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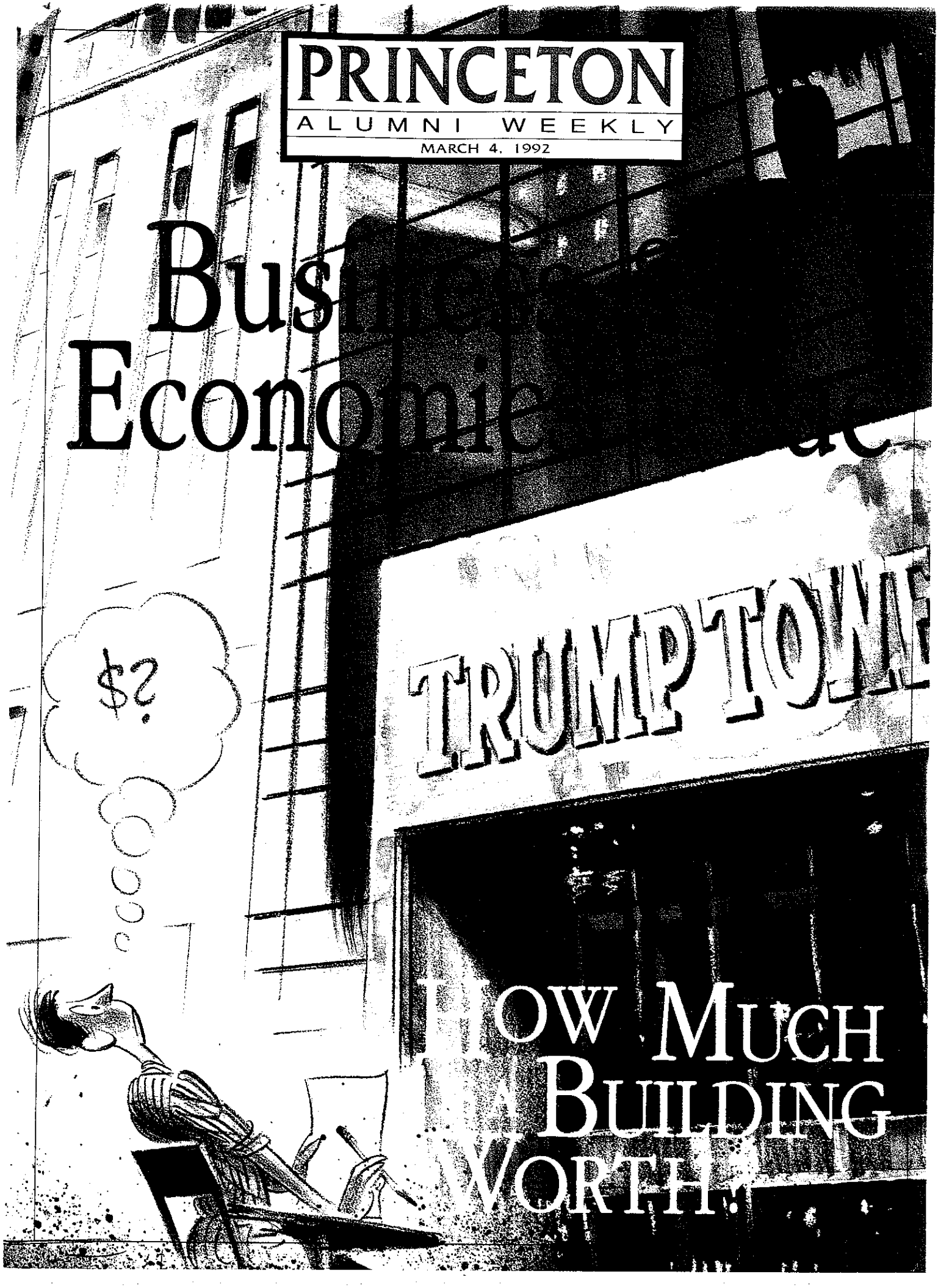


OW MUCH BUILDING ORTH

How Much Is a Building Worth?

Reflections on the Wondrous American Real-Estate Market

By Uwe E. Reinhardt

IMAGINE YOURSELF STANDING IN FRONT of Trump Tower or some other marbleous edifice and wondering, "How much is this #X$%&@ thing worth?" We regularly explore this question in my undergraduate accounting course, because it goes to the heart of the problem accountants face in placing values upon long-lived assets. But the question also goes to the heart of a larger question: How did America's real-estate industry get itself into its current fix?

