If it fails, feed it

The Comptroller of the Currency proposes diversification as a cure for the banking mess.

Comptroller of the Currency Robert L. Clarke offered a solution to America's banking crisis that might have been taken for Swiftian, were it not meant in earnest. Clarke told the Boston Economic Club on May 14 that the solution to collapsing bank profitability was to permit the largest banks to expand in all possible directions, through so-called diversification.

Normally, when an industry runs into prolonged and serious trouble, regulators assume that its management may be at fault. Clarke reverses the usual logic: The misery of the present banking system, is due to the limitations placed on it. Since administration mythology insists that an economic "recovery" has been in progress since 1983, the most obvious explanation, that banks are losing money because their customers are going bust, appears to have escaped the Treasury's top bank regulator.

The national banking system, Clarke said, is "trapped in an industry that is becoming less and less profitable with each passing year—both in an absolute sense and relative to the risks banks assume. As a result, the *system* is losing strength."

However, Clarke added, permitting banks to move into whatever other financial fields they please, starting with the thrift industry, would allow them to increase profitability. The proposition is absurd by ordinary business standards, except for two assumptions. The first is that banks would be able to buy good assets at distress prices. The second is that the federal as well as state governments would intervene, to pay large banks for taking over failing institutions, as in the case of Mellon and Chase in recent takeovers of failed S&Ls.

Those assumptions were, of course, missing from the text of Mr. Clarke's remarks in Boston.

The problems he referred to are real, in any case. Banking profitability is at the lowest level in 20 years. The average return on assets for America's 4,200 national banks with assets of less than $300 million, representing 85% of the total regulated by Clarke's office, declined in 1985 for the sixth consecutive year. The average return on assets for these banks fell from 1.13 in 1980 to 0.53 in 1985. During the same period, the average return on assets for all national banks fell by more than half, from 1.08% to 0.45%. Since many of these banks lend to rural areas devastated by the agricultural crisis, Clarke's numbers are no surprise.

Clarke also dismissed the apparent rise in bank profits reported for the first quarter of 1986, as the result of "sideshows to traditional banking." He said that the increase in profits was largely due to capital gains on government bonds portfolios, bond trading profits, foreign-exchange dealings, sales of assets, service fees, and so forth.

These types of income are generated by the creation of what the regulators call off-balance-sheet liabilities. In other words, a bank may earn a fee for setting up a so-called foreign-exchange "swap" agreement, but it remains liable for the performance of the parties involved during the entire life of the agreement. Or, it may earn a so-called service fee for guaranteeing a loan, but must pay on the loan if the borrower cannot.

In that sense, Clarke did not go far enough in making his own case: The banks showed short-run profits, both in market speculation and in the creation of liabilities, which could turn into much greater losses in the future.

For example, if the collapse of long-term government bond prices during April continues through May and June, many of the major commercial banks will be hard-put to show any profit whatever.

"As a bank supervisor," Clarke said, "I see an *Omen*—tremors in the banking system. The tremors tell me that things are not as steady as they used to be. At this point, they don't indicate an *eruption*. They *do*, however, indicate an *erosion*. And that *erosion* is of concern to me."

So the answer to a weakening population of banks, in Clarke's view, is to feed the weak ones to the strong ones. That corresponds precisely to Italian Finance Minister Nino Andreatta's warning to the press in mid-May, that only 25 or 30 banking institutions will exist by the end of the century.

Eating one's fellow passenger in the lifeboat may well solve some pressing, and temporary problems, but it does not make the situation in the lifeboat any better. The banking system will not emerge stronger, in any financial sense, from Clarke's exercise. On the contrary, it will merely load up additional problems. But the major banks hope that these 25 to 30 survivors will be in position to dictate terms to any government in the world.