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Your money's not safe—U.S. banks about to blow

by John Hoefle

In May 1933, newly elected President Franklin Delano Roosevelt used his executive authority to declare a national "bank holiday." Across the country, banks were shut down, and credit reorganized. The President acted thus to bring under control the banking panic generated out of the economic disasters of Herbert Hoover. Out of his actions in subsequent weeks, the institutions were born which shaped the banking and credit system of today.

It may not happen this May in quite the same form. In fact, no one can really know precisely when it will happen. But happen it will: The nation's banking system is on the eve of the same kind of crisis as the one which forced FDR to act back in the spring of 1933. The end of the road has been reached for the institutions shaped in the spring of 1933. The process of economic collapse, accelerating since 1982 unchecked, with new impetus in the year since George Bush was inaugurated, has wiped out entire classes of the physical assets which provide collateral for banks' transactions, and has now begun to wipe out the core of the fiction on which the banks' continued existence has come to depend.

This last class of physical asset is real estate. Especially since the enactment in 1982 of the Garn bill deregulating the nation's thrifts, and the corollary first Reagan tax reform, which created tax shelters for certain kinds of real estate investment, the speculative inflation of real estate prices has been one of the principal motors for the spread of usury and speculation which both the Reagan and Bush administrations foolishly named the "Great Recovery."

The nation's banks have invested heavily into all forms of real estate, both directly and indirectly. Besides the loans made directly on real estate ventures, for speculative profits and, before 1986, tax benefits, the banks have also used real estate as collateral for commercial, industrial, consumer, and other types of loans. Speculative pricing of inflated real estate replaced competent economics in the assessment of the value of obsolete and fully depreciated

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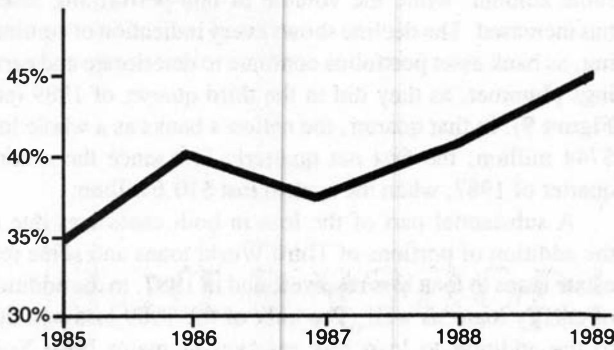
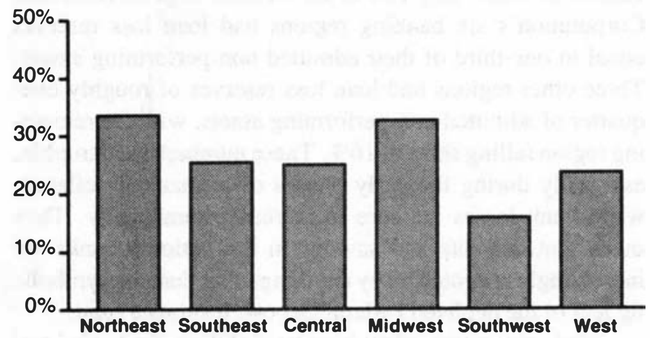
FIGURE 1
Non-performing real estate assets, as percentage of total non-performing assets



Source: Comptroller of the Currency

FIGURE 2
Loan loss reserves, as percentage of non-performing assets, by FDIC region



Source: FDIC

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Anxious depositors line up at a bankrupt Maryland savings bank, 1987; frenzy on the Frankfurt monetary exchange after the October 1987 crash.

physical assets. The speculatively inflated real estate prices carry over into all classes of economic transactions.

Now as the depression deepens, and the collapse of household and corporate earnings begins to bite into bone, the speculatively inflated real estate markets around the country are beginning to collapse back to the lower levels indicated by the shrunken state of the nation's physical assets.

This has a direct impact on the banks, in several ways. First, it means that the real estate which the banks are carrying on their books—both directly and as collateral for loans—is no longer worth what they claim it is. Second, it means that loans to speculators and others whose profits were dependent upon the money returns on real estate speculation, are increasingly going into default. As a result, the banks are going to have increasing numbers of non-performing loans on their hands, especially increasing numbers of non-performing real estate loans. Try as they might to resist it—and they are trying—the banks will eventually be forced to revalue their real estate portfolios and collateral holdings to reflect their decreased value, meaning huge losses. As they do so, they will have to devalue all other assets affected by the speculative pricing of real estate.

