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Domestic Credit by David Goldman

Real estate: a 25% crash or worse

Thanks to "tax reform," some $250 billion in assets of already troubled financial institutions are at stake.

The president of one of the country's largest private real-estate firms estimates that the price of prime commercial property—including the Manhattan market—will fall by at least 25% in the next year, and perhaps considerably further. Studies of the impact of tax reform, which wipes out real-estate tax shelters, suggest a fall of around 40%.

Apart from tax reform, the 25% vacancy rate for office buildings in prime commercial markets, by far the worst in history, has already collapsed commercial construction, and left observers waiting for the big crash in building prices.

That implies that there is bad news, and worse news, for the U.S. banking system. Rumors of Bank of America's impending bankruptcy or sale are not as exaggerated as they appear to be; the nation's third-largest bank will be lucky to keep its foreign deposits during the next few weeks, and a merger or bailout is unavoidable.

Otherwise, more than 100 U.S. banks have failed this year, including three of Oklahoma's top four banks, all billion-dollar institutions.

But the worst has not yet hit, namely, the $250 billion overhang of bad real-estate debt, by our own estimate. A September 1986 study by Salomon Brothers, written by Brookings Institution economist Anthony Downs, indicates why. Downs cites "the remarkable drop in mortgage . . . rates during the past year. Home mortgage rates fell about 2% from April 1985 to June 1986, a decline of 16.7%. . . . Effective rents could have declined 16.7% without producing any change in market values. But lower interest rates also have a cost-reduction effect. So, effective rents could have fallen by even more than this—say, 20-25%—without producing any declines in market values."

That implies that the present turnaround of interest rates will produce market-value declines of 20-25%. However, a more important source of support for asking prices in the prime commercial markets, Downs says, is outright fakery. Many "office-building owners fully realize their properties are worth less today than when they were first built, but do not want to recognize that fact explicitly on their books. This group includes some large financial institutions who believe they can 'ride out' the period of high vacancy, as noted above.

"Also, some financial institutions in deep trouble are deliberately postponing the recognition of as many losses as possible so as to prevent having to become explicitly bankrupt. This group includes many savings-and-loans that would be considered bankrupt according to generally accepted accounting principles. They are being kept in operation by the regulatory authorities through use of more liberal 'regulatory accounting principles.'"

This tactic is being employed by the regulatory authorities because the Federal Savings and Loan Insurance Corporation does not have enough resources to take over all such institutions in the near future.

"Other financial institutions not yet actually bankrupt are still reluctant to confront current losses in the value of their office properties. Like most businesses, they do not like to take losses when they can avoid doing so."

EIR's Quarterly Economic Report for the first quarter of 1986 used the Federal Savings and Loan Insurance Corporation's own reports on bad loans, to estimate that roughly 20% of all real-estate loans were in arrears by the end of 1985. The situation by now is much worse, but that is nothing compared to what will happen next.

Salomon Brothers' report concludes that real-estate values "will in many cases be subject to strong downward pressures in the next 2-3 years. . . . Surpluses of office space in many markets will become worse in 1986 than in 1985. This will occur because more new space will come onto the market in 1986 than will be absorbed.

"Moreover, the decline of interest rates of the past two years—the major factor counteracting drops in effective rents—is not likely to continue during the next two years. . . .

"Also, many owners of existing office buildings who have been unwilling to recognize explicitly any declines in values will have to do so during the next 2-3 years. One group will be forced to sell because it no longer has the resources to cope with huge negative cash flows from operating half-empty buildings, or full buildings rented with enormous concessions."

On Sept. 17, Bank of America took the occasion of a $620 million sale of its stake in the Arco Plaza building to deny rumors of its impending failure. Not long from now, banks will announce their demise at cut-rate sales of their commercial properties.

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