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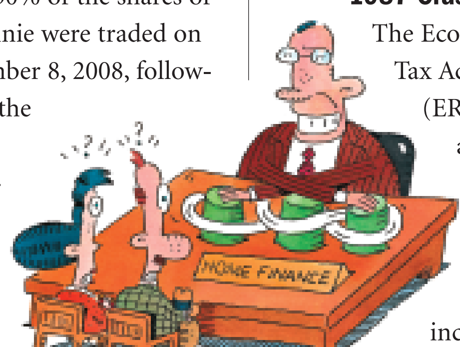
Reinflating Real Property Values

BY A.J. CATALDO, CMA, CPA, & ANTHONY P. CURATOLA

On September 8, 2008, Freddie Mac (NYSE: FRE) and Fannie Mae (NYSE: FNM), the holders of approximately 50% of mortgages in the United States, were seized by the U.S. government in a "bailout" that may cost American taxpayers between $100 billion and $300 billion. Effectively, owners of common equity saw the value of their holdings in these two firms decline by 80% to 90% as the common stock price per share for Freddie dropped from $5.10 to $0.88 per share and the common stock price per share for Fannie dropped from $7.04 to $0.73 per share. Because short positions effectively increase the number of shares issued and outstanding, more than 110% of the shares of both Freddie and Fannie were held by institutions. Approximately 50% of the shares of Freddie and Fannie were traded on Monday, September 8, 2008, following the news of the seizure over the preceding weekend. While many possible solutions may be under consideration, one possible fiscal policy-based answer may be to simply reduce the depreciable lives for residential real property, effectively increasing the net present value (and, therefore, the value) of these properties, if held for trade or business purposes. Some comparison between a less-recent historical crisis and the present situation warrants review.



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Change in Fiscal Policy: 1987 Crash

The Economic Recovery Tax Act of 1981 (ERTA81) greatly accelerated the depreciation deductions available for all asset classes, including real property, under the accelerated cost recovery system (ACRS). The Tax Reform Act of 1986 (TRA86), passed by Congress on October 22, 1986, provided for an increase in the depreciable lives of real property from their ACRS-based lives of 15 years to a MACRS-based (modified ACRS) life of 27.5 years (or longer) while severely restricting passive activity losses (PALs). Approximately one year later, on Monday, October 19, 1987, the Dow Jones Industrial Average (DJIA) dropped more than 22% in a single trading day. While there's no denying that program trading led the list of contributing variables to the 1987 stock market "crash," another possible causal link is the extension of depreciable lives—the move from ACRS to MACRS—and the imposition of passive activity loss limitations (PALs), which together placed downward pressure on real property values as an asset class. These provisions of TRA86 may have made economic sense on one dimension, but they were also likely to have contributed to the end of the real estate boom in the early to mid-1980s as well as to the savings and loan (S&L) "crisis" and the formation of the Resolution Trust Corporation (RTC) that followed.

Change in Monetary Policy: 2008 Crash

The stage was set for the current housing crisis during the 2002 through 2004 period. Many Americans refinanced their existing home mortgages at lower interest rates, effectively "cashing in" and consuming much of their equity, but the real problem arose when no-qualifying and no-documentation (no-doc) mortgages were approved by lenders. In many cases, these were negative amortization loans for the first few years of the life of the mortgage and/or adjustable rate mortgages, and, as interest rates recovered (June 2004), payments on these mortgages were reset at higher interest rates and higher monthly payments. Many new homeowners, as well as speculators anticipating a continuing rise in real property values, were unable (or unwilling) to make these higher payments as their equity positions evaporated. Lenders' declining collateral positions in these real properties, loan defaults, and home foreclosures grew, increasing the nonperforming components of lender portfolios of home mortgage loans. The Mortgage Forgiveness Debt Relief (MFDR) Act of 2007 provided some relief to taxpayers. As real property values declined and mortgages exceeded the fair market value of these properties, financial institutions holding these nonperforming, or "at risk," loans experienced increased shorting and even naked shorting of their equity securities. ("Naked shorting" is the sale of a stock that you don't own in anticipation of buying or "covering" this position at a future date and a lower price for a profit.) The Securities & Exchange Commission, the Federal Reserve, and the Secretary of the Treasury joined forces to suspend "naked shorting" of Freddie, Fannie, and 17 other financial institutions, but the suspension was only temporary. During the early portion of the suspension period (July 11, 2008, through July 23, 2008), nearly one-third of a trillion dollars of market capitalization recovery occurred for these financial institutions.

Stabilizing Residential Housing Values and Stimulating Demand

One of many possible solutions might include a reduction in the depreciable lives for residential housing. Increases in depreciation expense increase the depreciation tax shield, after-tax cash flow, and net present values for long-lived assets. While this may not solve the problem for homeowners, the consensus in the business and general press is that home foreclosures and mortgage defaults combined with the increase of these nonperforming loans in lenders' portfolios suggests that many of those approved for these troubled loans simply weren't economically able to purchase these homes at the time these mortgages were approved. Therefore, it appears that an insufficient number of creditworthy homeowners may be available to absorb the increased inventory of residential housing, and the only alternative may be to provide fiscal policy-based economic incentives to investors to absorb the surplus supply for the near term. Perhaps it's merely a question of the "form" of the bailout: (1) a tax-incentive-based fiscal policy measure or (2) direct governmental ownership of Fannie and Freddie. ■

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