldn't possibly afford them became a problem as prices were falling.

The rise of mortgage brokers is a relatively new phenomenon, [manifesting] only in the last 25 years. Most mortgages were made at banks and savings and loans 25 years ago. But I think that half the loans were made by mortgage brokers--non-financial institutions--in recent years, and certainly a majority of the subprime loans were written by mortgage brokers. The [mortgage brokers] were not regulated by the Fed or other regulatory institutions for savings banks, they were just sort of players who were matching borrowers with investors. They accumulated money from around the country, made and packaged loans and sold them to the secondary mortgage market. So it is likely that there will be a set of regulations that will limit the ability of mortgage brokers to engage in these practices.

BNA: Do you anticipate or would you advocate a change in the way due diligence is performed?

JAFFE: Perhaps. The rating agencies have taken a lot of heat for this because they would rate a lot of these pools as AAA and didn't even know what was in them, they were so complicated. The ratings agencies are charged with providing an assessment of the quality of the instruments and they did not do that at all.

There are also some technical things. I came to the conclusion that the CDOs [collateralized debt obligations] were [so] complicated that people could not figure out what they were. Mortgage bankers took mortgages and pooled them into mortgage-backed securities (MBS), then they sliced them into different tranches. The CDOs were constructed from tranches taken from a wide range of MBS and it was this interaction between the different tranches across various MBS that made them very difficult to value. Those interactions are problematic … they exist today, [and] people can't figure out what they're worth.

So there are some technical aspects that exist with valuing securities that will have to be solved. There will not be a mortgage-backed security market like this in the future.

BNA: There seem to be a lot of bargains out there. What effect do you think they could have on the real estate market, especially the commercial real estate (CRE) market, down the road?

JAFFE: Commercial real estate has not been in play yet, in terms of the crisis. This has been a mostly residential financing phenomenon and is now a general economic downturn. The commercial market has held its own until now, but is now showing significant signs of slipping. The prices have certainly not bottomed out for CRE. I think, for instance, shopping centers are likely to fall in the months ahead. But the more general question, I think, is that when there's significant price changes--whether up or down--that always provides opportunities. Someone who owns it thinks that its time to sell, and someone [else] sees it as a bargain.

In residential real estate, where we have significant price declines around the country--especially in the former hot areas--for example, in southern California--you're beginning to see activity pick up, month to month, because houses are available at a fraction of their former value. That is a sign of the beginning of the recovery, sort of. So in markets like Los Angeles, Las Vegas, Phoenix, and Florida there may be some sales activities developing, but these are sort of vulture sales at the low end; either foreclosure sales or other specialized sales, because the inventory is so large … [and] the prices are low. There will be some of this going on, and I think the commercial market will be soft and is going to get softer and we'll see some surprising sales.

BNA: What should wise investors do right now?

JAFFE: The same things they used to do won't serve them well. For example, when they do a financial analysis, traditionally the expectation is that asset prices will sell these assets in the future at higher prices than they do now. Now, unless they're talking about long-term, I don't see much price appreciation in the next several years. Therefore the traditional analysis that says you're going to have price appreciation--I think that that kind of analysis is gone.

I think also that the market for CRE will be very slow because the market for CMBS is probably shut down, and so financing will be a problem. People with cash on the sidelines might be able to do like others have done famously in the past and behave like vultures, and pick among the down and out.

BNA: What is the single most important thing that has to happen to get CRE back on track?

JAFFE:I think the answer is that asset prices have to stop falling. When asset prices bottom out, the psychology will change and the expectations will be a lot better for the future and that change in mental psychology will stop asset prices from falling further and that will change the dynamics of the market. I think that is certainly true for residential but also for CRE, that the market prices will stabilize once there is a belief in the market that has reached the bottom.

BNA: And you said earlier that CRE is nowhere near the bottom?

JAFFE: The commercial market hasn't fallen as much yet and my guess is that it will follow the residential market and I think it is following the residential market because of the nature of this decline. If you look at the financing, the CMBS market is not even close to thawing yet. I think that's indicative.

BNA: What scars or changes do you anticipate on the overall face of CRE from this crisis?

JAFFE:I think it's a new era. I think there are significant scars. The period we've just come through [was] at least half a generation, if not longer, of incredibly available liquidity and financing. Plus, we had gone through a period [with] a lot of technology to make this financing even more available. A lot of that technology was worked out so that products in the real market reflected those technical developments.

We went through a period where world was flushed with liquidity. For real estate, especially CRE, that world is over now. Even when things stabilize we will be facing a period in which people will have to face real financing costs. Cheap financing will be very difficult to come by. It will be a period where … projects will have to live and die based on their cash flows rather than their abilities … with cheap financing sources. And I think this will be painful for a lot of people in the business because so many people have never known a period where they didn't have a large amount of liquidity.

I think that this period is going to be different, largely based on the different attitude toward real estate finance. Players will lament and remember the days when financing was readily available and they could do deals and make large profits because financing was so readily available. They are going to have to figure out how to make the deals based on the fundamentals.