As real estate falls, the bank run is on

The speculative boom which fueled the spectacular growth of the nation's banking system during the 1980s is over, and the paper profits which propped up the banking system are relentlessly vanishing. The run is on.

This paper collapse takes many forms, but underlying it all is the biggest financial time bomb: The real estate market blowout has begun all across the nation, devastating the financial institutions in its path.

Banking collapse

The stock market crash of Friday, Oct. 13, 1989, was a singular point in the collapse of commercial banking. Since that day, the stocks of the major U.S. banks have been plummeting, with New England banks leading the way. From the close of business Oct. 12 to the close of business Dec. 15, the stock of the Bank of New England, the second-largest in the region, dropped an astounding 53%; the largest, the Bank of Boston, dropped 30%; and Shawmut National dropped 23%. The driving force behind the collapse of the region's banking system is the collapse of real estate values. These banks are holding billions of dollars in non-performing real estate loans on their books, which are in many cases no longer worth the money owed. What the financial community used to call the "Texas disease," is now referred to as the "New England disease."

Yet, the nation's biggest banks have *all* taken significant stock hits since Oct. 12. Citicorp, the largest, is down 19%; Bank of America is down 25%; Chase Manhattan is down 24%; Chemical Bank is down 21%; Manufacturers Hanover is down 24%; Security Pacific is down 23%; Bankers Trust is down 25%; First Chicago is down 24%; and First Interstate is down 23%. J.P. Morgan, the pride of Anglo-American finance, is down 7%.

True, most of these banks still have higher stock prices than they had going into this year, but such linear comparisons miss the point. With a banking crash under way, the highly inflated bubbles are collapsing in an increasingly non-linear way.

Thrift 'bailout'

The commercial banks have at least managed to keep up the pretence of solvency. The thrift institutions have not, and are rapidly disappearing. The much-touted $166 billion savings and loan "bailout" bill signed into law by President Bush Aug. 9, was not a bailout at all, but rather a federally subsidized gift to Wall Street, designed to force the $1.2 trillion in deposits currently held by thrifts into the hands of the commercial banks and their allies.

The bill, known as the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), restructured both the thrift industry itself, and the network of government agencies which regulate it. The thrust of the bill was to make it harder for the S&Ls to stay in business, and make it easier for the banks to take them over. The bill abolished the Federal Home Loan Bank Board, which had previously regulated the thrifts, and turned them over to the new Office of Thrift Supervision, a unit of the Treasury, and to the Federal Deposit Insurance Corporation. The fox is now in charge of the chicken coop.

To dispose of the hundreds of billions of dollars of assets from the failed thrifts, the bill created the Resolution Trust Corporation, and also created a Resolution Funding Corporation to sell bonds to fund Resolution Trust. The Federal Savings and Loan Insurance Corporation was replaced by the Savings Association Insurance Fund (SAIF), under the auspices of the FDIC. The FDIC's own insurance fund was renamed the Bank Insurance Fund (BIF). Together, SAIF and BIF form the Deposit Insurance Fund (DIF). (Only STIFF, which is what will be left of the S&L industry, has been omitted.)

The bill allows, for the first time, commercial banks to take over healthy S&Ls, and to integrate such acquisitions into existing branch operations. It also allows S&Ls to convert to bank charters; thrifts that convert will still have to pay the higher S&L insurance premiums for five years, however.

FIRREA established new loan guidelines for thrifts, forcing them to keep nearly 70% of their assets in mortgage-related investments, and prohibited them from buying junk bonds and other speculative practices. The restrictions on the thrifts' loan portfolios will prevent them from regaining their health, forcing them into failure or takeovers.

The bill established new capital requirements for S&Ls. The new standards, which took effect Dec. 7, call for a minimum of 3% core capital—including 1.5% in tangible capital—and an additional capital reserve based upon a risk analysis of assets. As of that date, some 800 thrifts, which hold some 45% of the total $1.3 trillion in thrift assets, failed to meet the capital requirements by about $20 billion. They will have until Feb. 5 to file plans with the agency detailing how they intend to bring their capital-to-assets ratios up to the required level.

There are two ways thrifts can increase their capital-to-assets ratio. The best way is to increase the amount of equity capital in the thrift, either by putting profits back into the institution, or by attracting additional funds from investors. Since the thrifts are losing money at an alarming rate, there are few profits to reinvest, and investors are hard to find. The second way is for thrifts to reduce assets by selling them off, and by reducing the level of deposits. This self-cannibaliza-

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tion goes by the name "downsizing," and is considered clever in some circles.

