

Donald Rundblom Discusses Mortgage Markets, U of I

Donald Rundblom has an extensive background in the mortgage lending and mortgage-backed securities fields. In fact, he could be called a pioneer in the area of commercial loan securitization. His own story, to a great extent, parallels the development of the secondary mortgage markets over the past several years.

A native of Wheaton, Illinois, Rundblom began his collegiate studies as a forestry major at the University of Montana. But after a year, Midwestern roots and career considerations led him back to Illinois and to the real estate concentration in the University of Illinois finance program. While still a U of I student, Rundblom became involved in property management and real estate development.

Upon graduation in 1975, Rundblom began a series of career steps that have taken him from traditional corporate finance to mortgage lending to the forefront of Wall Street's involvement in mortgage-backed securities. In September of this year, Rundblom left the fast-paced New York lifestyle behind and returned to Illinois to form a commercial mortgage banking firm with Champaign businessman Clint Atkins. Rundblom will also teach the University's course in Real Estate Financial Markets in the coming semester.

ORER Letter spoke with Rundblom on his career, past and present; on the real estate and mortgage markets; and on his instructional undertakings.

How did your real estate career take shape? I got a good start from my course work at the University. Karl Guntermann was in charge of the program, Jerry Wagner taught investment, and Austin Jaffe was a T.A. And while I was in school I managed student apartment complexes for Norrick and Morrow. During the two school years and summers I was there, I progressed to looking at deals they were putting together and doing demographic research.

I wanted to work in real estate when I

graduated, but the job market was still suffering from the 1973-74 recession. Brunswick Corporation interviewed on campus, and I accepted a position in their corporate finance department. It was an interesting job, analyzing the credit of companies Brunswick dealt with. And while it wasn't really what I wanted to do, the job brought me into contact with mortgage bankers Salk, Ward, and Salk. I worked with them on a bond issue they underwrote for Brunswick to finance construction of bowling alleys.

In June of 1976 Salk asked me to join their organization. That was the start of my career in commercial mortgage banking. They were then one of Chicago's premier mortgage bankers; many successful Chicago mortgage bankers got their start working for Salk. I began as a loan analyst, doing everything from appraisals to demographic studies on financing deals senior partners were putting together for institutional clients. A year after joining the firm, I graduated to loan officer. My job was to contact developers who needed financing for commercial, industrial, and multi-family projects, and then place the loans with various correspondent lenders. I left Salk in 1978 to become a loan officer with Banco Mortgage, which later became Norwest Mortgage and is now GMAC Mortgage. My duties still involved commercial mortgage banking, though I had more autonomy. But by 1979 I saw a cloud on the mortgage banking horizon. I felt rates might go above 10%, and I didn't see how you could do deals at 10% rates. So I accepted a position, which I held for almost five years, at Talman Federal in Chicago, supervising origination of commercial, industrial, and multi-family loans. I was responsible for procurement, bringing in new business. I saw myself as a mortgage banker working for a captive portfolio.

Our operation was very successful. When I joined Talman, assets were about \$2.3 billion. A series of mergers with other S&L's, some of them billion dollar institutions themselves, took the level to

about \$6.5 billion. Unfortunately, interest rates went quite high, and the portfolios of the acquired S&L's had a lot of loans at very low rates. Under "purchase accounting," assets were marked to their current market values. The difference from par was put into goodwill and amortized over forty years. It kept thrifts technically solvent and in business.

Rates finally started to rally, that is to move downward, allowing us to recognize some profit and to do some balance sheet restructuring. Thrifts had begun more active asset-liability management; they didn't want to hold long-term loans financed by short-term deposits. To better manage its portfolio, Talman began, as did many thrifts, to sell loans in the secondary market. I was in charge of the commercial portfolio; it had a value of probably \$250 million.

Selling these discounted loans was my first exposure to Wall Street. In 1982 Talman worked with First Boston and Salomon Brothers in structuring some early forms of commercial mortgage-backed securities. Selling a couple of hundred million dollars' worth of some of the first commercial mortgage-backed securities to other institutions and to Wall Street really developed my interest in the field of securitization.

In the summer of 1983, Fannie Mae contacted me about running their new multi-family mortgage operation out of Washington; they had just received HUD approval to buy non-insured multi-family loans in the market. They decided I was too young for that position, so they hired me to run the Midwest operation.

