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EIR Economics

U.S. real-estate crash to flatten the FSLIC

by David Goldman

The various governmental and private agencies debating the fate of the bankrupt Federal Savings and Loan Insurance Corporation (FSLIC) resemble a building inspector about to condemn a termite-ridden house, without noticing that the house stands in the path of an oncoming avalanche.

Until now, the insolvency of the FSLIC, which was pronounced defunct March 3 by the General Accounting Office, has reflected, for the most part, a regional problem, namely the collapse of the oil-belt banking system. The FSLIC has $2 billion in net reserves, but would need as much as $8 billion to cover losses of problem thrifts already identified; some 20% of the nation's 3,200 thrifts are in trouble.

The $8 billion loss for 1986 at the nation's insurer for $900 billion in savings deposits, came largely from the 30 Texas savings and loan institutions that went under last year.

It happens that the big Texas cities suffered an office vacancy rate of around 30% even before the oil price crash, and lenders to real-estate developers stood to lose the most, the fastest. However, the oil-patch problem merely constitutes the weakest link in a rusted-out chain, which may break at any point. As real-estate prices crash in other sectors, including the "boom" belt from Boston to Washington, D.C., the FSLIC will be flattened.

As matters stand already, the proposals circulating from House Banking Committee chairman Fernand St Germain (D-R.I.), Senate Banking Committee chairman William Proxmire (D-Wisc.), and the administration itself, have no credibility whatever. The Reagan administration has sided with St Germain in his debate with Proxmire, proposing to borrow an additional $15 billion for the FSLIC during the next five years. The debt is to be serviced by a combination of contributions from Federal Home Loan Banks, pledging FSLIC's future income, and continuing special assessments on FSLIC-insured thrifts. The United States League of Savings Institutions, the trade group for the institutions which will have to service this debt, has proposed a two-year, $5 billion plan.

But the Shadow Financial Regulatory Committee, the "monetarist" critics of the Federal Reserve Board, spit in the cream pitcher on March 9, with a report warning that the bill would be at least double the administration and congressional estimates. Edward Kane of Ohio State University, a committee member, said the government's funding estimate of $15 billion was "the largest number they could agree on." In fact, the standard Wall Street estimate of the hole at the FSLIC is $30-50 billion; the so-called shadow group has merely pointed out that the emperor has no clothes. Another group member, Prof. Paul Horvitz of Texas, warned that the congressional plans will lead to massive runs against other financial institutions.

The "shadow group" finally pronounced the magic words "general revenue," that is, recommended that Congress bail out the FSLIC from the general fund, rather than trying to gerry-rig a new debt arrangement. On cursory inspection, a plan which proposes to bail out the bankrupt guarantor for troubled savings and loan institutions, on the basis of debt-issuance to be backed by contributions of the same institutions which are now without a guarantee, sounds like the kind of investment that brokers receive prison sentences for offering.

However, the ultimate bill Congress will receive could run into the total amount of bad real-estate loans in the sav-

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ings system, i.e., well over $150 billion. And that is assuming that additional S&Ls are not brought down by runs by frightened depositors.

The real estate crash

As of last fall, senior real-estate industry sources were predicting a 25-40% crash in prime commercial real-estate prices, including in such previous boom areas as downtown Manhattan. A January 1987 study by Brookings Institution real-estate economist Anthony Downs warned that the rate of office absorption would be slowed considerably from the 1985 rate of 5.8% of total inventory, because of the following factors: 1) the slowdown of labor force growth; 2) cutbacks in white-collar employment (e.g., the 25% cutback at General Motors); and 3) economic recession. Downs's study was circulated to private clients by the New York brokerage house Salomon Brothers. He writes:

"Even if annual absorption rates fall only moderately, substantial declines in new construction will still be required to cut vacancy rates substantially. . . . Further sharp declines in new office construction are almost certain to occur in 1987-88. . . . However, if absorption rates also decline notably . . . it will take quite a few years before probable levels of new office building slash vacancy rates down to . . . 10%. . . . Meanwhile, negative cash flows in many office buildings will be driving more owners into financial hardship, and forcing office building prices down. . . . There is still a big economic price to be paid for current overbuilding, and someone is going to pay it. . . ."

