

Domestic Credit by D. Stephen Pepper

The secondary mortgage crisis hits

With the primary mortgage and home construction markets depressed, how many S&Ls can survive this new shock?

A recent study by the General Accounting Office for Rep. Stan Parris (R.-Va.) revealed that 42% of all savings and loan institutions are already broke or have dangerously low net worth. The study estimated the cost of liquidating all these thrifts at \$15 to \$20 billion—against an insurance fund (FSLIC) of \$6 billion, only half of it currently deployable.

While estimates vary as to how many institutions are vulnerable, one official believes that up to 1,000 failures could occur, costing up to \$50 billion in insured deposits. There is no doubt that at least \$20 billion is already at risk. The creation of a new corporation (FADA) to relieve the FSLIC of \$3 billion in bad-asset obligations on its books, is a drop in the bucket.

But now, a new crisis is beginning to unfold: failures in the secondary mortgage market. S&Ls are among the largest holders of such assets. Given the stagnation in the primary mortgage and home construction markets, this can only spell huge new problems for thrifts.

Landbank Equity Corp. of Virginia Beach, Va., once the largest second-mortgage lender on the East Coast, filed for bankruptcy in September. This followed within a week the collapse of First American Mortgage Co. of Baltimore, Md. The losses from Landbank's failure are not yet known, but Landbank marketed \$178 million in notes, to financial institutions from Hawaii to Florida. So far court papers reveal that Landbank owes to the buyers of its mortgages at least \$10 million. Not only are some of these loans

uninsured, but it is clear that Landbank greatly inflated the value of the mortgages it was selling.

The mortgage market is by far the largest credit market in the nation, with a book value of several hundred billion dollars. Earlier this year, it was shaken when an investment fund in mortgage packages, EPIC, failed. EPIC was owned by Community Savings of Maryland, one of the thrifts whose deposits are still frozen by Maryland Gov. Harry Hughes.

Investors place money with a mortgage management company and receive a return on a package of mortgages owned by that company. Financial institutions provide the financing for the company to float its mortgages, which are in turn insured by private insurance companies specializing in this area. Investor confidence is key, which in turn depends on insurance against default. In the case of EPIC the S&Ls stood to lose up to \$200 million unless insurers made good.

In the case of Landbank, investors also looked to the insurance that accompanied the portfolios. Once the investor has taken the plunge, he relies on the company servicing the mortgages. As long as he receives his money, he has no reason to think anything is wrong. One noteholder, Fidelity Federal S&L of New Haven, bought \$29 million of Landbank's loans—since these notes paid very attractive rates, since Landbank overvalued its assets and itself charged usurious rates. Another holder was the Federal National Mortgage Association (Fannie Mae) itself, which was also heavily exposed in EPIC.

In all, Landbank marketed some 6,000 loans. Prudential Bache helped by placing some \$40 million of Landmark-originated loans. The securities firm now claims that it was the job of the buying institution to review the mortgage portfolio. With such help, Landbank's portfolio grew at an incredible rate, from a mere \$20 million in July 1983, to \$87 million in July 1984, to \$150 million a year later. Then in June, Landbank stopped remitting mortgage payments, and in September filed funder Chapter 11, then switched to a Chapter 7 liquidation. In court papers, it estimates its unsecured indebtedness at \$11.7 million. However, its financial affairs are so tangled that the creditors agreed to lend \$200,000 to the bankruptcy trustee so that he could figure out what happened.

The case of Landbank appears to be one more instance of "high-flyers" who cross the line between risk and swindle. But in fact, its spectacular growth was due to the fact that financial institutions, knowing the high risk, were willing to buy anyway. The reason: Under deregulation, a thrift institution to survive must show a spectacular growth of its net worth. This is the only way it can attract investors and capital. As the productive sectors of the economy have plunged, thrifts have been forced toward more marginal assets to supply the appearance of growth.

The secondary mortgage market is exactly such a marginal business. Its companies are shylocks, lending money at up to 140% interest rates to borrowers who could not qualify elsewhere. Most of the borrowers were doomed to default, but by that time, the mortgage company had moved on to new borrowers, and had sold its high-risk loans to S&Ls eager to show high-yield paper on their books.