The ensuing chain reaction takes the form of the "run against the banks" which FDR acted to stop in the spring of 1933.

Non-performing real estate

Real estate has grown rapidly as a component of the total non-performing assets of the banking system as a whole. In 1985, non-performing real estate loans made up 35% of total non-performing assets, but by the third quarter of 1989, that figure had risen to 45% (see **Figure 1**). Except for a small dip in 1987, when banks wrote off some of their bad real estate loans, that figure has been rising steadily. And this rise has occurred in a period in which total non-performing assets have been rising as well, meaning that the collapse of real estate has been even more dramatic than the figures show. This growth rate is the death knell for the banks as presently organized.

The banks have been reluctant to admit the extent of their real estate and other losses, and naturally so, given their magnitude. The best indication of the banks' "official" estimate of the status of their loan portfolios is the level of their loan loss reserves to their admitted non-performing assets. Loan loss reserves are funds set aside to use in writing off bad loans, but are distinguished from the actual write-offs themselves. Loan loss reserve funds are counted by the banks as part of their capital until the loans are actually written off, or "charged off," in banking terminology. Once loans are charged off, the bank is forced to deduct the amount of the charge-offs from their capital. Funds added to the loan loss reserves are, however, deducted from net income, making banks reluctant to increase those reserves.

The nation's banks have miserably low levels of loan loss reserves compared to even their admitted level of non-performing assets, much less compared to their actual level of non-performing assets (see **Figure 2**). As of the third quarter of 1989, only two of the Federal Deposit Insurance Corporation's six banking regions had loan loss reserves equal to one-third of their admitted non-performing assets. Three other regions had loan loss reserves of roughly one-quarter of admitted non-performing assets, with the remaining region falling short of 16%. These numbers spell trouble, especially during the early phases of a financial collapse, when bank losses are sure to increase dramatically. They mean that deposits and savings in the nation's banks are increasingly unprotected by anything other than the symbolic fig leaf of the depleted Federal Deposit Insurance fund.

While real estate values have been sliding, the banks' real estate exposure has been growing. For the banking system as a whole, real estate loans amount to almost four times stockholders' equity (see **Figure 3**). For all intents and purposes, stockholders equity can be considered to be the same as paid-in capital, though the two are not exactly co-extensive. It is the "reserve" available which covers such contingencies as runs against the banks.

The exposure varies somewhat by region (see **Figure 4**), from about 4.5 times equity in the West, to "only" 2.5 times equity in the Midwest. Since stockholders' equity is roughly the "net worth" of a bank, were real estate values to collapse anywhere near the 75-80% forecast by LaRouche, the banking system would be thrown into immediate bankruptcy. This process is well under way, as admitted non-performing real estate loans have already risen to about 17% of stockholders' equity for the system as a whole—a 70% increase in the last five years (see **Figure 5**).

While much has been made over the last decade about the exposure of the banking system to Third World loans—which are, after all, for the most part uncollectable—the Third World loan problem pales in comparison to the crisis in real estate. While Third World loans were about half the level of real estate loans in 1985, today they are closer to one-third the level of real estate loans (see **Figure 6**). Furthermore, the Third World loans are held mainly by the biggest banks, whereas real estate loans permeate the entire banking system. Also, while the level of Third World loans has remained nearly flat over the last few years, real estate loans have not. As **Figure 7** shows, even during 1988 and 1989 real estate loans have been increasing as a percentage of total loans.

Although the pundits have dismissed as insignificant the 190-point drop in the Dow Jones Industrial Average on Oct. 13, 1989, it was indeed a significant inflection point in the escalating financial crisis. The stock prices of many of the nation's banks have plummeted since that date. As the *EIR* Bank Stock Index shows (**Figure 8**), the stock prices at the nation's largest money center and regional banks have dropped by over one-third since the Friday the 13th market crash.