To explore that question, let's begin with the simplest hypothetical case. You are loaded with zillions of dollars in loose change, and you are eyeballing a handsome skyscraper with one million square feet of rental space. The building is estimated to have a useful life of another fifty years. It now nets the owner an annual average of $20 per square foot, taking into account all annual operating expenses, routine maintenance, and the cost of renting the site (which belongs to the city), but not including interest payments or other costs of financing. Purely for the sake of simplicity, assume initially that this net rental income will stay at that level for the next fifty years, meaning that the building will throw off a net cash flow of $20 million a year for the balance of its useful life.

Under these circumstances, what would you be willing to pay for this edifice? Because you, the Princeton graduate, are superbly educated and always utterly rational, you would convert that fifty-year cash stream of $20 million per year into its "present-value equivalent" and call that the max you'd pay, would you not?

• Sigmund Freud, Irving Krankheit, And the Concept of Present Value

Just in case you forgot or never knew the concept of present value, let's quickly do a little Econ 101 on the idea, because it is so fundamental to the valuation of assets.

Suppose you deposited $100 in a bank that offered you a compound interest rate of 7 percent per year on such deposits. At the end of the first year, you would have $107 in your account. At the end of the second year, you would have $114.49—that is, $107 plus 7 percent thereon. At the end of the third year, your balance would be $122.50. At the end of fifty years, your account would have a balance of $2,945.70.

If Jones made you a totally believable promise to pay you $122.50 exactly three years hence, what is the maximum amount of money you would now pay Jones for that promise? You guessed it, of course! You'd pay $100, because that is all you would have to pay your friendly neighborhood bank today to obtain $122.50 in three years. In technical jargon, you would be discounting the $122.50 receivable three years hence at a rate of 7 percent per year to arrive at the present-value equivalent of that sum.

But if you trusted Jones a bit less than your bank, you'd probably not pay him quite as much as $100 for that promise, would you? You might pay, say, only $90. In so doing, you would be using, implicitly, a discount rate of about 10.82 percent per year, for at that interest rate $90 will grow to $122.50 in three years. We may think of the 10.82 percent as the sum of two components: the riskless rate of 7 percent, which covers the *opportunity cost* of investing your money in Jones's promise rather than in the trusted bank, and a premium of 3.82 percent to compensate you for the risk of investing in Jones's promise.

This risk premium is a phenomenon first explored by the renowned psychiatrist Sigmund

Freud in his monumental tome *Libido and Capitalism.* Risk, according to Freud, has the effect of ruining the capitalist's love life, as (s)he lies awake at night in a sweat, worrying about the possibility that financial promises may be broken. "Ven de love life is kaput," Freud theorized, "de poor kapitalist must sublimate, und nutting so helps in de act of sublimation as a few extra basis points of yield on das kapital inwestment." (A hundred basis points equal one percentage point.) It is a subtle point Karl Marx completely overlooked in his vituperative *Das Kapital.*

To compensate for the void in his or her life, the modern capitalist typically extracts from society a risk premium that varies inversely with the capitalist's position on the famous Krankheit Nervousness Scale. This scale, developed by one Irving Krankheit, M.D., ranges from –10 (utter, mindless despondency) to +10 (utter, mindless euphoria). The scale plays a crucial role in our economy, for, as we shall see further on, every so often American bankers and other financial "experts" climb frantically toward +10—the state of utter, mindless euphoria. Whilst there, their risk premiums actually swing into the highly *negative* range, as they fool themselves into making deals in which, at the end of the year, they effectively *forgive* the borrower x percent of the amount owed at the beginning of the year. If you find this incredible—and a rational person should—just ask The Donald (Trump), that princely ward of America's bankers, or the Canadian developer Robert Campeau, or Macy's Edward Finkelstein. All these gentlemen, and many more, have been recent beneficiaries of the bankers' beneficence. You might also read the chapter entitled "The Road to Junk Heaven" in Professor Louis Lowenstein's recent *Sense and Nonsense in Corporate Finance* (Addison-Wesley, 1991), especially his section "Why 'Prudent Bankers' Is an Oxymoron."

• Placing a Value upon a Building

Equipped with these ideas, let's return to the hypothetical skyscraper whose current value we are trying to determine. The building, you will recall, "promises" a fifty-year net cash stream of $20 million per year. If you were willing to convert this future flow of cash into its present-value equivalent at a discount rate of 7 percent, you would be willing to pay about $276 million for that edifice. (I'll spare you the math. Alas, my students aren't so lucky.)

But would you really be prepared to pay quite that much? On reflection, surely not. Owning a building is always risky. For example, competition from other buildings might drive the net rental fees below $20 per square foot. The building might have prolonged periods of high vacancy rates. It might be found to have been constructed with a cancer-causing material. Crime might grow in the area around it. There are many such worries, and these could ruin your love life as you fretted about them.

