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The Real Estate Institute of New York University

The disastrous potential of deregulating the savings and loan industry.

Taking Uncle Sam for a \$200 Billion Ride

Paul Zane Pilzer



THE MANAGERS of a savings and loan association (S&L) in California believe that interest rates will rise in the near future, so they sell off \$500 million of their fixed-rate home mortgages, planning to buy back similar mortgages at a lower price when interest rates increase. The owners of a New York S&L believe that interest rates will be falling, so they buy the \$500 million of fixed-rate home mortgages from the California institution, hoping to sell them at a much higher price when interest rates decline. If interest rates move only 130 basis points in either direction, one of these associations will gain as much as \$100 million, and the other will lose \$100 million.

INSURED DEPOSITS MAKE A GAME OF S&L SPECULATION

Eventually, however, all savings institutions win at this game (at the expense of the American public) for the following reason. In order to get \$500 million in insured deposits to play with, an S&L need have only \$15 million (3 percent of assets) in capital. Furthermore, the institution's owners are

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personally liable for losses only to the extent of their capital investment. Moreover, current federal regulations allow the winning S&L to dividend the \$100 million in profits out to its owners, but the losing S&L need not "recognize" its \$100 million loss immediately. It may spread recognition over the life of the mortgages (sometimes as long as thirty years), even though it has had to sell the mortgages for a \$100 million actual cash loss.

The results of the game are that the owners of one S&L make \$100 million in cash, the owners of the other S&L will eventually lose their \$15 million capital investment (unless they can make back their loss by further speculative investments), and the federal government picks up the remaining \$85 million in losses (or more if the losing S&L continues to speculate unsuccessfully) by paying off the insured depositors 100 percent.

Refining the Game

A land speculator in Texas decides that it is a good time to purchase \$100 million of undeveloped property in Houston for future development. An Iowa land speculator believes that prices for farmland have bottomed out and wants to make a similar \$100 million investment. Today, both land speculators need go no further than their local S&Ls to get their \$100 million. Each institution needs to have \$100 million in insured deposits to make the loan that supports the land speculation. To lend that \$100 million, a savings and loan association need have a net worth of only \$3 million (3 percent of assets). If the land speculation is successful and makes \$60 million for the S&L (which is participating in the appreciation), the owners of the S&L are allowed to dividend out \$60 million (100 percent of the profits) to themselves. If the value of their \$100 million investment falls \$60 million to a value of \$40 million, the S&L owners lose only their \$3 million in capital (per \$100 million of investments) and the federal government picks up the remaining \$57 million in losses by paying off the insured depositors 100 percent.

Stacking the Odds

The S&L's speculative investment is usually made in the form of a very high interest rate loan to the land speculator. The institution usually demands 3-4 points (\$3-\$4 million) paid up front, plus a 25-50 percent profit participation. Typically, the loan amount includes the \$100 million land price plus the \$3-\$4 million in points paid up front *plus*

up to several years of interest payments at 200 basis points (2 percent) over prime. Even though the land might have fallen in value, the hypothetical S&L described above need not necessarily accept an immediate \$60 million loss. It can delay recognizing its loss, and it may even be allowed to dividend out as *profit* (1) the \$3-\$4 million it paid itself up front and (2) the profit it earned from the premium interest rate.

At one time, S&Ls made speculative land investments like these as equity purchases for their own account, but they developed this participating high interest rate loan approach when their regulators told them to "make more loans and fewer risky equity investments."

THE DANGEROUSLY FLAWED SOLUTION

Up until this decade, the savings and loan industry couldn't make these kinds of high-risk loans. Its investments generally were single-family home mortgages (at interest rates limited by state usury ceilings). S&L liabilities (deposits) were limited to individual insured passbook accounts (at interest rates established by the federal government). When interest rates rose sharply after 1978, the industry ran into trouble because most S&L assets were long-term home mortgages that were earning the lower returns prevalent in the early 1970s, while most S&L liabilities were short-term passbook deposits, and to retain these deposits institutions were now forced to pay much higher interest rates. One government response to this crisis in 1981 was to permit the institutions to engage in innovative accounting. S&Ls were allowed to sell off their mortgage portfolios. Since the book values of these mortgages were higher than the market prices, the institutions experienced enormous losses, but for accounting purposes, the S&Ls were permitted to amortize these losses over the lives of the sold mortgages. The regulators hoped that by permitting S&Ls to convert their mortgages to cash and by expanding the investment powers of the industry, the institutions could earn enough investment profits to cover the losses that they would annually report to reflect the sale of depreciated mortgages.

One may ask: How could the savings and loan industry and its regulators possibly believe that the industry as a whole, with no prior sophisticated financial management experience, could beat the nation's major commercial banks, insurance companies, and investment banking houses at their own game? Desperation apparently fosters self-delusion.

