"Recent problems in the thrift industry -- real estate lending problems"

Remarks by

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Good morning, ladies and gentlemen. It's a pleasure to join the National Council here in New York today, and continue our exchange of ideas on the financial system.

So it's nice to be here in New York with my many friends in the Council.

On a historical note, it was 56 years ago today that one era of failed government regulation came to an end -- the 21st Amendment was ratified and Prohibition was repealed. Certainly a welcome development down in Washington -- a place with the highest per person consumption in the U.S.A.!

One lesson that should have been learned from Prohibition is that government can't stop people from doing things they really want to do, especially when economic incentives encourage that activity.

Unfortunately, Prohibition was not the end of perverse incentives and failed government policies. The recent problems in the thrift industry illustrate the point. Incentives to grow with federal credit, and without appropriate standards, created a terrible situation -- with accompanying losses.

I hope that 1989 marks the end of that story of failed government policy.

As the saying goes, "Judgement comes from experience, but experience comes from bad judgement." With all the bad judgement of the past, we now have plenty of experience.

I don't need to go over the details of the S&L mess with this informed group, but I thought I would take a moment to explore a few lessons learned from this costly experience in "failed regulation." The lessons may prove useful as we go forward into the nineties.

First, when formulating strategies make sure to get the facts. Without facts you can't hope to reach a sound solution. In the case of the S&L problem, both the government and the private sector failed to come to terms with the magnitude of the thrift crisis until it had reached epic proportions -- no one wanted to talk about it.

Promoting devices like phony accounting and distorted capital regulations made the real facts difficult to discern.

<u>Second, face the facts</u> -- no matter how unpleasant.

The government failed to face the fact that by increasing deposit insurance levels and reducing capital requirements, thrifts were being given a government guaranteed credit card with no limits.

Failure to analyze the situation properly, and thus, failure to recognize that S&Ls had an inherent flaw -- an interest rate mismatch problem -- meant that all that followed was flawed.

Rather than facing the unpleasant facts, the rules -- and the facts -- were altered to obscure them.

A strategy was never developed to deal with reality -- the fundamental problems of low capital, interest rate risk, and lack of supervision. As Alice learned on her way through Wonderland, "when you don't know where you're going, any path will do."

<u>Third, act on the facts</u>. In the S&L situation, painful choices were avoided. The easy way of unregulated growth was chosen over the more distasteful way of strict capital standards and close supervision.

The flag that proclaims: "Not on my watch," flies over too much of the Washington scene, as well as over many corporate enterprises and college campuses. It flew at full mast over the S&L problem.

If we had straightforwardly dealt with the S&L problem just a few years ago, the cost would have been small compared with what we're facing now.

Madame Rubenstein's law: <u>Every day, do first, the thing you dislike the most</u> -- was not followed. Even Seidman's Rule: <u>If you can't do the tough things first, you still have the rest of the day to get it done</u> -- wasn't used.

Finally, over time, plenty of facts showed up to make it clear that deregulation and growth, absent enhanced supervision, was not the solution. However, no change of course was forthcoming.

We just kept driving straight when the road had turned. In the case of the S&L debacle, it became clear early on that the strategy of "growing out" of insolvency, although it may have had some promise when proposed, was a failure.

Let's hope we learn: get the facts -- face the facts -- act on the facts -- and review the results. These lessons will serve us well in the future -- and maybe sooner in the future than we would like.

For example, a clear-headed approach to the facts is needed in order to deal with the developing real estate lending problems, especially as exemplified in the northeast. This is an emerging area of real concern for financial institutions and their insurer.

Over the last 12 months real estate loan growth has accounted for nearly two-thirds of all bank asset growth, and now comprises almost one-fourth of all commercial bank assets. From the second quarter to the third quarter real estate assets have grown at a 13 percent annual rate. In this last quarter net growth in real estate assets exceeded net growth in total assets by $7 billion.

Nonperforming real estate assets constitute almost half of all nonperforming assets in the banking system. In the northeast, the percentage of real estate loans in nonaccrual status has almost doubled over the past year. The northeast now exceeds the national average.

So far this year, net charge-offs of real estate loans across the country, on average, are running 47 percent higher than the same period a year ago. We expect real estate losses to accelerate in the fourth quarter.

Although the numbers look bad, they would look even worse if it were not for the FDIC's efforts FDIC assistance has effectively removed billions of dollars in bad real estate assets from the commercial banking sector. At NCNB Texas alone, FDIC guarantees have allowed NCNB to remove $5 billion in nonperforming real estate assets from its balance sheet.

I've been the Cassandra of real estate forecasting for some time now, and unfortunately, events confirmed this view.

The new problems are particularly evident in the Northeast, Arizona, and parts of Florida, to name a few areas. Certain northeastern areas, like Stamford, Connecticut, and central-New Jersey, have some of the highest commercial vacancy rates in the country.

The present difficulties may foretell more problems down the road. Forewarned should mean forearmed.

The FDIC is currently preparing a study of the real estate markets across the country. We think it's critical that both regulators and the financial industry do a better job at getting ahead of the curve by anticipating problems. That's our goal in this study!

The direction of the real estate market is of primary importance to the FDIC. Not only because it can help determine our failure resolution work load, but because the FDIC and the Resolution Trust Corporation are the largest holders of real estate for sale in the country. Over the next few years the FDIC and the RTC are charged with the disposal of hundreds of billions of dollars of assets, and as much as $180 billion of problem assets -- many of them real estate related. So believe me, we are as interested as any one in the conclusions of our real estate study!

As they say, the difference between education and experience is really quite simple: Education is what you get from reading the fine print. Experience is what you get from not reading it.

As insurers, we don't need any more "experiences" -- like we saw with real estate lending in the southwest.

Let me conclude on a more optimistic note.

The number of savings bank failures is down from the early eighties.

As of September 30, only 15 FDIC-insured savings banks were on our "Problem List", representing 3 percent of your industry. This is far lower than the nearly 18 percent in 1984. Those statistics in themselves bode well for the future.

But remember the trend in real estate is not encouraging. Clearly, <u>caution</u> is in order.

We are living in a challenging economic environment. Our challenge is to turn these difficulties into opportunities.

In some ways these times reminds me of the problems we faced in the mid-seventies when I served as the economic advisor to President Ford. In fact, tomorrow marks the sixteenth anniversary of Gerry Ford becoming Vice President and my introduction to national economic problems. My experience in the White House with President Ford taught me that problems that appear formidable can be handled if they are addressed resolutely and promptly. We should all take pains to remember "not on my watch" can be a costly emblem.

Thank you for your kind attention, ladies and gentlemen.

Now I'd be most pleased to take any questions and listen to your comments.