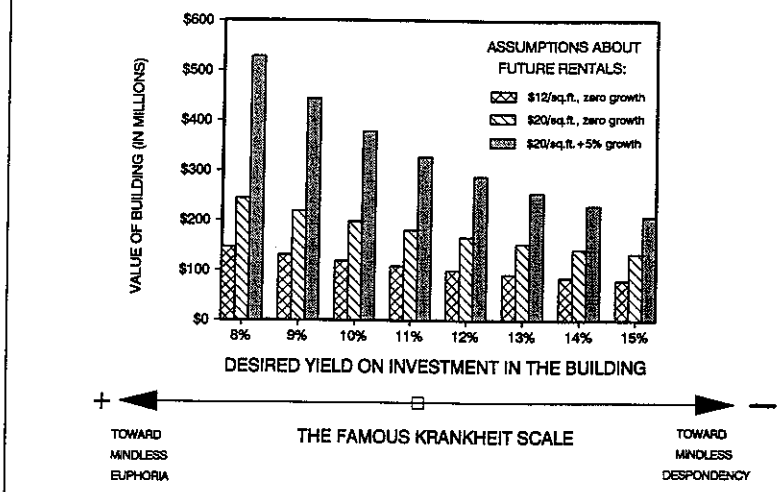
Suppose your very best guess is that the building will, indeed, yield an annual cash flow of $20 per square foot, but you aren't certain. That uncertainty makes you slide down your Krankheit Scale toward, say, –6. An equation deeply embedded in your emotional software translates this somber score into a risk premium of 500 basis points, or 5 percent. In other words, you must insist on an overall annual yield of 12 percent on this deal—7 percent to cover what your cash would have earned in the bank, and another 5 percent to help you sublimate properly. At a discount rate of 12 percent, however, you would be willing to pay only $166 million for the building.

Figure 1 shows what the building might be worth to you under varying assumptions about future net rentals and at different desired yields. That expectations of lower rental rates will lower the value of the building should be intuitively obvious. But even if your best guesstimate about future rentals does not change, mere uncertainty about the future can lower your estimate of the present value of real estate, because uncertainty makes you slide down the Krankheit Scale and raises the rate at which you discount future cash flows. This is especially true if rental rates are expected to grow over time, as is clearly shown in Figure 1.

FIGURE 1

THE VALUE OF A BUILDING TO AN INVESTOR

UNDER VARIOUS ASSUMPTIONS ABOUT THE FUTURE



We can draw from the preceding analysis—particularly from the role played by the risk premiums investors exact—the following important insight: even if the fundamentals of our economy are sound, uncertainty about the future can seriously depress the value of assets in the economy, because it drives down peoples' Krankheit Scores and, thus, increases the risk premiums they demand on investments. It may be said that one of President Reagan's economic achievements was to pull up the nation's overall Krankheit Score from the depths to which Jimmy Carter's incessant talk of a national malaise had driven it. To some extent, our presidents can act either as economic aphrodisiacs, so to speak, or as economic saltpeter.

• The Brittleness of Rental Rates

Fundamental to an understanding of real-estate values is that, once a building has been constructed in a city, the square footage offered for rent is

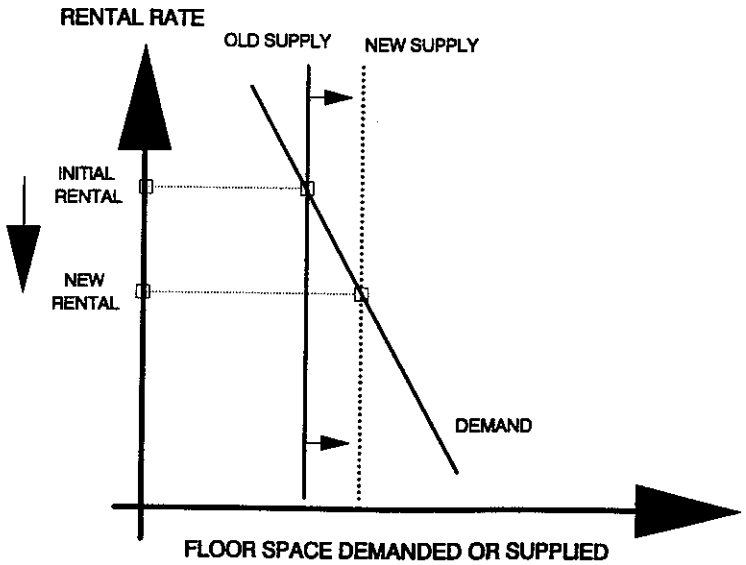
Uwe E. Reinhardt

highly insensitive to rental rates. The source of this price-insensitivity resides in the cost structure of real estate. Once it has been built, much of the cost of an edifice comes from amortizing construction costs in the form of depreciation expense. Unlike operating expenses (such as heating, maintenance, security, and so on) and debt-service payments on loans used to finance the construction, this depreciation expense does not cost the owner cash at the time it is "booked." It merely represents the accountant's more or less arbitrary way of spreading the original construction costs over a series of fiscal years.