Thus, the reserves available to cover contingencies such as runs against the banks, have shrunk by approximately the same amount, while the volume of non-performing assets has increased. The decline shows every indication of continuing, as bank asset portfolios continue to deteriorate and earnings plummet, as they did in the third quarter of 1989 (see **Figure 9**). In that quarter, the nation's banks as a whole lost $744 million, the first net quarterly loss since the second quarter of 1987, when the system lost $10.6 billion.

A substantial part of the loss in both cases was due to the addition of portions of Third World loans and some real estate loans to loan loss reserves, and in 1987, to the addition of energy loans as well. The bulk of the 1989 loss was due to the addition to loan loss reserves at major New York banks. J.P. Morgan added $2 billion to its reserve for such debt in the third quarter, while Bankers Trust added $1.65 billion and Manufacturers Hanover added $1.1 billion. The final figures for the fourth quarter are not in, but Citicorp added $1 billion to its loan loss reserves for Third World debt during the final quarter, indicating that the losses will continue.

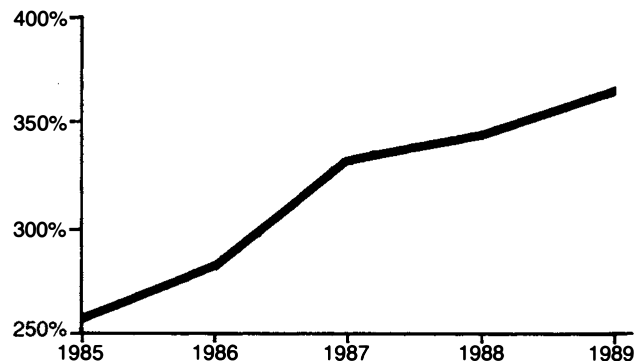
Texas comes to New England

The focal point of the banking blowout now under way is New England, whose banking system is dominated by the big Boston banks: Bank of Boston, the Bank of New England, and Shawmut National Bank. Fleet/Norstar of Rhode Island is also a major player, but Boston is the region's financial center.

When *EIR* analyzed the Texas banking system (April 11, 1986, "Oil Price Crash: The Demise of the Lone Star State"), we were surprised to learn that nearly 50 cents out of every

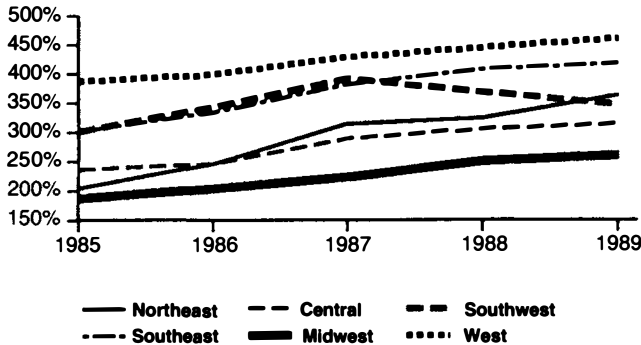
FIGURE 3

U.S. commercial banks' real estate loans, as percentage of stockholders' equity



Source: Comptroller of the Currency

FIGURE 4
U.S. commercial banks' real estate loans as percentage of equity, by region



Source: Comptroller of the Currency

FIGURE 5
U.S. banks' non-performing real estate loans, as percentage of stockholders' equity

Source: Comptroller of the Currency

dollar in new lending between 1982 and 1986 had been for real estate. Such a headlong rush into real estate is what killed Texas banking. When the Texas real estate market collapsed, it took the Texas banking system with it. Today, not a single one of the former six largest Texas banks remains as it was in that period. RepublicBank and InterFirst merged to become First RepublicBank, which failed spectacularly and today is known as NCNB Texas. MCorp still exists, but federal regulators seized almost all of the holding company's banks and sold them to Bank One of Ohio. Texas Commerce was acquired before it failed by Chemical Bank of New York, and First Interstate similarly acquired Allied Bancshares. First City Bancorp. was purchased by a group led by Armand Hammer crony A. Robert Abboud, and is a new company, under the same name. Texas American Bancshares and National Bancshares Corp. also failed. Of the top ten Texas banks of the period, only the sleepy Cullen/Frost Bankers remains.

