Banking Kathy Burdman

'Let Continental be a lesson'

New bank crises loom for the fall as Volcker asks bankers to take their lumps.

The government's forced nationalization of Continental Illinois bank on July 26 seems to have calmed the international debt crisis, but a new round of bank-stock drops and deposit losses could be coming up this fall. On July 25, Federal Reserve chairman Paul Volcker told the Senate Banking Committee that the Continental bailout "may be an object lesson" to other U.S. banks.

Volcker first praised what he called the "substantial progress" by Mexico, Brazil, and Venezuela, which thus far have adhered to the International Monetary Fund's (IMF) harsh austerity programs. He said that these "good" debtors—as distinct from Bolivia and Argentina, which have rebuffed the IMF—should be rewarded by "long-term restructuring of their external debt."

It is the U.S. banks, however, he said, which will have to make tough adjustments—or end up, like Continental, suffering major runs on their deposits. Conti's situation is "unique for a large bank, but the episode may be an object lesson about the importance of looking ahead to anticipate problems."

According to Volcker, Continental's downfall was to raise deposits at whatever rate was necessary and assume that "loan rates can be raised as fast as deposit rates." This approach tended to "undermine the creditworthiness of weaker borrowers," bringing down Conti's debtors until a run hit Continental itself.

Volcker concluded that the other major U.S. banks have put their Third World debtors into just this position, which "impairs the ability of otherwise creditworthy borrowers to maintain debt service."

To avoid Continental's fate, major U.S. banks should move immediately to long-term renegotiation and stretch-out of LDC loans, Volcker said, as he has proposed for Mexico, Brazil, and Venezuela. "Prudent banking may indeed suggest forebearance and renegotiation of outstanding loans . . . restructuring of foreign credits over a substantial period . . . may be indispensable."

"The Fed has been saying banks ought to come to accommodations which might last more than a quarter at a time," said one congressional staff chief after Volcker's remarks.

Most of the virulent congressional criticism of the government's recent Conti bailout, led by that of House Banking Committee Chairman Fernand St Germain, has been directed at forcing other banks to take early losses, the source revealed. "They want these banks to take some of these losses now," he said. "Congress does not like the idea of lending to pay interest and piling up the debt to a larger amount."

On Aug. 6, St Germain filed formal demands with the Fed, the FDIC, and the Treasury's Comptroller of the Currency for all internal documents they might have regarding the Conti bailout. "They're asking for everything, including examination reports which we've never given," said one regulator. "There's going to be a big fight."

Volcker's idea is to divide and conquer the Third World debtors, the congressional official continued. "Work out a deal with those countries which are in a position to get on to a long-term solution—like Mexico—so that we could whittle down the problem to the countries which you could write off."

Bolivia is the first country to be "triaged," he said. "The banks are already writing down the Bolivian debt, and when you've done that, you've already got some sort of a triage process you can implement. There's a lot of sympathy for that approach on the Hill." Argentina, he said, could not be tackled yet because "it's bigger."

But if banks do stretch out billions of Mexican, Brazilian, and Venezuela debt this fall, to try to avoid non-performing loans at the end of the September quarter, they could be in worse shape than before.

Long-term renegotiations ostensibly do not change a bank's loan principal valuation, but bank analysts and investors will look askanse at a $1 billion bank loan due, not in 3, but in 10 to 15 years.

Furthermore, none of the debtors at present are repaying principal in any case. The real problem, unaddressed by Volcker, is how will Mexico and others continue to pay $10-13 billion per year interest bills with interest rates at 13%?

Both the Fed staff and Congress would like the banks to take losses on interest income as well, my source said, by setting up "fixed rates" for the newly renegotiated loans. Some of these might even be below market rates, which would mean that the banks would be paying 13% to get money, but only earning 10%, or whatever the new low rate would be. "The question is whether the banks are going to have to absorb the reduction in their earnings," the staffer laughed.

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