As you may recall from Econ 102, the owner of a building in an overbuilt market will accept rental rates far below the total "book" costs of the building (including depreciation expense) as long as the proceeds of rentals exceed current operating costs. Any contribution that rental receipts make toward debt service and depreciation expense is better than nothing, even if the building operates at an overall "book" loss. In fact, the owner will eventually accept rental rates that do not even cover debt-service payments, let alone depreciation expense. In that circumstance, the owner will plead with his or her lenders to "restructure" the loans (in plain English: to reduce the interest rate specified in the mortgage ex post facto, or even to forgive some principal by accepting a minority equity position in the deal). Failing this proposition, the owner will simply "walk off" the deal altogether, leaving the lenders to assume ownership of the building through foreclosure. Rare is the owner who will throw more good cash into a bad deal just to honor a mortgage. In short, the owner of a building in an overbuilt market will make truly awesome concessions to potential renters. In the jargon favored by economists, the supply of floor space is said to be price-inelastic.

FIGURE 2

THE SENSITIVITY OF RENTAL RATES TO SHIFTS IN THE SUPPLY OF FLOOR SPACE



The demand for floor space in a given market also tends to be price-inelastic, at least in the short term. This is because the number of posteriors to be seated in offices tends to be relatively fixed in the short run (barring some major change, such as a large employer moving into or out of the area). Figure 2 shows that, when both the demand for something and its supply are insensitive to price (in this case, rental rates), even small shifts in a particular market's available supply—say, a skyscraper or two—can trigger large swings in prices (rental rates). In many American cities, rental rates recently have plummeted from $20 to $30 per square foot to $10 to $15 per square foot in the span of just a few years.

• Real Estate in the Roaring Eighties

Armed with the foregoing principles, let us now contemplate the real-estate lending practices of American and foreign banks during the 1980s.

Two types of loans generally come into play in real-estate deals. Usually, a commercial bank is the prime lender to a developer during the construction of a building. Once the building is completed and substantially leased out, the construction loan is paid off with the proceeds of a more long-term mortgage loan, which may be offered by a commercial bank as well or (more typically) by an insurance company or a pension fund.

Mortgage loans are so-called "non-recourse" loans, which means that they are secured only by the value of the underlying real estate. If the borrower cannot service the debt as scheduled, the lender cannot claim any of the borrower's other assets. As already noted, the lender can take possession only of the building itself. For this reason, a prudent lender normally lends a developer much less than 100 percent of the value of the building and asks the developer to contribute the balance in the form of equity (ownership) capital. This equity cushion protects the lender in two ways. First, should the value of the real estate fall, it is the owner's equity position that evaporates first. Second, it gives the developer a powerful incentive to manage the building efficiently.

Alas, during the wild 1980s many American and foreign lenders saw fit to finance close to 100 percent of the cost of new real-estate projects, leaving only trivial equity cushions. For reasons that warrant further analysis by economic historians, players in the world of finance rocketed on the Krankheit Scale toward "mindless euphoria." Amidst the euphoria, the nation's real-estate developers achieved an astounding feat: they managed to impose upon traditionally cautious lenders a game of "Heads I Win and Tails You Lose." In a typical deal, if the value of the real estate financed by the lender shot up, the gain usually was entirely the developer's, as (s)he owed the lender only the interest and fixed principal of the mortgage loan. But if the value of the real estate plummeted below the amount of the outstanding

PHOTO BY ROBERT P. MATTHEWS

loan, the developer simply defaulted on the loan's debt service, leaving the lender holding title to real estate with a vastly deflated value.

We should not, of course, blame real-estate developers for the financial disasters this one-sided game eventually triggered. It is well known that developers, like cowboys and wildcatters, are the economy's ultimate romantics. The mere sight of a vacant lot tends to trigger in them a Pavlovian response that they are powerless to resist: their blood pressure rises, and their hearts palpitate, as their minds swiftly project some bold structure into that plot, with nary a thought to the region's demand for office space. Just as swiftly, they will produce a handsome rendering of that structure, and, as long as some banker will play along, they'll secure forthwith the financing for its construction. In *Libido and Capitalism*, Freud diagnosed this affliction as the "Edifice Complex." He identified prudent lending practices as its only known remedy.

