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Banking by David Goldman

$3 trillion off the balance sheets

Regulators have no idea of how to defuse this time-bomb in the international banking system.

Despite tough statements from Federal Reserve chairman Volcker, bank regulators are treating commercial banks' "off-balance-sheet liabilities" the same way that a small-town police bomb squad might view the discovery of a thermonuclear explosive device. They don't know how to defuse the $3 trillion bomb in the international banking system, and wouldn't touch it if they did.

The Office of the Comptroller of the Currency (OCC), the Treasury agency responsible for regulating the nation's banks, said as much in a recent statement concerning off-balance-sheet liabilities.

The 15 top American banks have $1.26 trillion in obligations not counted on their balance sheets—against a balance sheet of only $750 billion. If these were counted as risk assets, the banks' capital would cover only 4% of their liabilities, against the 7% considered standard for banking safety.

On March 25, the OCC published in the *Federal Register* a proposal for accounting for risks not reported on banks' balance sheets. The most remarkable thing about this proposal is the section regarding foreign-exchange and futures-market commitments of commercial banks, which (as reported below) comprise by far the largest section of such liabilities:

"*Swaps, options, and foreign exchange contracts*. The OCC seeks comments concerning how best to incorporate the off-balance-sheet risk associated with securities trading, foreign exchange trading, and managing interest rate risk.

"At present, the OCC does not propose incorporating off-balance-sheet items used for hedging interest rate and currency risk (specifically swaps, options and futures, and foreign exchange contracts) into the risk-based capital standard. Those contracts may reduce interest rate risk or foreign exchange risk; however, they do entail some credit risk."

That is quite an understatement. Commercial banks have sold more than a trillion dollars' worth of "swaps" of various kinds. Under such arrangement, a bank automatically converts a loan in one currency into a loan in another currency, by matching the requirements of borrowers and lenders in different countries. Strictly speaking, the bank has not lent the money; it has simply acted as an intermediary between holders of different currencies, and taken a fee for its trouble. However, if the borrower defaults, the bank is stuck with the bad debt.

Currency swaps are no different in principle from the traditional trade-financing instrument, the bankers' acceptance. An exporter will accept an importer's IOU on condition that it is "accepted," i.e., guaranteed, by a bank of international standing. The bank purchases the importer's paper, and either holds it as an asset until maturity, or sells it like any other tradeable asset.

Securities trading is another matter. American Express announced April 17 that it had to put up a special $55 million fund to cover losses from the collapse of the London tin market, after the inability of insolvent tin traders to meet their obligations caused hundreds of millions of dollars in losses. The OCC does not mention the $1.4 billion bankruptcy of the EPIC securities-trading firm, or the failure of ESM Securities in Florida, which brought down one of Ohio's leading savings and loan institutions, in a money-laundering scandal concerning Marvin Warner, the Carter administration's ambassador to Switzerland.

The banks themselves may claim that they are not taking speculative positions, but merely hedging their own or their customers' bets on the high-risk foreign exchange, securities, and commodities markets. To say anything else would be to admit that they are taking their depositors' money to the racetrack.

Even if the banks were as prudent as they claim to be—and they are not—they must trade with hundreds of firms who are in the market for pure speculation, like ESM securities. It does not matter whether the banks or their supposedly less prudent trading partners take the beating; if a small security firm goes down, it will not be able to pay on contracts written with the banks, and the banks will take a loss in any case.

That is why Federal Reserve chairman Paul Volcker warned the House Banking Committee Feb. 20 that off-balance-sheet liabilities "pose a clear threat not only to the coherence, but also to the safety and soundness" of the banking system, adding, "time is growing short."

The regulators' limp response, however, indicates that the situation is out of Volcker's control.

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