Click here for Full Issue of EIR Volume 17, Number 2, January 5, 1990

The banking crisis of 1990 has begun

by John Hoefle

"We feel a bit vindicated in Texas; it goes to show we're not the dumbest people in the world. Misery loves company," one Texas investor told the *Wall Street Journal* Dec. 21, prompting the *Journal* to reply that "misery is getting a lot of company."

Misery will indeed have a lot of company among banks and other financial institutions in 1990, the year in which the "Texas disease" spreads to the Northeast and other parts of the country. The "Texas disease"—the collapse of an entire state's financial system—never was, strictly speaking, a Texas problem. It is a systemic problem affecting the entire United States financial system, of which Texas is thus far merely the most serious outbreak. It is now erupting with a vengence in New England, but it will not stop there.

While the Texas financial system was dying, the nearly uniform line emanating from such annointed experts as bankers, economists, and analysts, was that this was an isolated phenomenon caused by the collapse of the oil industry and the greedy speculation of Texas developers. There was no chance, they insisted, that the crisis could spread; it couldn't happen. But it has.

The analysts, again almost in unison, now insist that the banking blowout under way in New England cannot be compared to Texas. Why? Because the Texas crisis was triggered by an oil price collapse. New England doesn't have an oil industry, the chorus claims, and besides, New England has a diversified economy.

Such claims are nonsense. First of all, the dear departed Texas economy was quite diversified, with oil, agriculture, electronics, medicine, transportation, and manufacturing, to name a few. Second, the oil price drop was not the *cause* of the banking crisis, it was merely the *detonator*. The real explosion was caused by the collapse of the speculative real estate bubble. Now the New England real estate bubble has popped, bringing with it similar consequences. The fact that the New England crisis was detonated by collapses in financial services, technology, and defense spending rather than oil is significant, but the end result is the same.

Real estate crisis

Throughout the late 1980s, the nation's commercial banks and thrifts turned increasingly to real estate lending, in the vain attempt to stay profitable in the midst of a collapsing economy. With industry and agriculture on the skids, only real estate and other forms of quick-buck speculation offered banks the chance to make up for their losses in more traditional lending areas. One might compare their actions to that of a bankrupt person in a casino, betting all his remaining money in the desperate hope that he could hit the jackpot and get back on his feet. Since 1985, according to the Federal Deposit Insurance Corporation, nearly half the loans issued by commercial banks have been real estate-related, and today, two-thirds of all new commercial bank loans are real estate-related. This repeats the pattern in Texas in the early 1980s.

The crisis in New England is exemplary. According to figures issued on Dec. 19 by the Office of the Comptroller of the Currency, "The biggest increases in real estate lending since 1985 have occurred in banks located in the Northeast. Outstanding real estate loans in the OCC's Northeastern District increased $133 billion between the fourth quarter of 1985 and the third quarter of 1989, approximately 45 percent of the rise in all commercial bank real estate loans during that period." The danger of such a rush to real estate was also clearly spelled out by the Comptroller: "The rise in nonperforming real estate in the Northeast was especially

© 1990 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

pronounced in the first three quarters of 1989, rising $4.5 billion. Further increases—including those announced in the past week—will push nonperforming real estate in the Northeast even higher by the end of the year."

At the same time that real estate lending has dominated banking, the real estate markets themselves have begun to soften. A recent study by the Rutgers University Center for Urban Policy Research shows that home prices nationally have peaked and are starting to decline. The study attributes the decline to the slowdown of the economy nationally, the bursting of the speculative bubble, and to the aging of the "Baby Boomers." The study indicates that home prices in the Northeast will be some 10% lower in 1990 than they were in 1989.

"We've had a generation now that was imbued with the belief that housing ownership was the route to guaranteed wealth and that housing investment was the best possible investment that could be made. That was absolutely true for the last 20 years. But we are entering a new housing era," Prof. James W. Hughes, one of the study's authors, recently told the *Philadelphia Inquirer*. Homeowners will now have to face the fact that their homes might not be worth as much next year as they are this year. "It is traumatic for somebody who bought at the peak of the market in 1987 or 1988," Hughes said.