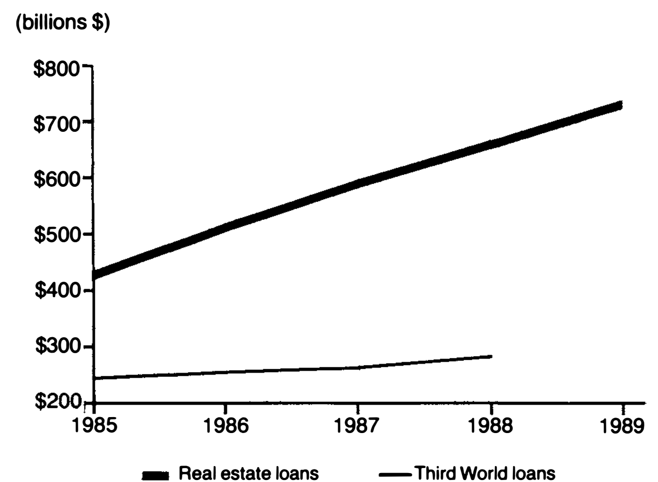
Texas was not an isolated event, however. The collapse of Texas banking is just the first manifestation of the effects of the deflationary blowout in real estate values across the nation. Texas was the prologue to what is about to hit the banking system as a whole.

Pundits and financial analysts, in their haste to pretend that the current banking crisis in New England is totally separate from what happened in Texas, insist that New England is different because Texas was overly dependent upon energy, while New England has a more diversified and broad-based economy. Such shallow proclamations overlook three key points.

First, the Texas economy was in fact diversified, a mix of energy, agriculture, technology, defense, medicine, and transportation. Second, the collapse in energy prices was merely the *detonator*; the real explosion was real estate. In New England, the detonator is different, but the effect is the same. Third, and most important, the nation is sinking ever more deeply into a depression, which is the driver for all the allegedly isolated regional crises around the country.

The situations in Texas and in New England are strikingly similar. In fact, New England banks have gone even more deeply into real estate loans than did their Texas counterparts. During 1984-88, the big three Boston banks made significantly more of their new loans in real estate than did the biggest Texas banks (see **Figure 10**). The Bank of New England is now paying the price for loaning out 59 cents of every new dollar in loans for real estate during that period,

FIGURE 6
U.S. commercial banks' real estate loans and Third World loans
(billions $)



Source: Government Accounting Office

and where the Bank of New England now goes, the Bank of Boston and Shawmut are sure to follow.

The Bank of New England has entered a pattern similar to the big Texas failures (see **Figures 11-14**). The Bank of New England's new management has embarked upon a program of selling off assets in order to save the bank, but the move is too little, too late. On top of that, the bank has been forced to borrow billions from the Federal Reserve Bank of Boston just to cover depositor withdrawals. The Bank of New England is being asset-stripped, whence it will be thrown on the federal junk heap, along with the carcasses of the major Texas banks, with the other New England giants soon to join it.

The Northeast is next

The crisis in New England is merely the most visible aspect of what affects the Northeast as a whole. Real estate loans amount to some 375% of stockholders' equity for banks in the Office of the Comptroller of the Currency's Northeastern District, which consists of New England, New York, Pennsylvania, and New Jersey.

Real estate loans have nearly doubled as a percentage of stockholders' equity for Northeastern banks since 1985 (see **Figure 15**). Considering the massive losses when portions of their much smaller Third World loans were added to loan loss reserves, one can well imagine the turmoil when the big New York banks begin to admit their real estate losses. Nonperforming real estate skyrocketed during the first three quarters of 1989, to about three times the 1985 level (see **Figure 16**). The median price of housing in New York City fell 14% during 1989.

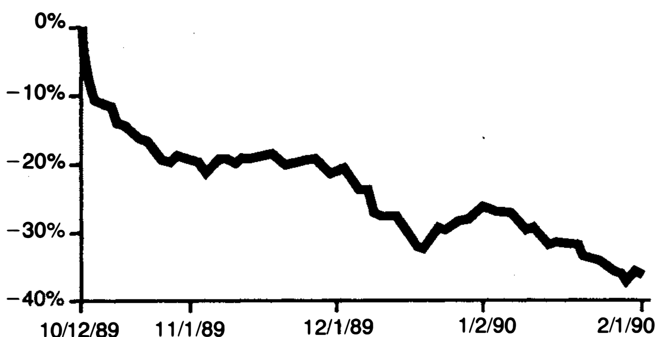
Given the dominant position of the Northeastern District in the U.S. banking system, with about 40% of the entire system's assets (see **Figure 17**), any crisis in the region will have dramatic repercussions on the nation as a whole. When—not if, but when—the banking system of the Northeast collapses, it will take with it the rest of the system—whatever that may be at that point.

