Chapter 10
Banking Problems in the Northeast

Introduction

The banking problems in the Northeast were indissoluble from the region's real estate problems.[1] Fueled by a strong regional economy, both residential and commercial real estate markets in the region boomed during the 1980s, but the boom eventually led to overbuilding and rampant real estate speculation. Late in the decade, when the regional economy weakened and a high volume of new construction projects coincided with diminished demand, the real estate market boom turned into a bust. During the early 1990s, an oversupply of completed projects came on the market and real estate prices went into a sharp decline. In an environment of increased real estate loan defaults, a significant number of northeastern banks failed: 16 in 1990, 52 in 1991, and 43 in 1992.[2] These failures accounted for substantial portions of the nation's total volume of failed-bank assets and of the FDIC's bank-failure resolution costs for those years. Losses from northeastern bank failures totaled $1.3 billion in 1990, $5.5 billion in 1991, and $2.8 billion in 1992—and constituted 45 percent, 91 percent, and 77 percent, respectively, of total FDIC failure-resolution costs for those years. Failures were particularly prominent in 1991, when assets of failed banks represented 25.4 percent of prior year-end banking assets in New Hampshire, 18.3 percent in Connecticut, 15.2 percent in Maine, and 12.0 percent in Massachusetts.[3]

The 1991 failure of three subsidiaries of the Bank of New England Corporation (the Bank of New England, Connecticut Bank and Trust Co., and the Maine National Bank), a failure which many would identify as the last major failure of the banking crises of the 1980s and early 1990s, was especially significant. The Bank of New England's failure re-

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[1] The Northeast includes the six New England states (Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut) plus New York and New Jersey.

[2] Throughout this chapter, "banks" refers to commercial banks and savings banks supervised by the FDIC, the Office of the Comptroller of the Currency (OCC), or the Federal Reserve. Savings and loan associations supervised by the Federal Home Loan Bank Board until 1989 and then by the Office of Thrift Supervision (OTS) are not included.

[3] These ratios were calculated from assets at failure as a percentage of prior year-end state banking assets for all banks failed and open.

sulted in the first use of the cross-guarantee provision of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) to close an institution (Maine National Bank). In addition, the participation of Kohlberg, Kravis, Roberts & Co. as a partner with Fleet/Norstar in the acquisition of the three subsidiaries of the Bank of New England Corporation marked the first time that a nonbank "financial" buyer participated in the purchase of a failed commercial bank. This company's involvement not only allowed capital to enter the banking industry from nonbanking sources but was also expected to increase the number of potential bidders in future bank failures.[4] Finally, the decision to protect all deposits of the three subsidiaries of the Bank of New England Corporation again focused attention on the "too-big-to-fail" bank disposition policy. Later in 1991, Congress included provisions in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that made it more difficult to resolve bank failures in ways that would protect uninsured deposits.[5]

The problems of the northeastern banks arose to a large extent because they had been aggressive participants in the prosperous real estate markets of the 1980s. Between 1983 and 1989 the median ratio of real estate loans to assets rose from approximately 25 percent to 51 percent. Both residential and commercial real estate loans contributed to the increase, but the increase in the median commercial real estate loan concentration is widely held to have been a primary reason for the asset-quality problems and eventual failure of many of the region's banks in the late 1980s and early 1990s; commercial real estate loan portfolios as a percentage of bank assets rose from 6.5 percent in 1982 to 14 percent in 1989 and 1990.

Since real estate lending played such an important role in the expansion and collapse of banks in the Northeast, the area's real estate markets of the 1980s are discussed in some detail, with the focus first on New England and then on New York and New Jersey. The chapter then provides an overview of banking's relationship to real estate in the region as a whole and then specifically in New England and in New York and New Jersey. The two succeeding sections present and analyze data on bank performance in the region and on bank failures by state. Finally, the rise and fall of the Bank of New England Corporation is recounted.

The Northeastern Economy and Real Estate

The Northeast recovered quickly from the 1981–82 national recession. Between the end of the recession and 1988, the region's rate of change in gross product outperformed that of the nation as a whole, and its commercial and residential real estate markets boomed,

[4] John W. Milligan, "KKR, Member FDIC," *Institutional Investor* 25, no. 7 (June 1991): 59.
[5] See Chapter 7, "Continental Illinois and 'Too Big to Fail.' "

fueled by the strong regional economy as well as by employment growth. But late in the decade—partly because of a slowdown in the growth of military spending as the Cold War came to an end, a decline in the computer industry in the Boston area, and cuts by Wall Street firms after the stock market crash in October 1987—the regional economy weakened. Employment fell, growth in personal income slowed, and from 1989 through 1992 the region's rate of change in gross product underperformed the nation's (see figure 10.1).

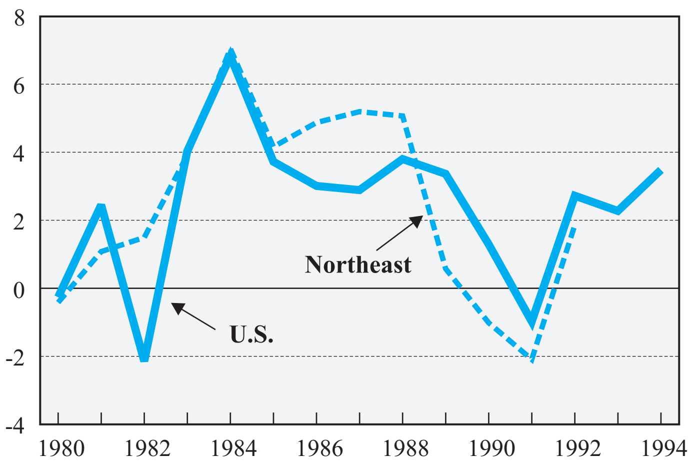
The weakening of the regional economy exacerbated the problems of the overbuilt real estate markets, and these markets fell off dramatically. For example, the total value of nonresidential construction permits in the region, having jumped from $4.4 billion in 1980 to $10.2 billion in 1988, then declined to $6.5 billion by 1991. And the number of newly issued permits for residential construction, after soaring 172 percent between 1982 and 1986, plummeted by 67 percent between 1986 and 1991 (see table 10.1).

New England

In 1988, when the New England economy began to weaken, many were caught by surprise. Until then New England had been one of the most prosperous areas of the country. Its unemployment rate had fallen to 3 percent and its per capita income had climbed to 123 per-

Figure 10.1

Changes in Northeast Gross Product versus Changes in U.S. Gross Domestic Product, 1980–1994



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Table 10.1
Nonresidential and Residential Construction, Northeast Region, 1980–1994

Year	Value of Nonresidential Permits ($Thousands)	Number of Residential Permits Issued
1980	4,415,720	87,840
1981	5,415,443	85,502
1982	5,584,465	84,454
1983	5,273,951	130,848
1984	6,966,098	161,348
1985	8,988,867	216,146
1986	9,348,328	229,816
1987	10,049,755	216,992
1988	10,178,196	176,343
1989	9,915,156	133,473
1990	8,037,836	88,643
1991	6,510,983	75,173
1992	6,519,954	86,531
1993	7,448,605	93,395
1994	7,338,631	98,258

Source: Bureau of the Census (Building Permits Section, Manpower and Construction Statistics Branch).

cent of the national average, up from 106 percent in 1980.[6] Yet despite many favorable aspects of New England's economy, some signs of potential problems had been evident. In the mid-1980s the computer industry, a regional specialty, had begun to confront a more competitive environment, and New England firms had found themselves with products and strategies that did not necessarily fit the changing marketplace. In addition, defense contractors in the region were facing the end of the Reagan defense buildup. Finally, the cost of doing business in the region had escalated during the prosperous times, causing some manufacturers to move their operations to less-expensive parts of the country. Although none of these factors had appeared to be especially harmful in itself and the resulting job losses in any one year had not been particularly noteworthy, together they added up over time. For example, between 1984 and 1988, manufacturing employment in New England declined by 140,000 jobs, or approximately 9 percent.

New England's real estate markets turned down along with the economy, and the commercial real estate markets were hit particularly hard. The decline in the commercial mar-

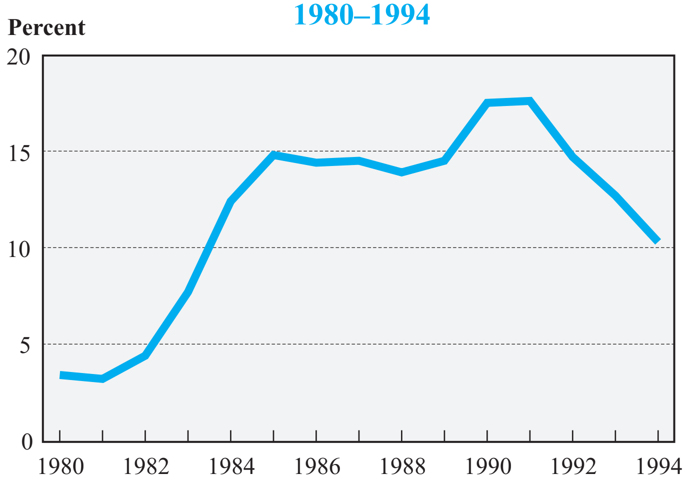
[6] This discussion is based on Lynn E. Browne, "Why New England Went the Way of Texas Rather Than California," Federal Reserve Bank of Boston *New England Economic Review* (January/February 1992): 24, 33.

kets was surprising to the many who believed that development in New England had been relatively cautious and that the region would not experience the problem of overbuilding that had occurred in the Southwest. For example, the president of Fleet Real Estate Inc. in Providence stated in June 1987 that “the builders [around] Boston are not going hog-wild like they did in Houston. The New England marketplace, I think, is a sensible market.”[7] Another reason the downturn was unexpected was that vacancy rates in New England’s major office and industrial markets were not markedly different in 1988, at the end of the boom, from what they had been in 1984, at its beginning (see figure 10.2).[8] Nevertheless, as the head of the Bank of Boston’s structured real estate department noted late in 1989, “Overbuilding has resulted in high vacancy rates and revenue shortfalls of 10% to 30% or more for many projects.”[9]

The deterioration in the New England commercial real estate markets was evidenced by the 22 percent decline between 1988 and 1991 in the Torto Wheaton Rent Index for Boston, and the 17 percent decline between 1990 and 1991 in the index for Hartford (see

Figure 10.2

Office Vacancy Rates in Boston, 1980–1994



Source: CB Commercial/Torto Wheaton Research, *The Office Outlook* (spring 1997), vol. 1.

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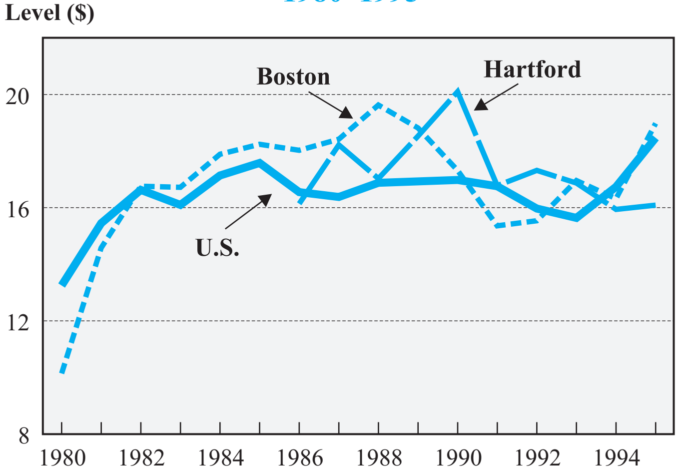
[7] Michael Weinstein, “New England Banks Finance a Healthy Real Estate Market,” *American Banker* (June 4, 1987), 12.
[8] Browne, “Why New England Went the Way of Texas,” 25.
[9] David Neustadt, “Bank of Boston Acts to Stem Losses,” *American Banker* (December 5, 1989), 6.

figure 10.3).[10] Nationally over both time periods, this index fell only about 1 percent. But as dramatic as the rent index declines were, they probably did not reflect the full extent of the collapse in New England real estate values. According to one contemporary study, if commercial values at the end of 1992 had been based on then-current rental agreements and occupancy rates, the value of the office stock in the Boston metropolitan area would appear to have fallen more than 70 percent since 1987.[11]

The collapse of commercial real estate is further illustrated by the jump in the amount of repossessed property in Massachusetts between year-end 1988 and year-end 1989, from $339 million to $1.5 billion.[12] In 1990, many real estate professionals believed that troubled properties represented the fastest-growing segment of the Metropolitan Boston commercial real estate market. These problems arose in part because the "Massachusetts Miracle" had lured novice developers—many with weak business plans often based on little or poor market research—into the real estate game. Some commercial projects were 100 percent fi-

Figure 10.3

Rent Indices, Boston and Hartford versus U.S., 1980–1995



Source: CB Commercial/Torto Wheaton Research, *The Office Outlook* (fall 1996), vol. 1.

[10] The Torto Wheaton Rent Index is a statistically computed dollar value for a five-year, 10,000-square-foot lease for an existing high-rise building in the statistical average of the metro area.