Over the next few months we got approval for a Midwest loan servicer and put some loans on the books. But then at the end of 1983, after I'd been with Fannie Mae less than six months, First Boston invited me to join their operation in New York to trade commercial whole loans. Fannie Mae was a very interesting place to work, but Wall Street was a career move I couldn't pass up.

At First Boston I started an operation to trade commercial loans and other real

estate related products. This was during the period when the market for whole loans, both residential and commercial, was really developing. I was involved in trading at First Boston for close to two years. Then Morgan Stanley offered me the chance to get into the actual structuring of securities. I accepted a position in the mortgage products group within their Fixed Income department. I worked on structurings with insurance company clients and with our real estate department, known initially as Brooks Harvey and now as Morgan Stanley Realty.

Morgan Stanley Realty people were the classic brokers and mortgage bankers on high profile transactions. When they had a large scale project and wanted a securitized transaction so they could commit to the developer, they worked with me and with the Fixed Income department. The mortgage products group handled a number of investment banking activities, including mortgage finance, commercial mortgage-backed securities, strips, collateralized mortgage obligations (CMOs), AA-rated pass throughs, and other asset-backed transactions, such as securities backed by car loans or airplane leases. I was involved in those activities from 1985 until I came back to Champaign.

What could lure a Wall Streeter back to the prairie? The opportunity to work with a long-time friend, Clint Atkins, did the job. Clint has many business interests, including Hobbico, Herr's in Danville, and his accounting, insurance, and real estate operations. It's great to be employed by someone who supports the University the way Clint does; he's willing to let someone coming in to build one of his new businesses take time for activities on campus. He's been very supportive of my plans to teach a course.

Clint hired me to start a commercial mortgage banking firm, and to run his new real estate acquisitions program. We'd like to eventually operate nationwide, but we're starting in the Midwest because of the importance of property management. While we're putting together the infrastructure of this firm, it would be difficult to effectively manage an apartment complex in San Diego.

For now, we see remarkable potential here, in a community at the crossroads of three Interstates and within a few hours of Chicago, St. Louis, and Indianapolis. I think you'll see continued growth in Champaign-Urbana, particularly in warehousing and distribution. The economy is stable, because of the University and a diversified group of other employers.

We want to start out buying existing properties instead of developing. I know the insurance industry, which has followed a portfolio strategy of owning both mortgages and equities. We think the equity component is starting to turn over, and that's good for us; it's the type of high quality product we definitely want to consider. We've got the mortgage banking firm to do our leveraging, and we'll provide our in-house expertise to other people. I'm not sure that the area has yet attracted its fair share of capital. By approaching life insurers and other major institutions, I feel we can introduce a new element of competition that will benefit developers in Central Illinois.

What are your activities with the Mortgage Bankers Association? The Mortgage Bankers' Association of America is a tremendous trade organization. People don't realize how many different types of firms are involved. In addition to mortgage bankers, commercial banks and S&L's are major members. Insurers, pension fund advisors, and Wall Street firms are also active participants. MBA is split into two segments, residential and commercial. The Association's biggest committee is the income property committee. As one of four vice-chairmen of that committee, I'm in charge of overseeing a number of subcommittees, including the securitization and secondary markets subcommittee and the environmental subcommittee. The environmental area is extremely important right now. Hazardous wastes and asbestos are having a major impact on lending practices and loan purchasing.

Lenders face tremendous liability exposure. For example, a lender in Maryland foreclosed on a property and was held liable for toxic waste cleanup. So now before lenders foreclose and take title they investigate their liability. A

cleanup could easily cost more than the market value of a property. Or consider a building built in the early 1970's with asbestos. There are lenders that will not lend on properties with asbestos problems, even midtown Manhattan properties. Removal costs can be extraordinarily high; think how that affects property value. This is a major issue that we've barely begun to uncover.

Which other mortgage market developments should we be following? We've only scratched the surface on where the secondary markets are going to go. No longer are lenders assuming that loans will be held to maturity in their portfolios. Institutional investors are certainly looking at commercial lending for purposes other than their own portfolios. A couple of insurers are looking to originate commercial mortgage loans to use as collateral for CMO's. Although there is a lull at the present, I think capital market firms will continue to be committed to this area.