The folly of 'controlled disintegration'

The banking crisis is systemic. It was not confined to Texas, it is not confined to New England and the Northeast, it is not confined at all. Nor is it actually a banking crisis. The banks are bankrupt because the economy is bankrupt. The economy was crushed by Federal Reserve chairman Paul Volcker on behalf of the insane policy of "controlled disintegration" during 1979-82. Since then, the physical economy has functioned below breakeven, operating at a net loss, with the discrepancy covered over by financial speculation and inflation, and by imports of goods the U.S. no longer pro-

FIGURE 8

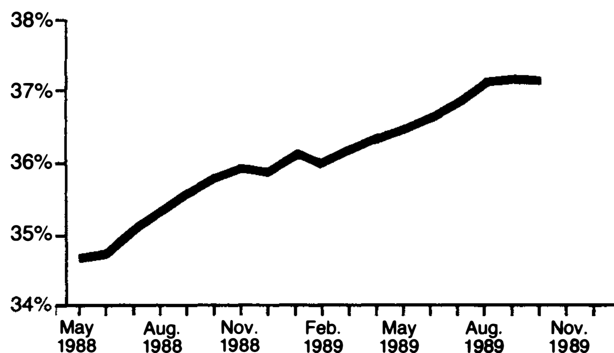
EIR Bank Stock Index,* change since Oct. 13 stock market crash



* Composite of 26 money center and regional banks.

FIGURE 7

U.S. commercial banks' real estate loans, as percentage of total loans

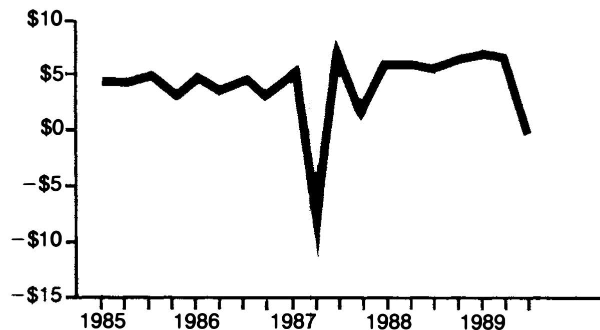


Source: Federal Reserve

FIGURE 9

U.S. commercial banks' quarterly net income

(billions $)



Source: FDIC

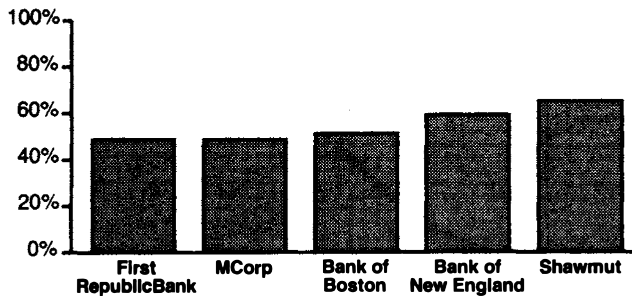
duced for itself.

In 1985, when annual debt service demands exceeded the annual wealth generated by the U.S. economy, a bankrupt financial system was added to a bankrupt economy. Since then, debt and speculation have continued to spiral upwards, amounting to a combined mass in excess of $20 trillion by the end of 1989. The banks moved out of their traditional activity—i.e., lending to increase wealth generation through creation and improvement of physical capital assets—and into the speculative, chain-letter Ponzi scheme they called "creative" or "innovative finance." Speculatively appreciating real estate prices, the related expansion of debt, and the bloated stock market were the symptoms of the disease.

The combination killed America's banks, victims of decades of incompetent economic policies which have thrown the nation into the greatest depression in its history. Over the Reagan-Bush years—the years of the so-called "Great Recovery," the nation's banks have been failing at a rate not seen since the Great Depression (see **Figure 18**). The effect of this calamity is relected in the ill health of the Federal Deposit Insurance Corporation, the agency created in 1933 to put the full faith and credit of the United States government behind citizens' deposits in the nation's banks. After many years of profitability, the FDIC lost $4 billion in 1988, meaning that it had to pay out $4 billion in deposit insurance more than it took in in premiums from the banking system (see **Figure 19**). The loss caused a sharp drop in the amount of money available in the FDIC's Bank Insurance Fund (see **Figure 20**).