[11] Lynn E. Browne and Eric S. Rosengren, "Real Estate and the Credit Crunch: An Overview," Federal Reserve Bank of Boston *New England Economic Review* (November/December 1992): 28.

[12] Information in this paragraph is derived from Paul Korzeniowski, "Distress for Success," *Metro Business*, Danvers, MA (October 1990), available: DIALOG, File: 635: Business Dateline.

nanced and based on such unrealistic expectations as the continuation of 10 percent annual price hikes into the 1990s. "Many projects simply should not have been built," observed the principal at Richard Flier Interests, a Brookline real estate firm.[13]

Some of the most serious difficulties in the commercial real estate markets occurred in New England's condominium market, where some developers went bankrupt when units failed to sell.[14] The condominium market in Connecticut was so glutted in early 1990 that just absorbing the units then available was expected to take two years.[15] An illustration of the depth of the problem was an action taken by the Collaborative Co., one of Boston's leading specialists in marketing troubled properties, which made news in the spring of 1990 by halving prices at the St. George condominium development in Revere.[16]

The commercial real estate debacle was graphically demonstrated by banking analyst Gerard Cassidy of Tucker, Anthony Inc., Portland, Maine, who developed a 40-mile guided tour of New England real estate lending disasters for potential investors. One stop on a 1990 tour was a rubble-strewn development site in the Boston suburb of Weymouth, with a ghostly row of unfinished condominium units long abandoned by builders. A bank had lent $25 million for the development of the property and had foreclosed in June 1990. Another stop, this one in Boston's high-tech heartland, revealed empty commercial space with boarded-up windows—ten empty buildings within an area of a mile and a half. "I thought I knew how bad it was," said a portfolio manager at Fidelity Investments who took the tour, "but it was worse than I anticipated. I mean, 20-story towers of see-through tinted green glass: What I saw was no different than Dallas during the worst days of the slump."[17]

The commercial real estate market was not alone in its volatility. The New England housing market, too, had a turbulent decade. As the region emerged from the national recession of 1981–82, housing was not much more expensive in New England than in the rest of the country. In 1983, the median home resale price in Boston was $82,600, 17 percent above the national median of $70,300 (see figure 10.4). In Providence in the first quarter of 1983 the median was 26 percent *below* the national median. But strong pent-up housing demand and slowly responding supply led to a boom in housing prices throughout New England from 1983 to 1987. In Boston, resale prices rose 21 percent in 1984, 34 percent in 1985, and 19 percent in 1986. In 1987, Boston's median home resale price reached

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[13] Ibid.

[14] Margot E. Jenks et al., "New England Economic Summary, First Quarter 1990," Federal Reserve Bank of Boston *New England Economic Indicators* (August 1990): ix.

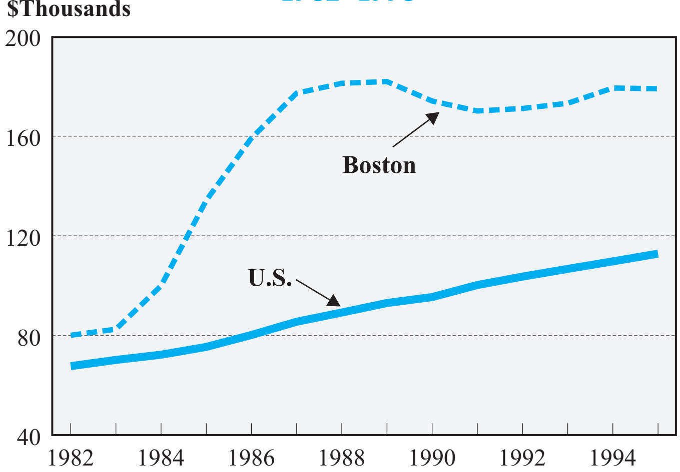
[15] Katherine Morrall, "Weakening Northeast Real Estate Market Raises Concerns," *Savings Institutions* 111, no. 4 (April 1990): 13.

[16] Korzeniowski, "Distress for Success."

[17] This paragraph is based largely on Tom Leander, "New England Graveyard Tour: Here Lie Nonperforming Loans," *American Banker* (September 12, 1990), 1, 16–17.

Figure 10.4

Median Home Resale Prices, Boston versus U.S., 1982–1995



Source: National Association of Realtors

$177,200, which was 115 percent higher than in 1983 and more than twice the national median price (which had increased by only 22 percent during the same four years). The price boom lagged one year in Providence and two years in Hartford, where the most rapid increases occurred in 1986 and 1987, respectively. Nevertheless, the result was the same: by 1988, housing in New England was more than twice as expensive as comparable housing in most other parts of the country.[18]

Favorable economic conditions certainly played an important role in the housing-price escalation in New England.[19] For example, a building boom coupled with expansion in the region's trade and service sectors created a substantial increase in the demand for labor. This helped personal income increase more rapidly in New England than in any other part of the country between 1984 and 1988. Higher home prices were also supported by advantageous tax laws, favorable demographics, lower interest rates, and an accommodating banking sector. Yet despite these positive economic circumstances, economists Karl E. Case and Robert J. Shiller argued that fundamentals alone were insufficient to explain the

[18] Data on Boston housing prices were obtained from the National Association of Realtors. Other housing price information in the paragraph was derived from Jenks et al., "New England Economic Summary," viii, ix.

[19] Information in this paragraph is derived primarily from Karl E. Case, "The Real Estate Cycle and the Economy: Consequences of the Massachusetts Boom of 1984–87," Federal Reserve Bank of Boston *New England Economic Review* (September/October 1991): 37–39.

extent of the price increases, at least in Boston. For example, Case's 1986 model, which took into account a number of variables that affected prices, predicted a 15 percent increase in single-family housing prices in Boston between 1983 and 1986, whereas in fact the prices approximately doubled. Case and Shiller also wrote articles in 1988, 1989, and 1990 contending that home buyers were significantly influenced by boom psychology.[20] In other words, reacting to rising prices and generally favorable economic conditions, home buyers paid inflated prices in anticipation of future price increases and capital gains.

Some individuals were indeed worried about potential problems from the escalating real estate prices. For example, in mid-1987 a senior vice president at Moseley Securities Corp. in Boston expressed concern because "we've had enormous inflation in real estate values. If there's a slight hiccup up here, there could be serious repercussions."[21] Nevertheless, despite occasional views such as these, most observers were far more anxious about the long-term consequences of high housing prices on the region's ability to attract workers. In fact, the rising prices of real estate were generally seen as a sign of economic health in the short term.[22]

The escalation in home prices occurred even though the population of the region grew at a very slow pace.[23] Prices were therefore rising not because more people wanted to live in New England but because the optimism of those who lived there led them to purchase larger, more expensive dwellings in the expectation of future price increases. As a result, when residential construction finally caught up with the price explosion, the region overbuilt and overbuilt quickly. Excess supply began to appear in areas of New England as early as 1987. (Compounding the problem, the regional economy began faltering at the end of the decade, exhibiting falling employment and slow growth in personal income.) The combination of overproduction and slowing demand led to a softening, though not a collapse, of home prices throughout the area. For example, median home resale prices in the Boston area increased by less than 1 percent from 1988 to 1989 and then fell 4 percent from 1989 to 1990 and another 2 percent from 1990 to 1991.

New York and New Jersey

In New York and New Jersey, too, the commercial real estate sector was overbuilt and exhibited serious problems. In New York City, for example, zoning and tax incentives had prompted a flurry of excess building, with the result that office vacancy rates escalated throughout the 1980s, leaving Manhattan with about 25 million square feet of vacant office

[20] Citations for the other articles referenced in this paragraph can be found in Case, "The Real Estate Cycle," 46.
[21] Weinstein, "New England Banks."
[22] Browne, "Why New England Went the Way of Texas," 36.
[23] Information in this paragraph was derived primarily from Jenks et al., "New England Economic Summary," ix.

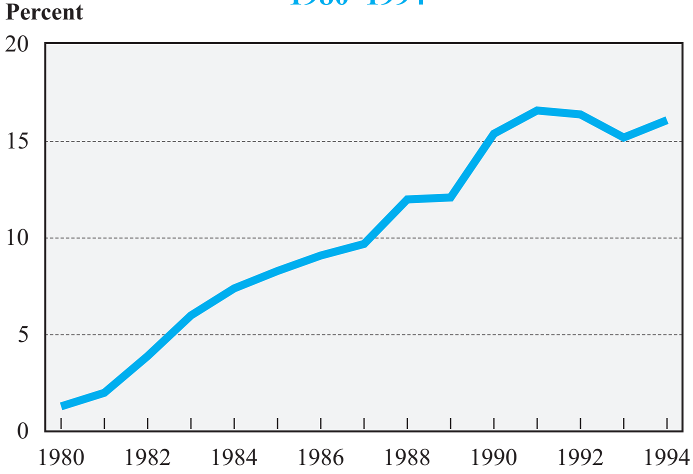
space by mid-1990 (see figure 10.5).[24] At the same time, office vacancy rates were even higher in the New York suburbs than in Manhattan.[25]

The substantial amount of vacant office space put downward pressure on rents. Between 1988 and 1992 the Torto Wheaton Rent Index for Long Island showed a 25.3 percent decline, and between 1988 and 1993 the index for New York City showed a 23.0 percent decline (see figure 10.6). Nationally over the same periods this index fell 5.4 percent and 7.3 percent, respectively. Official statistics on rental rates were likely to have masked the pattern of newly negotiated contracts, which probably showed a greater response to the depressed market. Falling rents notwithstanding, between 1987 and the last quarter of 1991 the vacancy rate for downtown office space grew from just over 10 percent to over 20 percent.[26]

The residential market in New York also weakened significantly. During the 1980s, residential home prices in New York rose at rates considerably above the national average. By 1988, the median single-family home in the New York metropolitan area sold for as

Figure 10.5

Office Vacancy Rates in New York City, 1980–1994



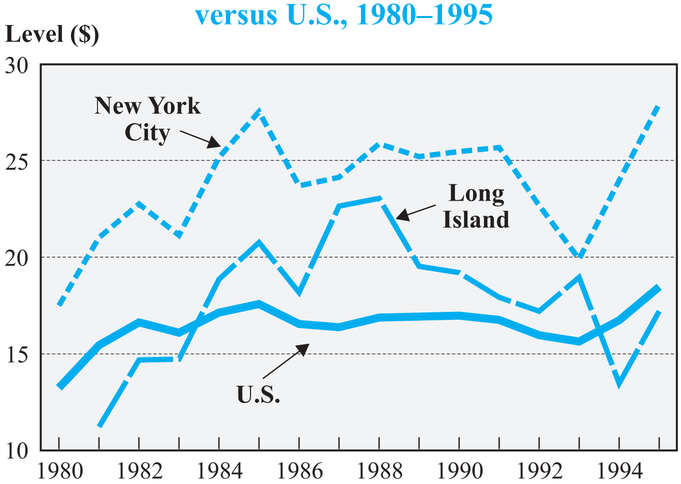
Source: CB Commercial/Torto Wheaton Research, *The Office Outlook* (spring 1997), vol. 2.

[24] Stephen Kleege, "Fate of Banking in the 1990s Hinges on Real Estate Loans," *American Banker* (October 15, 1990), 1, 24; and Larry Light and John Meehan, "The Walls Keep Closing In on New York Developers," *Business Weekly* (July 2, 1990): 72.

[25] Light and Meehan, "The Walls Keep Closing In," 72.

[26] David Brauer and Mark Flaherty, "The New York City Recession," Federal Reserve Bank of New York *Quarterly Review* 17, no.1 (spring 1992): 70.

Figure 10.6
Rent Indices, New York City and Long Island versus U.S., 1980–1995



Source: CB Commercial/Torto Wheaton Research, *The Office Outlook* (fall 1996), vols. 1 and 2.

much as $194,000, more than double the national average and almost triple what the median price of a home had been in the New York area in 1981.[27] However, after 1988 prices began declining. In the New York City area, for example, prices of homes fell approximately 5 percent in 1989.[28] By mid-1990, the weak housing market increased the average time needed to sell a residential unit to six months, double the time that had been required in 1987.[29] Residential prices continued to fall, and by the fourth quarter of 1991, median single-family home prices in the New York metropolitan area had declined by 12 percent from their peak, to $170,800.[30] Cooperatives and condominium units were hit particularly hard and many developments were as empty as mausoleums—despite falling prices.[31] In fact, the price declines of condominium developments were sometimes staggering. For example, in mid-1990 in New York City, broker Saul Stolzenberg tried to sell an empty 66-unit building that he said had a value of $14.5 million. The only offer he received was $6 million.[32] There

[27] Ibid.
[28] Michael Quint, "Northeast Banks Face Heavy Losses on Problem Loans," *The New York Times* (December 15, 1989), available: LEXIS, Library: NEWS, File: NYT.
[29] Light and Meehan, "The Walls Keep Closing In," 73.
[30] Brauer and Flaherty, "The New York City Recession," 70.
[31] Light and Meehan, "The Walls Keep Closing In," 72.
[32] Ibid., 73.

are indications that portions of the New Jersey housing market suffered similar declines. For example, from 1989 to 1990 the National Association of Realtors' median sales price of existing single-family homes declined by 8 percent for Bergen and Passaic, and 3 percent for Middlesex, Somerset, and Hunterdon.