Naturally, if a lender does not demand from a developer a healthy share of equity capital, we can hardly expect those afflicted with the Edifice Complex to exercise caution as they contemplate the erection of yet another building in an already overbuilt city. Such an expectation would be inhuman. In the 1980s, of course, the developers were egged on by a host of professional up-front fees for sundry services—such as their ability to massage local zoning codes—that they could tack on to their deals. In many instances, these up-front fees substantially covered the minimal equity position a developer may have had. Markets naturally became overbuilt. Vacancy rates for office space now run to 20 percent or more in most American cities, which are also plagued by excessive numbers of hotel rooms, condominiums, and shopping malls. It may take a decade or so for the economy to absorb all this space and for the nation's commercial real-estate market to recover fully.

•The Economic Fallout from the Game

The empty office towers and housing developments across the land now stand as reminders of the waste begotten by this game. Yet it is easy to exaggerate the magnitude of this waste. Indeed, there actually may be a silver lining in this otherwise dark cloud: while European and Asian businesses are constrained by scarce, high-priced real estate, American entrepreneurs can look forward to a long-term buyers' market. Arguably, the glut of space may eventually contribute to economic growth.

In my view, the main damage wreaked by the developers' game has been on the balance sheets of the nation's financial institutions and in the minds of the executives who run them. When the financial sector catches a mere cold, the rest of the economy often catches pneumonia. Right now, the executives of these financial institutions (and, lest we forget, the nervous governmental regulators who oversee them) seem disoriented and more than a bit gun-shy, as their Krankheit Scores have plummeted toward mindless despondency. Consequently, they now seem unwilling to finance even intrinsically sound capital projects. And without this kind of investment, it will be a long time before the economy recovers. Those who lose their jobs as a result of the bankers' high Krankheit Scores, or who have failed to get the jobs they might otherwise have obtained, are among the chief losers of the game.

Another set of losers are the shareholders of the commercial banks, savings-and-loan associations, and commercial insurance carriers who, in turn, financed the developers' game of Heads I Win and Tails You Lose. The managers of these financial intermediaries stuck their shareholders with assets (loans receivable) whose book value now far exceeds the deflated value of the real estate securing the loans. These managers are now busily writing off against their shareholders' equity billions of dollars of loan balances they will never collect.

In any lending institution, shareholders' equity is the first cushion to absorb a write-down of asset values. Depositors' funds are the second cushion. Luckily for the depositors of commercial banks and S.&L.s, the federal government's deposit insurance deflects these shocks onto the taxpayer—yet another of the game's hapless victims—possibly to the tune of $200 billion or so in present-value terms. Government-backed deposit insurance has its virtue, to be sure, but it also serves to combine the worst features of capitalism and socialism in one legal entity, as the S.&L. industry so clearly demonstrated during the 1980s.

It may take a decade for the economy to absorb all this excess space.

And what of the mutual companies—financial intermediaries such as pension funds and insurance companies—which have neither shareholders nor insured depositors, and whose suppliers of funds are the so-called "participants"? The only choice these intermediaries have is to pass on the write-offs to their participants in the form of lower overall yields to savings than had been anticipated when the real-estate deals were first struck. It remains to be seen if, ex post facto, the overall yields will be higher than what could have been earned elsewhere with these funds.

Finally, we should reserve some compassion for our nation's valiant professors of finance, who must somehow work the wondrous 1980s into their lectures on the much-cherished *efficient-market hypothesis*. According to this theory, the seasoned adults who run the financial markets value assets efficiently and, in the process, allocate the nation's scarce capital efficiently, even as their Krankheit Scores undulate from –10 to +10 and back. Try sometime to sell that theory to your neighbors with a straight face, even after a Scotch or three. You will discover that such a sales job presupposes not only superb analytic skills and the power to abstract, but also superb control of certain facial muscles.

But perhaps you will prefer a theory according to which our financial markets are sometimes quite efficient and sometimes just plain *meshuga*. You might have a point there, and you probably could make money with such a theory!

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THE ASIAN WALL STREET JOURNAL

5 [illegible] FRIDAY - SATURDAY, DECEMBER 14 - DECEMBER 15, 1990

Soft Property Market Pinches U.S. Banks

By David B. Hilder
Staff Reporter

Rising 48 stories above downtown Indianapolis, the $200 million Banc One complex, little more than half-leased, is a monument to the overbuilt U.S. commercial real-estate market. It also illustrates a major dispute over how to value real estate.