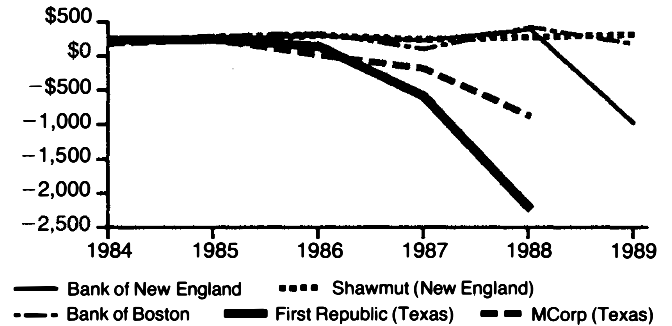
The number of banks is also steadily decreasing (see

FIGURE 10
Increase in real estate loans in Texas and New England
(% of all new loans)



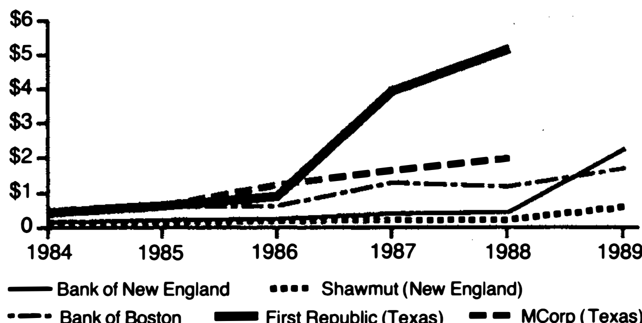
Note: Texas figures are for 1982-86; New England for 1984-88.
Source: EIR

FIGURE 11
Net income of selected Texas and New England banks
(millions $)



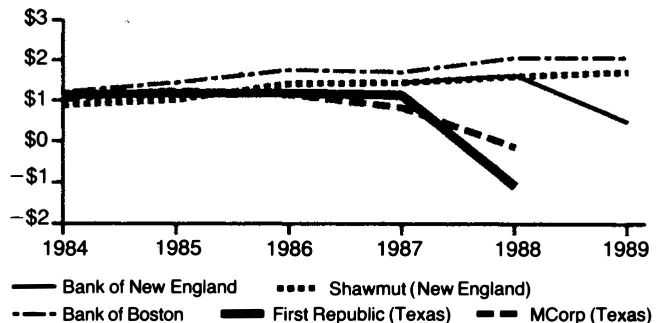
Source: annual reports

FIGURE 12
Non-performing assets of selected Texas and New England banks
(billions $)



Source: annual reports

FIGURE 13
Stockholders' equity in selected Texas and New England banks
(billions $)



Source: annual reports

Figure 21), dropping by about 10% since 1985. Unless present policies are shifted rapidly in the direction outlined repeatedly by LaRouche, that process will continue until either a single event or combination of events touches off an explosion, or until the speed of the collapse begins to outrun the ability of the perception managers to make it appear that the system is still solvent.

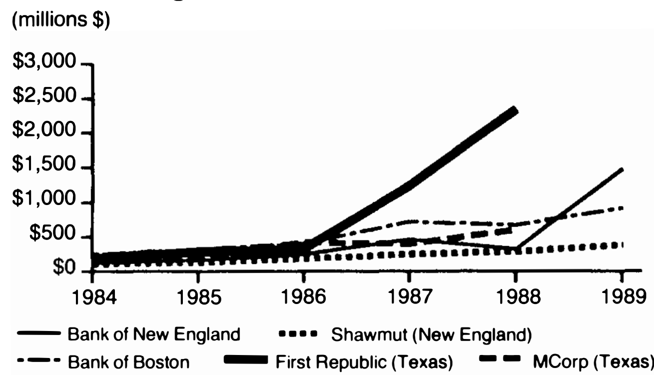
The LaRouche banking reform

The nation's banking system is bankrupt, and no amount of rhetoric or sleight of hand can save it. The collapse of the financial system is inevitable and unstoppable. However, it is not too late to save the productive part of the economy, including the structure of the banking system, and with it the livelihood of the millions of Americans whose very existence is at stake. The speculative bubble is finished, but the economic infrastructure can still, even at this late date, be saved—if we immediately return to the American System of economics that built this once great nation.

