

Gramm-Rudman, tax reform, and real estate: \$1.3 trillion at risk

by David Goldman

The current default rate for home mortgages is at an all-time historical high of 0.25%. Conditions in the commercial real estate market are much worse. Roughly 20% of all debt attached to commercial real estate in the United States is already bad, according to banks' own lax standards of reporting debt. About a quarter of all prime office building space in the country is vacant, counting new construction about to come on line. Most of what the U.S. government has reported as economic growth in the past three years, apart from outright fabrication of statistics, is a gigantic bubble in the real estate market, now in desperate financial condition.

That's the bad news: The worse news is that the combined effects of Gramm-Rudman and the associated tax reform legislation passed by the House (and under review in the Senate Finance Committee) will puncture this bubble. Elementary calculations derived from a variety of authoritative public and private sources put the size of the disaster in the real estate market at about a quarter trillion dollars.

That is, one-quarter trillion dollars of bad real estate loans will bring down a large part of the \$1.3 trillion in savings and loan or savings banks' deposits, along with scores of billions of dollars of commercial-bank deposits. Since almost all of these deposits are guaranteed by the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Deposit Insurance Corporation (FDIC), the Gramm-Rudman bill and associated tax legislation will trigger costs to the federal government several times in excess of proposed savings.

At year-end 1984, all savings institutions in the United States had \$1.266 trillion in liabilities, including \$1.084 trillion in deposits.

Assets of \$1.309 trillion were invested as follows:

Mortgages (billions)	716.4
Of which	
Home mortgages	550.0
Commercial	100.1
Multi-family	66.3

U.S. government securities	224.8
Corporate and foreign bonds	20.4
Tax-exempt obligations	2.8
Consumer installment credit	106.1
Miscellaneous	124.2

The savings institutions (savings and loan associations, mutual savings banks, and credit unions) held \$550 billion of a total \$1.324 trillion in outstanding home mortgages, or 42% of the total; \$62 billion of \$162 billion of multi-family residential mortgages, or 41%; and \$100 billion of \$406 billion in total commercial mortgages, or 25%, as shown in **Table 1**.

Since Volcker's banking deregulation, the composition of savings institutions' assets has shifted noticeably. Commercial mortgages went from 10% to 14% of total mortgages, while home mortgages fell from 80% to 76%. The portion of multi-family mortgages remained the same at 10%.

Of the savings institutions, the largest sector is the savings and loan associations, with \$1.062 trillion in liabilities as of November 1985. These institutions are guaranteed by the Federal Savings and Loan Insurance Corporation, and their balance-sheet situation is disastrous. Their so-called

TABLE 1
Outstanding mortgages
(Billions \$)

	Amount	Savings institutions % of total
Total	2,003	36
Home	1,324	42
Multi-family	162	41
Commercial	406	25
Farm	112	n.a.

"regulatory net worth," i.e., their equity under the stretched definition of the FSLIC, is officially \$45.1 billion, or 4.2% of liabilities.

Against this 4.2% equity cover for liabilities, the S&Ls list "substandard loans and repossessed assets" at 3.01% of total assets, as of November 1985. That proportion grew from 2.05% in November 1984, i.e., from \$19.68 billion to \$31.95 billion in November 1985. Before any substantial shake-out occurs in the market, the current growth rate of bad loans would wipe out the entire listed equity of the S&Ls during the course of 1986.

However, the listed \$45.1 billion figure for "regulatory net worth" must be adjusted downward, by anywhere from \$14 billion (*Wall Street Journal*, Jan. 8, 1986) to \$50 billion (GAO report, October 1985, worst-case scenario). The reason is that the FSLIC has not forced institutions whose net worth is already negative, to liquidate bad assets at what the market will bear. The FSLIC has issued its own scrip, called Income Capital Certificates, to S&Ls with negative net worth, and has committed itself to issue additional such certificates for failing institutions it has brought under "management contracts" with stronger S&Ls.

A Nov. 18, 1985 report by Prudential-Bache Securities analyzed the FSLIC's balance sheet as follows:

\$10 billion assets of FSLIC
minus \$4 billion in liabilities
\$6.0 billion net worth of FSLIC
minus \$1 billion of inflated asset value
\$5.0 billion net worth at market
minus \$1.8 billion in outstanding ICCs
\$3.2 billion
minus \$1.8 billion in additional ICCs
required to bring institutions under
management contracts above \$0 net worth.
\$2.0 billion net assets.

In other words, the S&Ls as a whole have, effectively, no net worth, adjusting for bad loans as of 1985, and their regulator, the FSLIC, has no funds worth mentioning to do anything about this. A closer look at the state of the real estate market, in the light of tax reform, indicates how rapidly the entire structure will be capsized.

All parameters of soundness of all sectors of the real-estate market are already at historical low points, prior to the outbreak of actual credit disturbances. What is remarkable is that the S&Ls percentage of bad loans to risk assets, as opposed to total assets, is 4.5%. Assuming that the bad-loan category does not apply to securities held by the S&Ls, the bad loan ratio is already extraordinarily high.