When Citicorp took the lead in making a construction loan for the building in 1987, the developer, Galbreath Co., hoped to lease the almost one million square feet of office space for nearly $20 a square foot. But the annual rents have dropped as low as $12 a square foot, and the building isn't generating enough cash to pay the interest on the loan.

By some valuation methods, the tower today might be worth only half what it cost to build. Should Citicorp and other banks, which could end up owning the building, write off half the value of their loans? Or should the banks take smaller write-offs because they don't plan to sell the building until real-estate prices recover, perhaps in several years?

The difference, applied to $350 billion of commercial real-estate loans on the books of U.S. banks, is sending shock waves through the nation's financial system.

For dozens of banks that were big real-estate lenders in the late 1980s – and now are enmeshed in a debate with regulators over this accounting issue – what is at stake is survival. And even many banks that survive the current real-estate slump will be seriously weakened; funds that they set aside for potential loan losses must be subtracted from earnings or capital even before any losses are incurred.

Drying Up

Meanwhile, lending for commercial properties is drying up, and the scarcity of financing for real-estate purchases can create a vicious cycle: Illiquidity in the market drives down values, that forces bankers to set up bigger loss reserves, and that further crimps their lending.

Many bankers complain that regulators are overemphasizing short-term market problems. "Real estate is not one of those commodities that can be sold quickly," says Richard Sprayregen, a real-estate accountant at Kenneth Leventhal & Co., of Los Angeles. "If you have to evaluate it on a moment-in-time basis, you would most likely always come up with a valuation that's quite low."

Bankers have traditionally been able to ride out their big problems, largely by treating them on their books as if the economy or the borrower's prospects would improve. Most big banks, for instance, don't value their troubled loans to less-developed countries as if the loans had to be sold in the open market today.

However, regulators say the lower values that they want put on real estate reflect a fair estimate of future values. They also contend that a large dose of reality is needed to curb the overexpansion in real estate and bring supply and demand back in balance faster.

Robert L. Clarke, the U.S. comptroller of the currency and chief regulator of 4,200 federally chartered banks, says that valuing real-estate loans is necessarily inexact, but he defends his examiners' methods as realistic. "We're not smart enough to tell precisely how much loss there is in a loan, and neither are the bankers," he says.

But bankers complain that the regulators' approach to determining real-estate values and reserves for real-estate loan losses is far different today than it was during the last national real-estate recession, in the mid-1970s. At that time, Bank of Boston Corp., for example, had about the same portion of its loans in the problem category as it does today, Ira Stepanian, the bank's chairman, says. However, in the 1970s, he says, loan-loss reserves were set at only about 1% of total loans, compared with 4% today. "Do we really need four times the reserves?" he asks. "I think the answer is no."

Some bankers and accountants say bank examiners are taking a "mark-to-market" approach to real estate, in effect marking the value of loans down to whatever price the regulators estimate a property might fetch if sold immediately.

"Examiners are making some estimate of the current value of the collateral and requiring banks to either establish loss reserves or write down the asset value, even if the loan's balance is current," says Thomas Taylor, an accounting partner at Ernst & Young and chairman of the bank committee of the American Institute of Certified Public Accountants.

Bankers' Dismay

He understands the bankers' dismay, he says. "Why would you recognize a loss today for a loan that's currently paying in accordance with its terms and the bank has no intention of taking title (to the property) and disposing of it?" he asks.

Bank regulators deny marking to market. "We're reflecting what we think the long-term value of that loan is going to be," says Karen J. Wilson, deputy comptroller of the currency for the northeastern U.S. "If you were marking to market, you'd have much more dramatic write-downs than you do."

Ms. Wilson says bankers may think that examiners are marking to market because

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the examiners are now basing estimates o new, sophisticated computerized model. "In the '70s, when we looked at an a praised value and felt that the apprais needed to be adjusted, we did a calculatio on the back of an envelope," she says.

For U.S. banks, problem real-estat loans are like a morning-after headache. I 1987, real-estate loans surged past comme cial and consumer loans to become th banks' biggest lending category. Of the $51 billion increase in all categories of ban loans from 1984 to 1989, $367 billion, or 72% was in real-estate loans. The loans fuele unprecedented overbuilding, especially o office space.

Bankers are unwilling to disclose spe cific examples of how regulators have forced them to revalue properties anc loans, citing client confidentiality and rules prohibiting banks from revealing the re sults of examinations. A typical situation, however, is described by Guilliaem "Rusty" Aertsen, who heads real-estate lending at Bank of Boston. The bank, in valuing property, uses a discounted cash-flow analysis similar to regulators' methods.