By definition, every loan a mortgage banker makes is to be sold. Lenders that make loans conforming to Fannie Mae and Freddie Mac standards look to Wall Street to hedge risks and make a continuing market in their newly-created securities. Wall Street is very important for residential mortgage bankers, and is becoming important to the commercial market. During the past eighteen months a tremendous flow of funds has become available for long-term commercial mortgages, particularly from insurers flush with cash. Yet the real estate market nationwide has been seriously overbuilt. There isn't the same quantity of quality assets to lend on that there once was.

Securitization of new loans over the past few years hasn't been as strong as it was in the immediately preceding period. There's been so much competition among lenders for a finite supply of products that spreads have been driven down to a point at which it's difficult to make money doing commercial securitization on new originations. I view these thin spreads as a short-term phenomenon, though it's hard to say when the trend will change.

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The Morgan Stanleys and First Bostons try hard to find arbitrage possibilities, but the spreads just haven't been there. There was a big bang a couple of years ago about commercial conduits being formed to channel originations into securities to be sold worldwide. It hasn't occurred, because traditional lenders, especially insurance companies, have become so aggressive in lending on quality properties that it's not profitable to package the loans into securities. Money can't be made on thin spreads, given the cost of rating agencies, registration, credit enhancement, and underwriting.

On the residential front, you can see why sometimes there aren't many CMO's available in the market; many different dealers watch every tick of the market, and as soon as there's an arbitrage possibility they hit it. Morgan Stanley had three professionals at computers, working every coupon of every mortgage-backed security available. If a price change of two or three 32nds gave us an arbitrage and we could make a deal, the CMO was brought to market immediately.

Insurance company motivations are changing. They're more careful about asset-liability mismatches on their balance sheets, and they can now work with a whole new group of assets. Commercial loans were seen as illiquid five years ago, whereas now, because of rating and credit enhancement, they are assets that can be managed. That's why I'm bullish long term, though over the next year there may not be a lot of activity. In the 1970's, people felt the same way about Ginnie Maes, when they weren't a major component of the capital market. Now any loan not made for portfolio purposes can be put into a Ginnie if it's new VA or FHA, into a Fannie or Freddie security depending on underwriting and statutory loan limits, or into a AA pass-through if it's a non-conforming loan. ARMs and bi-weekly loans are being securitized now, not just long-term, fixed rate mortgages.

Asset-backed transactions will continue to grow substantially, especially in light of the new risk-adjusted capital requirements that institutions insured by the Federal Deposit Insurance Corporation will be applying to loan portfolios by 1991.

This system will cause commercial bankers to behave more like mortgage bankers, making decisions on risk in relation to capital requirements put forth by FDIC. Traditional lenders will probably continue to be the biggest originators of all types of loans, but they'll manage their balance sheets much more effectively.

What are your plans in your new role as instructor for the Real Estate Financial Markets course? Teaching isn't completely new to me. I've done a lot of speaking on securitization through the Mortgage Bankers Association and National Council of Thrifts. And I'll give a Mortgage Bankers Association seminar in New York this year, as I have for several years. I'll review new trends in the industry, the deals that were done, and the deals that didn't go through and why.

Students who study real estate can build very promising futures. A good understanding of real estate and securities should open career options far beyond the traditional fields of brokerage, lending, and development. That's why the course should blend practical aspects of real estate and capital markets with the more theoretical aspects. We'll have a basic textbook, plus a lot of additional materials that I'll get from the industry. Wall Street produces a lot of tremendous research. Morgan Stanley and other dealers have agreed to provide us with research publications, which will be a valuable addition to the text.

My experiences will certainly influence my approach to the class. You don't really know real estate lending until you're forced to foreclose on a property that you made the loan on and thought was terrific collateral; we'll cover that aspect. One of the last things I worked on at Morgan Stanley was the securitization of home equity lines of credit. How do you securitize a loan that can be out for six months or ten years? Wall Street has developed methods for structuring unique securitizations, such as credit card loans and lines of credit. We'll spend time on the structuring of securities like these.

With experience in everything from structuring commercial mortgage-backed securities to originating huge commercial

ORER News

U OF I FACULTY ACTIVE AT AREUEA

Several University of Illinois faculty who work actively with ORER will present papers or serve as session leaders or discussants at the 1988 meetings of the American Real Estate and Urban Economics Association (AREUEA).