Banking and Real Estate in the Northeast

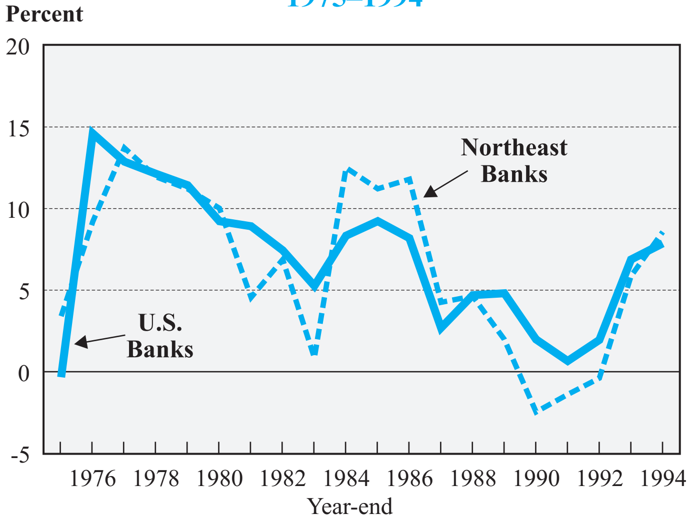
The northeastern region is a highly concentrated banking market. As of year-end 1994, it was the nation's largest in terms of domestic banking assets. At the end of 1980, when the region contained only 5 percent of U.S. commercial and savings banks, these banks nevertheless accounted for 17 percent of domestic bank assets. By year-end 1994, when northeastern banks constituted 7 percent of U.S. banks, their share of domestic bank assets had increased to more than 24 percent. Although much of this bank asset concentration can be attributed to the large money-center banks located in New York, many of the other northeastern states contain densely populated urban centers with strong banking markets that have been fostered not only by the region's high population density but also by its well-established educational, commercial, industrial, and manufacturing industries. Moreover, the region's state legislatures have been very supportive of the banking industry, typically leading the nation in expanding bank products and powers.

Many northeastern banks aggressively participated in the booming real estate markets of the 1980s. Between 1983 and 1986, bank asset growth for the region increased from an annual rate of less than 1 percent to nearly 12 percent (see figure 10.7). This growth was supported by substantial new capital investment during the 1980s resulting from increases in mutual-to-stock-form bank conversions, capital restructuring, retention of high levels of income, and an increase in bank chartering.

The conversion of savings banks from mutual to stock ownership was especially significant for asset growth.[33] Mutual-form institutions have no equity shareholders and therefore must rely solely upon internally generated capital. Conversion to stock form provided institutions with access to equity capital and an expanded potential for loan growth, thus augmenting an institution's ability to participate in the region's booming real estate markets. In addition, conversion to stock form often caused an institution to feel pressure to

[33] The Northeast is home to a substantial portion of the savings bank industry, and savings banks and savings associations were historically mutual-form institutions. As of 1986, approximately 32 percent of the region's depositories were savings banks, 23 percent were savings associations, and 45 percent were commercial banks. In the early 1980s, many northeastern states legalized mutual-to-stock-form conversions. Between 1985 and 1990, 199 mutual-form depositories in the Northeast—a third of the 586 savings banks and savings associations in the region as of year-end 1984—converted to stock form. The converted institutions typically exhibited rapid asset growth, which also contributed to a significant number of failures. For further discussion of this subject, see Jennifer L. Eccles and John P. O'Keefe, "Understanding the Experience of Converted New England Savings Banks," *FDIC Banking Review* 8, no. 1 (winter 1995).

Figure 10.7
Asset Growth Rates, Northeast versus U.S., 1975–1994



seek substantial increases in earnings: conversion led to a significant increase in an institution's capitalization, thereby diluting returns on equity. To maintain competitive returns on equity, a rise in the volume of loans and other earning assets was therefore needed.

Chartering activity, which was also an important contributor to the expansion of the northeastern banking markets, escalated in the Northeast as the economy prospered: during the 1980s the annual number of new charters soared from 3 in 1980 to a peak of 39 in 1987, and the total number of banks chartered in the region was 212. After the region's economy weakened, chartering steadily declined, and in 1994 only 3 charters were issued.

Overall lending concentrations at the region's banks rose substantially during the 1980s, primarily because of real estate loans (which had represented a sizable portion of northeastern banks' loan portfolios even before the real estate market boom). Between 1983 and 1988 the median loans-to-assets ratio for northeastern banks jumped from a low of just under 55 percent to a peak of 73 percent, an increase that significantly exceeded the national trend (see figure 10.8), and between 1983 and 1986 the median total real estate loan concentration as a percentage of bank assets rose from approximately 25 percent to nearly 39 percent; in 1989, it reached a high of 51 percent (see figure 10.9). (It should be noted that a portion of this growth is attributable to the fact that a large number of state-insured savings banks obtained FDIC insurance between 1980 and 1986 and began reporting financial data to federal bank regulators. The savings banks' real estate activity is therefore not fully

Figure 10.8

Median Gross Loans and Leases, Northeast versus U.S., 1976–1994

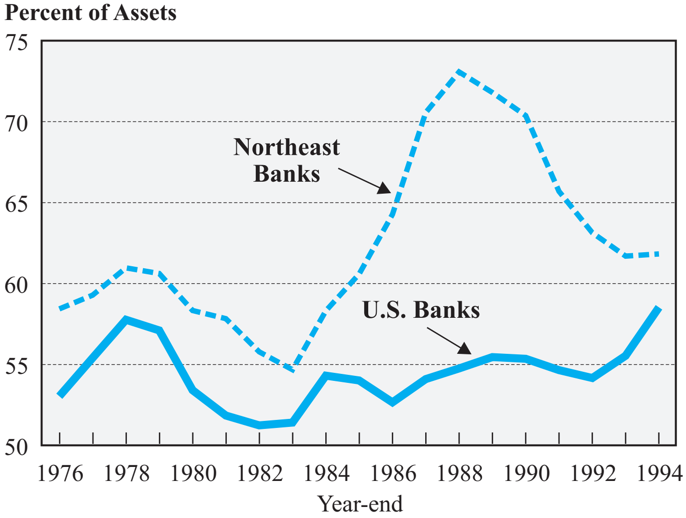
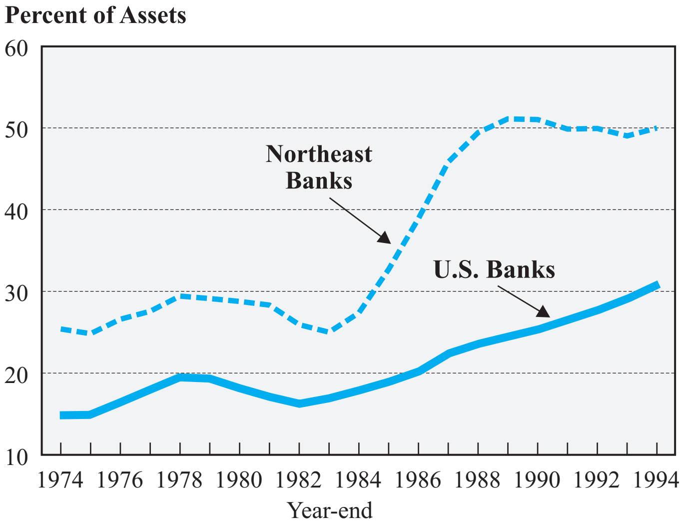


Figure 10.9

Median Total Real Estate Loans, Northeast versus U.S., 1974–1994

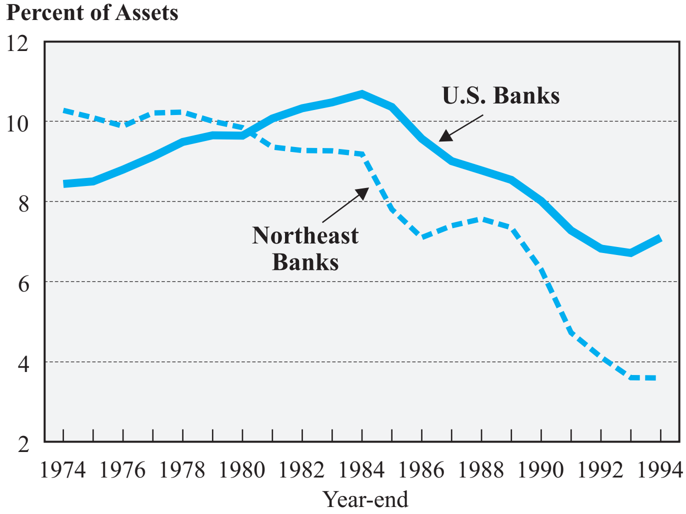


reflected in the data until 1986.)[34] This expansion in real estate lending may have been due partly to the shrinkage of the banks' traditional loan markets, as is indicated by the decline in the concentrations of commercial and industrial loans throughout the 1980s (see figure 10.10).

The higher concentrations of real estate loans reflected activity in both residential and commercial real estate lending. The median ratio of residential real estate loans to bank assets rose from about 19 percent in 1980 to approximately 23 percent in 1986 and then climbed to 32 percent in 1994 (see figure 10.11). More significant was the growth in commercial real estate lending, particularly the relatively risky short-term loans secured by properties in development whose income-generating potential was uncertain at the time the

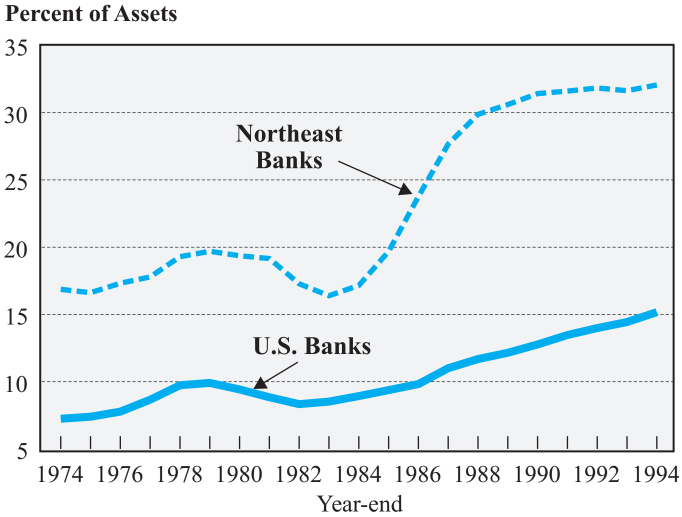
Figure 10.10

Median Commercial and Industrial Loans, Northeast versus U.S., 1974–1994



[34] In the Northeast, the number of savings banks reporting to federal bank regulators rose from approximately 287 in 1980 to 444 by 1986. Events in Massachusetts accounted for a large proportion of this increase. After the failure of Ohio's private deposit insurance fund, privately insured mutual savings banks and cooperative banks in the Commonwealth of Massachusetts recognized the potential for a loss of public confidence in their private fund. The Massachusetts Banking Department required approximately 200 savings banks to acquire federal deposit insurance from either the FDIC or the Federal Savings and Loan Insurance Corporation. Most of the institutions obtained FDIC deposit insurance (FDIC, *Annual Report* [1985], 16–17). The failure of many savings banks and the industry's consolidation by the late 1980s and early 1990s reduced the number of savings banks in the Northeast at year-end 1994 to 367.

Figure 10.11
Median Residential Real Estate Loans, Northeast versus U.S., 1974–1994



loans were made.[35] The median commercial real estate loan concentration for the region's banks, as a percentage of bank assets, rose from 6.5 percent in 1982 to a peak of 14 percent in 1989 and 1990 (see figure 10.12).

The loan expansion of the early 1980s was initially successful in augmenting profits by generating substantial interest and non-interest income, as is indicated by the rise in the median return on assets (ROA) for northeastern banks from 0.72 percent in 1980 to 1.06 percent by 1986 (see table 10.4 on p. 365). However, the weakening real estate market of the late 1980s led the northeastern banks' ROA to drop to only 0.20 percent in 1990. (Interestingly, the rise in northeastern banks' ROA occurred while the ROA for banks outside the Northeast was declining, and conversely the decline in the northeastern banks' ROA occurred during a generally rising trend in ROA for other banks.) This drop in the Northeast was largely attributable to problems of asset quality—problems widely held to have been caused primarily by the increase in commercial real estate lending—as the regional recession and real estate market bust led to rising levels of nonperforming assets and increasing loss rates on these assets (see figures 10.13 and 10.14).

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[35] See Chapter 3.