Figuring the Values

Nine months ago, Mr. Aertsen says, a 10-year-old office building in Boston might command effective annual lease rates of $25 a square foot after its owner made improvements worth $5 to $10 a square foot. The owner could expect to lease the space in three to six months. In that case, the bank might apply a discount rate of 10% a year to the anticipated cash flow – the rent revenues minus the costs of operating the building – in estimating the property's net present value.

Today, Mr. Aertsen says, that same building might have effective rents of $15 to $18 a square foot, tenants might demand improvements costing $15 a square foot, and leasing the space could take nine to 12 months. In addition, the bank would apply a 12% or 13% discount rate to projected cash flows, substantially reducing their net present value. So, the building's estimated current value would drop 20% to 40%.

However, Mr. Aertsen says, the building is in Boston, not a suburb where it might never be filled up. "If you look at it two or three years from now, a lot of those variables might become better."

In such a case, bankers say, regulators are being unrealistic in forcing them to write down the building to today's value because the bank will hold the property until the market recovers. (So far, insurance companies haven't had to take similar write-downs, although regulators in some areas are moving in that direction.)

U.S. Banks and Regulators Spar Over Real-Estate Values

The chairman of a large northeastern bank cites another regulatory thicket: After lending $16 million to build an apartment building in a weak rental market, the bank finds that the project, though 97% rented, produces enough cash to make payments on only about $12 million of debt. The bank wants to write off $4 million, restructure the loan at $12 million and then move it out of the nonperforming category. But regulators and accounting rules won't allow that. Banking consultants say regulators are enforcing the letter of the law on loan documentation and appraisals that once might have been waived.

"The care with which they are reviewing each loan, the demands for current realistic and even pessimistic appraisals and the unwillingness to give the benefit of the doubt on any appraisal is the primary mechanism used by the regulators to stiffen credit rating," says Christopher L. Snyder Jr., president of Loan Pricing Corp., of New York, which helps banks evaluate loan portfolios. "It's unfortunate that these rules weren't tightened two or three years ago in a more gradual and orderly way." Now, he says, the change has "forced the downgrading of billions of dollars of loans," and probably "many good loans have been sold off at a loss."

Another major problem is the "performing nonperforming loan." On such a loan, the developer has made all interest payments on time – so the loan is "performing" – but bank examiners expect it to go into default soon because the cash income from the project isn't enough to cover future interest payments. In the regulators' view, the loan is performing only because the developer is paying the interest from the original principal or by dipping into his own pocket – and neither maneuver can long continue.

At Fleet/Norstar Financial Group Inc., a big Providence, Rhode Island, bank holding company, $360 million of loans on which interest payments were up-to-date or less than 90 days past due have been put on non-accrual status, meaning the interest isn't included in quarterly revenue. In addition, Fleet/Norstar has set up loss reserves equal to about 75% of the loan amounts.

Why? The regulators "keep referring to Texas," says John W. Flynn, the company's vice chairman. On such loans in Texas, he adds, regulators say "suddenly, one month, there were no more payments" from the developer to make up the cash shortfall on a project. Regulators fear a rerun of that elsewhere, he says.

How would such a loan have been treated in the mid-1970s? Generally, it would have been on performing status, Mr. Flynn says, adding: "The climate and the rules in effect would have made it far easier to have gotten that property sold and the loans restructured."

Regulators are also tougher when valuing foreclosed real estate. Under accounting rules, any property that a bank owns through foreclosure must be accounted for at fair market value. But in valuing properties in some areas with few sales of comparable real estate, regulators are discounting expected cash flows at annual rates as high as 13%.

The current climate is putting a freeze on construction and the resale market for commercial properties. "Effectively, no one is making real-estate loans," Mr. Flynn says. "The normal process of real-estate properties being bought and sold on an ongoing basis is certainly not taking place in the northeast, and there is evidence that it isn't taking place in other parts of the country."

However, many analysts view bank regulators as closer to reality in valuing real estate than bankers and developers are.

"The reality of vacant space and falling rents is not being caused by the regulators," says David Shulman, who heads real-estate research at Salomon Brothers Inc. "It's being caused by the marketplace. While most lenders were assuming 5% vacancy rates, that assumption is no longer tenable because the vacancy rate is 20%."

Counting vacant space and buildings under construction, Mr. Shulman puts office space waiting to be filled at a 10-year supply. "There are only two places in the country where you can find a 5% vacancy rate," he says. "One is Honolulu and the other is on a developer's pro forma," a projection made to justify building plans.

