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Deflationary real estate bust looms

by Steve Parsons

Over the summer months, the "recovery" plunged the U.S. economy into ever deeper levels of depression—mounting corporate and personal bankruptcies, mass layoffs, plummeting profits, and declining sales of everything from autos to clothing. On the same day that the Federal Reserve announced a cut in the discount rate to 5%, August retail figures came out showing a monthly drop of 0.7%, three times greater than expected, while for the first 10 days of September, auto sales dived 15.3%. All but the most insane economists and White House personnel are now admitting that the recovery game is up.

This collapse is devastating the real estate market. The delinquency rate for residential mortgages reached its highest level in five years in the second quarter, to 5.28%, according to the Mortgage Bankers Association. This is a 20% increase from the second quarter of 1990. At the same time, the delinquency rate for commercial real estate loans made by life insurance companies has increased nearly 50% since the end of 1990, to a level of 5.41% in the second quarter, as compared with 3.69% in the last quarter of 1990. Prior to this year, delinquencies in the industry had never surpassed 4%. "That's off the charts," said David Shulman, director of real estate research at Salomon Brothers. "These are the kind of numbers we were projecting for 1993. Everything is happening much faster than we thought."

Of note, while delinquencies are surging, the rate of foreclosure and property seizure is falling. This indicates that banks and mortgage companies simply are not taking back properties, because they can't resell them; any widespread attempt to do so would precipitate a plunge in the "value" of real estate and thus of these firms' assets. The delinquency rate is undoubtedly much higher. What banks and mortgage companies have been doing is renegotiating and "working out" the delinquencies so as to keep these dead mortgages on the books as "performing assets."

The enormous illiquidity resulting from the collapse is intersecting what appears to be a frenzied attempt to dump real estate. Everyone, especially banks and insurance companies, is scrambling to get out before the crash, trying to sell their deflating investments to each other. While the Resolution Trust Corp. recently managed to find a buyer on which to unload more than $1 billion worth of real estate for just 48% of the nominal value, for most would-be sellers, the money for these deals just isn't there.

For example, the troubled Kemper insurance company said that it will invest in no new real estate projects, while at the same time trying to sell nearly 39% of its real estate holdings, or $809.6 million of its $2.1 billion portfolio, during the next five years. This does not mean the properties are in trouble, insisted John Fitzgerald, Kemper's chief financial officer. "I don't think we're doing anything different than any bank in the country is doing."

But that's precisely the problem. The banks and insurance companies are all trying to sell at once, which threatens to blow out the already badly depreciating real estate market and further wipe out their "assets."

Chain reaction under way

In fact, a chain reaction might have already started, as big insurers and banks begin to default on real estate debt owed to each other. Indicative of this is Citicorp's initiating foreclosure procedures on Gateway IV, a Chicago office tower owned by Equitable Life Assurance Society. Usually, when big corporations have debt problems, the prospect of default and foreclosure is used as a negotiating tactic in working out loan restructurings.

In this case, however, Equitable said it did not make the mortgage payment to Citicorp because the value of the building was *less* than the cost of servicing the mortgage. Citicorp then acted with lightning speed to begin foreclosure on its $137 million mortgage, which is a major portion of the total financing for the $543 million investment in the building.

This development exposes just how fast the daisy chain of real estate debt is coming apart. First, Equitable is one of the largest life insurers, and is in extremely bad shape from its rotten real estate. Second, and more ominous, no one wants to buy these office towers; their high vacancy rates preclude their meeting debt obligations, to the point that now the nominal "value" of the property is way below the mortgage servicing costs.

As in the cases of untold thousands of homeowners in areas where home prices are dropping, Equitable and other companies are simply walking away from the debt, leaving banks and other insurance companies holding the increasingly worthless property. Red ink, writeoffs, and dwindling cash flow are the end result for everyone.

Equitable's default itself was a result of the bankruptcy of one of the building's principal tenants, the large accounting firm Laventhol and Horvath, as well as the virtual collapse of the investment partnership in which Equitable was involved. Now Citicorp is left holding this particular bag—and, like Equitable, its own debt obligations and other liabilities are imperiled by the collapse of its cash flow and earnings. Will Citicorp default on its own debts soon? Or be unable to pay depositors who want their money?

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