Banks, insurance giants totter, as bills fall due

by Steve Parsons

Nothing better captures the degeneracy of the July 16-17 Group of Seven economic summit in London than the gala dinner at Buckingham Palace that concluded the heads of state conference. Fawning before Her Majesty the Queen, the leaders were treated to a dazzling display of fireworks and lasers filling the night sky with giant dollar signs and symbols of other currencies, with such inspiring songs as "Money, Money, Money" and "If I Were a Rich Man."

At that very moment, the rotten debt structure underpinning George Bush's new world order was rocked by two events: the merger of two of America's largest bankrupt banks, Chemical and Manufacturers Hanover (see *Banking*, page 15), and the run on, and virtual collapse of, Mutual Benefit Life Insurance, the 18th largest U.S. life insurance company.

These two cases show that regardless of the hype about the great "recovery," the bills for the usury of the 1980s are now coming due and are battering the most venerable banks and insurance companies. The volume of unfunded, now maturing debt that riddles every sector of the economy could, at any point in the coming months, push the U.S. financial system and economy over the edge into the last phase of collapse: uncontrollable liquidation and banking panic.

'Bullet loans' shoot down banks

At the center of the crisis is the punctured bubble of real estate debt, where the level of non-performance is now so high and the cash flow so low, that the usual "workouts" and refinancings simply cannot be maintained.

According to a new survey by the Federal Reserve Board, a whopping 40% of some $400 billion in outstanding real estate and construction loans made by banks is coming due in the next year. Insurance industry analysts project a similar proportion coming due for the $300 billion or more in real estate loans made by life insurers. That means that there is some $280-300 billion maturing over the next 12 months.

Much of this is comprised of "bullet" and "semi-perm" loans, which mature in 5, 7, or 10 years, with little amortization of principal during the life of the loan, but with large balloon payments at maturity. These relatively short-term loans, which reached a record high in 1986, were extended to finance the speculative commercial construction and real estate boom of the mid-1980s "Reagan recovery." Lenders assumed that the properties, many of which are virtually vacant office buildings, would be quickly sold at ever-higher prices, and the original loans easily paid by new mortgages made by other lenders.

But that daisy chain has now fallen apart. "These loans are maturing in an illiquid market," said Thomas Borman, a former commerce commissioner of Minnesota, in testimony on the insurance industry July 17 before a House Commerce subcommittee. "In other words, *there is no source of financing other than from the original lender.*"

Borman further revealed that a high proportion of these loans simply cannot be rolled over or stretched out, because that is patently illegal. "These loans are maturing in an environment where vacancy rates are higher and rental rates are lower than the assumptions upon which these loans were underwritten in the mid-80s. In other words, many of these could not meet the underwriting criteria on which they were originally underwritten, because property values have dropped significantly. . . . This means that in many cases, if the original lender refinances a loan, it will have to take a write-down if it is faithful to its original criteria or if the loss in value of the collateral causes the mortgage to fail statutory loan-to-value ratios."

The Fed survey revealed that only 36% of construction loans that have come due in the past year were paid in full under the original loan terms. That means that banks refinanced most of their real estate loans, while writing off only a small percentage. But for the loans coming due in the next 12 months, only 20% have been refinanced.

The implications are enormous. If only 50% of these loans held by life insurers and banks is either paid off or refinanced, that means that as much as $150 billion of this debt could go into default in the coming months. That alone is disastrous. But much more ominously, none of this takes account of the several trillion dollars tied up in residential mortgages and other real estate loans made by mortgage banks, savings and loan institutions, and corporations—a sizeable percentage of which also is coming due at the same time.

Deregulation: a formula for bankruptcy

Exactly parallel to what has happened in the banking sector, deregulation and high interest rates were the driving force behind the insurance industry collapse. This combination, plus the early 1980s explosion in new speculative investment, caused savers and investors throughout the United States to seek higher returns wherever they could. This "free market competition" siphoned funds from such traditional markets as low-interest savings accounts and life insurance, and forced the entire financial sector to offer higher-interest investments in order to attract sufficient funds to stay alive.

The insurance industry, for example, created the guaranteed investment contract (GIC), which offered investors much higher fixed rates of interest than either traditional life insurance policies or bank certificates of deposit, in exchange for the investor being obligated to leave the money there for several years.

To pay these higher rates, insurance companies, as well as banks, S&Ls and others, had to make much more money. Hence the stampede into high-return junk bond and real estate speculation, which could yield 20-100% profits at the height of the frenzy, with companies selling and re-selling property at breakneck speed and ever-higher prices. Now, of course, they are victims of "reverse leverage," a collapse and deflation of these "assets," at the same time that GICs and other such investments are coming due for repayment.

The shift by life insurers is illustrated by the following figures. In 1969, some 69.4% of the industry's business was life insurance, while only 26% was annuities and pensions. By 1989, these figures were reversed: 29.9% was life insurance, and 66.6% was annuities and pensions.

Concomitantly, to pay for these investments, the insurance industry's commercial real estate loans zoomed. In 1969, only 34% of life insurers' real estate assets were in commercial real estate, meaning that 66%, or two-thirds, were in far more stable residential mortgages. But by 1989, an estimated 81% of their real estate assets were in commercial property.

A recent study by the National Association of Insurance Commissioners revealed that the life insurance industry as a whole has 24% of its assets in real estate. Some insurers have more than 50% of their assets tied up in real estate—and it goes as high has 87.9%. Another study notes that "among 20 of the nation's largest life insurers, investments in real estate and mortgages range from 34-52% of their assets."

Increasing rate of defaults

Thomas Borman's analysis of 15 large life insurers shows that "many companies experienced extraordinary increases in defaults over 1989 data . . . the number of loans that were at least three months delinquent were more than 2.5 times 1989 levels." Even worse, a Townsend and Schupp survey of 61 life insurance companies put average real estate investments at more than 400% of capital in 1989. Travelers' ratio was nearly 900%, Mutual Benefit's almost 1,000%, and Aetna's 1,100%!

Falling profits from real estate investments—not to mention actual losses and devaluation of real estate assets—are blowing to smithereens all the premium rates determined through actuarial projections. As a consequence, insurance companies have raised their premiums again and again, while cutting costs primarily by excluding more and more customers who might dare file claims. This has especially affected such lines as health, auto, and liability insurance.

That means that insurance has increasingly been placed out of people's reach. It is likely that the volume of new policies is now generally decreasing, while those with policies are being forced to drop them or opt for cheaper coverage. All this feeds the spiral of further premium increases, forcing more people to drop policies.

The bottom line is that it is becoming no longer profitable for the insurance industry to remain in the insurance business, leaving state governments—or, ultimately, the federal government—to bail them out or take them over. That's just what the state of New Jersey did with Mutual Benefit, when a run by institutional investors pulled hundreds of millions of dollars out of the company and threatened to consume all of its capital.

The Mutual Benefit seizure exposed another time bomb: the $1.2 trillion municipal bond market. Mutual Benefit had guaranteed $750 million in municipal debt, the ratings of which were immediately suspended when the firm was taken over by the state government. Investors rushed to dump the bonds as quickly as possible, and the market quaked in fear. It doesn't take a genius to see the implications for this market, which has something like $500 billion of paper backed by guarantees and enhancements from insurers and other companies in not much better shape than Mutual Benefit. Throw in the growing insolvency of the nation's states and cities faced with paying off these bonds, and you get a market that can blow at a moment's notice.