'Far Different Results'

Regulators, too, blame the real-estate slump and deny changing the rules. "In the kind of environment we're in, the application of the same sets of rules produces far different results than in an environment where all the curves are going up," Comptroller of the Currency Clarke says.

However, many bankers and analysts suspect regulators of overreacting to what several call "the Danny Wall syndrome," named after the former top savings-and-loan regulator who resigned last year in the wake of congressional criticism that he was far too easy on some S&Ls that later failed. "No examiner's career will be ended by being too hard, but it may be ended by being too loose," says Eric Hemel, a former economist for the S&L regulatory agency and now a First Boston analyst.

To such observations, Mr. Clarke says, "It's hard to know in this environment whether you can get into more trouble by being too tough or too easy."

Fifty years ago the Japanese bombed Hawaii. This year Hawaii is bombing the Japanese banks—to the tune of billions of dollars.

Banzai loans

By Thomas Bancroft

Don Riggs/Forbes

Would-be Four Seasons Hotel on the island of Hawaii **Like many other Japanese projects around the state—out of money.**

DRIVING NORTH along the coastal Queen Kaahumanu Highway on the big island of Hawaii, just past the Kona airport tourists are confronted with an incongruous sight amidst the fields of black lava: a skeleton of steel girders, a half-completed golf course and a solitary crane that hasn't been moved in weeks. This was to have been the Four Seasons Hotel, but the Japanese developer, Cosmo World, ran out of money, and its banks won't refinance the loan.

An increasingly familiar sight in Hawaii is half-finished resorts scrapped or suspended by their mostly Japanese sponsors. Fueled by inflated Japanese real estate values and cheap financing, the Japanese have poured billions of dollars into vacation projects in the islands since 1985, in the process increasing the number of luxury hotel rooms to roughly 13,000. Hotel occupancy rates in Hawaii are 72% (close to an alltime low for the state), down from 81% only five years ago.

Victims of the recession? It goes deeper. Many of the projects never made economic sense to begin with. Take the recently opened Grand Hyatt Wailea on Maui. It cost $600 million, about $800,000 per room, to build. It features such touches as a $2 million statue of a fat naked woman smoking a cigarette and 800 tons of granite imported all the way from Mount Fuji. With interest costs close to $100,000 a day, the Grand Hyatt will have to run 100% occupancy and charge an average room rate of $500 a day to break even.

Filling those rooms to anything like 100% will be a near impossibility. Occupancy rates in surrounding area hotels were 52% for the first six months of the year, with the average room rate running about $130.

Industrial Bank of Japan financed the majority of the Grand Hyatt, but it is not the only Japanese bank stuck with huge loans on inflated properties. Other big losers include Long Term Credit Bank of Japan, Mitsui Trust and Dai-Ichi Kangyo Bank. Together with developers, they have invested some $10 billion in island resort properties over the past decade, probably few of them today earning their interest.

What caused the glut? You can't blame the developers: Give them money and developers will develop. Blame the banks. Eager to make loans at the then prevailing Japanese interest rates of 3% to 4%, the banks shoveled the money out, frequently taking as collateral Tokyo real estate that was itself overvalued.

Most of the loans had adjustable floating rates, and were largely based on asset values, not cash flow, says David Ramsour, chief economist at the Bank of Hawaii. If a developer needed more money, say to cover an operating deficit, he simply pledged additional property in Japan.

But the economy changed radically in Japan in the last two years. The prime rate jumped to 8%, doubling interest expenses on many of Hawaii's hotels. Property values in Tokyo slumped. The Ministry of Finance told the big commercial banks to stop lending to construction projects outside Japan. Properties once trophy pieces have become nooses around the necks of developers and lenders. Many are said to be for sale: in Kaanapali, for example, Masao Sen's Embassy Suites; in Maui, The Four Seasons Wailea.

There is speculation that billionaire Kitaro Watanabe is being pressured by his banks, one of which is Mitsui Trust, to relinquish control of his numerous hotels, including the Hyatt Regency Waikiki. A Watanabe spokesman denies this.

How badly hurt are the Japanese banks? Worse than they will admit; few would respond to FORBES' queries on their Hawaii losses. Banking laws and customers in Japan are considerably different from those in the U.S. For instance, Japanese banks are allowed to work out the troubled loan with the developer, often restructuring the loan or writing it down without foreclosing. Or they find another borrower to take over the project to avoid the public embarrassment of foreclosing.

But there can be no denying that losses could run into the billions of dollars, a serious drain for banks already facing something of a capital shortage. In the Japanese way, the problem will probably be disposed of quietly, but the pain will be very real. ■