Nationally, the officially reported rate of delinquent home mortgage loans is 0.25%. If this rate had applied to the S&Ls total mortgages, their bad loans would be one-twentieth of what they are in reality. Using the above numbers, assume that three-quarters of their total mortgage loans of \$648 bil-

lion are home-mortgage loans. Applying the reported delinquency rate, we find that \$1.2 billion in home-mortgage loans are delinquent, a tiny fraction of the \$32 billion in total reported problem loans. The remaining \$30.8 billion in delinquent loans applies, therefore, to non-single-family mortgage loans or related loan categories. We thus obtain a delinquency rate on the commercial and multi-family residential mortgage categories (along with a small volume of non-housing consumer lending) of 19%.

That may be slightly exaggerated, since much of what the S&Ls report as home-mortgage loans are undoubtedly no such thing, and the reported delinquency rate is undoubtedly much higher. However, 0.25 is the highest recorded delinquency rate in U.S. history, and the implication that it is, in fact, substantially higher, is ironic considering all the nonsense about consumer-led recovery. However, even if we assume that the home-mortgage default rate were an historically astronomical 0.4%, the imputed default rate on remaining mortgages would be 18%.

That is to say that even before tax reform hits the fan, the present bad-loan rate on commercial and multi-family residential real estate is in the 15 to 20% range: a striking conclusion. It is less striking in consideration of a national vacancy rate for office space estimated at 16%. In reality, the vacancy rate is much higher than the usual estimates.

According to the fall/winter 1985 survey of the real estate market published by the Office Network:

- The national vacancy rate is leveling off at 16.3%, after climbing continuously since 1980. The rate was 16.4% at the beginning of the year.
- Current construction of 177.1 million square feet exceeds that of the 1981 boom and defies the double-digit vacancy rate.
- National average rental rate has hit a new high of \$22.32 per square foot. Quoted rental rates are expected to continue escalating as space under construction is completed and added to the existing market.
- Absorption reached a new high of 75.9 million square feet during the past 12 months.
- Available space, including uncommitted space under construction, has reached the 365.9 million square-foot level, an amount 4.8 times the absorption figure for the past 12 months.

These remarkable numbers permit the following insight: If the vacancy rate is calculated on the basis of uncommitted space under construction plus existing vacant space, *the true vacancy rate is 27.4%*. Even if it were assumed that the absorption rate of 1985 would prevail through 1986, the true vacancy rate would be 23.9%. We can split the difference and say that one-quarter of all prime office space is currently vacant. In Houston and Dallas, vacant space is currently listed at 28%, and new construction already on line is expected to bring this level up to 40% in the course of 1986.

TABLE 2

Real estate: approximate market value in 1981

(Billions \$)

Total	5,501
Residential	3,664
Single family	3,316
Commercial and industrial	761

TABLE 3

Real after-tax rates of return for varying debt ratios

(%)

Debt ratios	Current law	Tax reform	Decline in rate of return
60%	7.5	6.7	-12
70%	9.3	7.9	-18
80%	12.5	8.9	-40
90%	20.3	9.8	-52

The lowest cited figure for vacant space is Manhattan, with a vacancy rate of only 9%.

Most significant in this regard is that resale prices have not yet softened, and rents have continued to rise, from a national average of about \$19 per square foot in 1981, to an estimated \$22 per square foot at the end of 1985. 1985 was the biggest year for major sales of real estate in U.S. history, with 23 sales in excess of \$500 million.

Sachs took the opportunity to sell off their headquarters building while the going was good.

The conclusion we may draw from this singular behavior of the real estate market—a combination of astronomical loan-delinquency and vacancy rates, with still-rising rents and prices—is that *bankers and developers have engaged in a massive fraud to preserve the nominal values of commercial properties, and avoid writing down the values of loans on their books.*

According to the most recent published estimates, the value of real estate holdings in the United States, by major categories, is shown in **Table 2**.

The value of commercial space may be calculated as follows: Approximately 1.5 billion square feet of prime office buildings exist in the 24 top market areas surveyed by the Office Network. At \$22 per square foot average rent, their income-production capacity is \$33 billion annually. According to a Price-Waterhouse formula of \$.855 in rent for every \$10 of property, we can estimate a market value in

the major market areas of about \$386 billion. That corresponds roughly to the existing numbers for outstanding commercial mortgages.

A bad-loan rate of 15% to 20% translates into a \$57 to \$77 billion loss for the banking system. However, the current vacancy rate of 25% suggests that the loss will escalate, to \$96 billion.

That is *before* Gramm-Rudman and tax reform, whose impact we calculate below. They stand to devalue commercial real estate by about 40%, with an additional *potential* loss (based on lower resale value of buildings) of at least \$154 billion. The immediate losses plus potential loan losses we can anticipate—as a matter of pure arithmetic—are more than \$250 billion, divided about equally between savings institutions and commercial banks. For reasons made clear earlier, this is sufficient to wipe out the entire banking system.

Effects of tax reform

According to the Price-Waterhouse study commissioned by the National Realty Committee and published in July 1985, the decline of rates of return on commercial real estate under the administration's tax reform proposal, as opposed to existing law, would look as shown in **Table 3**.

