

## Domestic Credit by David Goldman

### S&Ls hit by real estate crash

*The entire industry suffered losses during the third quarter, but the worst is yet to come.*

**E**IR's first *Quarterly Economic Report* of 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.

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. What the actual loss might be is far from clear; an early FHLBB projection showed a net profit of \$500 million. The three-quarter-billion-dollar swing into the red was attributed to the late arrival of data from the devastated Texas thrifts. However, a wave of billion-dollar bankruptcies in Texas, California, and Florida will increase the losses drastically.

The *Wall Street Journal* complained Oct. 27, "The savings and loan industry's commercial real estate lending has turned into what could be the biggest single investment debacle for the U.S. financial system since the Depression, and it seems to get worse every day."

The administration's 1981 tax giveaways to real estate investors amounted to a White House order to put money into office buildings and similar speculations. Now 25% of the nation's prime commercial property stands vacant, as a result of the over-

building 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.

As we reported previously, the price of prime commercial property—including the Manhattan market—will fall by at least 25% in the next year, and perhaps considerably further. A study of the impact of tax reform by the accounting firm of Price Waterhouse, suggests a fall of around 40%.

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.

The net loss for the savings banks as a whole reported for the third quarter, demonstrates that the vicious cycle has been set off.

The Federal Savings and Loan In-

surance Corporation already estimates that it will need an additional \$30 billion to bail out bankrupt thrift institutions during the next couple of years. However, the number is arbitrary, and could rise easily to two or three times that amount.

In fact, the effect on the savings banks' own portfolios, terrible as it is, may be trivial compared to the problems for the federal government, which has guaranteed almost \$1 trillion of paper backed by home (as opposed to commercial) mortgages. Although commercial real estate is much worse off than residential real estate, the collapse of the entire market will rapidly engulf first multi-family, then single-family, real estate values as well.

The capitalization of the federally sponsored agencies is trivial relative to the potential demands upon them. The Federal National Mortgage Association has \$92 billion in debt, and only \$1.3 billion in capital. Losses in excess of that will presumably be borne by the Treasury.

The likely collapse of the federal mortgage-guarantee agencies, however, is only where the trouble begins. More than two-fifths of savings banks' total portfolios now consist of mortgage-backed securities, rather than mortgages as such. Supposedly, the securities, which can be sold on the market at a moment's notice, give the banks more liquidity, i.e., ability to raise cash quickly.

But a security that can be traded at a moment's notice, can also lose most of its value at a moment's notice, should purchasers decide that the federal government's "full faith and credit" might not be all it is supposed to be. A sharp rise in interest rates, and a significant increase in the default rate for home mortgages, could collapse the value of these securities, and destroy much of the assets of the savings banks almost instantaneously.