Figure 10.12

Median Commercial Real Estate Loans, Northeast versus U.S., 1980–1994

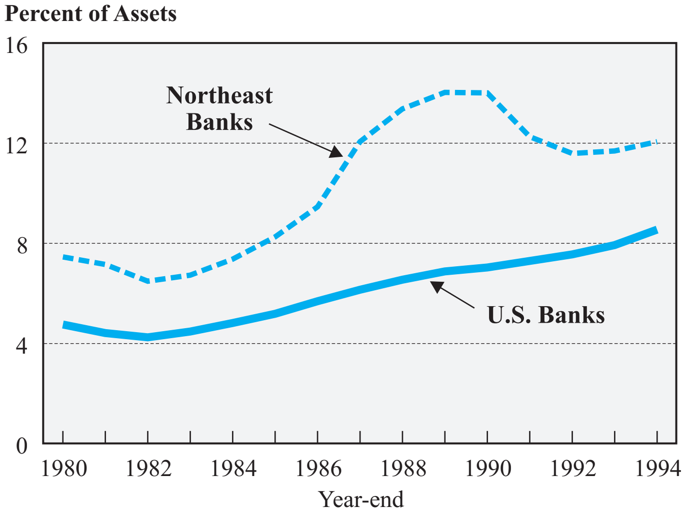


Figure 10.13

Median Total Nonperforming Assets, Northeast versus U.S., 1982–1994

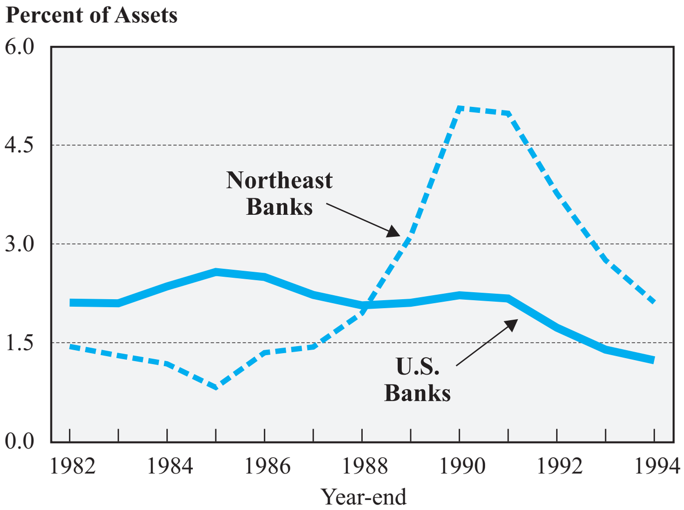
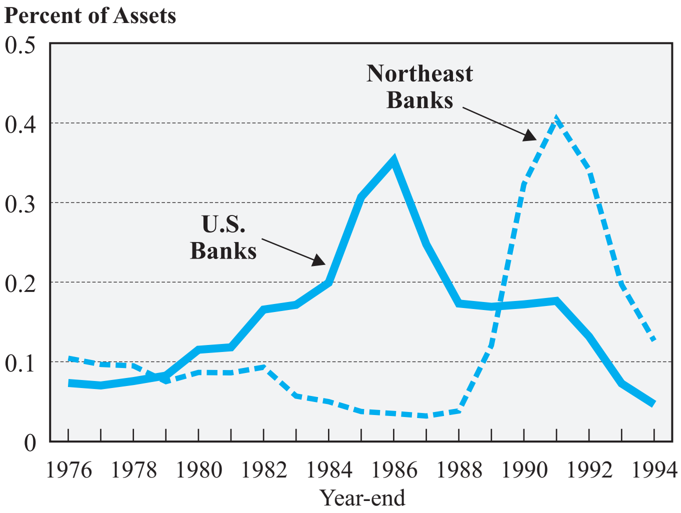


Figure 10.14

Median Net Charge-Offs on Loans and Leases, Northeast versus U.S., 1976–1994



Bankers in the Northeast remember 1990 as the year they were hit harder than bankers in any other region by losses precipitated by a plunge in real estate values.[36] With office vacancy rates reaching 25 to 30 percent in places like central New Jersey and Stamford, Connecticut, and with many condominium developments only half filled after two years on the market, a number of developers were unable to repay their bank loans. L. William Seidman, chairman of the FDIC, noted in late 1989 that certain northeastern areas "have some of the highest commercial vacancy rates in the country."[37] Even more disturbing was the fact that eight of the ten states whose banks showed the highest increase in bad real estate loans in 1989 were in the Northeast. In addition, according to an analysis of second-quarter 1990 results prepared by Veribanc Inc., a Wakefield, Massachusetts, consulting firm, the 15 U.S. banks whose problem domestic loans were most in excess of equity and reserves were all in the Northeast.[38] Robert Clarke, the Comptroller of the Currency, stated in early 1990 that real estate was the main cause of weakness among national banks in the Northeast, noting

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[36] Marian Courtney, "The Great Loss: Analyzing the Northeast Banking Crisis," *Business Credit* 93, no. 6 (June 1991): 10.

[37] Quint, "Heavy Losses on Problem Loans."

[38] Ibid; and Charles McCoy and Ron Suskind, "FDIC's Expected Losses Reflect Slump in Northeast: Increase in Reserves Stems from the Agency's Fear of Major Bank Failures," *The Wall Street Journal* (December 20, 1990), available: WESTLAW, File: WSJ.

that "during 1989, nonperforming real estate loans jumped to $9.1 billion from $3.6 billion at Northeastern banks."[39]

The root of these problems, according to some analysts, was overzealous lending by institutions that sought new markets because opportunities to lend to businesses had dwindled and foreign lending frequently resulted in losses. This eagerness to lend led to an excessive number of new buildings flooding the market in many areas.[40] Losses on real estate loans hit savings banks in the Northeast particularly hard, according to Don J. Fauth, an analyst at the First Albany Corporation, a securities firm. He noted that savings banks raised additional capital by issuing stock to investors during the 1980s and then attempted to increase profits through risky lending on construction projects rather than stay with their traditional home mortgage lending business.[41]

The real estate problems that hit the northeastern banks beginning in 1989 had been quite unexpected just two years earlier. Bankers' confidence in northeastern real estate had been strong because the commercial real estate markets in the region remained robust despite problems nationwide. Nationally the Comptroller of the Currency expected troubled commercial real estate loans to be one of the factors behind lower bank earnings in 1987, stating in mid-1987 that "the number of nonperforming assets is high and it's going to get higher."[42] Others, too, believed that problems with commercial real estate loans nationally would worsen before improving. For example, Robert Grossman, a bank analyst at Standard & Poor's Corp., said in 1987, "I think it's a while before we hit bottom." By contrast, real estate in the Northeast appeared to be in excellent shape. James F. Murray, senior vice president at Chase Manhattan Bank, observed in mid-1987 that "the whole Northeast corridor is much stronger than the rest of the country."

Even though many bankers in the Northeast became cautious soon thereafter and began cutting back on new lending and tightening loan standards as early as 1988, they were still overwhelmed by the real estate market's rapid deterioration.[43] It quickly became apparent that real estate would cause severe problems for many banks. Commenting on the situation, Michael Zamorski, deputy regional director for the FDIC, observed in mid-1991 that "banking problems shift geographically with the economy. Troubles in agriculture led

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[39] Barbara A. Rehm, "Banks Binging Despite Realty Hangover," *American Banker* (March 8, 1990), 1.

[40] Quint, "Heavy Losses on Problem Loans."

[41] Ibid.

[42] All quotations in this paragraph are from Nina Easton, et al., "Shaky Real Estate Loans Hitting Banks," *American Banker* (June 4, 1987), 10.

[43] Quint, "Heavy Losses on Problem Loans."

to bank failures in the Midwest, then falling energy prices caused problems in the Southwest. Now the focus is in the Northeast, where the worst real estate problems are."[44]

New England

The boom and bust in New England real estate took its toll on the area's banks, which had been among the healthiest in the nation during much of the 1980s but which later experienced high rates of failure, primarily because of their extensive exposure to real estate loans. During the 1980s, real estate portfolios at New England banks grew at twice the national rate, and some lenders, in the belief that "we've just had such a terrific market, it's hard to make mistakes," became lax. Moreover, bankers generally believed that New England's diversified economy would protect the region from a real estate debacle. Said one banker, "I don't see any disasters out there."[45]

At the end of the 1980s, when economic growth and nominal real estate prices began to decline in New England, cash-flow problems as well as the diminished collateral values led many borrowers to stop making their loan payments.[46] By early 1989, according to one analyst at Merrill Lynch, everyone was "very jittery about real estate."[47] The anxiety may have stemmed from credit-quality problems that had begun to surface rather frequently at many New England banks and other financial institutions. Yet at the beginning of 1989, despite mounting problems with real estate–related loans, most analysts and bankers continued to remain cautiously optimistic because of New England's basically healthy and diversified economy. Dennis F. Shea, who followed New England banks for Morgan Stanley & Co., said in early 1989 that "I'm not expecting a debacle. I think it's a very good banking market. I think what it's suffering from is indigestion."[48]

The banks, however, turned out to be more than dyspeptic. For example, during the first quarter of 1989, while the nation as a whole exhibited a decline in foreclosures, in New Hampshire foreclosures on conventional mortgages rose from 0.05 percent of all such mortgages a year earlier to 2.41 percent—the largest such gain in any state. The second-largest increase was in Massachusetts, from 0.10 percent to 0.49 percent.[49] Cynthia Latta, senior financial economist for DRI/McGraw Hill Inc., explained this rise in foreclosures by noting

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[44] Courtney, "The Great Loss," 10–11.

[45] Both comments were made in 1987. See Weinstein, "Healthy Real Estate Market," 12, 18.

[46] Joe Peek and Eric S. Rosengren, "The Capital Crunch in New England," Federal Reserve Bank of Boston *New England Economic Review* (May/June 1992): 21, 24.

[47] Michael Weinstein, "Slower Growth Forecasted for New England Financial Institutions," *American Banker* (January 10, 1989), 28.

[48] Ibid.

[49] Phil Roosevelt, "Home Loan Defaults Rise in Northeast; Region Shows Foreclosure Gains as US Figure Decreases," *American Banker* (June 22, 1989), 2. Quotations and information in the balance of this paragraph are from the same source.

that home buyers throughout the Northeast "have had to really stretch themselves to the limit to buy homes in the past two years" (at the time, fixed-rate-mortgage monthly payments in the Northeast were about $1,000, compared with $620 nationwide) and, she said, their burden became heavier as "buyers who took adjustable mortgages in the past two years experienced steady payment increases, first as the loans adjusted from their introductory 'teaser' rates and then as market rates increased." Robert Rosenblatt, an economist with the Mortgage Bankers Association, said he "had found anecdotal evidence that many lenders in New England qualified borrowers based on payment sizes as set by teaser rates, rather than second-year rates" (secondary markets generally require borrowers to be qualified on the basis of the maximum second-year rates). Moreover, New England lenders tended to retain loans—and thus the risk of default—in their own portfolio rather than sell them in the secondary market.

A rapid increase in nonperforming loans led to serious problems for New England banks in 1989.[50] The banks were hit particularly hard by commercial real estate loan losses. Many commercial projects were highly leveraged, and the owners were frequently individuals or partnerships whose assets either were unavailable to banks or were concentrated in real estate whose value was declining. Banks were therefore forced to absorb much of the loss on commercial real estate projects. As it became clear that loan losses would be substantially greater than anticipated, banks dramatically increased loan-loss reserves, thereby causing a rapid deterioration in bank capital throughout the region. Coincident with this substantial erosion of the capital base of New England banks, regulators were placing increased emphasis on bank capital ratios. Banks with substandard capital-to-assets ratios were required to either increase equity capital or shrink their asset portfolios. Since loan losses prevented banks from increasing capital through retained earnings, the only realistic alternative for raising capital was to issue new shares. For many institutions, however, such an option was not feasible, because investors required a large risk premium, which made it difficult to sell stock at a reasonable price. As a result, the only choice open to many New England banks that were trying to satisfy their capital-to-assets ratio requirements was to reduce the size of their institution. Thus, New England banks substantially contracted during the early 1990s. Although some shrinkage was inevitable after the collapse of the area's real estate markets and slowdowns in both the New England and the national economies, some observers believed that the effects were aggravated by the increased emphasis on bank capital ratios.[51]

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[50] The discussion in this paragraph is based on Browne and Rosengren, "Real Estate and the Credit Crunch," 28; and Peek and Rosengren, "Capital Crunch," 24, 26–27, 30.

[51] For a discussion of the development of capital standards, see Chapter 2.