The study revealed that the average price of a home in the New York City-northern New Jersey-Long Island area was 5.1% lower in the third quarter of 1989 than it was in the third quarter of 1988. That compares to a price increase of 200% between 1980 and 1988. Given the importance of the metropolitan New York area to the nation's economy, such figures are indeed cause for concern. When the New York City real estate bubble pops, the remains of the nation's economy will go with it.

Further accelerating the decline in real estate prices is the financial crisis itself. The savings and loan business is in a period of intense "downsizing," dumping real estate holdings and mortgage-backed securities on the market in an attempt to shrink into compliance with the higher regulatory capital standards that took effect Dec. 7. According to *Investor's Daily*, 816 thrifts failed to meet the capital standards, meaning that one-third of the nation's 2,700 remaining S&Ls have inadequate capital. The only chance—slim though it is—for most of these thrifts to survive, is to dump even more of their real estate and real estate-related assets on the market. Such dumping will only further depress real estate prices.

The United States government is faced with a similar problem. The Resolution Trust Corp., the entity charged with selling all the assets obtained from failed thrifts, does not have enough money to close all the existing insolvent thrifts, much less close newly insolvent ones. The only way the RTC can raise the funds, short of another government bailout bill, is to sell the assets it already possesses. However, if the RTC, already the nation's largest real estate company, tries to unload its vast portfolio, it would have to sell the properties at substantial discounts to attract sufficient buyers. Doing so would, of course, further depress already collapsing real estate prices, and cause more companies and individuals to go broke. This would set off a downward spiral of defaults on real estate loans at banks and thrifts, with these escalating nonperforming loans putting an ever-greater number of banks over the edge of insolvency.

The disease spreads

Banks in New England are currently feeling the brunt of the crisis. The Bank of New England, the region's second-largest bank, has had a massive increase in its nonperforming real estate loans; it has suffered a pounding of its stock on the market and is frantically searching for a buyer or for someone to inject $200 million in capital. Banks said to be interested in buying the Bank of New England include Fleet/Norstar, Citicorp, Chase Manhattan, Wells Fargo, Shawmut, and Security Pacific. Significantly, none of the banks which bought Texas banks is in the running—they now know better.

Many of the banks and thrifts in New England have what the *Boston Globe* referred to recently as an "unrealistically rosy" view of the coming year. Their loan loss reserves, the *Globe* said, are declining at a time when their nonperforming loans are increasing. Such actions may temporarily mask the extent of the financial problems, but they insure that when the problems are finally admitted, they are often insurmountable. Again you have the Texas pattern, in which banks put off revealing the true extent of their loan losses until it was too late—and when they finally did, they went under.

New England banks aren't the only ones suffering, either. City Federal Savings Bank, the largest thrift in New Jersey, recently failed. The New Jersey real estate market began to soften in late 1987, when the stock market crash caused many layoffs on Wall Street. Building permits for new homes and apartments peaked at 57,074 in New Jersey in 1986, falling to 40,268 in 1988, according to the New Jersey Department of Labor. Banks in the greater Washington, D.C. area have also suffered. The area is "two or three quarters behind New England," Johnston Lemon bank analyst Elisabeth Hayes recently told the *Washington Times*.

The real estate bubble is collapsing nationwide, and with it the nation's banking system. Texas was not an isolated problem, and neither is New England; both are previews of the fate that awaits the national economy. The nation's banking system, already suffering mightily from the collapse of the productive economy, is now feeling the effects of the collapse of the financial side of the economy. The speculative real estate boom, which formed the foundation for the vast speculative bubble known as the Reagan-Bush "recovery," is quickly turning to sand. As it collapses, it will inevitably bring down the entire structure, banks and all.