The thrift business is, in fact, downsizing just as fast as it can. James Barth, the chief economist for the OTS, told the annual meeting of the U.S. Savings and Loan League in Chicago Nov. 4-5, that preliminary OTS data show the thrifts reduced their assets by nearly $30 billion in August and September, and reduced their assets by nearly $15 billion during that period. Even with this fire sale of assets, the thrifts still lost $2.5 billion in the third quarter, giving them a loss of $9.7 billion through the first nine months of 1989.

Texas as the model

The collapse of the Texas financial system is a harbinger for the nation as a whole. Over the past two years, several hundred Texas banks and S&Ls have failed. In 1988, according to FDIC figures, 118 Texas banks failed. In 1989, with two weeks left to go, 133 Texas banks have failed. Both years set records for the most failures in a state since the Great Depression of the 1930s. Texas also leads the nation in failed thrifts for the period. How this came to be, has national implications.

The oil boom pumped billions of dollars into the Texas economy, feeding the real estate boom already in progress. All those oil companies and their employees needed places to work and live, and their prosperity brought in many more service businesses, each with the same needs. Real estate loans seemed like a sure thing to short-sighted bankers. Since real estate values were skyrocketing, even poor businessmen were making money hand over fist, and even if the loan defaulted, the bankers figured, they would always have the property. What could go wrong? During the 1982-86 period, nearly one out of every two dollars lent by the big Texas banks was for some sort of real estate transaction.

This pattern of increased real estate lending has been repeated across the country. FDIC chairman William Seidman recently warned that real estate loans, which account for almost two-thirds of all bank loans made over the past several years, now make up about 35% of all commercial bank loans in the country, and about half of all non-performing bank loans.

In their zeal to maintain profits, the Texas banks overlooked the obvious—that the collapse of energy would detonate a much larger blowout in the real estate market. Energy loans weakened the banks, but real estate loans killed them.

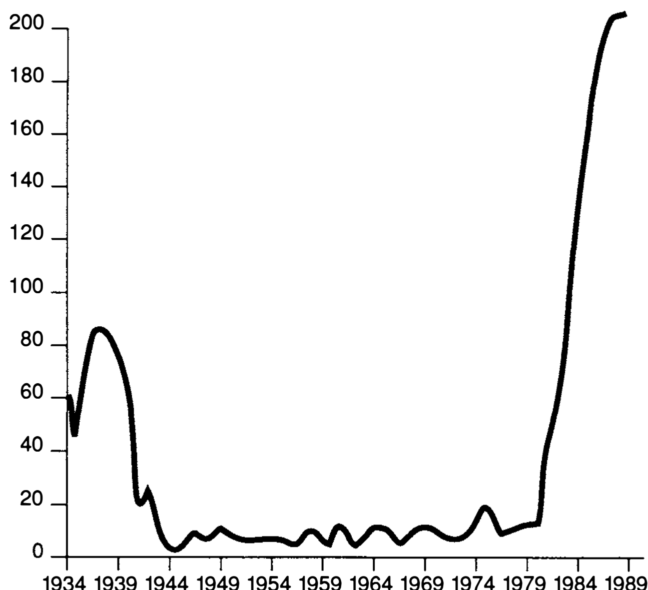
Save the banking system

In February 1989, Lyndon LaRouche issued a set of proposals to save the nation's savings and loan system from what he described as "a catastrophe as bad as or worse than that of the 1931-34 period." LaRouche proposed that the following measures be taken immediately to rescue the nation's banking system:

"*1) Federal Reserve reform establishing a two-tier credit system*. The Fed would be prohibited from creating fiat money, and forced to issue low interest credit for through the banking system for mortgages, agriculture, new capital investment, production, transportation, and other productive ventures. Non-productive loans would be made at higher rates. Banks and thrifts which loan at least 80% of their assets for productive purposes would be allowed lower reserve standards than their more speculative brethren, giving market advantage to traditional S&L mortgage lenders and industrial and agricultural bankers.

FIGURE 1

Number of U.S. bank failures 1934–1989*



Source: FDIC.*
*Figure for 1989 is as of Dec. 7

"*2) Tax reform*. Remove all tax liability up to annual incomes of $30,000. Under this proposal a great many savers would pay no tax on S&L deposit income, encouraging deposits. For depositors with higher income, provide savings incentives with exemption of 50%, or $1,000, whichever is higher, on interest income on deposits in those S&Ls and banks whose asset bases meet the productive loan targets. This would make interest income on large deposits competitive with tax-free bonds.

"*3) Tax financial institutions with a certain level of business in the Eurodollar market at a much higher relative rate*. Revenue to replenish the FSLIC and make up for the family-formation tax cut by increasing tax schedules on income and capital gains on non-productive investment, especially commercial real estate. This would include financial institutions with a significant proportion of assets and deposits in the Eurodollar market.

"*4) Reinforce and strengthen the Glass-Steagall Act of 1933*."