New York and New Jersey

New Jersey's real estate experience was similar to New England's and caused problems for many of the state's banks. During the 1980s, New Jersey's strong economy made it one of the most desirable banking areas in the country.[52] By the end of the decade, although the state's commercial real estate boom was over, banks expected a soft landing, not a collapse such as had shaken the Southwest and New England. This expectation was based partly on the diversification of the state's economy. As an analyst with a New York brokerage firm noted, "Five hundred of the Fortune 1,000 have a significant presence in New Jersey."[53] But later that same year (1989) the same analyst stated, "Every bank in [New Jersey] has experienced a significant increase in nonperforming loans."[54] In the third quarter of 1989, for a group of New Jersey banks rated by Thomson BankWatch, nonperforming loans of all types were up 25 percent.[55] By late 1990, major New Jersey banks had suffered through a severe slide in real estate values and, according to a report by Fitch Investors Service, Inc., were not likely to feel relief soon.[56] The credit rating firm noted that "sharply deteriorating asset quality is destroying earnings and eroding capital ratios at most major New Jersey banks."[57] Even the $24 billion Midlantic Corporation in Edison, New Jersey, the second-largest banking company in the state and, according to analysts, one of the best run, suffered greatly from real estate loan losses.[58]

By mid-1991, the collapsing real estate markets caused many bankers to abandon their belief that such problems would solve themselves because the property market would inevitably recover.[59] "The typical banker's approach was always to give developers time to work out their problems," said an executive in charge of real estate lending at a New York money-center bank. "Now, bankers believe the change in value is permanent. Prices aren't coming back to their old levels."[60]

In New York the story was similar. Primarily because of the weak real estate markets, the seven largest New York banks ended 1990 with $30.7 billion worth of nonperforming

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[52] Gordon Matthews, "New Jersey Banks Won't Rebound Anytime Soon, Rating Agency Says," *American Banker* (November 16, 1990), 24.

[53] David Neustadt, "Jersey Braces for Lending Slowdown; Vacancy Rates Drop, But So Does Demand for Space," *American Banker* (November 21, 1989), 10.

[54] Ibid.

[55] Ibid.

[56] Matthews, "New Jersey Banks Won't Rebound Soon," 24.

[57] Ibid.

[58] Courtney, "The Great Loss," 11; and Michael Quint, "A Crystal Ball for Banking's Ills," *The New York Times* (January 12, 1991), available: LEXIS, Library: NEWS, File: NYT.

[59] John Meehan, Larry Light, Geoffrey Smith, Joseph Weber, and bureau reports, "For Banks, the Panic Is Coming to an End," *Business Week* (June 17, 1991): 87.

[60] Ibid.

assets, compared with $24.1 billion at year-end 1989.[61] The New York money-center banks suffered relatively greater losses than the smaller banks. For example, Citicorp, then the nation's biggest banking organization with assets of $217 billion, lost $382 million in the fourth quarter of 1990.[62] Chase Manhattan, then the nation's third-largest bank, continued to reel from its $9.5 billion portfolio of deteriorating commercial real estate loans, adding $200 million to its provision for possible credit losses in the fourth quarter of 1990 while charging off $230 million worth of domestic loans.[63] Chemical Bank recorded high real estate–related loan losses in its New York–New Jersey home base, where problem assets were 27 percent higher in the fourth quarter of 1990 than in the third quarter.[64]

The collapsing real estate markets hit the two states' savings banks with a vengeance. Several large savings banks suffered huge losses, primarily from nonperforming real estate loans, and failed in 1992. These included CrossLand Savings Bank (New York, $7.4 billion in assets), Dollar–Dry Dock (New York, $4.0 billion in assets), The Howard Savings Bank (New Jersey, $3.5 billion in assets), and American Savings Bank (New York, $3.2 billion in assets).

CrossLand was a particularly interesting case because of the circumstances leading to its collapse as well as the methods used to resolve the failure (see footnote 70). Although it lost millions in the junk bond market, losses on commercial real estate loans were the primary cause of its failure. In early 1986, CrossLand Savings converted from mutual to stock ownership and, by early 1989, had increased its asset size from $8 billion to just over $15 billion.[65] The once-specialized thrift that was primarily a lender on apartment buildings and other commercial real estate in the New York metropolitan market became a diversified financial services company that operated up and down both coasts through acquisitions of other financial institutions. CrossLand's activities included mortgage banking, commercial and consumer lending, discount brokerage and life insurance services, and real estate development.

In the first quarter of 1990, CrossLand realized a loss of $136.5 million.[66] Much of the problem was due to the Office of Thrift Supervision's (OTS) new rule that disallowed the inclusion of CrossLand's $363 million of cumulative preferred stock as core capital, thereby creating a capital deficiency of $113 million. Because it was undercapitalized, CrossLand

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[61] Jed Horowitz, "NY Bank Profit Disappointing as Loans Falter," *American Banker* (February 8, 1991), 1.

[62] Courtney, "The Great Loss," 11.

[63] Horowitz, "NY Bank Profit Disappointing," 13.

[64] Ibid.

[65] Information in this paragraph was taken from Mark R. Wolff, "CrossLand Savings, Before and After," *Bottomline* 6, no. 3 (March 1989): 44, 46.

[66] Unless otherwise noted, information in this paragraph was taken from John Liscio, "Star-Crossed CrossLand: But a Recap Plan Could Revive the Thrift's Prospects," *Barron's* 70, no. 18 (April 30, 1990): 30–31.

was forced to sell its junk bond portfolio in a weak market, suffering a substantial loss. In early 1990, CrossLand had 22 percent of its assets in Metropolitan New York City commercial real estate loans, and the bank was adversely affected in 1990 and 1991 by the decline in the area's real estate market. Further, management asset-allocation decisions left CrossLand highly vulnerable to the fortunes of the real estate markets, as could be seen at year-end 1990 when approximately 49 percent of the bank's portfolio was composed of high-risk real estate investments and acquisition, development, and construction loans.[67] As of September 30, 1991, regulators had classified 21.5 percent ($1.68 billion) of CrossLand's assets as substandard or lower.[68] These circumstances resulted in CrossLand's incurring net losses of $421 million in 1990 and an additional $308 million for the first nine months of 1991, which wiped out its equity capital.[69] On January 24, 1992, CrossLand Savings of Brooklyn was closed by the OTS, and the FDIC was appointed receiver of the institution.[70]

The Howard Savings Bank was another notable loser in the floundering real estate markets. The 70-branch, state-chartered savings bank based in Livingston, New Jersey, was the largest bank failure in New Jersey's history.[71] By the mid-1980s, the bank's portfolio had become heavily concentrated in commercial real estate loans. The assets of the bank peaked near $5.2 billion in 1988 and then declined to $3.5 billion by October 1992. Although the overall rate of asset growth was relatively moderate during the 1980s, loans and

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67 "CrossLand Savings, Brooklyn, Placed in Receivership; Depositors Protected," *U.S. Newswire* (January 24, 1992), available: LEXIS, Library: NEWS, File: WIRES.

68 Ibid.

69 Susan Benkelman and Timothy L. O'Brien, "CrossLand Bailed Out; Seized Thrift Gets $1.2B from FDIC," *Newsday* (January 25, 1992), available: LEXIS, Library: NEWS, File: NEWSDY; and Phil Roosevelt and Barbara Rehm, "CrossLand Seized as Regulators Reject Bids," *American Banker* (January 27, 1992), 10.

70 In response to the FDIC's solicitation of bids for the failed bank, the best offer submitted was only $17 million for CrossLand's branches. Accepting that offer would have left the FDIC with the task of disposing of billions of dollars' worth of real estate loans and investments. As a result, under what then-Chairman William Taylor called his "bank hospital" plan, the FDIC decided to spend $1.2 billion to keep the bank open, intending to nurse it back to health and sell it for more than it would bring in January 1992. Chairman Taylor believed that this was a less-expensive course of action than closing CrossLand; in addition, he said the FDIC "wanted to let [the bidders] know that we have alternatives" and that the FDIC was willing to keep banks open rather than give them away. Under the "hospital plan," CrossLand executives renegotiated with borrowers rather than automatically foreclosing and selling off their holdings, according to Richard Kraemer, the veteran banker whom the FDIC had installed as CrossLand's president. According to an April 1994 GAO report, the FDIC expected savings of $517 million as a result of having used this method of dealing with CrossLand's failure. In August 1993, the FDIC sold CrossLand by public offering and realized savings from the conservatorship sale (adjusted as if savings had been realized in 1992) of around $333 million (Jerry Knight, "FDIC's 'Hospital' Plan a Bitter Pill for Some; Government Takeover of Ailing CrossLand Savings Bank Called Unfair, Uneconomical," *The Washington Post* [March 1, 1992], available: LEXIS, Library: NEWS, File: WPOST; and U.S. General Accounting Office, *Failed Bank: FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test* [GAO-GGD-94-109, April 1994], 8–9).

71 Information about The Howard Savings Bank is taken from James L. Freund, "Howard Savings Bank: Observations of Regulator/Banker Differences in Evaluating Commercial Real Estate Risks" (unpublished paper, FDIC, 1996).

real estate investments nearly doubled between 1984 and 1989 (from $2 billion to approximately $3.7 billion). By 1988, The Howard was already burdened with severe commercial real estate problems. The Report of Examination for 1988 noted a rapid increase in total classified loans due to "poor credit underwriting and administration and a desire for loan growth and out-of-area lending." As the economy weakened in the late 1980s, The Howard experienced massive asset deterioration and debilitating losses; the bank's CAMEL rating dropped from a 2 in 1988 to a 5 January 1992.[72] After three successive years of substantial losses resulting from its aggressive real estate lending practices, The Howard was declared insolvent and placed in receivership on October 2, 1992. It was a somber ending for the 135-year-old institution, which had been able to survive the Great Depression but succumbed to the real estate bust.

Bank Performance

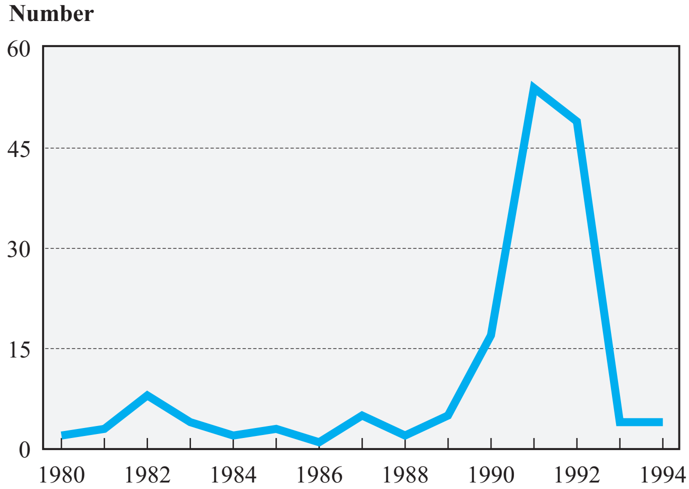
The northeastern banking markets had historically been extremely stable, and until the 1990s, few banks had failed. Even during the turbulent 1980s there was an average of only three bank failures a year in the region (see figure 10.15). Moreover, in 1986 and 1987, when the northeastern real estate markets were still healthy, the region's banks were sound and compared very favorably with banks outside the Northeast. For those two years, CAMEL ratings of northeastern banks were superior, on average, to those of all U.S. banks; return on assets and return on equity were vastly superior to the U.S. average; the percentages of nonperforming assets to total assets and charge-offs to total assets were well below those of all U.S. banks; a far lower percentage of northeastern banks had negative net income than did other banks; and northeastern banks had lower ratios of commercial and industrial (C&I) loans to assets than other banks. On the other hand, during those two years the region's banks had substantially higher percentages of total loans to assets, real estate loans to assets, and commercial real estate loans to assets.

Despite the very sound condition of the region's banks in 1986 and 1987, analysis demonstrates that beginning in 1989 they experienced drastic, pervasive deterioration. As the discussion below indicates, CAMEL ratings degenerated; ratios of median return on assets and nonperforming loans compared poorly with the ratios at other banks; the percent-

[72] The CAMEL rating system refers to capital, assets, management, earnings, and liquidity. In addition to a rating for each of these individual or "component" categories, an overall or "composite" rating is given for the condition of the bank. Banks are assigned ratings between 1 and 5, with 5 being the worst rating a bank can receive. See Chapter 12 for a detailed explanation of CAMEL ratings.

Figure 10.15

Northeast Bank Failures, 1980–1994



age of northeastern banks with negative net income skyrocketed; and the number of failures escalated.

CAMEL ratings of the region's banks worsened along with the area's real estate problems (see table 10.2). For example, from 1983 through 1988, approximately 24 to 26 percent of all northeastern banks were rated 1; the comparable figure as of year-end 1991 was 10 percent. In addition, from year-end 1988 to year-end 1991, the percentage of 4-rated northeastern banks rose from 2.1 percent to 16.5, percent and the percentage of 5-rated banks rose from 0.6 percent to 6.7 percent. (In other words, the percentage of northeastern banks that were rated 4 and 5 rose from 2.7 percent to 23.2 percent.) At the same time, the percentage of all 4- and 5-rated banks that were located in the Northeast rose from 2.4 percent to 19.4 percent (see table 10.3).

