After Brazil, $300 billion real estate bubble sags

by David Goldman

No sooner had American bank regulators begun considering how to re-cook the books of the big commercial banks—some of whom stand to lose twice their shareholders' capital through Brazil's debt moratorium—than an even bigger pot exploded. American savings and loan institutions are sitting on at least $100 billion of worthless real-estate loans, amounting to about 11% of their total deposit base, and about four times their net worth.

The costs of paying off the depositors of the weakest of these institutions has already ruined the Federal Savings and Loan Insurance Corporation (FSLIC), which was pronounced insolvent by a report of the General Accounting Office of Congress on March 4.

The FSLIC's bankruptcy raises the question: How long can the Emperor stand around in his "new clothes," before he freezes to death? The $80 billion Farm Credit System went bankrupt at the end of 1985, and regulators responded by opening a second set of books for the failed agency which does not account for loan losses. The FSLIC has permitted hundreds of insolvent institutions, with deposits of about $100 billion, to continue operating, despite the fact that their net worth is, or is about to be, less than zero, because it cannot afford to close them, sell off the assets, and pay off the depositors.

Now, according to sources close to federal regulatory agencies, the Federal Reserve and Treasury officials responsible for the health of the nation's banking system, are hoping to ignore the Brazilian debt moratorium, and find some way to postpone writing off Brazilian debt.

Unless there is a run against the banks, the regulators hope, the entire bankrupt mass may drag on indefinitely. However, the unraveling of the thrift sector, with $900 billion in deposits, suggests that the near-term effect of the bankruptcy will be to force a generalized collapse of real-estate values, let alone a collapse of the homebuilding industry, and commercial real-estate construction, as bankrupt institutions are forced to realize whatever cash they might from devalued assets.

The FSLIC's demise

The nation's insurance fund for savings deposits lost up to $8 billion last year, more than wiping out its remaining reserves, according to the General Accounting Office (GAO) report. GAO is the research arm of Congress.

So-called "contingent liabilities," i.e., the costs of paying off depositors of bankrupt thrift institutions closed during 1986, could rise to $20 billion—dwarfing the $1.9 billion earnings of the FSLIC, which guarantees thrift-institution deposits of up to $100,000, according to the report. The report estimates that the FSLIC ran a loss of between $6 and $8 billion, rather than the $1.9 billion reported surplus.

In fact, the FSLIC has permitted hundreds of bankrupt savings and loans to continue operating, simply because it cannot afford to close them and pay off the depositors. Estimates by Wall Street analysts of the cost of closing these institutions run between $50 and $100 billion.

Although the GAO report is supposed to motivate an emergency congressional plan to bail out the bankrupt insurer, the amounts that Congress is willing and able to spend for such a bailout are trivial compared to the monstrous overhang of bad debt on the S&Ls' books.

House Banking Committee Chairman Fernand St Germain (D.-R.I.) is currently fighting with his counterpart at the Senate Banking Committee, William Proxmire (D-Wisc.) over whether to offer $15 billion or only $7.5 billion to the FSLIC during the next five years (for more of the story, see *Congressional Closeup*, page 68).

In effect, they are squabbling over sums that amount to a tenth or twentieth of what the savings banks will need.

EIR's *Quarterly Economic Report* for Summer 1986 calculated that at least $100 billion of bad commercial real-estate assets were sitting on the books of savings and loan associations, and that an additional $150 billion stood to go sour after "tax reform" eliminated most of the reasons such projects were built in the first place.

Tax reform kills building boom

An unofficial calculation of the thrift industry's performance during the third quarter of 1986, conducted by the Federal Home Loan Board Bank in early October, shows a net loss for the entire industry of $257 million. A wave of billion-dollar bankruptcies in Texas, California, and Florida will increase the losses drastically.

Twenty-five percent of the nation's prime commercial property stands vacant, as a result of the overbuilding boom created by this blunder. Worse, recently passed tax reform legislation eliminates all the tax breaks found in the 1981 bill, plus most of the ones that real estate investors got earlier.

The flip-flop on tax policy will blow away another $150 billion in real estate loans, on top of $100 billion already gone sour—a total of $250 billion in bad debt, more than American banks' total lending to the Third World. That is more than enough to blow the banking system out of the water.

The price of prime commercial property—including the Manhattan market—will fall by at least 25% in the next year, and perhaps considerably further.

The worst of it is that the S&Ls, as major holders of problem properties, have maintained real-estate values at artificial highs, by keeping bad loans on their books. As they are forced to liquidate such loans, they will force more property onto the market, collapsing the value of other properties, and forcing rents down. The self-feeding cycle will make life exciting for the bank regulators for some time to come.

Implications for U.S. economy

Already, the FSLIC's limited, timid attempts to prune the most bankrupt among the S&Ls, have collapsed home and commercial-property prices in affected areas, according to a study conducted privately for the FSLIC by the consulting firm Booz Allen Hamilton. The report, released by the *Washington Post* on Feb. 28, says that the FSLIC's frantic effort to raise funds for depositors has led to "forced sales" of properties into already depressed real-estate markets.

At very best, the geniuses at the regulatory agencies believe, they will be able to preserve the fiction that several hundred billion dollars' of mortgage paper are worth something, by shutting down the construction sector of the U.S. economy. Housing starts are down to an annual rate of barely 1.5 million units a year, fully 25% below the peak of early 1986, while sales of single family houses fell to a seasonally adjusted annual rate of 716,000, about 7% below the previous month's level.

That apparently shows the first effects of the contraction of the volume of mortgage-backed securities, which reached a staggering $400 billion annual rate during the third quarter of 1986. Since the principal purchasers of such securities are the savings and loans, and the savings and loans are entering into a generalized shakeout, it is not surprising that the leading private credit forecasts show the annual issue volume falling by half, i.e., to only $200 billion during 1987.

U.S. thrift institutions stopped issuing straight fixed-rate mortgages against deposits, for fear of being crushed between low-yielding mortgage portfolios and high-interest deposits. Now, at least 40% of their assets are "securitized" mortgages, of which the federal government guarantees close to $1 trillion.

As noted, the savings and loans are already liquidating real estate at distress prices, either on their own initiative, or on the initiative of federal regulators, who are anxious to raise what cash they might in order to pay off depositors. What happens now?

Both the Proxmire and St Germain schemes imply—by the minuscule amount of funds they provide—that the regulators will have to "pay their own way," by squeezing the declining, solvent portion of the thrift industry, and liquidating the rest to raise cash. Already, the U.S. League of Savings and Loans has raised a strong protest against both schemes, warning that the increased insurance costs to surviving instutitions would be prohibitive. That is a serious worry, but it pales beside the potential for a collapse of asset values.

The regulators will find that their ability to realize any cash whatever on the sale of commercial properties financed by defunct S&Ls has disappeared, in a bottomless decline of speculative real-estate prices. At this point, the defunct institutions will have to sell off their tradeable paper, in order to raise cash. What then happens to the re-sale value of $1 trillion of mortgage-backed securities? The United States faces a collapse of bond prices comparable to the murderous 1930-31 bear market, where the liquidation of bonds by cash-desperate institutions brought bond prices as far down as the stock market.

Under these circumstances, the net worth of the thrift industry could fall by an additional $50 to $100 billion, merely on the account of bond portfolio declines; and Congress will be contemplating a bill an order of magnitude larger than the currently proposed bailout of the FSLIC.