The New Limited Liability Investor

Unfortunately, an industry that was used to having both its selling price (interest rate on home mortgages) and its cost of goods sold (passbook deposit interest rate) established by the regulatory authorities, and one that had little or no experience with equity investments, was unprepared to enter the sophisticated world of financial management. However, it didn't take long for others in the investment community (speculators and conservative investors) to recognize that the ownership of an S&L in the new deregulated environment could confer many benefits. The investor/owner could have a relatively inexpensive cost of funds (insured consumer passbook deposits), receive 100 percent of the profits from his investments, and be liable for only 3 percent (required capital to asset ratio) of his losses. During the first half of this decade, the hottest investment vehicle for sophisticated investors was a newly chartered or purchased stock S&L.



Today, savvy investors throughout the nation pursue their investments with risks limited to only 3 percent of their project capital, because they own an S&L. If an S&L is still owned (and managed) by its original (pre-1980) owners/managers and has not taken advantage of its windfall opportunity investment powers, its owners are under increasing pressure to sell out their charter at several multiples of its true net worth to other more perspicacious investors.

There is nothing inherently wrong with an investor using other people's money to make more money for himself. However, in the "zero sum game world" of financial investments where one investor's gain is usually another investor's loss, there is something incredibly wrong with a system in which investors receive 100 percent of their profits and the American public is forced to pay up to 97 percent of their losses (as they pay back insured depositor accounts).

Patching the Leaks

Congress is beginning to address individual symptoms of this disease by such actions as reforming the deposit insurance system in response to recent financial events in Maryland and Ohio. But such reforms will only further compound the magnitude of the eventual catastrophe by allowing the industry more time to dividend out its profits and delay discovery of its losses. The disease of allowing individual S&L owners the power to speculate with public money should be stopped until the regulatory authorities can survey the damage already done and develop long-term solutions. It is estimated that one third of the thrifts currently have negative net worths that are being covered up by the misguided accounting methods that regulations now permit. Up to \$200 billion of savings institutions' capital (mostly government-insured through their deposits) might have already been lost. The total assets of the Federal Savings and Loan Insurance Company (FSLIC) available to protect depositors are only approximately \$6 billion, although no one doubts that Congress would insist that the federal government stand behind the FSLIC's obligations.

POLICY RECOMMENDATIONS

The following immediate reforms are needed to stop the types of activities that have been described here so as to stabilize the situation while the authorities survey the damage and work toward a permanent solution:

Eliminate accounting games. The ability of an S&L to defer the recognition of cash losses from its investment portfolio and to spread loss recognition over a fictional period should be eliminated. Similarly, an institution's ability to book profits from fees and interest payments on loans for which the S&L has loaned the borrower the funds from which these payments are made should be eliminated.

Increase minimum capital requirements. No S&L owner should be allowed to dividend out profits until its minimum net worth reaches at least 9 percent of assets.¹

Mandate matching assets and liabilities. An S&L that promises to pay a specific interest rate for a specified time period to a government-insured depositor should be required to purchase a government-guaranteed asset (say, a treasury note or an

¹ Federal Reserve Board Chairman Volcker has suggested this ratio for commercial banks.

FNMA-insured mortgage) at an equal or higher interest rate for a similar time period.

Long-Term Solutions

Over the long term, it is essential to reexamine the entire "savings industry" and cast a critical eye on the logic of government insurance on any consumer deposits at a time when government-guaranteed savings instruments like treasury notes and U.S. savings bonds are readily available. In an era that concentrates on tax reform, one must ask if it is reasonable for the tax law to reward excess spending behavior by letting a consumer deduct interest on his unpaid credit card purchases and to penalize savings behavior by taxing the same consumer on the interest he earns on his personal savings.

A Recommended Tax Reform

One way to significantly increase consumer savings would be to allow a taxpayer to defer income taxes on up to 20 percent of his earned income if

he puts that income into a government-guaranteed savings account that is secured by a corresponding government instrument like a treasury instrument. Interest earned on the account would also be tax deferred, but both income and interest would be taxed when the consumer removes the funds for consumption. (Effectively, the system would tax consumption instead of savings.)

The treasury loss from deferred tax revenues would be offset several times by the advantage of the lower interest rates on government borrowings that would result from the increase in the banking system's demand for government securities.

Despite the deferred taxes, the treasury would not be exposed to cash shortage. If the *average* federal income tax rate of savers is 25 percent, the taxpayer must deposit \$4 with the treasury (indirectly, via the purchase of a treasury obligation) for every \$1 of deferred income taxes. The thrift industry would function as an intermediary, serving the public interest as it does when it implements Individual Retirement Accounts.