Examination of the capital ratios of northeastern banks is also enlightening (see table 10.4). The ratio of equity to assets for northeastern banks remained fairly stable during the troubled years and actually compared favorably with the percentages for the region's banks during the first half of the 1980s. For example, from 1980 through 1984 the average ratio of equity to assets for northeastern banks was only 6.9 percent, but from 1988 through 1992 it increased to 7.8 percent. In contrast, the equity-to-assets ratio for other banks remained constant at 8.2 percent for both periods. The improvement in the capital ratios of northeastern banks can be attributed largely to the substantial amounts of equity that resulted after savings banks converted to stock form.[73]

Table 10.2

CAMEL Ratings for All Northeastern Banks, 1981–1994

Report Date (Year-end)	Number of Banks/Percentage of Total					
	CAMEL Rating					
	1	2	3	4	5	**Total**
1981	213	584	100	28	9	**934**
	22.8	62.5	10.7	3.0	1.0	100%
1982	204	568	110	26	17	**925**
	22.0	61.4	11.9	2.8	1.8	100
1983	210	540	81	18	16	**865**
	24.3	62.4	9.4	2.1	1.9	100
1984	216	508	73	24	18	**839**
	25.7	60.6	8.7	2.9	2.2	100
1985	242	573	76	15	18	**924**
	26.2	62.0	8.2	1.6	2.0	100
1986	263	644	63	16	11	**997**
	26.4	64.6	6.3	1.6	1.1	100
1987	263	646	64	15	5	**993**
	26.5	65.1	6.5	1.5	0.5	100
1988	249	635	87	21	6	**998**
	25.0	63.6	8.7	2.1	0.6	100
1989	200	621	113	40	18	**992**
	20.2	62.6	11.4	4.0	1.8	100
1990	130	486	196	117	41	**970**
	13.4	50.1	20.2	12.1	4.2	100
1991	91	364	236	148	60	**899**
	10.1	40.5	26.3	16.5	6.7	100
1992	83	386	225	123	25	**842**
	9.9	45.8	26.7	14.6	3.0	100
1993	118	473	147	70	18	**826**
	14.3	57.3	17.8	8.5	2.2	100
1994	167	475	98	36	8	**784**
	21.3	60.6	12.5	4.6	1.0	100

Note: Examination ratings were obtained from the FDIC's historical database. In some instances examination ratings were missing; however, from 92 to 99 percent of banks' ratings were in the database. As a result, the number of CAMEL-rated banks each year was slightly smaller than the total number of northeastern banks in other tables.

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[73] The total capital raised by converted savings banks in Massachusetts alone in 1986 was approximately $1.1 billion, sufficient capital to support a 17.5 percent increase in the state's banking assets (assuming a 4.8 percent capitalization rate on the additional assets). As a comparison, the largest bank in Massachusetts at year-end 1986 had equity capital of $1.2 billion (information derived from Eccles and O'Keefe, "The Experience of Converted New England Savings Banks," 1).

Table 10.3

CAMEL 4- and 5-Rated Institutions, Northeastern Banks versus Banks in Rest of U.S., 1981–1994

Report Date (Year-end)	Number of 4- and 5-Rated Banks/Percentage of Total: Northeastern Banks	Other Banks	Total	Total Northeastern Banks/ % Rated 4 and 5
1981	37 15.9	196 84.1	233	**934** 4.0
1982	43 9.1	431 90.9	474	**925** 4.7
1983	34 5.1	628 94.9	662	**865** 3.9
1984	42 4.7	850 95.3	892	**839** 5.0
1985	33 2.7	1,190 97.3	1,223	**924** 3.6
1986	27 1.9	1,433 98.2	1,460	**997** 2.7
1987	20 1.5	1,280 98.5	1,300	**993** 2.0
1988	27 2.4	1,097 97.6	1,124	**998** 2.7
1989	58 5.6	979 94.4	1,037	**992** 5.9
1990	158 15.0	897 85.0	1,055	**970** 16.3
1991	208 19.4	863 80.6	1,071	**899** 23.2
1992	148 20.2	584 79.8	732	**842** 17.6
1993	88 22.5	303 77.5	391	**826** 10.7
1994	44 19.7	179 80.3	223	**784** 5.6

Moreover, although the percentage of northeastern banks with very low (less than 5 percent) ratios of equity and reserves to assets rose from 1.3 percent in 1988 to 4.7 percent in 1990, this ratio was still much lower than it had been for 1981–84, when it averaged 10.3 percent (see tables 10.5 and 10.6). In addition, the percentage of strong northeastern banks—those with equity and reserves to assets exceeding 11 percent—remained fairly steady through the troubled years. It is noteworthy that in 1986 there was a large increase in the percentage of northeastern banks with capital ratios greater than 11 percent. This jump can be attributed primarily to the influx of mutual savings banks into the FDIC fund be-

Table 10.4

Median ROA, ROE, and Equity Ratios of Northeastern Banks versus Banks in Rest of U.S., 1980–1994

Report Date (Year-end)	Number of Banks		ROA		ROE		Equity-to-Assets	
	NE Banks	Other Banks	NE Banks	Other Banks	NE Banks	Other Banks	NE Banks	Other Banks
1980	1,030	13,728	0.72	1.13	10.26	13.52	7.15	8.26
1981	1,010	13,735	0.72	1.09	10.36	12.96	7.08	8.26
1982	974	13,794	0.75	1.04	10.55	12.44	6.86	8.28
1983	898	13,849	0.77	0.98	11.59	11.79	6.57	8.21
1984	883	13,891	0.82	0.91	11.61	11.00	6.62	8.11
1985	982	13,814	1.02	0.89	14.49	10.64	6.93	8.10
1986	1,055	13,613	1.06	0.77	14.45	9.33	7.21	7.90
1987	1,064	13,122	0.97	0.79	12.51	9.30	7.73	8.02
1988	1,061	12,552	0.81	0.88	9.90	10.19	7.83	8.06
1989	1,049	12,147	0.60	0.94	7.05	10.75	7.92	8.17
1990	1,016	11,799	0.20	0.89	2.78	10.24	7.71	8.09
1991	925	11,445	0.26	0.92	3.42	10.51	7.63	8.21
1992	858	11,123	0.65	1.10	8.04	12.30	7.91	8.51
1993	838	10,714	0.89	1.16	9.92	12.39	8.49	8.90
1994	792	10,270	0.89	1.11	9.87	11.92	8.68	8.90

tween 1980 and 1985, many of which converted from mutual to stock form in 1986 and increased their equity capitalization substantially. The percentage of commercial banks with capital ratios of 11 percent or more increased only slightly from year-end 1985 to year-end 1986 (from 14.6 percent to 15.1 percent). For savings banks, however, this ratio jumped from 7.7 percent to 20.3 percent over the same period.

The percentage of nonperforming loans of northeastern banks reflected the deterioration in the region's real estate markets. From 1982 to 1987 the percentage was lower than for other banks, but from 1988 through 1994 it was higher (see figure 10.16). During the most troubled years, 1990–92, this percentage averaged 7.9 percent for northeastern banks, compared with 3.6 percent for other banks. This high level of nonperforming loans led to a substantial increase in the percentage of northeastern institutions with negative net income: 9.4 percent in 1988, 40.2 percent in 1990, and 35.2 percent in 1991 (see figure 10.17). Over the same period, this ratio for other banks dropped from 14.9 percent to 10.5 percent.

This declining performance of the northeastern banks resulted in an enormous increase in the number of failures (see table 10.7). In 1989 there were 5; in 1990, 16; in 1991, 52; and in 1992, 43 (in 1993, the number tumbled to only 3). In 1991 and 1992, 5.6 percent and 5.0 percent, respectively, of northeastern banks failed. Northeastern bank failures as a

Table 10.5

Equity and Reserves to Assets, Northeastern Banks, 1980–1990

Report Date (Year-end)	Number of Banks/Percentage of Total					
	Equity Capital and Reserves to Total Assets					
	<5.0	5.0–7.0	7.0–9.0	9.0–11.0	>11.0	**Total**
1980	66	318	355	176	115	**1,030**
	6.4	30.9	34.5	17.1	11.2	100%
1981	104	289	336	156	125	**1,010**
	10.3	28.6	33.3	15.5	12.4	100
1982	114	305	304	142	109	**974**
	11.7	31.3	31.2	14.6	11.2	100
1983	87	355	251	114	91	**898**
	9.7	39.5	28.0	12.7	10.1	100
1984	85	346	270	92	90	**883**
	9.6	39.2	30.6	10.4	10.2	100
1985	55	348	340	121	118	**982**
	5.6	35.4	34.6	12.3	12.0	100
1986	34	344	353	142	182	**1,055**
	3.2	32.6	33.5	13.5	17.3	100
1987	17	244	406	167	230	**1,064**
	1.6	22.9	38.2	15.7	21.6	100
1988	14	206	414	210	217	**1,061**
	1.3	19.4	39.0	19.8	20.5	100
1989	25	167	400	217	240	**1,049**
	2.4	15.9	38.1	20.7	22.9	100
1990	48	144	378	225	221	**1,016**
	4.7	14.2	37.2	22.2	21.8	100
1991	42	146	331	221	185	**925**
	4.5	15.8	35.8	23.9	20.0	100
1992	15	106	306	238	193	**858**
	1.8	12.4	35.7	27.7	22.5	100
1993	12	52	271	263	240	**838**
	1.4	6.2	32.3	31.4	28.6	100
1994	4	55	244	242	247	**792**
	0.5	6.9	30.8	30.6	31.2	100

percentage of all bank failures went from 2.4 percent in 1989 to 40.9 percent in 1991 and to 35.2 percent in 1992. Northeastern bank failures in the early 1990s accounted for substantial portions of the volume of failed-bank assets and of the FDIC's bank-failure resolution costs (see table 10.8).

Since recently chartered institutions generally fail at higher rates than established banks, the sizable number of newly chartered northeastern banks (see above, "Banking and Real Estate in the Northeast") contributed to the substantial number of bank failures in the

Table 10.6
Equity and Reserves to Assets, Nonnortheastern Banks, 1980–1990

Report Date (Year-end)	Number of Banks/Percentage of Total					
	Equity Capital and Reserves to Total Assets					
	<5.0	5.0–7.0	7.0–9.0	9.0–11.0	>11.0	**Total**
1980	88	1,529	5,945	3,787	2,379	**13,728**
	0.6	11.1	43.3	27.6	17.3	100%
1981	108	1,583	5,887	3,701	2,456	**13,735**
	0.8	11.5	42.9	26.9	17.9	100
1982	143	1,648	5,668	3,679	2,656	**13,794**
	1.0	11.9	41.1	26.7	19.3	100
1983	156	1,986	5,437	3,469	2,801	**13,849**
	1.1	14.3	39.3	25.0	20.2	100
1984	145	1,903	5,531	3,438	2,874	**13,891**
	1.0	13.7	39.8	24.7	20.7	100
1985	156	1,736	5,502	3,520	2,900	**13,814**
	1.1	12.6	39.8	25.5	21.0	100
1986	290	2,058	5,256	3,324	2,685	**13,613**
	2.1	15.1	38.6	24.4	19.7	100
1987	364	1,505	5,088	3,296	2,869	**13,122**
	2.8	11.5	38.8	25.1	21.9	100
1988	395	1,311	4,800	3,202	2,844	**12,552**
	3.1	10.4	38.2	25.5	22.7	100
1989	285	1,223	4,539	3,209	2,891	**12,147**
	2.3	10.1	37.4	26.4	23.8	100
1990	218	1,134	4,627	3,038	2,782	**11,799**
	1.8	9.6	39.2	25.7	23.6	100
1991	139	920	4,374	3,184	2,828	**11,445**
	1.2	8.0	38.2	27.8	24.7	100
1992	73	611	3,844	3,543	3,052	**11,123**
	0.7	5.5	34.6	31.9	27.4	100
1993	15	352	3,145	3,771	3,431	**10,714**
	0.1	3.3	29.4	35.2	32.0	100
1994	34	490	2,989	3,331	3,426	**10,270**
	0.3	4.8	29.1	32.4	33.4	100

region.[74] During 1991 and 1992 approximately 12 percent of the banks in the Northeast that had been in existence for five years or less failed annually, compared with an annual failure

[74] See John P. O'Keefe, "Risk-Based Capital Standards for Commercial Banks: Improved Capital Adequacy Standards?" *FDIC Banking Review* 6, no. 1, (spring/summer 1993): 1–15. De novo bank failure rates are discussed in note 23 of the article.

Figure 10.16

Nonperforming Loans as a Percentage of All Loans, Northeast versus Rest of U.S., 1982–1990

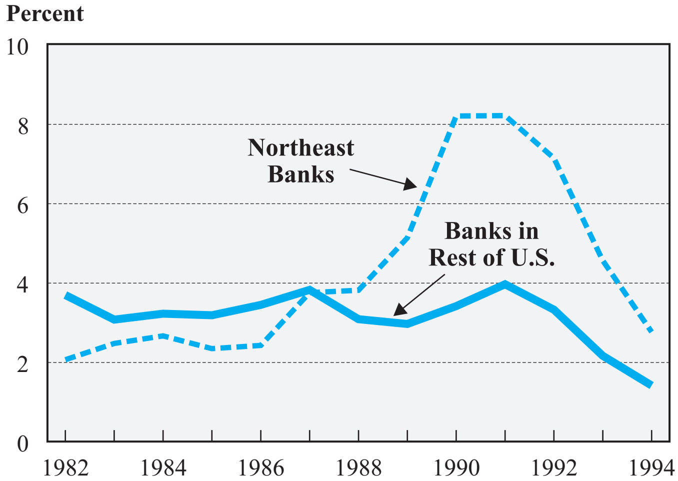
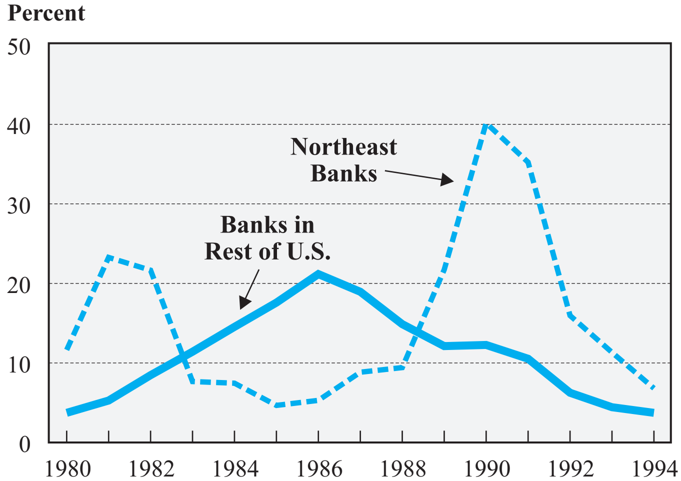


Figure 10.17

Percentage of Banks with Negative Net Income, Northeast versus Rest of U.S., 1980–1994



rate of less than 5 percent for all other banks in the region. The large number of mutual savings banks that converted to stock form during the 1980s also contributed to failures in the

Table 10.7
Bank Failures, 1980–1994

Year	Northeastern Banks	All Banks	Northeast as a Percent of All Failures
1980	1	11	9.1%
1981	3	10	30.0
1982	6	42	14.3
1983	3	48	6.3
1984	1	80	1.3
1985	3	120	2.5
1986	0	145	0.0
1987	4	203	2.0
1988	1	279	0.4
1989	5	207	2.4
1990	16	169	9.5
1991	52	127	40.9
1992	43	122	35.2
1993	3	41	7.3
1994	4	13	30.8

Table 10.8
FDIC Bank-Failure Resolution Costs, 1990–1994

Year	Losses to FDIC from Northeastern Failures ($Millions)	Percent of Total U.S. Failure Costs
1990	$1,300	45%
1991	5,500	91
1992	2,800	77
1993	192	29
1994	46	22

Northeast. These conversions led to rapid growth and increased risk taking at such institutions. More than 20 percent of the stock savings banks that existed at year-end 1989—32 of 149—failed between 1990 and 1994. Only 8 percent of the mutual savings banks that existed at year-end 1989 failed during the same period.

A major reason for the large number of northeastern bank failures in the early 1990s was the combination of a regional recession in the late 1980s and a national recession between 1990 and 1991. But each of the recessions was rapidly followed by a regional or national economic recovery; and between 1991 and 1993 the yield curve became very favorable, leading to record-high net interest margins for banks. Further, mortgage rates began declining substantially in 1991 and reached a 30-year low in 1993, bolstering the recovery of real estate markets. The drop in mortgage rates led to an increase in first-time home ownership and a wave of mortgage refinancing, resulting in substantial fees for mortgage lenders. These conditions no doubt helped reduce the number of northeastern bank failures to only three in 1993 and four in 1994.

As in other regional recessions, the rapid economic decline in the Northeast did not affect all banks in the same way. Even with the large number of northeastern bank failures (111 between 1990 and 1992), most of the approximately 1,000 banks in the region as of December 1989 survived the turmoil. The FDIC has conducted research to determine if there were characteristic differences between the banks that survived and those that failed. As is shown in Chapter 13, many years before a bank fails, it usually has a riskier operating strategy than do surviving banks.

To see if this pattern existed in the Northeast, the FDIC researchers studied two cohorts of banks. The first consisted of all northeastern banks that existed in 1986 and either failed in 1990 or 1991 or never failed. The second cohort consisted of banks that existed in 1988 and either failed in 1992 or 1993 or never failed. To analyze the effect of risky bank strategies, the researchers used eight financial ratios.[75] To assess how varying degrees of risk affected northeastern banks, they ranked each bank for each financial ratio. Each ranking was then divided into five risk groups, and the failure rate was determined for each group. For the 1986 cohort, banks in the highest loans-to-assets group had the highest percentage of failure four to five years later—10.6 percent. This was 3.8 times as high as the percentage of failures for the remainder of the banks (see figure 10.18). In the 1988 cohort, the banks with the highest asset growth had the highest incidence of failure—10.1 percent, 3.2 times as high as for slower-growing banks (see figure 10.19). The finding for 1986—that banks in the highest loans-to-assets quintile had the highest failure rate—is consistent with the findings for banks nationwide in that period.[76] However, the results for 1988 are not the same as those for the nation as a whole. As noted above, the large-scale conversion of mutual savings banks to stock form and their subsequent rapid asset growth was a distinguishing feature of the Northeast's banking environment. Growth rates of converted savings banks in the Northeast were very high, and a disproportionate percentage of these institutions failed as compared with failure rates in the rest of the country (thus, high growth rates in 1988 were a better predictor of future failure in the Northeast than they were for banks nationwide).

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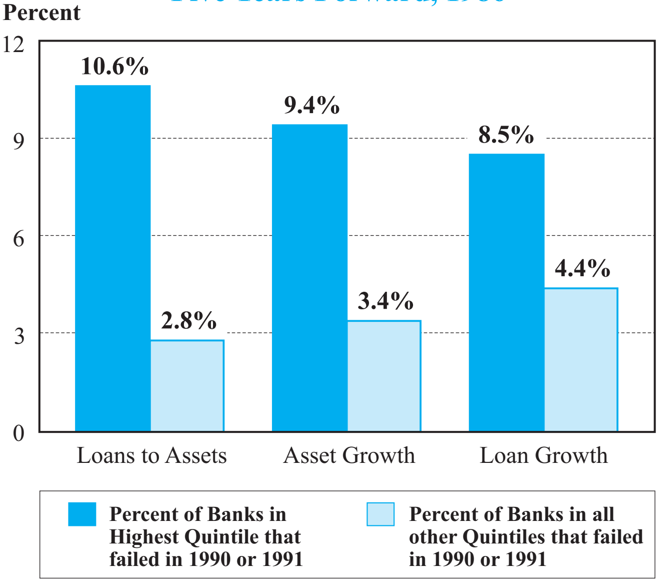
[75] The eight risk factors are loans-to-assets ratio, return on assets, asset growth from the previous year, loan growth from the previous year, operating expenses to total expenses, average salary expenses, interest on loans and leases, and interest plus fees on loans and leases.

[76] See Chapter 13, "Off-Site Surveillance Systems."

Figure 10.18

Comparison of Selected Factors in Predicting Northeastern Bank Failures Four and Five Years Forward, 1986



Note: These three factors represent the two highest risk factors (left and center) and the lowest risk factor (right) in predicting bank failures.

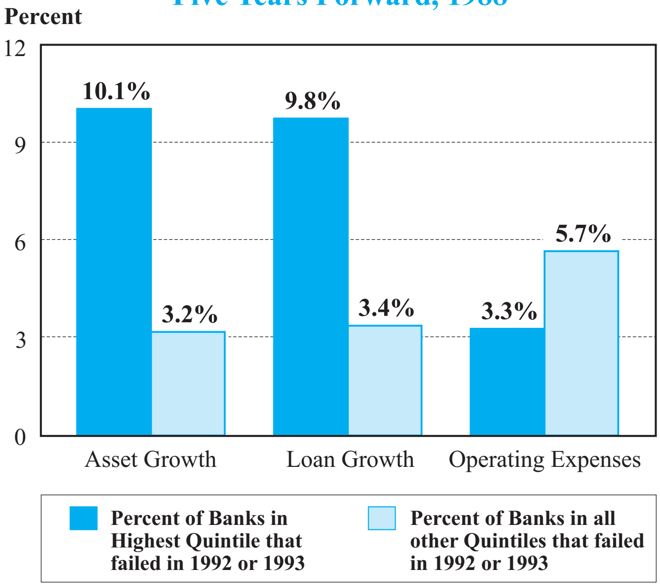
Data on Bank Failures by State

The impact of the northeastern banking crisis varied depending on the state, but the adverse effects tended to be fairly concentrated in time, peaking between 1991 and 1992. In terms of failed-bank assets relative to each state's total banking assets, the most severely affected state was New Hampshire: in 1991, 12 banks failed with assets of $5.2 billion (25.4 percent of the state's prior year-end assets). Comparable figures were 18.3 percent in Connecticut, 15.2 percent in Maine, and 12.0 percent in Massachusetts. In contrast, an average of only about 3.0 percent of bank assets failed in the region's other states (New Jersey, New York, Rhode Island, and Vermont).[77]

[77] Most of the franchise of a failed bank, both assets and liabilities, typically remains within the same geographic market after the bank's closure. This is because the typical way to resolve bank failures is by selling portions of the assets and liabilities to healthy former competitors in the state. Consequently, one should not infer that failed-bank assets are "lost" to these markets.

Figure 10.19

Comparison of Selected Factors in Predicting Northeastern Bank Failures Four and Five Years Forward, 1988



Note: These three factors represent the two highest risk factors (left and center) and the lowest risk factor (right) in predicting bank failures.

Included among the region's bank failures were many of the Northeast's larger banking organizations (see table 10.9). It is noteworthy that in New York and New Jersey, although the percentage of failed-bank assets was relatively small, there were several major failures, including Goldome ($9.9 billion), Dollar–Dry Dock ($4.0 billion), Seamen's ($3.4 billion), and American Savings Bank ($3.2 billion), as well as CrossLand Savings Bank ($7.4 billion) and The Howard Savings Bank ($3.5 billion), as discussed above.

The 1990s northeastern bank-failure experience will perhaps be most remembered for two events. The first was the failure of the Bank of New England Corporation (BNEC) on January 6, 1991. (This failure is described in the next section.) BNEC had a significant regional presence through the Bank of New England (Boston), Connecticut Bank and Trust Co. (Hartford), and Maine National Bank (Portland). BNEC had assets of approximately $22 billion at the time of its failure, and its resolution cost the FDIC approximately $733 million. The second memorable event was the failure of seven New Hampshire banks on October 10, 1991. These seven failed banks included four of the state's ten largest (Amoskeag Bank, Dartmouth Bank, Bankeast, and Numerica Savings Bank) as well as

Table 10.9
Large Northeastern Bank Failures in the 1990s

Institution	Failure Date	Assets ($Millions)	Resolution Costs ($Millions)	Cost as a Percentage of Assets	State
The Seamen's Bank for Savings, FSB	04-18-90	$ 3,392	$189	5.57%	NY
Bank of New England Corporation	01-06-91	21,886	733	3.35	
Connecticut Bank & Trust Co.	01-06-91	7,211	152	2.11	CT
Bank of New England	01-06-91	13,429	581	4.33	MA
Maine National Bank	01-06-91	1,046	0	0.00	ME
Maine Savings Bank	02-01-91	1,183	6	0.47	ME
First National Bank of Toms River	05-22-91	1,418	132	9.31	NJ
Goldome	05-31-91	9,891	848	8.57	NY
First Mutual Bank for Savings	06-28-91	1,130	181	16.02	MA
Citytrust	08-09-91	1,919	505	26.32	CT
Mechanics & Farmers Savings Bank, FSB	08-09-91	1,084	323	29.80	CT
Connecticut Savings Bank	11-14-91	1,045	207	19.81	CT
CrossLand Savings Bank	01-24-92	7,432	548	7.37	NY
Dollar–Dry Dock	02-21-92	4,028	357	8.86	NY
American Savings Bank	06-12-92	3,203	470	14.67	NY
First Constitution Bank	10-02-92	1,571	127	8.08	CT
The Howard Savings Bank	10-02-92	3,461	87	2.51	NJ
Heritage Bank for Savings	12-04-92	1,288	22	1.71	MA

Note: Resolution costs are as of year-end 1995.

three relatively large banks (Nashua Trust Company, New Hampshire Savings Bank, and Bank Meridian). These seven New Hampshire failures represented approximately 25 percent of the state's commercial and savings bank assets.

The Rise and Fall of the Bank of New England Corporation

The "new" Bank of New England Corp. (BNEC), headquartered in Boston, was formed in June 1985 after the merger of the "old" Bank of New England Corp. of Boston ($7 billion in assets) and CBT Corp. (Connecticut Bank & Trust) of Hartford ($6.8 billion in assets).[78] The merger was designed to take advantage of the best features of both institutions—Bank of New England Corp.'s expertise in real estate lending and CBT's knowledge

[78] Alan Lavine, "Bank of New England Corp. Takes Its Name Seriously with Ambitious Acquisition Strategy in Four States," *American Banker* (September 2, 1986), 24; and John P. Forde, " 'New' Bank of New England's Rosy Prospects," *American Banker* (December 19, 1985), 3.

of retail banking.[79] The reaction to the merger was favorable. An analyst at Goldman, Sachs & Co. said, "The 'new' Bank of New England Corp. is a well managed, $14 billion–asset bank holding company located in a booming region."[80] James J. McDermott, Jr., an analyst at Keefe, Bruyette & Woods Inc. in New York, believed that "the Bank of New England and CBT merger was one of the more brilliant strokes in banking. Two strong retail and wholesale markets were merged."[81]

After the merger, BNEC initiated a growth strategy in which it spent over $1.4 billion, mostly in stock swaps, to buy leading banks in key economic areas of New England. For example, in December 1985 it completed a merger with Maine National Bank of Portland (MNB), a $700 million institution.[82] These acquisitions helped BNEC grow to $24 billion in assets within 20 months.[83] By mid-1988, BNEC had executed mergers with more than a dozen institutions and had captured a major share of the New England market, with about 12 percent of domestic deposits and about 19 percent of commercial loans.[84] As of July 1989, BNEC had $32 billion in assets, 8 subsidiary banks, and 482 branches in the states of Connecticut, Maine, Massachusetts, and Rhode Island.[85]

BNEC's spectacular growth ended when problems began to develop in the late 1980s as the regional economy declined and real estate markets became troubled. By the end of the first quarter of 1989, BNEC's banks had $551 million in nonperforming loans—2.2 percent of the banks' total loans. The depth of BNEC's problems was indicated by Kidder Peabody's mid-1989 recommendation that its clients sell their stock in the company.[86]

The growing financial problems of BNEC's banks, especially its lead bank, the Bank of New England, Boston (BNE), were of increasing concern to the Office of the Comptroller of the Currency (OCC).[87] The results of the agency's year-end 1988 examination (completed in May 1989) of BNE and each of its affiliated banks were such that BNE and its directors consented to a formal agreement on August 10, 1989, to correct deficiencies the OCC examiners had identified in the banks' real estate lending practices. Beginning in September 1989, the OCC had examiners in BNE on a continuous basis. However, the finan-

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[79] Alice Arvan, "The Regionals That Roar," *Bankers Monthly* 105, no. 5 (May 1988): 68.
[80] Forde, " 'New' Bank of New England's Rosy Prospects," 3.
[81] Lavine, "Bank of New England Corp. Takes Its Name Seriously," 23.
[82] Forde, " 'New' Bank of New England's Rosy Prospects," 3; and Lavine, "Bank of New England Corp. Takes Its Name Seriously," 24.
[83] Lavine, "Bank of New England Corp. Takes Its Name Seriously," 24.
[84] Arvan, "The Regionals That Roar," 68.
[85] Alan Wade, "Bank of New England's Woes," *United States Banker* 98, no. 7 (July 1989): 46; and Arvan, "The Regionals That Roar," 68.
[86] Wade, "Bank of New England's Woes," 48–49.
[87] For the OCC's views on BNE, see Clarke statement, testimony in OCC *Quarterly Journal* 10, no. 2 (June 1991): 31–32.

cial deterioration continued, and in late 1989 the OCC began to increase its supervision of the bank's day-to-day operations.

In January 1990, the chairman of BNEC (who was also chairman of BNE) resigned after the corporation announced that its constituent banks had lost $1.1 billion in 1989. On January 22, 1990, BNE found it necessary to borrow $225 million at the Federal Reserve's discount window in order to meet its immediate liquidity needs. On February 26, 1990, BNE and its directors consented to a cease-and-desist order with the OCC; the order served, among other things, to prevent further dissipation of the bank's assets. The OCC executed similar cease-and-desist orders in April and May with, respectively, CBT and MNB and their directors.[88]

Despite the efforts of a new management team to improve performance, BNE lost another $80 million in the first half of 1990; and by year-end 1990, $3.2 billion, or 20 percent, of BNEC's loans were nonperforming.[89] On January 4, 1991, after BNEC announced that it expected a $450 million fourth-quarter loss that would render both the holding company and BNE technically insolvent, depositors mobbed BNE's branches and withdrew $1 billion.[90] On Sunday, January 6, 1991, the OCC formally declared BNEC's three major banking units—BNE, CBT, and MNB—insolvent and appointed the FDIC as receiver. On the same day the FDIC announced that (1) the OCC had chartered three new bridge banks (New Bank of New England, N.A., Boston; New Connecticut Bank & Trust Company, N.A., Hartford; and New Maine National Bank, Portland) to assume the assets and liabilities of the three insolvent banks; (2) the bridge banks would be open for business as usual on Monday, January 7, 1991; and (3) all deposits of the three insolvent banks would be protected, even those over the $100,000 insured limit.[91]

The insolvencies of CBT and MNB were triggered by the failure of BNE. Because of BNE's insolvency, CBT was unable to recover $1.5 billion in federal funds it had loaned to BNE. The FDIC charged the resulting loss against the capital accounts of CBT, with the result that CBT had an equity capital deficiency of $49 million.[92] The OCC then declared CBT insolvent and placed it in receivership. Furthermore, under the cross-guarantee provision contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the FDIC demanded immediate payment from MNB of an amount equal

[88] Ibid., 32.

[89] Geoffrey Smith, "Lawrence Fish's Best May Not Be Good Enough," *Business Week* (October 22, 1990): 98–99; and "Bank of New England: Here We Go?" *Economist* 318 (January 12, 1991): 72.

[90] "Bank of New England: Here We Go?" 72; and Clarke testimony, 32.

[91] FDIC News Release PR-3-91, "FDIC Establishes Three New Banks to Assume Deposits of Bank of New England, N.A., Boston, Massachusetts, Connecticut Bank & Trust Company, N.A., Hartford, Connecticut, and Maine National Bank, Portland, Maine," January 6, 1991.

[92] Clarke testimony, 32–33.

to the FDIC's expected loss as receiver of BNE.[93] When MNB was unable to make the payment, the OCC declared it to be insolvent and placed it in receivership. This was the first time the cross-guarantee provision of FIRREA had been used to close a bank.

On April 22, 1991, the FDIC announced that the three bridge banks would be acquired by Fleet/Norstar Financial Group, Inc., of Providence and investment managers Kohlberg, Kravis, Roberts & Co. (KKR). Fleet agreed to raise $683 million in capital for the banks within three months; KKR would provide $283 million, and the bank planned to raise the remaining $400 million in stocks and bonds. The participation of KKR as a partner with Fleet/Norstar in the acquisition of the three bridge banks was the first time that a nonbank "financial" buyer participated in the purchase of a failed commercial bank. KKR's involvement not only allowed capital to enter the banking industry from nonbanking sources but was also expected to increase the number of potential bidders in future bank failures.[94]

The decision to protect all deposits of the three BNEC banks again focused attention on the "too-big-to-fail" bank disposition policy. During congressional hearings held on January 9, 1991, many members of the House Banking Committee had expressed the view that paying depositors of large institutions in full was not only unfair to those with deposits in small banks but also undermined depositor discipline.[95] FDICIA consequently included provisions making it more difficult for bank failures to be resolved in ways that would protect uninsured deposits.[96]

After the failure of the BNEC banks, the chairman of the Senate Banking Committee asked the U.S. General Accounting Office (GAO) to review the factors that had caused the failure. The 1991 GAO report noted that between 1985 and 1989, the assets of BNEC banks grew from $7.5 billion to $32.6 billion, primarily through aggressive acquisitions and increased real estate lending.[97] The GAO believed that this expansion should have caused the OCC to conduct a thorough and aggressive examination early in the period to assess the potential adverse affects of both BNEC's rapid growth and its concentration in commercial real estate lending.[98]

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[93] The cross-guarantee provision of FIRREA provides that an insured depository institution can be held liable for any loss that the FDIC expects to incur in connection with the default of a commonly controlled insured depository institution.

[94] FDIC News Release PR-61-91, "FDIC to Sell Bank of New England Franchise to Fleet/Norstar," April 22, 1991; Barbara A. Rehm, "How the Acquisition by Fleet Will Work," *American Banker* (April 24, 1994), 8; and Milligan, "KKR, Member FDIC," 59.

[95] U.S. House Committee on Banking, Finance and Urban Affairs, *Failure of the Bank of New England: Hearing,* 102d Cong., 1st sess., January 9, 1991, 1–50 (comments by various members of the committee and by Mr. Seidman and Mr. Clarke).

[96] FDIC, "Systemic Risk ('Too Big to Fail')" (unpublished paper), 1995, 7.1-1 to 7.1-5. For additional information, see Chapter 7.

[97] U.S. General Accounting Office, *Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful* (GAO/GGD-91-128, September 1991), 1.

[98] Ibid, 22.

The GAO report also pointed out that during BNEC's high-growth years OCC examiners repeatedly identified and reported problems with BNEC banks' controls over lending operations and strategies, but not until 1989 did the OCC take enforcement action to compel corrective measures.[99] For example, the OCC found that over half of the commercial real estate loans reviewed at BNE during the December 1987 examination were 100 percent financed and that nearly half of the loans reviewed had inadequate or stale credit information on borrowers, but the agency generally relied on BNEC management's assurances that it would address problems such as these.[100]

The GAO concluded that the BNEC banks failed as a result of their liberal lending practices, poorly controlled growth, and concentration in commercial real estate loans in a severely declining regional economy.[101] The GAO findings indicated that the OCC had failed to take timely and forceful supervisory actions to compel BNEC to correct problem areas before they adversely affected capital adequacy. Although the GAO could not say with certainty that close supervisory scrutiny would have saved BNEC's banks, the agency did believe that more vigilant supervision could at least have reduced losses.[102]

Although the "new" Bank of New England had been established with great expectations in 1985, by early 1991 it was the country's third-largest bank failure (after First RepublicBank Corporation and Continental Illinois). BNEC's aggressive lending practices had produced a large concentration of real estate loans, and when New England's construction boom faltered, BNE's loan book was "reduced to rubble."[103] There were other factors in BNE's collapse. Former executives, competitors, and customers told "a tale of confused and haphazard management." Lines of authority and responsibility were blurred, lending standards were often lax, and numerous unwise real estate loans were made. It was reported that the former chairman had personally courted large real estate developers and, in an effort to complete a transaction, sometimes offered bargain-priced loans without seeking any collateral. Some former executives alleged that the chairman had "often made such loans without even consulting his lending officers."[104] While these activities were certainly examples of poor bank management, they were not illegal. In fact, it was reported the chairman was not only allowed to retire rather than resign, thereby becoming eligible for lifetime

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99 Ibid, 5.
100 Ibid, 13–15.
101 Loans were issued with favorable terms, such as 100 percent financing, no collateral except the development project on which the loan was made, and interest-only payments for a number of years.
102 U.S. GAO, *OCC's Supervision of the Bank of New England*, 38.
103 "Bank of New England: Here We Go?" 70, 72–73.
104 Laura Jereski, "A Stomachache for the Bank That Ate New England," *Business Week* (February 5, 1990): 68–69.

retirement benefits of approximately $1 million a year, but was also offered a severance package worth several million dollars.[105]

Conclusion

The banking problems in the Northeast in the 1980s and early 1990s were associated with the third in a series of four rolling regional recessions that had been preceded by speculative booms (the first two were in the farm belt and the Southwest; the fourth was in California). The Northeast's regional problems were exacerbated by the national recession that took place during 1990–91. With respect to banking problems, the most important element of the region's boom was real estate—particularly commercial real estate. Expecting a continuation of the substantial gains that accompanied the building boom of the mid-1980s, numerous banks throughout the region lent aggressively into projects that, in many cases, became increasingly marginal, especially as the economy worsened. As in the Southwest, vacancy rates shot up and many real estate loans made during the boom turned into problem loans. Although many observers believed that the Northeast's diversified economy would cushion the region against a Texas-style collapse, that assessment proved inaccurate. As had been the case in the farm belt and in the Southwest, the end of the boom led to significant numbers of bank failures. In 1989 only five banks failed in the region, but two years later, in 1991, the number had risen more than tenfold to 52. Also like the Southwest, the Northeast experienced a number of large-bank failures. In the New York area, several large savings banks failed, including Goldome, CrossLand, and Dollar–Dry Dock. The most notable failure was undoubtedly that of the Bank of New England in January 1991, the resolution of which created pressure for legislative action to deal with the "too-big-to-fail" issue; Congress responded with FDICIA.

One important element of the banking problems in the Northeast was peculiar to the region: the presence of large numbers of mutual savings banks that converted to stock form during the period. Between 1985 and 1990, approximately 40 percent of all the mutual saving banks in the region as of year-end 1984 took this course. Converted institutions experienced significant increases in capitalization and therefore increased their loan growth in order to sustain returns on equity. Many of these savings banks had concentrated on traditional residential real estate lending, but upon conversion they pushed into unfamiliar commercial real estate in new geographic markets where their managements had little experience. Converted savings banks therefore became a uniquely northeastern element in the series of boom-to-bust cycles that had occurred in the Midwest and the Southwest in the middle to late 1980s and would occur once more, in California in the early 1990s.

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[105] Jed Horowitz, "Grapevine: That Connolly 'Chute,'" *American Banker* (January 31, 1990), 4.