In February 1989, Lyndon LaRouche issued a set of proposals to save the nation's banking system:

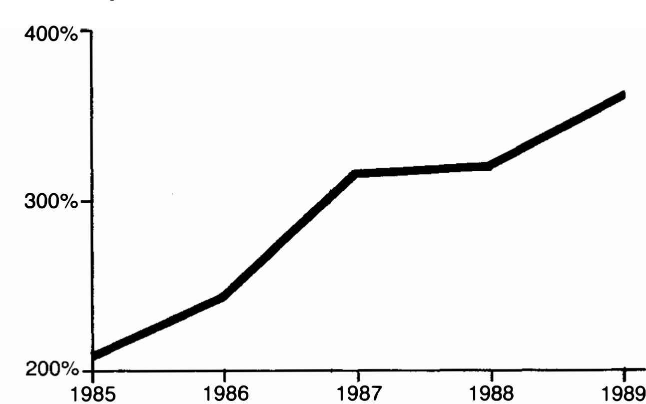
"*1) Federal Reserve reform establishing a two-tier credit system*. The Fed would be prohibited from creating fiat money, and forced to issue low interest credit through the banking system for mortgages, agriculture, new capital investment, production, transportation, and other productive ventures. Non-productive 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 mar-

FIGURE 14
Loan loss reserves of selected Texas and New England banks
(millions $)



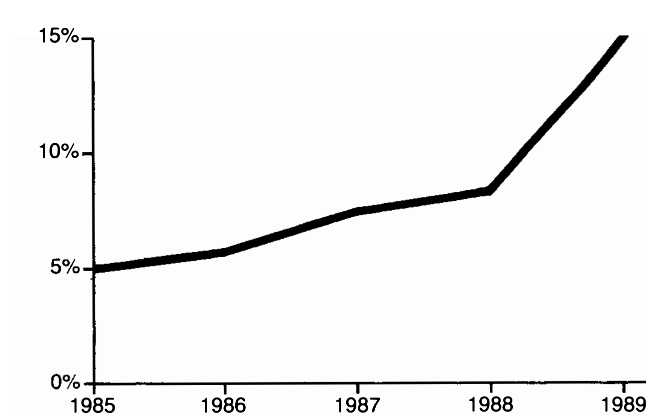
Source: annual reports

FIGURE 15
Real estate loans as percentage of equity in Comptroller's Northeastern District



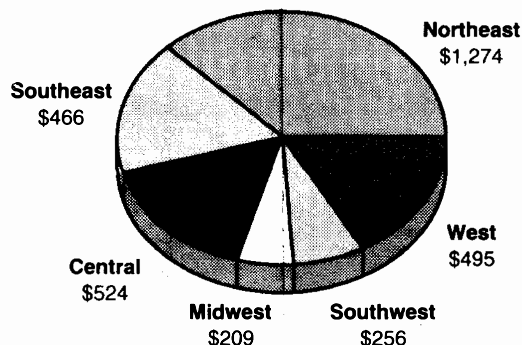
Source: Comptroller of the Currency

FIGURE 16
Non-performing real estate loans as percentage equity in Comptroller's Northeastern District



Source: Comptroller of the Currency

FIGURE 17
Distribution of assets in U.S. banking system
(billions $)



Source: FDIC

ket advantage to traditional S&L mortgage lenders and industrial and agricultural bankers.