ORER Professor Peter Colwell will present a paper on the value of non-residential property in Chicago, and will also be a presenter in a session on the economics of architectural design. In addition, he will serve as a discussant in sessions on real estate brokerage and the analysis of real estate returns.

Professor Roger Cannaday, an ORER Research Associate, will preside in a session on property taxes, and will present a paper on the relationship between brokerage firm activity and local economic activity.

Another ORER Research Associate, Professor Jan Brueckner, will serve as a discussant in sessions on urban structure and land rents, housing markets, and property valuation.

Professor Larry DeBrock of the Department of Economics will present the results of his study, "The Effect of Multiple Listing Services on Residential Real Estate Broker Behavior." The results have been published as Paper #62 in the ORER Paper Series.

Finance Professor Louis Scott, ORER Research Assistant Tai-Le Yang, and former ORER Director Jim Follain will present a paper (ORER Paper #69) that they co-authored on mortgage loan repayments.

Professor Yoon Dokko of the Department of Finance will present a co-authored paper on the optimal design of mortgage instruments.

Professor Phelim Boyle, a visiting faculty member in the Department of Finance, will present a co-authored paper on mortgage loan defaults.

The meetings will be held December 28-30 in New York City.

Self Reports of Motivation:

Vicki F. Hensler and Samuel E. Krug

Although it has been defined in different ways, "motivation" has consistently emerged as a fundamental variable in explaining behavior. Yet motivation sometimes receives less attention than it merits, due to a perceived difficulty in measuring it reliably. We have studied a new instrument designed to predict motivation's impact on job performance. The instrument is SPECTRUM (Braskamp and Maehr, 1985), a self-report questionnaire that measures four factors believed to affect motivation: Recognition, Accomplishment, Power, and Affiliation. The topic is motivation's impact on performance of real estate salespeople.

The sample consists of the full-time salespeople employed for more than a year at eight residential brokerage firms in three Midwestern cities. Objective performance data were obtained directly from managers of the agencies. The data consists of the number of listings, number of sales, and dollar sales volume, all for the same 12 month period. We measured the effectiveness of SPECTRUM by comparing its predicted results with the three actual measures of performance.

Correlations between SPECTRUM predictions and actual performance are statistically significant, meaning that relationships between self-reported motivation and subsequent performance is too strong to be explained by coincidence alone. The results suggest that internal motivation is a stronger predictor of success than are either the overall work climate of the salesperson's agency or the opportunities available in the job.

One method for interpreting the data is to observe differences in measured scores between those with more than \$3 million in sales and those who sold less than \$500,000 during the period of the study. On the Power scale, for example, top performers scored on average at the 86th percentile, while low performers scored on average at the 32nd percentile.

Brokers may tend to base hiring decisions primarily on interviews, which often provide invalid results. More valid

measures, such as responses to the SPECTRUM questionnaire, would result in the hiring of more productive salespeople.

Firms that are yet more selective can achieve results even better than those realized using SPECTRUM alone. For example, a firm might combine our validity results with productivity data from a 1986 study by Follain, Lutes, and Meier.

Using combined results, we estimate that a firm hiring only one out of ten applicants could achieve an average increase in sales of \$3,814 per new salesperson per year. Even a less selective firm, hiring nine out of ten applicants, would achieve a gain of \$697 per new agent. The impact is even more significant in terms of total firm profits. First, higher productivity should continue through the years of employment. Since, in our sample, average length of employment with a broker was four years, the total per person productivity impact during a salesperson's tenure could range, in non-discounted terms, from \$2,788 to \$15,256. Second, the typical firm in the study by Follain et. al. employed 16 or 17 agents. Therefore, productivity gain per person should be multiplied by total sales agents. Depending again on selectivity, total gain could range from \$46,000 to \$260,000. Motivation appears to be a critical factor in predicting behavior in general, and in predicting real estate salesperson productivity in particular. The results of this study demonstrate that self reports of motivation are useful predictors of objective performance measures. In particular, the results show that a self-assessment questionnaire, which should take only 15-20 minutes for the applicant to complete, can add dramatically to salesperson productivity and the firm's bottom line.

Vicki F. Hensler is Coordinator of the Job Placement Office at Parkland College. Samuel E. Krug, Ph.D., is President of MetriTech, Inc. Copies of a longer paper on this topic are available at no cost from MetriTech, 111 N. Market Street, Champaign, IL 61820, Phone (217) 398-4868.

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