Downs relates the collapse of the office market to the end of the service-industry boom: "The number of office workers employed grew 932,000 in 1983, 835,000 in 1984, and 767,000 in 1985—18% less than in 1983. Overall labor force growth averaged 2.4 million persons per year in the 1970s, but only 1.65 million annually from 1980 to 1984—down 31%."

More to the point, the economic collapse which flattened basic industries during 1986, has gotten around to eliminating white-collar jobs, Downs adds. "General Motors recently announced a drive to slash its white collar workforce by 25%. Other firms are substituting electronic machinery for clerical workers, although such machinery uses quite a bit of space. With the whole manufacturing sector still under tremendous pressure to cut costs, office jobs are likely to comprise a smaller share of new jobs than in the past."

Impact on pension funds

A quiet panic is under way among pension fund managers, who put hundreds of billions of dollars of fiduciary funds into real-estate investments during the past decade. There was a certain inadvertent humor in a report issued by Salomon Brothers in January, for the use of pension fund managers facing charges of fiduciary irresponsibility in such investments.

The report, entitled, "Appraisal Reform and Commercial Real Estate Investment for Pension Funds," recommends new procedures for appraisal to cover pension fund managers against charges of incompetence as building prices collapse:

"The integrity of the appraisal process has always been critical to social equity in terms of eminent domain, real estate taxation, legal disputes, and contract administration. However, the credibiliity of appraisal for income properties has been undermined over the past 25 years by an implicit conspiracy between financial institutions and the real estate development fraternity for appraisal form rather than substance. . . . The impact of faulty appraisal on fiduciary institutions has been examined in a recent congressional study that blames the attitudes and policies of the FDIC, the OCC, the FSLIC, and other regulators."

That is silly; appraisals in a boom-and-bust real-estate market are no more reliable than the average Wall Street guru's prediction of stock prices. Except for some cases of outright fraud cited by the congressional study, the "appraisal" argument is the pretext for a universal scramble by pension managers and other institutional investors, who are facing disaster as the value of their portfolio collapses.

As *EIR* reported last week, the danger to the banking system goes beyond the real-estate problem. Speculative real estate is the sort of investment that a failing institution cannot liquidate for cash in a bad market. Bankrupt banks sell off their good loans, not their bad loans, for cash. Since 40% of savings and loans' assets are in mortgage-backed securities, the susceptibility of this market to a shakeout of much worse proportions than, say, the 1930-31 bond market crash, is growing daily.

Most remarkable is that the savings and loans are still pushing mortgage-backed paper onto the market at a record rate, adding to the $1 trillion outstanding, of which $400 billion was issued last year alone. Gross mortgage security issuance in the past two months surpasses that of the first two months of 1986, and even exceeds last year's record average. It used to be that the federal agencies which packaged mortgages sold by issuing banks, and sold them to investors, did so to reliquefy the mortgage lenders. Now, the mortgage-lenders themselves, facing financial disaster, are doing the issuing themselves, changing from savings and loans into little merchant banks. In other words, they are depending on underwriting fees and trading profits to replace business that has otherwise disappeared, and to compensate for lending losses.

The bigger investment banks, which set up this mess to begin with, have begun to smell cordite in the mixture. The collapse of the mortgage-backed securities markets, due to pressures on both the S&Ls and their guarantee agency, will take the rest of the industry down with them. Now that the mortgage lenders, S&Ls and others, have stuffed their portfolios with "marketable" mortgage-backed securities, they resemble a group of men passing around a hand grenade, each hoping that the faster each of them passes it, the less likely he is to be holding it when it explodes.