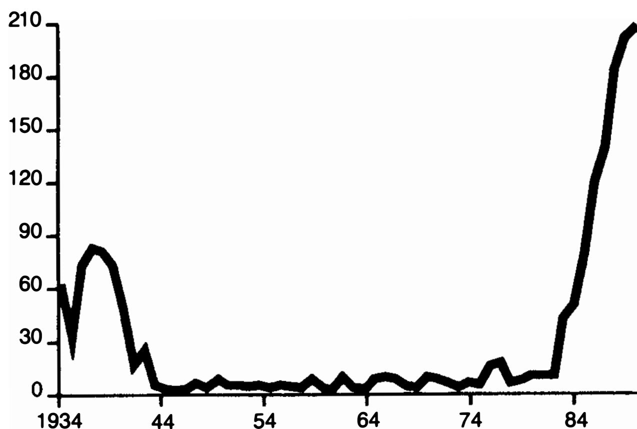
"*2) Tax reform.* Remove all tax liability up to annual incomes of $30,000. Under this proposal a great many savers would pay no tax on S&L deposit income, encouraging deposits. For depositors with higher income, provide savings incentives with exemption of 50%, or $1,000, whichever is higher, on interest 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 [Federal Savings and Loan Insurance Corp.—now part of FDIC] 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.*"

The response of the Bush administration, on the contrary, has been to continue the process of deregulation. The administration has floated several trial balloons indicating that it plans to either repeal or emasculate the Glass-Steagall Act, in order to allow Wall Street free rein. But as with all the scenarios the elite have come up with to maintain their grip, it won't work. The would-be Olympians are no longer controlling events—events are controlling them.

FIGURE 18
Failures of FDIC-insured banks, 1934-1989



Source: FDIC

FIGURE 19
Net annual income of FDIC's Deposit Insurance Fund
(billions $)

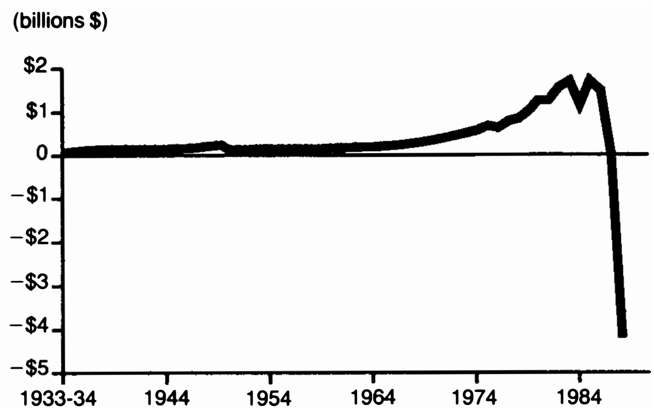


FIGURE 20
Size of FDIC's Federal Deposit Insurance Fund
(billions $)

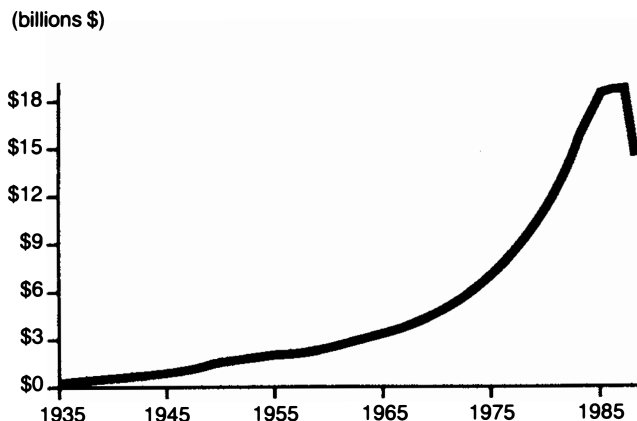
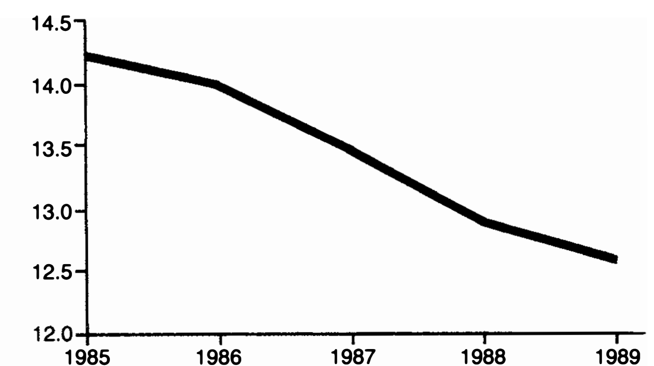


FIGURE 21
Number of banks in the United States
(thousands)



Source: Comptroller of the Currency