For the most typical case, i.e., the 80%-debt-based transaction, the decline in rate of return, and therefore of the imputed value of the building, is 40%. That is no surprise; the tax deals marketed through syndications since the 1981 tax code was changed to benefit this swindle, contained markets of this order, reflecting tax advantages.

Price Waterhouse conducted their study for pay on behalf of a tax-lobby group, but their analysis of the cost of eliminating the tax-advantages for real-estate syndications is straightforward and accurate. They comment:

The advantage of leverage is not simply a result of the fact that interest expenses are deductible. Since interest, properly measured, is a cost of doing business, incurring an additional deductible cost will not, by itself, increase the rate of return. Leverage is advantageous because it reduces the necessary investment per dollar of accelerated deductions.

As shown in the above table, increases in rates of return under alternative debt ratios are relatively small under the administration proposal. The reason is that the administration proposal limits the deduction for interest expenses incurred through a limited partnership. Consequently, leverage receives less favorable tax treatment under the administration proposal than under current law.

In addition, the total amount of available depreciation is less; rather than 19-year declining-balance (accelerated) depreciation, the various administration and Ways and Means Committee proposals prescribe 30-year straight-line depre-

ciation. Price Waterhouse estimates that the value of depreciation benefits will fall by 40% under the Treasury option, the Ways and Means Committee option, and the final version passed by the House, for real estate held for 30 years.

Also, appreciation of property held for investment purposes would not be taxed at the 20% capital gains rate, but at the 35% ordinary rate, under the tax reform proposals.

In conclusion, the rate of return on 80-percent-leveraged real estate would fall by 40%. That is the most typical case for the major commercial office market.

The crisis in government finances

The Treasury will be presented with a large part of the bill for the collapse of the real estate market, and associated banking sectors. The Treasury's direct or indirect commitment to the real estate market at the end of 1984 is shown in Table 4.

Of the Treasury commitments, the most vulnerable portion is the Federal Home Loan Banks' direct advances to S&Ls, which rose to \$82.7 billion as of the end of 1985. The Federal agencies' holdings of home mortgages have already become a problem, particularly for the Federal National Mortgage Association, with \$92 billion in liabilities and only \$1.3 billion in capital, forcing FNMA to announce a tightening of standards for purchases of mortgages last fall.

Far and away the biggest problem is the simple FSLIC guarantee of \$1 trillion of S&Ls deposits, not including the FDIC's guarantee of \$300 billion of savings banks' deposits, at a point when the entire system may collapse. The Treasury's liability can rise up to a significant proportion of total deposits, under conditions of a generalized run against the S&Ls.

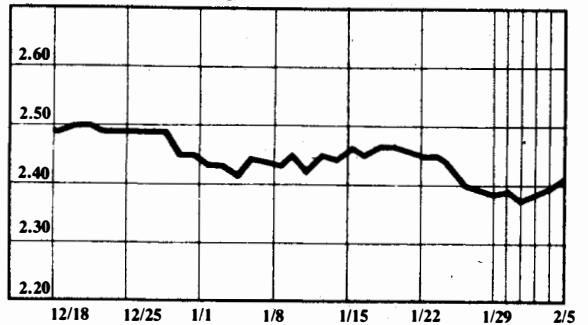
TABLE 4
Treasury commitments in the real estate market
(Billions \$)

	Amount
Sponsored credit agencies	
Housing credit	176.0
FHLB advances to S&Ls	74.6
Residential mortgages	101.4
Federally related mortgage pools	
Total mortgage holdings	289.0
Home mortgages	283.0
Multi-family mortgages	5.5
Farm mortgages	0.5
Total housing credit	464.5

Currency Rates

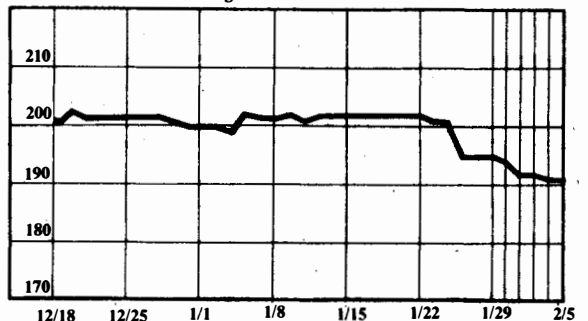
The dollar in deutschemarks

New York late afternoon fixing



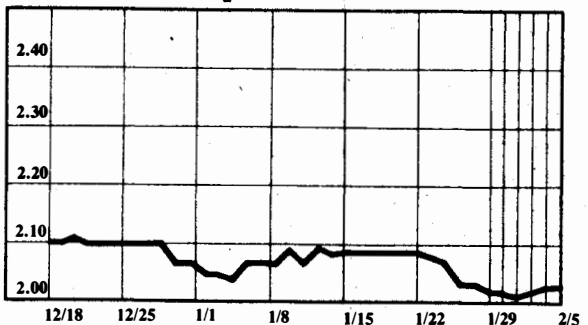
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing

