BIS orders retrenchment of U.S. financial power

by David Goldman and Laurent Murawiec

After three months of prodding by the Bank for International Settlements (BIS) and the West German Bundesbank's chief Karl-Otto Pöhl, the U.S. banks have begun to write off Latin American loans. On Monday, June 18, the Comptroller of the Currency issued stiff new guidelines requiring banks to report past-due loans for the second quarter and write the interest income down in the third quarter.

These moves were dictated by European banking interests, and pressed through at last weekend's annual meeting of the BIS. The Europeans expressed their extreme dissatisfaction with what they termed "the hysterical fixation of American bankers on quarterly dividends which lead them to lend money to debtors to allow the latter to 'repay' interest in time to escape the 90-day clause of non-performance." This, they have argued in speeches, articles, and private discussions, "prevents the setting up of any long-term solution to the debt crisis."

The Europeans are using their control over American banks' liabilities funding overseas to force the Americans into a head-on confrontation with the debtors' club meeting June 21-22 in Cartagena, Colombia.

The American Treasury's tough stance against the Argentines, who have refused to bow to International Monetary Fund conditions, as well as the insistence that the banks take their losses in order to preempt Argentine bargaining power, was also a product of the weekend BIS meeting. The decision of the Reagan administration to cancel a $300 million loan guarantee to Argentina "is wholly justified," said BIS chairman Fritz Leutwiler, who caused a few arms to be twisted and broken in Washington and Lower Manhattan to achieve this result. He told the BIS annual press conference that "this American decision took place after consultation among central banks"—which means that the BIS dictated the policies and Uncle Sam obeyed.

After this, most U.S. banks announced they wouldn't wait for the third quarter but would begin to write down the interest on the loans immediately. Manufacturers Hanover announced it is immediately taking at least a $25 million loss in the second quarter on interest that is already past due from Argentina, that is, writing off all the interest more than 90 days overdue by Argentina—in advance of June 30, whether Argentina decides to pay or not.

If Argentina does not pay on June 30, Manny Hanny will write off another $15 million, for a total $35 million in lost interest, which will lower their earnings by 37%. Crocker National Bank will probably take a flat loss for the quarter by doing the same. In fact, the Comptroller's regulations might even force banks to write down many *domestic* loans which are more than 90 days past due. Banks that may take big losses due to the comptroller's new guidelines include Bank of America, Security Pacific, and Continental Illinois as well.

In summary, the BIS argument to the American banks amounts to, "take your losses and we will continue to fund you." Clearly the Europeans do not expect the debtors to be put off indefinitely, which is to say that they do not expect to fund the American banks indefinitely. The new round of write-offs, far from stabilizing the banks' position (as the stock market appeared to believe on June 20), merely sets up the next round of bank runs.

"The biggest problem is yet to come—when the [Argentine] loans become 180 days overdue, in July," a senior administration official said June 20. "Under the law, the banks have to start taking actual losses on assets, on the asset side of the balance sheet. Then it's not just some interest income being lost, but the actual assets being written down. *Then* the markets could get worried.

"Right now, many of these loans are 160, 170 days overdue on interest. Argentina needs the $500 million to get those loans back down below the 90-day overdue interest mark. So if this is not done, the interest arrearages can quickly mount up from 170 to 180 days overdue."

Between the devil and the debtors' cartel

"It is clear that the European financial community will dictate the next several months of financial policy," a top adviser to the Reagan White House commented in mid-June. American banks have funded the $100 billion p.a. current-account deficit this year largely by borrowing on the Eurodollar market, shifting from net providers of funds to the offshore market to net borrowers in a sudden and dramatic turnaround.

The next step is already being aired by *Mitteleuropa*'s bankers: broaching an idea originally emitted by Swiss National Bank number three man Markus Lusser, Bundesbank head Pöhl said in a speech in Zürich on June 18 that he had "great sympathy for the idea of [creating] a secondary market for bank claims against debtor countries. Admittedly, this procedure would bring about an 'hour of truth' but it would smooth up new ways to get rid of the 90-day clause." Slyly, Pöhl added that this would allow a "soft landing" for the overvalued dollar, rather than the "market overshooting" result in case it were not done.

An official at the Swiss National Bank elaborated on the proposal, which was first issued by that bank's Markus Lusser: "These measures would force the banks to price their assets realistically, at what level the market would bear. It would force the banks to take other measures—the American banks would have to retrench quite a bit to do that."

A Dutch banker spelled out that creating a secondary market for bank and syndicated claims to be traded at a discount would not only establish the "true market value of the assets and market creditworthiness of the debtors," thus settling both the fate of borrowers and creditor banks alike, but also recreate "the situation before 1914 when bonds were the main international financial instrument." The *Times* of London had recently editorialized on the virtues of the pre-1914 system "which absorbed defaults very well without an IMF and without summits." In short, a return to the "free market" underpinned by gunboat diplomacy.

As cash-strapped and deposit-starved U.S. banks would rush to realize their assets, they would sell non-performing claims—still IOUs representing original par value—as well as high-yield assets in order to create liquidity, and thus yield their power to exact interest and principal from debtors, while the U.S. Treasury and Federal Reserve—the power of the U.S. government—would be used to bash the debtors over the head, to the benefit of the new claim-holders.

Since May 11, a massive retrenchment of U.S. bank funding and lending has been under way. U.S. banks are virtually quarantined on the international interbank markets. "Banks, especially American ones, have to fund themselves for these loans placed in non-accrual. But they cannot float CDs, deposits with them are not being rolled over, and credit lines are being cut down or cancelled. They must revert to the domestic market, and retrench, especially since what they need is to recapitalize, restore the health of their balance sheets," a London merchant banker said. At the Swiss National Bank, a senior official said: "Already Swiss banks, and the Germans too, enjoy much finer terms than U.S. banks on the interbank market—which they use for highly profitable arbitrage, relending to U.S. banks. But they differentiate—you don't lend to *any* American bank these days."

Preparing for the worst

The *Mitteleuropäer* clearly do not believe that such measures will produce stability. On the contrary, Swiss banks are quietly redenominating their dollar assets in their own currency, insulating their claims from any tempest in the dollar sector, to be ready for a dollar collapse.

The continuing unraveling of Continental Illinois is a possible trigger for such a collapse. One fear among bank analysts is the possibility that Continental Illinois might have to sell off its bad assets piecemeal, at whatever the market will bring. In the case of its Ibero-American debt exposure, this would lead directly to the state of affairs advocated by the Swiss and West German central banks. Some regional banks have already sold off significant amounts of Brazilian and Mexican paper in London, on the quiet, at roughly 60 cents on the dollar.

Were Continental to attempt to sell off Brazilian or Mexican loans now, they might bring considerably less—perhaps as little as the 20% to 30% that the Swiss National Bank's Lusser suggested. In this event the other money-center banks would have no choice but to write their portfolios down to this level, eliminating their stockholders' equity at one stroke.

To postpone this threat, the Federal Deposit Insurance Corporation is reportedly ready to dump $4.6 billion into any institution willing to buy up the bank's bad loans at face value.

According to a Dow-Jones news service item June 22, the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) are considering a massive $4.6 billion loan and loan-guarantee plan to assist the sale of all or part of the troubled Continental Illinois Bank.

Reportedly, the Fed would lend $2.6 billion to a new banking concern to purchase $4 billion of Continental Illinois problem loans, admitting in effect that the portfolio was worth only 35% of its stated value.

For legal reasons, the Fed loan would be guaranteed by the FDIC, which would also place $500 million of new equity into Continental Illinois, on top of the $1.5 billion already committed, bringing the total to $4.6 billion.

Set-up for catastrophe

Preparations for the squeeze against American banks formally began on May 6, at the international central bankers' conference hosted by the New York Federal Reserve Bank. As the Swiss daily *Neue Zürcher Zeitung,* reported the counsels of the central bankers: "The European creditor banks are inclined to long-term solutions and are increasingly dissatisfied with American banks. So far, the U.S. banks have only acepted short-term reschedulings . . . in order the better to control the debtors. For the sake of uninterrupted and punctual debt service payment . . . the Americans propose [the lending of] fresh credits to an extent that has become uncomfortable to many Europeans. The behavior of the Americans is to a large extent conditioned by the existing banking laws and, to name it, by the pressure of shareholders which in turn forces the banks to offer the highest possible dividends. . . ."

Days after the central bankers' meeting came to a close, and after U.S. interest rates had been increased by 0.5%, the Continental Illinois panic started.

Summing up the whole affair, an Austrian central bank spokesman stated early in June: "The question is simple: Uncle Sam must pay. U.S. banks behave ridiculously. They have to take their losses, that's all. And if they have to change their laws, let them change their laws. If they have to forego dividends, so be it. If they have to reorganize themselves and some to go belly-up, to merge or be acquired, let it be."

Fritz Leutwiler himself sounded the attack in a resounding interview to the German weekly *Die Zeit* on June 1. Asked whether interest capitalization would not conflict with U.S. legislation, he answered: "This is a problem for American banks. But it is not unsolvable. It is a political question: How fast can the Americans change their regulations. We cannot expect that the whole world hang on the peg of the 90-day clause. . . . American banks are today more vulnerable."

The Swiss think they have a deal with the Russians, so that they can get away with collapsing the United States and survive themselves. But they won't survive a U.S. banking collapse, and besides—they don't realize they're next on the Russian shopping list.

Documentation

'The U.S. government says no negotiation'

Excerpts from replies to questions made during an interview with a senior Reagan administration official involved in the formulation of debt policy:

What we have here is unfortunate brinksmanship. The U.S. government says there is no room for negotiations with a country like Argentina which forces its own unilateral ideas on the IMF, instead of going with the mandate of the IMF. It's not a matter for negotiation, no one tells the IMF what to do.

There is tremendous pressure on [Citibank's] Bill Rhodes [head of Argentina coordinating committee] from the IMF and Treasury, *not* to give a deal to Argentina. Volcker feels that the IMF must take the lead, and not the other way, as a precedent. The banks are going to have to play ball with the IMF, Fed, and Treasury. The banks have to go along with the old law of the IMF first, and they are therefore unwilling to be seen cooperating with Argentina.

Argentina has polarized the situation in Latin America. No one can be seen [bank nor official[caving in to them. The banks will not loan them the money to pay the interest.

The banks are willing to take it as a loss. They will just let it get 90 days overdue and take losses on interest income. They were willing to do it on March 30, and the markets know it and won't over-react.

The biggest problem is yet to come—when the loans become 180 days overdue, in July. Under the law, the banks have to start taking actual losses on assets, on the asset side of the balance sheet. Then it's not just some interest income being lost, but the actual assets being written down. *Then* the markets could get worried.

Right now, many of these loans are 160, 170 days overdue on interest. Argentina needs the $500 million to get those loans back down below the 90-day overdue interest mark. So if this is not done, the interest arrearages can quickly mount up from 170 to 180 days overdue.

Then the *real* cracks in the banking system start, when banks have to begin looking at 180-day losses.

That's why they want to crack the Argentina problem now. People want to treat it as an Argentina problem, to isolate Argentina, to not allow it to be a precedent in its treatment of the IMF to any other country. Argentina is going to get isolated by de Larosière's approach to Mexico. What we may have to do is write Argentina totally off, and bail out Mexico and later Brazil.